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The predictive ability of earnings and political uncertainty: evidence from Latin American Countries

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Abstract

Objective: To verify whether the ability of cash flow and current accruals to predict future cash flow is affected by political uncertainty.

Method: Years of national elections were considered a *proxy* for political uncertainty. Sys-GMM estimated the equation of cash flow forecast for one period ahead to capture the predictive ability of earnings components according to periods of political uncertainty.

Sample: 386 firms (4,127 observations-year) listed in the stock exchanges in Argentina, Brazil, Chile, and Mexico.

Results: The predictive ability of current cash flow was negatively influenced by political uncertainty, while the predictive ability of accruals was not. The conclusion is that political uncertainty negatively affects the predictive ability of disclosed earnings components, though this effect was conclusive only for current cash flow.

Contributions: Presenting the context of capital markets in emerging countries is this study's primary contribution. Furthermore, additional knowledge related to the hypothesis concerning political uncertainty is provided, shedding light on its impact on the supply and availability of helpful information concerning the capital markets of emerging countries. Finally, the findings are also relevant for agents forecasting the firms' future cash flows.

Keywords: Political uncertainty; Predictive ability of earnings; Accruals; Cash flows.

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1. Introduction

Many studies (Ashton & Trinh, 2018; Ball & Brown, 1968; Beaver, 1968; Beaver, Mcnichols & Wang, 2018) report the relevance of accounting information for agents operating in the capital market, considering that the organizations' future cash flows guide the decisions of agents operating in that market.

According to Wolk, Dodd, and Tearney (2004), one of the main reasons explaining such relevance refers to the predictive value of accounting information. In this sense, Barth, Cram, and Nelson (2001) argue that a company's ability to generate cash flows affects the value of its securities. For this reason, the Financial Accounting Standards Board (Fasb) indicates that the primary objective of accounting is to provide information that helps investors, lenders, and other users to assess future cash flows.

In this context, empirical evidence (Dechow, Kothari & Watts, 1998; Jordan, Waldron & Clark, 2007; Kim & Kross, 2005) has confirmed that earnings disclosed by the firms' accounting systems – considered an optimal informational sign to guide decisions concerning the allocation of resources in the capital market (Lev, 1989) – are effective predictors of future cash flows.

In turn, other studies (Barth, Cram & Nelson, 2001; Boina & Macedo, 2018; Lev, Li & Sougiannis, 2010) report an increase in the predictive power of models for forecasting future cash flows when considering the components of reported earnings separately, i.e., accrual and cash flow. There is also evidence indicating that cash flow has greater predictive ability than accruals, as suggested by Sloan (1996).

One factor that possibly explains this asymmetry between the predictive ability of current cash flow and accruals is the managers' discretionary power in recognizing accruals. Barth, Beaver, Hand, and Landsman (1999) argue that the accruals component carries a greater degree of subjectivity than cash flow because it is subject to the managers' discretionary power. Discretionary accruals are likely to contain unusual items, which are not likely to be repeated in the future, directly impacting the ability of accruals to predict future cash flows. Although less susceptible than accruals, cash flow may also be subject to managers' discretion intending to generate current cash flows to reach a specific target, though unsustainable in the future (Roychowdhury, 2006), which also impacts this component's ability to predict future cash flows.

In these situations, reported earnings deviate from their primary function of reflecting the expected underlying economic reality, characterizing what is known in the literature as earnings of poor quality information (Dechow, Ge & Schrand, 2010). Therefore, the ability of current earnings to predict future cash flows also depends on the quality of its components' information.

It is worth noting that the managers' discretion level may reflect the effect of events other than those directly linked to the business, more strongly affecting the quality of the earnings components, therefore, the predictive ability of cash flow and current accruals, if these events increase uncertainty about the firms' future performance. In this context, Leal, Girão, Lucena, and Martins (2017) present evidence from the Brazilian capital market that extreme earnings affect the predictive ability of the disclosed earnings components. The authors explain that in extreme situations, both earnings and cash flows are less persistent and, as a result, show greater volatility, concluding that both earnings (and their components) and cash flows have a lower predictive ability in extreme situations.

Another attribute that is possibly capable of increasing uncertainty associated with the firms' future performance refers to political uncertainty (Brogaard & Detzel, 2015). Chen, Hope, Li, and Wang (2018) define political uncertainty as changes that are likely to occur in governments and government policies. It has been characterized by its ability to increase uncertainty about future cash flows (Dai & Ngo, 2020) because it may increase volatility (Boutchkova, Doshi, Durnev & Molchanov, 2012; Brogaard & Detzel, 2015); greater cash flow volatility reduces its ability to predict a firm's future performance (Minton, Schrand & Walther, 2002).

