Essays on financial reporting quality, earnings management and corporate disclosure

---Executive Summary---

With the abundance of corporate accounting scandals that surfaced in recent years, it is an understatement to say that financial reporting quality and reliability has become a much-debated issue. Worldwide corporate fraud examples astonished various market participants and eroded the overall confidence in the quality and credibility of financial statement representation. With the recent examples in mind, the economic community gets convinced that financial reporting practices are important fundamentals of the economic process and that various parties are affected by the way financial reporting is conducted. Until recently, however, the causes and consequences of financial reporting quality are typically examined in a US setting for publicly listed firms. Nevertheless, the trend for economic globalization and accounting harmonization also alerted the economic importance of financial reporting quality for non-US based and unlisted firms and recently triggered a stream of analyses on this issue. This dissertation contributes to this developing cluster of studies and empirically analyzes financial reporting quality issues for unlisted firms in an innovative setting, namely in a private equity and business groups context.

In the first paper of the dissertation, I tackle two enquiry issues. First, I examine whether entrepreneurs manage earnings numbers in the private equity process to increase their chances in attracting external equity capital. This study is embedded in the earnings management research surrounding public equity capital offerings and conjectures analogous incentives and opportunities for private firms to manage earnings in the private equity process. Second, I analyze whether the financial reporting discipline of portfolio firms is affected by the intensified monitoring and corporate governance mechanisms that are typically installed by private equity investors in the post-financing period. Robust results show that prior to the financing date, entrepreneurs either opportunistically or over-confidentially massage their financial results upward to attract the attention of private equity investors. In the years after the private equity financing, private equity investors' governance acts as a restraining factor on this earnings management behaviour. In addition, multivariate conservatism tests show that portfolio firms have a higher timeliness of loss reporting once private equity investors are on board. The combination of these results suggests that private equity presence and the intrinsic professionalization associated with this, improves the quality of reported earnings of their portfolio firms.

In a second study, this database of Belgian private equity backed firms is further employed to analyze corporate disclosure policies in response to information asymmetries and agency problems in the private equity context. In doing so, this study is one of the first to treat disclosure decisions as non-random events, which depend on a firm's changing environment and economics. The disclosure proxy used in this study is based on a firm's willingness to report a complete financial statement although legally an abbreviated statement is sufficient. Results show that in a time frame of three years before until five years after the initial private equity capital injection, portfolio firm's disclosure policies change substantially. From one year before the initial capital injection, significantly more prospective portfolio firms disclose a complete financial statement compared to a sample of matched independent firms. This finding suggests that entrepreneurs employ disclosure as mechanisms to resolve information asymmetries in the pre-investment period. Moreover, multivariate panel regressions show that the decision to disclose complete financial statements increases further from the private equity-financing year onwards. This finding is consistent with the argument that private equity investor governance and monitoring influence positively affect a portfolio firm's disclosure behaviour. Finally, results show that investor type, i.e. government-related versus purely independent, does not affect the disclosure intensity of portfolio firms.

The third paper moves away from the private equity context and focuses on the relation between tax-incentives and earnings management decisions. In a Continental European setting, c.q. Belgium, where tax accounting and financial accounting are strongly linked, evidence suggests that firms manage earnings for tax reasons (Burgstahler et al. (2004), Coppens and Peek (2005), Sercu et al. (2002)). However, the difficulty in distinguishing among multiple incentives to manage earnings for various objectives generally leads to mixed study results (Fields et al. (2001)). Firms typically are not able to focus on tax minimization in isolation since financial reporting also affects contracts with banks and other creditors (Scholes et al. (2002)). To overcome this problem, this study concentrates on firms that are operating in a business group, where financial reporting costs of booking a lower income are generally less important than for independent firms. Group firms have less incentives to report high income levels as financial contracting is often provided through the group affiliations and is unaffected by financial reporting measures. As a result, group firms can concentrate their financial reporting on tax-minimization and capitalize on their business affiliations to manage earnings at the subsidiary firm-level and, in addition, to shift income from profitable to loss making firm entities. Analyzing tax-induced earnings management and income shifting for business groups provides a very powerful setting and is able to produce more distinct results than previous studies on tax-minimization in the Continental European context. Hence, this paper not only provides new insights in the importance of tax incentives in an institutional context where tax and financial reporting are closely linked but in addition sheds light on the tax rationale for the existence of business groups.

Results show that Belgian business group member firms are subject to lower effective tax rates (ETRs) and face a less positive association between pre-tax income and ETRs, compared to independent firms. These findings suggest that firms belonging to a business group apply efficient tax planning across group entities. As a rationalization for this, I hypothesize that Belgian group firms strategically manage firm-level earnings levels in response to tax incentives. The evidence is consistent with this hypothesis, in that group firms manage earnings significantly more downward (respectively: *upward*) when they face positive (respectively: *zero*) marginal tax rates. Moreover, I document that intra-group transactions are important instruments to alter the reported profit level in function of a firm's tax status. These findings have important implications for a multiple set of stakeholders. Results are robust to alternative model specifications, variable definitions and earnings management measures.

The overall contribution of this dissertation is its ability to provide valuable insight in the financial reporting process of unlisted firms that are subject to very specific external pressures and incentives. Moreover, by examining two highly specific and unique research settings, this dissertation moves beyond the developing cluster of financial reporting quality studies on European unlisted firms, which treat this issue rather broadly. Altogether, the combination of research that has been broached here is a contribution to several literatures. The first two papers expand the growing literature on earnings characteristics of private equity backed companies and additionally build on advances in the corporate governance literature on the role of private equity investors as monitors in the professionalization process of a firm. As such, the results presented here do not only complement the accounting literature but also the entrepreneurial finance literature, which often treats the corporate reporting environment as exogenous. The third paper adds to both the empirical accounting and tax research by providing new insights in firms' earnings management actions when financial and tax accounting are closely linked. In addition, this study complements the corporate finance literature on business groups.

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