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Stakeholder demand for accounting quality and economic usefulness of accounting in U.S. private firms ☆

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ABSTRACT

For some privately-held firms, the costs of providing high-quality accrual-based financial statements may outweigh the benefits of accommodating the demands of their stakeholders who may rely more on cash flows or have direct access to management. For other private firms, greater stakeholder demand for their financial information necessitates them providing higher-quality accounting. Using a large sample of U.S. private firms, we first confirm that accrual quality in private firms is associated with the ability of accruals to predict future cash flows. Next, we predict and find that accrual quality increases with the demand for monitoring by equity investors, lenders, and suppliers. Overall, our evidence suggests that accrual quality of private U.S. firms is useful, has economic consequences, and varies predictably with certain firm characteristics.

1. Introduction

The U.S. Private Company Council (PCC) recently issued guidance on its private company accounting project, *Private Company Decision-Making Framework* (PCC, 2013), which suggests that not all private firms need to prepare financial statements under the same set of U.S. GAAP as do public firms and that exceptions and alternatives should be allowed. To determine which exceptions to certain aspects of accrual-based accounting should be allowed, the PCC intends to consider the value relevance of the information to users of private firm financial statements relative to the firm's cost of producing it. Furthermore, the Decision-Making Framework explicitly considers that the tradeoff between the value relevance and cost of certain accrual-based accounting estimates can vary across private firms. To provide information relevant to these standard setting deliberations, the purposes of our study are to understand (1) whether accrual quality in private firms is "useful" and (2) whether accrual quality varies across private firm characteristics. For the first purpose, we provide evidence of the effect of accrual quality on the ability of accruals to forecast future cash flows. For the second purpose, we examine whether accrual quality varies predictably with demand from a variety of stakeholders (equity investors, debt investors, and suppliers).

Private (or nonpublic) firms make up a significant portion of the economic activity in the U.S. and nearly all other countries, yet prior research focuses primarily on public firms. To illustrate the relative contribution of private firms to

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international economic activity, Berzins et al. (2008) show that, in the aggregate, nonlisted firms have about four times more employees than listed firms, three times higher revenues, and twice the amount of assets, and that these statistics are representative for most countries in the world. In fact, more than 99% of limited liability companies are not listed on a stock exchange (e.g., Pacter, 2004; Nagar et al., 2011). In the U.S., there are about 8 million private firms with paid employees, representing one-half of the nation's GDP.[1,2]

Recently there has been increased emphasis on private firms' accounting practices (Bradshaw et al., 2014). In 2007, the Financial Accounting Standards Board (FASB) established the Private Company Financial Reporting Committee (PCFRC) with the goal of improving the overall financial reporting environment. The PCFRC and other groups contended that the complex standards currently being set by the FASB had become too focused on public companies, had little relevance to smaller private companies, and should be modified by a separate standards-setting board. In 2010, the joint "Blue-Ribbon" Panel (BRP), established by the Financial Accounting Foundation (FAF) and the American Institute of Certified Public Accountants (AICPA), agreed to a separate reporting model for private companies. The BRP recommended an independent standard setting body for private firms, but the FAF in October 2011 suggested that the FASB retain oversight. The result of BRP's recommendations was the establishment of the PCC in 2012.[3]

The key insight from the discussion above is that there is a growing trend to reduce the cost and complexity of private companies' financial reporting. The implication is that the unique characteristics of private companies reduce the demand for financial reporting and therefore do not justify the preparation and auditing costs of providing complex GAAP-based financial statements, relative to public firms (Durak, 2013; Murphy, 2015). As a result, many accounting standards updates have been passed in recent years that allow exceptions or alternatives for private company reporting (e.g., subsequent measurement of goodwill).

The lower demand for (costly) accrual-based financial reporting of private firms often is attributed to these firms lack of the typical agency problems observed in public firms. For example, private firms have capital providers that often take a direct role in helping to manage the company (Chen et al., 2011), or often include firms with a single manager-owner. Private companies may also have personal ties with lenders, who often are local financial institutions (Vera and Onji, 2010; Cole and Wolken, 1995). Because capital providers of private firms often have direct access to inside information and continuous contact with management, they often rely less on formal communication through published accrual-based financial statements (Berger and Udell, 1998). As stated in the PCC's Basis for Conclusion to the *Private Company Decision-Making Framework*, "Many preparers of private company financial statements said that the preparation efforts and audit or review costs of complying with some accounting guidance that does not affect reported cash amounts or liquidity often are not justified considering the limited benefits of reporting that information to users" (PCC, 2013, paragraph BC13). Instead, private firms' financial reports could more likely reflect other objectives such as tax reporting, dividend policy, or insurance requirements (Ball and Shivakumar, 2005; Burgstahler et al., 2006).

One aim of the PCC's *Private Company Decision-Making Framework* is to recognize "differentiating features" of private firms (e.g., ownership structure and type of external financing) that can be used "to identify opportunities to reduce the complexity and costs of preparing financial statements in accordance with U.S. GAAP" (PCC, 2013, paragraph 8). The costs allude to both direct costs of preparing the statements as well as indirect information processing and other proprietary costs (ICAEW, 2015, page 4). We identify the characteristics of private firms that are associated with higher quality accruals. Those firms that face a higher demand for accrual-based financial statements are more likely to show evidence of higher quality accruals. Our sample period ends before the introduction of new regulations for private firms, further highlighting the importance of demand factors (relative to regulation) that would have an impact on accounting practices among private firms.

We use accounting data from the Sageworks database for a sample of private firms over the period 2002–2009.[4] We measure accrual quality using three widely used metrics: (1) abnormal total accruals from Kothari et al. (2005) performance-matched model; (2) abnormal working capital accruals from Dechow and Dichev's (2002) cash flow-based model, controlling for sales growth and property, plant, and equipment (McNichols, 2002); (3) abnormal accrued revenues from McNichols and Stubben's (2008) model. We investigate the impact of demand from both equity stakeholders (i.e., equity investors) and non-equity stakeholders (i.e., lenders and suppliers). Based on multivariate analyses, which contain controls for standard firm characteristics found to explain variations in accrual quality, our evidence suggests that accrual quality is strongly positively associated with demand for monitoring from equity investors (ownership dispersion), relatively powerful debt investors (senior debt), and suppliers (inventory intensity).

Although our primary focus is on how accrual estimates are shaped by demand factors, we also assess the economic consequences of accrual quality for these firms. If accruals are less useful for private firms, we would not expect accrual quality to have economic consequences. However, there exist strong arguments that accruals "matter" for private firms (see

[1] http://www.aicpa.org/PRESS/PRESSRELEASES/2010/Pages/CouncilAdoptsResolutionSupportingBRP.aspx

[2] Another interesting aspect of the U.S. private firm market is that it is less regulated than in many other jurisdictions, (for example in many European countries) where private firms have to follow the same accounting (and legal) regulations as public firms (subject to firm size thresholds). In this respect, the U.S. has been an outlier in the worldwide regulatory landscape (Hope et al., 2012).

[3] Private firms and their financial reporting practices have also received increased attention from accounting standard setters elsewhere in the world. For example, the International Accounting Standards Board has developed a separate set of financial reporting requirements for small and medium enterprises (SMEs). In Canada, private firms must choose between using either International Financial Reporting Standards or Private Enterprise GAAP beginning in 2011.

[4] 2009 is the last year with firm-level data made available by Sageworks. Since then, Sageworks has ceased making firm-level data available. However, Sageworks continues to make industry-level data commercially available.

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