In this context, political uncertainty can negatively affect cash flow predictive ability, considering it can increase this component's volatility. Such an effect can also be expected for the accruals component since the volatility of cash flows also contributes to the accruals' lower predictive ability (Dechow & Dichev, 2002). Furthermore, according to Dechow and Dichev (2002), the greater volatility in periods of political uncertainty, the greater the chance of errors when estimating accruals, which reduces this component's ability to predict future cash flows.

Additionally, after examining the effect of political uncertainty on earnings management practice in a sample of 18 countries, Yung and Root (2019) report evidence that managers make accounting choices to manipulate both accruals and cash flow following periods of considerable political uncertainty, which also decreases the predictive power of both the components of reported earnings.

In these terms, both the cash flow's increased volatility and greater likelihood of the earnings components to be manipulated, associated with political uncertainty, can decrease the ability of cash flow and accruals to predict future cash flows; both current components are affected by political uncertainty, thus are unlikely to recur in the future.

No studies addressing this topic were found. In this regard, Chen, Chen, Wang, and Zheng (2018) highlight that there is little empirical evidence on the impacts of political uncertainty on the provision and availability of relevant information for investors in capital markets. Nevertheless, the authors emphasize the importance of this subject, given that the availability of relevant information is critical for the efficient allocation of resources and investors' investment decisions.

Examining this issue is relevant in the context of emerging markets because, as noted by Diamonte, Liew, and Steven (1998), the negative influence of political uncertainty more significantly affects emerging capital markets than developed ones. Note that the institutional environment of Latin American countries is generally characterized by poor enforcement and investor protection mechanisms (Brown, Preiato & Tarca, 2014; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 1998; Moura, Altuwaijri & Gupta, 2020). In such a configuration, managers may have more incentives to discretionarily report earnings components in periods of political uncertainty, which would reflect in the reported earnings components' lower predictive ability.

In this context, we seek to collect evidence to answer the following question: **to what extent does political uncertainty affect the ability of reported earnings components – accruals and cash flows – to predict future cash flows?**

This investigation is relevant because it captures an effect that is hardly documented in the international context. In other words, the influence of political uncertainty on the predictive ability of earnings components is disclosed in the context of emerging markets, thus, filling in a relevant research gap. In addition, this study innovates by considering the object of study in specific countries in Latin America, differing from the study by Yung and Root (2019). Another differential is that this study considers the adverse effects of political uncertainty, keeping in mind that it reflects the quality of accounting aggregates, i.e., the predictive ability of the reported earnings components, an aspect not addressed in that study.

This study contributes to the literature on the hypothesis concerning political uncertainty, an issue addressed in other studies (Brogaard & Detzel, 2015; Dai & Ngo, 2020). Note that this study also contributes to research on the quality of accounting information, specifically by presenting evidence that complements Chen, Chen et al. (2018), Leal et al. (2017), and Yung and Root (2019) on the negative impact of an event exogenous to firms with the potential to impact the quality of accounting information disclosed by managers.

Furthermore, this study is relevant for investors, analysts, and other market players forecasting firms' future cash flows, providing evidence regarding the importance of considering the effects accruing from political uncertainty in the context of such predictions, as evidence suggests a significant adverse impact of political uncertainty on the ability of current cash flow to predict future cash flows.

2. Theoretical Framework and Hypothesis Development

Since the seminal works of Ball and Brown (1968) and Beaver (1968), research (Ashton & Trinh, 2018; Beaver et al., 2018) has presented evidence that accounting information is relevant for capital market agents. The main argument lies in the predictive value of accounting information or its ability to predict future cash flows (Wolk et al., 2004).

In line with the predictive value of accounting information, researchers (Barth et al., 2001; Boina & Macedo, 2018; Lev et al., 2010) present evidence that the components of reported earnings – current cash flows and accruals – have marginal ability to predict future cash flows. Such evidence indicates an increase in the predictive power of models for forecasting future cash flows when both cash flows and accruals are included.

Despite increased predictive power, it is worth noting that both cash flow and accruals are subject to the managers' discretion, more likely so for the accruals component (Barth et al., 1999). The managers' discretion may result in reported earnings containing unusual items that are unlikely to recur in the future, impacting these components' ability to reflect expected underlying economic performance. Under this hypothesis, earnings are characterized as having poor informational quality (Dechow et al., 2010) and fail to play their role in efficiently predicting future cash flows.

In addition to the effect arising from the managers' discretionary power, other attributes with the potential to affect the predictive capability of the reported earnings' components, i.e., cash flows and accruals, refer to events that increase uncertainty associated with the firms' future performance.

