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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.

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]

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-

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[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.
(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.

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nancial 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 firms[3] 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)

FRF for SMEs can be adopted by private firms when GAAP requirements do not apply (AICPA, 2016). This reporting option is designed, in a sense, as an alternative competing reporting framework to the US GAAP for private firms (Lisowsky & Minnis, 2015). Currently, due to the co-existence of various options, it is still uncertain as to whether a standardized alternative to GAAP. e.g., the IFRS for SMEs, could be provided to private firms in the USA.[4]

2.2. Regulatory requirements for financial reporting for private firms in Europe

In Europe, 7.6 million companies are required by law to file audited financial statements (Pacter, 2014). European countries provide a unique institutional environment in which the European Union (EU) accounting regulations are based on a firm's legal form, rather than on its listing status. As a result, private limited companies face largely the same accounting standards as publicly traded corporations, although they are subject to very different capital market forces (Burgstahler et al., 2006). Most European countries require private companies to make their financial statements publicly available. This is considered one of the most important obligations imposed by governments on enterprises (Flower, 2004). In the UK, as a consequence of the changes to the Companies Act 2006 arising from the implementation of the EU Accounting Directive, significant amendments have been made to UK and Republic of Ireland accounting standards (effective as of January 1, 2016) (Deloitte, 2016a; FRC, 2015). Publicly listed companies are required to apply the IFRS in the preparation of their consolidated group accounts, but can choose between the IFRS and UK and Ireland GAAP for the preparation of individual accounts. Other entities have a free choice between the two frameworks.[5] Starting with the level of the least reporting complexity, eligible micro-entities[6] are allowed to report according to the micro-entities regime (FRS 105); eligible small entities[7] (neither public companies nor financial institutions) are required to report under Section 1A Small Entities in FRS 102; other small entities (not meeting the eligibility criteria of the previous two categories) can choose to adopt FRS 102; whereas entities that are part of a group may apply either the reduced disclosure framework (FRS 101) or reduced disclosures for subsidiaries and ultimate parents (paragraphs 1.8–1.13 of FRS 102). The micro-entities regime requires a minimal level of disclosure: only a condensed balance sheet and a profit and loss account are required.

The EU gave its member states the choice of whether to oblige/allow private companies to use the IFRS. As of 2012, IFRS can be used by (all or some) private companies in all European countries except for Austria, Belgium, France, Latvia, Romania, Spain, Sweden, and Switzerland: The adoption of the IFRS by private firms is prohibited in these countries (Cameran, Campa, & Pettinicchio, 2014; Kaya & Koch, 2015).

3. Theoretical frameworks

This Section discusses the theoretical frameworks for the demand for, and supply of, financial statements by private firms. Each framework is then used to survey the related literature to find out whether the extant literature supports or refutes particular theories.

3.1. Demand for, and supply of, accounting information by private firms

3.1.1. Demand for accounting information by private firms

High quality financial reporting acts as a credible mechanism for attenuating Type I agency problem: agency problems emanating from information asymmetry between managers and outside atomistic shareholders (Jensen & Meckling, 1976). The agency problem faced by private firms, on the other hand, is of different nature, in which dominant shareholders may expropriate wealth from minority shareholders: the Type II agency problem.

The closely held nature of the private firm institutional setup will minimize the demand for financial information in private firms, because their shareholders have access to insider information through private channels (Ball & Shivakumar, 2005). In addition, not all private firms have such an agency-oriented culture (e.g., opportunistic behavior by dominant shareholders), and others may be characterized by a stewardship orientation that promotes the welfare of all stakeholders. Both these circumstances will result in less demand for financial information. Furthermore, lack of capital market pressures reduces incentives for financial statement manipulation by private firm managers, thereby reducing the demand for financial statements to monitor managerial reporting behavior.

