The affair

American executives are betting that the president is good for business. Not in the long run

MOST American elites believe that the Trump presidency is hurting their country. Foreign-policy mandarins are terrified that security alliances are being wrecked. Fiscal experts warn that borrowing is spiralling out of control. Scientists deplore the rejection of climate change. And some legal experts warn of a looming constitutional crisis.

Amid the tumult there is a striking exception. The people who run companies have made their calculations about the Age of Trump. On balance, they like it. Bosses reckon that the value of tax cuts, deregulation and potential trade concessions from China outweighs the hazy costs of weaker institutions and trade wars. And they are willing to play along with President Donald Trump's home-brewed economic vision, in which firms are freed from the state and unfair foreign competition, and profits, investment and, eventually, wages soar.

The financial fireworks on display in the first quarter of this year suggest that this vision is coming true. The earnings of listed firms rose by 22% compared with a year earlier; investment was up by 19%. But as our briefing explains, the investment surge is unlike any before—it is skewed towards tech giants, not firms with factories. When it comes to gauging the full costs of Mr Trump, America Inc is being short-sighted and sloppy.

The view from the C-suite

Since winning Congress and the White House, the Republicans have sought to unleash the power of business. After the election Mr Trump held summits with tycoons, televised live from the boardroom at Trump Tower, and later from his new HQ in the Oval Office. Though bosses have tired of this kind of pantomime, particularly after Mr Trump's equivocations over white-supremacist protests in Virginia last summer, they remain bullish. A reason is the Republican corporate-tax reform passed in December, the first on such a scale since 1986. It does several sensible things, including cutting headline rates to average European levels. The annual saving of $100bn is worth 6% of pre-tax profits (it accounts for a tenth of the fiscal deficit).

Deregulation is in full swing. This week saw a relaxation of banking rules (see Finance section). The leaders of many agencies have been replaced with Trump appointees. The change at the top, firms say, means officials are being more helpful. A surprising number of boardrooms support a muscular stance on trade with China. If, for argument's sake, China capitulated to American demands and imported $200bn more goods a year, it could boost the earnings of America Inc by a further 2%. The benefits for business of Mr Trump are clear, then: less tax and red tape, potential trade gains and a 6-8% uplift in earnings.

The trouble is that companies are often poor at assessing nebulous risks, and CEOs' overall view of the environment is fallible. During the Obama years corporate America was convinced it was under siege when in fact, judged by the numbers, it was in a golden era, with average profits 31% above long-term levels. Now bosses think they have entered a nirvana, when the reality is that the country's system of commerce is lurching away from rules, openness and multilateral treaties towards arbitrariness, insularity and transient deals.

As the contours of this new world become clearer, so will its costs to business in terms of complexity and predictability. Take complexity first. One of the ironies of the Trump team's agenda is that, although they want to get out of businesses' hair at home, when it comes to trade they want to regulate. When they tinker with tariffs, large numbers of firms have to scurry to respond because they have global supply chains. The steel duties proposed in March cover a mere 0.5% of American imports, but so far this month 200-odd listed American firms have discussed the financial impact of tariffs on their calls with investors. Over time, a mesh of distortions will build up.

Because trade is becoming more regulated, a new surveillance bureaucracy is sprouting. On May 23rd the Department of Commerce launched a probe of car imports. A bill in Congress envisages vetting all foreign investment into America to ensure that it does not jeopardise the country's "technological and industrial leadership in areas related to national security". American firms have $8trn of capital sunk abroad; foreign firms have $7trn in America; and there have been 15,000 inbound deals since 2008. The cost involved in monitoring all this activity could ultimately be vast. As America eschews global co-operation, its firms will also face more duplicative regulation abroad. Europe has already introduced new regimes this year for financial instruments and data.

The expense of re-regulating trade could even exceed the benefits of deregulation at home. That might be tolerable, were it not for the other big cost of the Trump era: unpredictability. At home the corporate-tax cuts will partly expire after 2022. America's negotiators are gunning for a five-year sunset clause in a new NAFTA deal, although Canada and Mexico would prefer something permanent. Bosses hope that the belligerence on trade is a ploy borrowed from "The Apprentice", and that stable agreements will emerge. But imagine that America stitches up a deal with China and the bilateral trade deficit then fails to shrink, or Chinese firms cease buying American high-tech components as they become self-sufficient (see China section), or Mr Trump is mocked for getting a bad deal. If so, the White House might rip the agreement up.

The new laws of the jungle

Another reason for the growing unpredictability is Mr Trump's urge to show off his power with acts of pure political discretion. He has just asked the postal service to raise delivery prices for Amazon, his bête noire and the world's second-most valuable listed firm. He could easily strike out in anger at other Silicon Valley firms—after all, they increasingly control the flow of political information. He wants the fate of ZTE, a Chinese telecoms firm banned in America for sanctions violations, to turn on his personal whim. Inevitably, other countries are playing rougher, too. China's antitrust police are blocking Qualcomm's $52bn takeover of NXP, a rival semiconductor firm, as a bargaining chip. When policy becomes a rolling negotiation, lobbying explodes. The less predictable business en- ▸▸

vironment that results will raise the cost of capital.