In this sense, Leal et al. (2017) examined the ability of reported earnings to predict future earnings in extreme earnings situations in the Brazilian capital market. According to the authors, extreme profits were measured by dividing the variable profit into deciles, in which deciles 1, 2, and 9 are considered extreme. Evidence shows that the cash flows' predictive power in deciles 1 and 2 is lower than that of accruals. However, this situation is reversed on decile 9, in which the cash flows' predictive power exceeds that of accruals. These findings suggest that, in situations of extreme negative values (decile 1), accruals have greater predictive power than cash flows, whereas, in situations of extreme positive values (decile 9), accruals are less predictive than cash flows.

The authors conclude that extreme earnings and cash flow situations negatively affect the predictive value of both earnings and cash flow, though more so for the cash flows' predictive value. Furthermore, there is evidence that accruals are the component that decreases the earnings' predictive capability.

Research on the impact of extreme performance situations on the predictive ability of reported earnings may suffer from issues related to endogeneity, considering that such performance can be endogenously determined by the use of the earnings components; e.g., the managers' discretionary power over accruals can be used to generate extreme performances, if there are incentives for such a practice.

Political uncertainty is an event with the potential to marginally influence a firm's future performance and is less likely to be determined by a firm's attributes, mitigating potential endogeneity problems.

Political uncertainty is considered relevant because it adversely impacts economic activity and financial outcomes. Studies report adverse effects of political uncertainty on the prices of assets (Gao & Qui, 2014; Pastor & Veronesi, 2012) and corporate decisions (An, Chen, Luo & Zhang, 2016; Julio & Yook, 2012), which are characterized as the Political Uncertainty Hypothesis (Julio & Yook, 2012). Therefore, it is likely that, given the possibility of adverse shocks on assets' future value – future cash flows, market agents would discount the current price to reflect such adverse shock.

Dai and Ngo (2020) state that potential changes in political leadership and/or government policies increase uncertainty about firms' future cash flows. Evidence reported by Boutchkova et al. (2012) and Brogaard and Detzel (2015) confirms this statement, indicating greater volatility of future cash flows in periods of political uncertainty. According to Minton et al. (2002), greater volatility is negatively associated with the firms' future performance; greater volatility of operating cash flow reduces its ability to predict future performance. Furthermore, greater volatility implies less persistence of the cash flow component and, therefore, a lower ability to predict future cash flows.

In this sense, political uncertainty could negatively affect the predictive capacity of the cash flow component, as it would increase its volatility, decreasing its temporal persistence.

Such an effect can also be expected for the accruals component. In the event of more significant political uncertainty, it is likely that intentional errors, or otherwise, occur more frequently in the estimation of accruals, considering that uncertainty introduces volatility into the firms' environment, and such volatility affects the quality of accruals' estimation, therefore, also affecting the accruals' predictive ability, as suggested by Dechow and Dichev (2002).

Among the attributes that would also contribute to the accruals' lower predictive ability, Dechow and Dichev (2002) highlight the volatility of cash flows. They argue that the greater volatility of this earnings component reflects high uncertainty and that this attribute decreases the accruals' ability to predict future cash flows.

Furthermore, accruals are likely more susceptible to managers' discretion than cash flow (Barth et al., 1999) as managers can estimate discretionary accruals containing unusual items that are unlikely to recur in the future, reducing their ability to predict future cash flows.

In this sense, Yung and Root (2019) addressed a sample of 18 countries between 2001 and 2014 and present evidence of greater use of discretionary accruals in times of political uncertainty. Discretionary accruals were estimated according to the models of Jones (1991), Dechow and Dichev (2002), Dechow, Sloan and Sweeney (1995), and Dechow and Dichev (2002) and later modified by McNichols (2002), while political uncertainty was measured considering the political uncertainty index provided by Baker, Bloom, and Davis (2016). Thus, evidence suggests strong use of discretionary accruals when there is high political uncertainty.

Note that the cash flow component is also subject to managers' discretion (Roychowdhury, 2006) as managers can generate unsustainable cash flows to reach a specific target (Roychowdhury, 2006), negatively affecting its ability to predict future cash flows. Yung and Root (2019) performed additional tests and reported evidence that cash flows are manipulated after periods of considerable political uncertainty.

Based on Yung and Root (2019), in the hypothesis concerning managers' discretionary choices regarding cash flow and accruals when in the face of considerable political uncertainty, these components are expected to be less effective in predicting futures cash flows in times of political uncertainty.

Considering the context of increased discretionary power of managers in periods of political uncertainty, note that the institutional environment of Latin American countries may provide incentives towards it. The literature characterizes this environment as exhibiting poor enforcement and investor protection mechanisms (Brown et al., 2014; La Porta et al., 1998; Moura et al., 2020), also considering that these characteristics are associated with managers' opportunistic practices (Leuz, Nanda & Wysocki, 2003). In this context, one might expect more significant incentives for managers' discretionary practices in times of political uncertainty, impacting the earnings' predictive ability.

