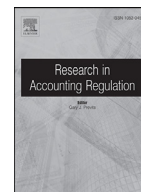




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A literature survey of financial reporting in private firms

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ABSTRACT

This paper provides a survey of the empirical literature on financial reporting in private firms. Although private firms play a dominant role in country-level economic development, research on their financial reporting is limited. The survey reveals that there remains uncertainty as to the purpose of financial reporting in private firms which is also reflected in the current body of the empirical literature. The survey provides implications for regulators with respect to regulating the financial reporting of private firms. The survey also identifies some limitations of existing research and offers potential avenues for future research.

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1. Introduction

The purpose of this paper is to provide a survey of topics related to financial statements of private firms. In contrast to the voluminous literature on the financial reporting of public listed firms, and excellent reviews of this literature (Beyer, Cohen, Lys, & Walther, 2010; Habib, 2007, for example), there is little published survey of the literature on financial reporting in private firms (Minnis & Shroff, 2017). This is despite the fact that private firms play a dominant role in country-level economic development. For example, according to the US Census Bureau, there are 29 million privately held companies in the US, representing half of the nation's GDP.

A privately held company or close corporation is a business company owned either by non-governmental organizations or by a relatively small number of shareholders or company members, which does not offer or trade its company stock (shares) to the general public on a stock market exchange. The Financial Accounting Standards Board (FASB) does not define a private company. Rather it defines a public company and if a company does not meet the definition, then it is a private company.¹

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E-mail address: a.habib@massey.ac.nz (A. Habib).¹ A public business entity is a business entity meeting any one of the criteria below (FASB codification glossary).

(a). It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

(b). It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.

Private firms play a significant role in the economy in terms of contributing a considerable proportion to the GDP and creating employment opportunities. As they are dispersed among a wide range of industries, they provide a variety of goods and services to the nation and expand export opportunities. According to industry analysts, IBISWorld, Australia's biggest private company generated total revenue of \$296 billion and employed 442,000 people in 2015. Although conventional wisdom suggests that China's economy is driven by state-owned enterprises, private companies also play a role in this regard (Bloomberg View, 2014). Therefore, private companies are an important element in the nation's economic stability and development.

Private firms are faced with financial constraints in terms of the capital required for growth and expansion. However, high quality financial statements will enable these firms to access capital (Hope, Thomas, & Vyas, 2011). As a majority of the world's business enterprises comprise private firms, it can be argued that if private firms overcome financial restrictions by providing high quality fi-

(c). It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

(d). It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

(e). It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

financial statements and external audits, they may be able to drive economic development in emerging and less developed countries.

Notwithstanding this important economic contribution and the importance of financial reporting in this context, academic research on financial reporting in private firms is scarce. The existing studies primarily use “agency theory” (agency theory can be briefly defined as the theory which explains the relationship between principals and agents in business and deals with issues that arise in agency relationships due to misaligned goals) as the dominant theoretical lens for examining the demand and supply of financial statements in public firms (Jensen & Meckling, 1976). The demand for financial statements arises because of the “decision usefulness” purpose served by published financial statements. Decision usefulness implies the provision of financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors (IASB, 2010). Financial information that is useful in making economic decisions is also helpful in assessing how management has fulfilled its accountability.

Whereas the demand for financial statements is unambiguously established for public firms, this is not the case for private firms. On one hand, as private firms have relatively less dispersed ownership and the potential to communicate via private channels, shareholders’ requirement for financial statements may be lower (Burgstahler, Hail, & Leuz, 2006). On the other hand, the demand for financial statements may still exist in private firms to protect the interests of minority shareholders against the risk of wealth misappropriation by dominant shareholders. This might be the rationale for mandating the production and dissemination of financial statements by private firms in most European countries. Lenders could also demand financial statements, as most private enterprises (small and medium-sized firms in particular) obtain finance through the private credit market,² which is dominated by banks and trade credit (Hope et al., 2011). Agency conflicts may arise between owners and creditors in this context due to information asymmetry. For example, owner-managers who have a controlling interest in private firms may expropriate from creditors (Type II agency problem). This opportunistic incentive of owner-managers becomes the main driver for the contracting role of financial accounting. According to Ball and Shivakumar (2005), financial reporting in private firms is more likely to be driven by dividends, taxation, and other policies, such as a compensation payment policy.