As America's expansion gets longer in the tooth, these arbitrary interventions could intensify. Mr Trump expects wages to rise, but 85% of firms in the S&P 500 are forecast to expand margins by 2019, reflecting a control of costs. Either shareholders, or workers and Mr Trump, are going to be disappointed. Given that interest rates are rising, a recession is likely in the next few years. In a downturn, American business may find that its fabled flexibility has been compromised because the politics of firing workers and slashing costs has become toxic.

Republicans are right that tax cuts and wise deregulation can boost firms' competitiveness. But little progress is being made on other priorities, including repairing infrastructure, ensuring small firms are not squashed by monopolies and reforming the education system. Most firms pride themselves on being level-headed, but at some point that bleeds into complacency. American business may one day conclude that this was the moment when it booked all the benefits of the Trump era, while failing to account properly for the costs. A strategy that assumes revenues but not expenses rarely makes sense. ■

Audit reform

Shape up, not break up

The audit industry needs fixing. But dismantling the Big Four is not the way to do it

When a company goes bankrupt, recriminations tend to follow. Even so, the fury caused by the recent collapse of Carillion, a British contracting firm, is unusual. A report on the debacle by British MPs, which was released this month, savaged everyone from the firm's executives to its regulators. But the MPs reserved special bile for the Big Four accounting firms—not just KPMG, which audited Carillion's accounts for 19 years, but also its peers, Deloitte, EY and PwC, each of which extracted fees from the company, before and after its fall. The MPs have called for a review into the audit market and asked it to say whether the Big Four's British arms should be broken up. The row is local, but concerns about the industry are global.

Critics of the auditors are right in two respects: that the industry matters, and that it needs reform (see Finance section). It is in everyone's interest that auditing works. If investors cannot trust financial statements, then companies' cost of capital will rise, crimping growth and employment. It is also true that the industry has flaws. It is highly concentrated. The Big Four audit 98% of the companies listed on the S&P 500 and the FTSE 350 indexes. And auditors are paid not by investors, whom they serve, but by the company whose accounts they scrutinise. That raises questions about objectivity, especially since the Big Four earn nearly twice as much from consulting and other services as they do from auditing. Past reforms banned them from providing both an audit and certain consulting services to the same client, but conflicts of interest remain. In America non-audit fees charged to the same client amount to a quarter of audit fees; in Britain the figure is around a half.

A break-up, whether to separate the audit arms from the consulting businesses or to turn the Big Four into a Middling Eight, seems to offer a simple solution to these problems. It would at first affect only the British parts of the firms' global networks, but the idea could spread.

Although a break-up might be justified as a last resort, it is premature. Investors have exaggerated expectations of auditors' ability to detect fraud. Because audits rely on sampling, some skulduggery will inevitably slip through. There are also signs that the industry is improving. Many countries tightened the rules after a scandal in 2001 sank Enron, an energy-trading firm, and its auditor, Arthur Andersen. In America the number of accounts that are restated because of a material error has fallen sharply over the past decade. Break-up would bring unintended consequences. As the world economy shifts from making goods to selling services, auditing is becoming more complicated: scale and the multidisciplinary expertise of large firms count for more. Smaller firms risk being too reliant on a few large clients, which may cloud their judgment.

If you want radical fixes, there are better ways to correct the incentive problems at the core of the industry. You could sever the link between auditors and their clients by requiring securities regulators to pick firms' auditors. Or you could introduce mandatory insurance of accounts, whereby companies must buy coverage for losses from accounting errors and the insurers would therefore appoint auditors to assess their risk.

One bean at a time

Such ideas have been floating around for years, but even these are too hasty. Instead regulators should sharpen tools that are already available in Europe. They could lower the cap on non-audit fees charged to an audit client from today's generous level of 70% of the audit fee. Under rules introduced in 2016, British companies with the same auditor for ten years must re-tender; they are forced to rotate after 20. Such rules look draconian to American eyes, where the average auditor tenure for the first 21 companies in the Dow Jones Industrial Average to have made disclosures this year is a cosy 66 years. New research finds that auditors are most likely to find misstatements early in their tenure; by the tenth year, the benefits of a fresh pair of eyes are lost. Academics also find that the Big Four's fees rise with tenure. Even Britain's 20-year limit is too long.

Auditors in many countries are already required to add flesh to the bare bones of the audit opinion. That is to be encouraged. Transparency over the main points of contention with management, and the size of revisions made to the accounts as a result of scrutiny, would cast light on auditors' successes, not just their failures. And that in turn would help investors to assess auditors' performance.

For years shareholders have waved through a company's choice of auditor at annual general meetings. A bit more bolshiness could be salutary. Last month, for instance, over a third of investors in General Electric voted against the reappointment of KPMG, its auditor for 109 years. The case for breaking up the Big Four is unproven. But every so often, shareholders need to remind the quartet who their main customers are. ■