It is worth noting that there is no consensus in the literature regarding a direct and efficient proxy for political uncertainty. However, Julio and Yook (2012) note that national elections are an attribute that provides an interesting configuration for researchers. According to the authors, national elections are relevant for corporate decisions, as they may affect the regulation of industries, monetary and marketing policies, taxation, and, in more extreme cases, the potential expropriation or nationalization of private firms.

Chen, Hope et al. (2018) argue that national elections reflect high political uncertainty because they can disrupt the established economic and political balance, significantly affecting resources allocation decisions. Furthermore, national elections are exogenously defined to any individual firm (Julio & Yook, 2012), which may alleviate potential endogeneity problems in research.

Given the previous discussion, political uncertainty has the potential to impact the predictive ability of earnings components according to the following: (i) increased cash flow volatility in times of considerable political uncertainty, possibly impacting the ability of both current cash flow and accruals in predicting future cash flows; and (ii) the managers' discretionary power in manipulating current cash flow and accruals in times of increased political uncertainty, affecting the predictive capability of both the earnings components. Thus, the following hypothesis is proposed:

> **H1: Political uncertainty negatively affects the ability of reported earnings components – current *accruals* and cash flow – to predict future cash flows.**

3. Methodological Procedures

The study's population include firms listed on the stock exchanges of six emerging Latin American countries: Argentina, Brazil, Chile, Colombia, Peru, and Mexico (Buenos Aires Stock Exchange, Brazil, Bolsa, Balcão – B3, Santiago Stock Exchange, Colombia Stock Exchange, Lima Stock Exchange, and Mexican Stock Exchange, respectively), based on the classification proposed by the International Monetary Fund [IMF] (2018). Moreira (2018) notes the economic relevance of these countries in the Latin American context, considering that they represent the highest Gross Domestic Products (GDP) in 2016, according to the World Bank (2018).

The sample comprised firms listed in Argentina, Brazil, Chile, and Mexico. The firms listed in Colombia were excluded as less than 100 companies were listed in its capital market (World Federation of Exchanges, 2018). According to the criteria proposed by Paulo Martins and Girão (2014), there was considerable missing data regarding the firms. The firms listed in Peru were also excluded because this market was not very representative compared to the others in the sample; e.g., data from the World Federation of Exchanges (2018) show that, until 2006, the Peruvian capital market exhibited an average capitalization of only 42% of the Argentine market capitalization. The Peruvian market has the lowest level of capitalization among the countries in the sample, which may reflect significantly different incentives between markets, considering that non-economic factors may be more relevant than economic factors in small markets (Alexakis & Petrakis, 1991). Furthermore, observations were also excluded due to missing data or because they belonged to firms in the financial sector, considering disclosure practices in this sector differ from the practice of firms in other sectors (Pincus, Rajgopal & Venkatachalam, 2007). Thus, the final sample consisted of 386 firms (4,127 observations-year), as detailed in Table 1:

Table 1
Sample composition per country

	Total sample	Argentina	Brazil	Chile	Mexico
Firms	386	43	221	34	88
Observations-year	4,127	469	2,507	408	743

Source: Study's data

The investigation included events observed between 1998 and 2018. This time frame took into account the objective of capturing potential effects of different electoral periods on the firms located in the countries in the sample.

Data were collected from: a) the Thomson Reuters® database, which is used to access accounting information; b) the Data and Database of Political Institutions from The World Bank; these bases are used to collect information related to variations in the countries' GDP and national electoral periods, respectively; c) the IFRS platform (ifrs.org), which is used to capture the periods in which practices converged to the IFRS standard in each country in the sample.

According to Monfared and Pavlov (2019), data winsorization was performed considering the 5th and 95th percentiles to mitigate the effects of outliers. Note that additional tests were performed considering the winsorization of data in the 1st and 99th percentiles and considering data without any winsorization process. However, the estimates were sensitive to these choices and were not consistent for the parameters and tests. This finding is possibly explained by the high dispersion of the study's main variables and outliers in these variables. These problems were more strongly mitigated only when considering the 5th and 95th percentiles in the winsorization process.

According to Chen, Hope et al. (2018), and Julio and Yook (2012), political uncertainty was measured considering the periods of national elections. For that, a dichotomous variable (*ELE*) was used for national elections, in which 1 refers to the occurrence of elections and 0, otherwise, as suggested by Julio and Yook (2012).