Agency theory advances the proposition that managers have incentives to provide misleading financial reporting to external stakeholders, generating the Type I agency problem (Healy & Palepu, 2001; Jensen & Meckling, 1976) (the supply-side argument). A plethora of research has identified the managerial incentives and mechanisms for earnings management, and the constraints on earnings management (see Dechow, Ge, and Schrand (2010) for a comprehensive survey).

Although some efforts have been made to examine financial reporting in private firms, the findings of these studies have been inconclusive and may not be particularly informative for regulators and investors concerning issues in private firms. Accordingly, this study intends to survey the literature on financial reporting in private firms, and to provide a summarized view of the existing literature. Academic researchers may also use the conclusions of this survey to undertake further investigation of financial reporting issues in private firms and, thereby, extend this stream of research into different but important areas.

Two criteria were used to determine whether to include an article in the survey. First, the search terms “private firms,” “private companies,” “family firms,” “financial reporting,” “earnings quality,” and “conservatism” were used to retrieve articles from EBSCOhost, Emerald, Scopus, ProQuest, Science Direct, and the Wiley Online Library databases. Second, the authors skimmed through the articles initially derived to identify whether they tested empirically the financial reporting in private firms. Unpublished working papers were included as long as they were relevant to the survey, although those were few in number.

The first large-scale empirical research, in the form of earnings quality in private firms, was conducted by Beatty and Harris (1999), who investigate the effects of taxes, agency costs, and information asymmetry on earnings management in public and private firms. The survey, therefore, focused on the papers published after the year 1999. The survey is categorized using a demand and supply framework (see Sections 4.1 and 4.2 respectively).

The paper proceeds as follows. Section 2 provides an overview of the institutional framework for financial reporting by private firms in the US and the EU countries. Section 3 explains the theoretical frameworks for financial reporting in private firms. Section 4 presents the literature on financial reporting in private firms. The final section concludes the paper and also highlights the implications of the survey for future research and for the regulators.

2. Institutional features of financial reporting in private firms in the US and Europe

2.1. Regulatory requirements for financial reporting for private firms in the US

In North America, the United States Securities Exchange Act of 1934 [§12 (g)] requires only public companies with asset values exceeding \$10 million and widely dispersed ownership (more than 500 “holders of record”) to produce financial statements (Allee & Yohn, 2009). In contrast to public firms, private firms³ are generally not required to disclose financial statements to the public (Badertscher, Shroff, & White, 2013; Bradshaw et al., 2014). The Financial Accounting Foundation (FAF, the parent of the FASB) established the Private Company Council (PCC) in 2012 (FAF, 2012). The purpose of the PCC is to improve the standard-setting process for private companies (FAF, 2013). As its first task, PCC approved the *Private Company Decision-Making Framework – A Guide for Evaluating Financial Accounting and Reporting for Private Companies* (Lisowsky & Minnis, 2015). This guide is used to assist the PCC in determining whether and in what situations alternative recognition, measurement, disclosure, display, effective date, transition guidance, and exceptions should be provided for private companies under US GAAP (FAF, 2013; O’ Dell, 2015). Among other responsibilities, the PCC have proposed alternatives to the US generally accepted accounting principles (GAAP) to address some of the aggravated and long standing private company issues including accounting for intangible assets, financial instruments, consolidations, share-based payments and uncertain tax positions (O’ Dell, 2015).

Somewhat differently, the American Institute of Certified Public Accountants (AICPA) established the new *Financial Reporting Framework for Small and Medium-Sized Entities* (FRF for SMEs) in June 2013 (Pacter, 2014). This is designed for the small business community in the USA to produce useful and relevant financial statements in a simplified, consistent, and cost-effective manner. The

² Some private firms also obtain finance through public debt: private firms with public debt (Givoly, Hayn, & Katz, 2010) and private firms backed by private equity ownership (Katz, 2009). These firms have different incentives for preparing financial statements, which may be similar to those of public firms.

³ US GAAP generally refers to small businesses as private companies, whereas IFRS uses the term SMEs (Pacter, 2014)

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