To examine the hypothesis that political uncertainty negatively affects the ability of reported earnings to predict future cash flows. The equation used was operating cash flow forecast for one period ahead (Barth, Clinch & Israeli, 2016; Hope, Thomas & Vyas, 2016), according to the model below:

$$FC_{i,t+1,k} = \beta_0 + \beta_1 FC_{i,t,k} + \beta_2 ACC_{i,t,k} + \beta_3 ELE_{t,k} + \beta_4 FC_{i,t,k} * ELE_{t,k} + \beta_5 ACC_{i,t,k} * ELE_{t,k} + \sum_{n=6}^{N} \beta_n \, CONTROLS + \varepsilon_{it} \quad (1)$$

Where $FC_{i,t+1,k}$ is the operating cash flow of period *t+1* for firm *i* in country *k*, scaled by the total assets in *t-1* of firm *i*; $FC_{i,t,k}$ is the operating cash flow of period *t* for firm *i* and in country *k*, scaled by the total assets in *t-1* of firm *i*; $ACC_{i,t,k}$ refers to accruals in period *t* for firm *i* and country *k*; $ELE_{t,k}$ is a dummy variable that represents the year of national elections in country *k*, in which 1 refers to the year of elections, and 0 otherwise ; $ELE_{t,k} * FC_{i,t,k}$ represents interaction with $FC_{i,t,k}$ in national election years; $ELE_{t,k} * ACC_{i,t,k}$ represents interaction with $ACC_{i,t,k}$ in national election years; CONTROLS refers to the matrix of control variables, namely, the firm's size (TAM) and growth (CRESC), dummy representing the IFRS period, the annual variation of the Gross Domestic Product (GDP) and dummies for countries, years, and sectors considered in the sample; ε_t is the error term that captures the residuals of the regression.

The period's accruals were measured using the Working Capital Requirement (WCR) variation as a proxy, as proposed by Dechow, Hutton, Kim, and Sloan (2012), expressed in equation (2):

$$ACC_t = [(\Delta AC_t - \Delta AF_t) - (\Delta PC_t - \Delta PF_t)]/AT_{t-1} \quad (2)$$

Where *ACCt* is the accruals in the period scaled by the total assets of t-1; *(ΔAC - ΔAF)* represents increases in Operating Current Assets in the period; *(ΔPC - ΔPF)* represents increases in Current Operating Liabilities in the period; and AT_{t-1} corresponds to Total Assets in period *t-1*.

In turn, operating cash flow was measured by the difference between Earnings Before Interest and Taxes on Income (EBIT), scaled by total assets of *t-1*, and the period's accruals estimated according to equation (2), following Passos and Coelho (2019).

Note that the indirect calculation of the accruals and cash flow variables is due to a lack of a Cash Flow Statement throughout the period addressed here, which prevents the use of the cash flow approach to obtain the measurements directly.

Firm size (*TAM*) was measured by the natural log of the firm's total assets, while the firm's growth (CRESC) was measured by the percentage variation in net revenue between *t* and *t-1*. Both measures represent control for the effects accruing from the firms' characteristics, as reported in previous research (Choi, Han, Jung & Kang, 2015; Farshadfar, Ng & Brimble, 2008). A positive and negative association is expected between TAM and CRESC and future cash flows, respectively, considering that larger and slower-growing firms exhibit more stable operating characteristics and contribute to their greater ability to predict future cash flows than smaller and high-growth firms.

A binary variable representing the period after convergence to the IFRS standard was included in the model (1), considering the different periods of convergence for each country in the sample, to control for potential effects arising from the change in the accounting standards, as reported by Machado, Silva Filho and Callado (2014) and Boina and Macedo (2018). The following convergence periods were considered on the IFRS platform (ifrs.org): Argentina – beginning in 2012, Brazil – beginning in 2010, Chile – beginning in 2009, and Mexico – beginning in 2012.

Dummies were also included to control for potential temporal effects from the firms' different sectors and different countries in the sample, as well as a variable representing the variation in national GDP to control for the potential effects of economic shocks.

The β_4 and β_5 coefficients of regression (1) are expected to be negative and significant, assuming a negative impact of greater political uncertainty on the ability of the earnings components to predict future cash flows.

The model was specified as multiple linear regression and estimated with the System Generalized Method of Moments (Sys-GMM), based on the estimation of dynamic models (Barros, Castro, Silveira & Bergmann, 2020). This method is more consistent than others in case of endogeneity problems or serial autocorrelation (Barros et al., 2020).

Regression (1) was estimated with variance correction for finite samples to correct potential heteroscedasticity of residuals, as Windmeijer (2005) noted. The existence of multicollinearity between the independent variables was verified with correlation analysis, as well as residual autocorrelation problems according to Arellano and Bond (1991). The tests showed that both problems were absent (not reported). Finally, the Hansen test was applied and was not significant, indicating that the instruments used to estimate the model (1) are valid, confirming that the estimation by Sys-GMM is consistent.

Note that the residuals were not normally distributed. However, this is not a critical condition, and according to Greene (2012), it can be relaxed, considering the property of estimators with normal asymptotic distribution as the sample size increases.

4. Results

Table 2 presents the description of the study's variables, showing that, on average, the firms in the sample present positive accruals and future and current cash flows. However, these attributes present high variability, evidenced by the relationship between their standard deviations and means. Additionally, electoral years represent approximately 21% of the period considered.

Table 2
Description of the variables

Variable	Mean	Median	Standard deviation	Minimum	Maximum
$FC_{i,t+1}$	0.061	0.066	0.111	-0.203	0.265
$FC_{i,t}$	0.060	0.065	0.113	-0.204	0.267
$ACC_{i,t}$	0.010	0.002	0.081	-0.145	0.207
ELE	0.209	0	0.407	0	1
TAM	21.905	21.890	2.061	18.160	25.583
CRESC	0.130	0.104	0.216	-0.238	0.673
IFRS	0.531	1	0.499	0	1
VPIB	2.291	2.804	3.253	-10.894	10.125

Note: Definitions of the variables: $FC_{i,t+1,k}$ is the operating cash flow of period *t+1* for firm *i* in country *k*, scaled by the total assets in *t-1* of firm *i*; $FC_{i,t,k}$ is the operating cash flow of period *t* for firm *i* and in country *k*, scaled by the total assets in *t-1* of firm *i*; $ACC_{i,t,k}$ refers to accruals in period *t* for firm *i* and in country *k*; $ELE_{t,k}$ is a dummy variable that represents the year of national elections in country *k*, in which 1 refers to the year of elections, and 0 otherwise; *TAM* represents the firm's size, measured by the natural log of the total asset; *CRESC* represents the firm's growth, measured by the percentage variation of net revenue between *t* and *t*-1; *IFRS* is a dummy representing the adoption of the IFRS standard in each of the countries in the sample; *VPIB* corresponds to the annual variation of the Gross Domestic Product (GDP). N=4,127 observations/year.

Source: study's data.

Table 2 also shows firms with 13% growth in net revenues, with this variable presenting a high variability. Additionally, approximately 52% of the period refers to when the IFRS standard was adopted, when the firms' accounting information was disclosed in the countries included in the sample, and the countries in general present positive variation in GDP, again, with high variability. Finally, we highlight that *TAM* was the variable with the highest level of homogeneity among all the quantitative variables presented in Table 2.

Table 3 presents the correlation coefficients of the variables object of this study. The tests are separated according to the measure representing political uncertainty (*ELE*). Pearson's correlation coefficients were found significant at 1% in both tests, indicating a positive association between future cash flows and reported earnings components (current cash flows and accruals). On the other hand, the magnitude of the correlation coefficients between these variables increases when the years of national elections are considered, with a seemingly greater effect recorded for the accruals component, presenting evidence that suggests a beneficial effect of periods of considerable political uncertainty on the predictive ability of both earnings components.

Table 3
Correlations according to the periods of national elections

	ELE = 0			*ELE* = 1		
	$FC_{i,t+1}$	$FC_{i,t}$	$ACC_{i,t}$	$FC_{i,t+1}$	$FC_{i,t}$	$ACC_{i,t}$
$FC_{i,t+1}$	1			1		
$FC_{i,t}$	0.325***	1		0.348***	1	
$ACC_{i,t}$	0.054***	-0.562***	1	0.111***	-0.567***	1

Note: Definitions of the variables: is the operating cash flow of period *t+1* for firm *i* in country *k*, scaled by the total assets in *t-1* of firm *i*; is the operating cash flow of period *t* for firm *i* and in country *k*, scaled by the total assets at *t-1* of firm *i*; $ACC_{i,t,k}$ refers to accruals in period *t* for firm *i* and in country *k*.
*** Significance at 1% level.

Source: Study's data.

Together, these findings provide evidence that the association between future cash flows and reported earnings components changes according to political uncertainty. The direction of this effect seems to be an increase in the predictive ability of these components in periods of political uncertainty, however.

Table 4 deepens the analysis by presenting the results from testing the influence of political uncertainty on the predictive ability of the current cash flow and accruals. In the regression estimation, the variables current operating cash flow ($FC_{i,t}$), accruals ($ACC_{i,t}$), size (*TAM*), and growth (*CRESC*) were identified as endogenous. Thus, from the second lag on, these variables were used as instruments. The variable representing the period of political uncertainty (*ELE*) and the interaction between these periods with current cash flow and accruals were treated as exogenous, as well as the variables representing variation in GDP (*VPIB*), the IFRS standard (*IFRS*), and the dummies for years (*D_ANO*), sectors (*D_SETOR*) and countries (*D_PAÍSES*).

Table 4

Predictive ability of profit components and political uncertainty

	Dependent variable: FC_{t+1}		
Variables	**Coefficients**	**Standard Error**	**P-*value***
FC_t	0.783	0.090	0.000
ACC_t	0.787	0.236	0.001
ELE_t	0.017	0.009	0.064
$ELE_t * FC_t$	-0.199	0.103	0.053
$ELE_t * ACC_t$	-0.140	0.232	0.547
TAM	0.013	0.007	0.065
CRESC	-0.085	0.043	0.050
IFRS	0.010	0.009	0.271
VPIB	-0.001	0.001	0.521
Intercept	-0.332	0.141	0.018
Dummies for years		Yes	
Dummies for sectors		Yes	
Dummies for countries		Yes	
Observations-year		4.127	
Number of instruments		108	
Number of firms		386	
Wald Statistic		3.599.48***	
AR(1)		-5.69***	
AR(2)		1.11	
Hansen test		74.31	

Notes: Model: $FC_{i,t+1,k} = \beta_0 + \beta_1 FC_{i,t,k} + \beta_2 ACC_{i,t,k} + \beta_3 ELE_{t,k} + \beta_4 FC_{i,t,k} * ELE_{t,k} + \beta_5 ACC_{i,t,k} * ELE_{t,k} + \sum_{n=6}^{N} \beta_n \, CONTROLS + \varepsilon_{it}$. Definitions of the variables: $FC_{i,t+1,k}$ is the operating cash flow of period *t+1* for firm *i* in country *k*, scaled by the total assets in *t-1* of firm *i*; $FC_{i,t,k}$ is the operating cash flow of period *t* for firm *i* and in country *k*, scaled by the total assets in *t-1* of firm *i*; $ACC_{i,t,k}$ refers to accruals in period *t* for firm *i* and in country *k*; $ELE_{t,k}$ is a dummy variable that represents the year of national elections in country *k*, in which 1 refers to the year of elections, and 0 otherwise; $ELE_{t,k} * FC_{i,t,k}$ represents interaction with $FC_{i,t,k}$ in years of national elections; $ELE_{t,k} * ACC_{i,t,k}$ represents interaction with $ACC_{i,t,k}$ in years of national election; CONTROLS refers to the matrix of control variables, namely, the firm's size (*TAM*) and growth (*CRESC*), dummy representing the IFRS period, the annual variation of the Gross Domestic Product (GDP) and dummies for countries, years, and sectors considered in the sample.
*** Significance at 1% level.

Source: Study's data.

Table 4 confirms the ability of both earnings components – $FC_{i,t}$ and $ACC_{i,t}$ – to predict future operating cash flows, as the coefficients are positive and significant in 0.1% of these variables, as reported by other studies (Barth et al., 2001; Boina & Macedo, 2018; Lev et al., 2010).

Regarding the impact of political uncertainty on the predictive ability of the components of disclosed earnings (current cash flows and accruals), there is a decrease in the predictive ability of current cash flow (FCi,t), as shown by the negative and significant coefficient (at the 6% level) of the *FC* ELE* variable. Note that, in the presence of national election periods, the predictive ability of the $FC_{i,t}$ decreases by approximately 25% [(*FC–ELE*FC)/FC* = (0.783-0.199)/0.783], when compared to its ability in non-election periods. This indicates a non-trivial impact of periods of political uncertainty on the predictive power of the current cash flow component.

This finding confirms the expected adverse effect, i.e., periods of more significant uncertainty negatively affect the predictive ability of cash flow, as Leal et al. (2017) report on the effects of events that lead to increased uncertainty associated with future cash flows.

On the other hand, *ACC*ELE* was not significant and presented a negative coefficient, not allowing for inferences regarding the adverse effect of political uncertainty on the predictive ability of the accruals component. The accruals component was expected to have a lower predictive ability in times of political uncertainty, which would be in line with evidence presented by Leal et al. (2017) in the context of increased uncertainty.

Note that *TAM* and *CRESC* variables proved to be significant in impacting future cash flows, as already indicated in previous studies (Choi et al., 2015; Farshadfar et al., 2008). On the other hand, *IFRS* and *VPIB* were not significant in affecting future cash flows, as their non-significant coefficients show (Table 4).

The results in Table 4 were tested to verify whether they were sensitive to the proxy used for political uncertainty and examine the findings' robustness. Hence, model (1) was estimated with configurations similar to those reported in Table 4. It replaces *ELE* and its interactions by the reported earnings components, adding a measure of the economic policy uncertainty index (*EPU*) for each country in the sample (except for Argentina, which did not present data for this measure), considering its interaction with those components. Baker et al. (2016) developed this measure, which is available in Economic Policy Uncertainty (2020). The results show a negative effect of economic and political uncertainty (*EPU*) on the predictive ability of both earnings components, suggesting that these findings are sensitive to the measure used for political uncertainty when the accruals component is considered. Even though this is relevant evidence, applying *EPU* to only three countries in the sample restricts comparisons with the results presented in Table 4.

Additionally, we tested whether the impact of political uncertainty on the ability of the current cash flow and accrual components to predict future cash flows would persist more than one period ahead. Thus, model (1) was estimated with configurations similar to those reported in Table 4, considering the cash flow of two periods ahead (t+2) as the dependent variable. The results showed, once again, a negative effect of political uncertainty (*ELE*) on the predictive ability of both of the earnings components.

Together, the robustness tests confirm the negative effect of political uncertainty on the predictive ability of current cash flow, as reported in Table 4, and provide evidence of an adverse effect of that event on the predictive ability of the accruals component.

Based on these findings, the hypothesis that political uncertainty negatively affects the ability of the disclosed earnings components - accruals and cash flow - to predict future cash flows is not rejected. This effect was conclusively captured only regarding current cash flow, though. Therefore, we can infer that the ability of the current cash flow component to predict future cash flows is negatively associated with periods of considerable political uncertainty, reflected in times of national election.

5. Conclusion

This study's objective was to investigate the interaction between periods of greater political uncertainty and the ability of reported earnings components to predict future cash flows in the context of Latin American capital markets. This interaction is expected, considering evidence that political uncertainty increases both uncertainties associated with the firms' future cash flows and the possibility of managers manipulating earnings components. That would reduce the ability of both earnings components – current cash flows and accruals – to predict future cash flows.

Periods of national elections – the year when national elections occur – were considered a proxy to represent periods of greater political uncertainty. The cash flow forecast equation of one period ahead served to capture the predictive ability of the earnings components according to periods of political uncertainty.

Evidence suggests that periods of political uncertainty differentiate the ability of earnings components to predict future cash flows, specifically contributing to lower the predictive ability of current cash flow during times of national elections. These findings were robust, both the alternative measure of political uncertainty and the alternative configuration of the forecast period for future cash flows.

On the other hand, the accruals component was not significant in negatively affecting the predictive ability of future cash flows in times of national elections. This does not align with the notion that an increase in uncertainty would be associated with this component's lower ability to predict future cash flows. However, this evidence seems to be sensitive to the proxy used for the political uncertainty event and the forecast period defined in the equation for forecasting future cash flows, considering that the predictive power of that component decreased in both test configurations.

Evidence shows that political uncertainty affects the predictive ability of the reported earnings components; however, this effect's direction differentiates according to the component and measure adopted to represent political uncertainty. Nevertheless, the conclusion is that current cash flow is negatively affected by national elections.

These results contribute to the international literature by providing evidence that adds to research addressing the hypothesis concerning political uncertainty, specifically regarding its adverse effects on the usefulness of the information provided by firms in the context of emerging markets. In this regard, this study complements the findings reported by Chen, Chen et al. (2018), and Yung and Root (2019) concerning the negative impact of political uncertainty on the quality of disclosed accounting information.

It is noteworthy that this negative impact proved to be persistent, even when considering specific countries in Latin America, which exhibit different characteristics from other countries considered in previous studies. Along these lines, this study's results confirm the relevance of political uncertainty in different capital markets, thus characterizing its pervasive nature. Also, considering political uncertainty in various markets, some authors argue that political uncertainty has a more significant impact on emerging than on developed markets (Diamonte, Liew & Steven, 1998). No tests in this sense took place, however, which is a suggestion for future research.

Furthermore, these findings complement evidence reported by Leal et al. (2017) for the context of emerging markets, which help to clarify the impact of events that increase uncertainty associated with future cash flows on the availability of helpful information to capital market agents.

Note that the evidence presented has direct practical implications for Latin American capital markets players, specifically regarding the adverse impact of political uncertainty on predicting future cash flows. In this aspect, evidence shows a need to consider election years as a relevant factor reducing the ability of current cash flow to predict future cash flows.

This study's objective was to capture the effect of political uncertainty considering periods of national elections only. Additionally, a political economy uncertainty index (*EPU*) was used, though with restrictions. Other measures, such as political risk and political crisis indexes, can be used as alternative proxies to capture that effect in future research. Considering the limitations previously mentioned, it represents an opportunity for future studies to examine whether events surrounding the effective change of governments or other factors related to elections would also affect the quality of accounting information.

Furthermore, the interactive effect of the impact of political uncertainty on the predictive ability of the earnings components and manipulation of these components on the part of managers was not tested, which is another suggestion for further research.

The effect of political uncertainty on the predictive ability of profit components is likely to be found in other emerging markets with a configuration similar to the countries sampled in this study, another possibility studies might consider in the future.

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