However, the 'demand hypothesis' may still be in play, whereby minority shareholders may demand published financial statements to protect themselves against dominant shareholders' opportunistic behavior designed to expropriate minority shareholders' wealth. Although accounting discretion may be less used to communicate firm performance to outsiders; it can, however, be used to achieve other objectives, including tax savings. The 'demand hypothesis' is further substantiated by creditors' demand for accounting information. For smaller US private companies seeking a bank loan, the lender typically requires the personal guarantees of the owner/shareholders. The lenders also may require other information in addition to financial statements such as inventory listings, and accounts receivable aging analysis on a monthly basis in order to monitor the loan. Future research might explore the effect of a personal guarantee on the reliability of the information submitted to the lender.

Owner-managers who have a controlling interest in private firms may expropriate resources from creditors. This opportunistic incentive of owner-managers becomes the main driver for the contracting role of financial accounting in private firms, similar to that in public firms. According to Holthausen and Watts (2001) and Watts (2003), conservative accounting as manifested in timely loss recognition, provides early signals on declines in debt values, and facilitates the timely transfer of control rights to debt holders (Ball & Shivakumar, 2005). However, as long as debt holders can obtain required information through private channels, the demand for published financial statements may become less onerous. Nevertheless, all parties, including debt holders contracting with private firms, will be unable to obtain information through private channels of communication. Further, based on the information rent approach, if there are more debt contracting parties, then they will increase the demand for public financial information. Therefore, creditor demand for financial reporting and other additional information in private companies is a significant component of the financial reporting environment.

3.1.2. Supply of accounting information by private firms

The flip side of the demand for accounting information is its supply. Two related issues dominate the supply side arguments.

[4] See for example, Is Private Company GAAP a Threat? http://ww2.cfo.com/gaap-ifrs/2014/11/private-company-gaap-threat.

[5] The UK Companies Act 2006 recognizes two financial reporting frameworks: the IFRS and the UK and Ireland GAAP (FRC, 2015).

[6] Micro-entities are companies that meet two of the following criteria: (1) turnover < £632,000; (2) balance sheet total < £312,000; (3) no. of employees < 10 (FRC, 2015).

[7] Small entities are companies, limited liability partnerships, or any other type of entity comprising a company incorporated under company law (i.e., charities) that meet two of the following criteria: (1) turnover < £10.2million; (2) balance sheet total < £5.1million; (3) no. of employees < 50 (FRC, 2015).

First, given the voluntary reporting regime faced by many private firms globally, why would they voluntarily supply financial statements? Second, what incentives drive private firms' decision to provide high quality financial statements? Regarding the former, the regulatory environment creates competing incentives for private firms in supplying financial statements. Supply of financial statements to the public is mandatory in some countries while it is voluntary for others in the private firm context. Voluntary supply of financial statements may be motivated by the desire to access debt financing at a cheaper cost (Beuselinck, Deloof, & Manigart, 2013). Mandatory supply of financial statements may be motivated by regulators' desire to protect minority shareholders' interests against opportunistic behavior by dominant shareholders.

Competing theoretical arguments exist regarding the quality of financial statements supplied by private firms. The arguments for the provision of high quality financial statements by private firms include capital market incentives and the debt contracting motivation. The former view suggests that although the personal wealth of private firms' managers is tied to their firm's value, these values are not subject to capital market performance pressures. Accordingly, the managers of private firms have fewer incentives (relative to public firms) to manage earnings and, thus, the financial statements of private firms may be of higher quality than those of public firms (Ball & Shivakumar, 2005; Burgstahler et al., 2006). Furthermore, agency costs in private firms can be reduced effectively by means of shareholders' direct monitoring activities and subjective performance measurement (Ke, Petroni, & Safieddine, 1999). From a debt contracting perspective, private firms have incentives to supply informative financial reports to signal performance and cash flows to creditors in order to obtain favorable loan terms.

Managers and controlling shareholders in private firms may have opportunistic incentives to supply lower quality financial reports, to access finance at a lower cost and to conceal wealth expropriation behavior. Furthermore, avoiding covenant violations and creditor interference provide incentives for managers to supply lower quality financial reports opportunistically (e.g., by documenting inflated profit). In addition, private firms that are highly leveraged and are in financial distress may engage in earnings management to prevent creditor interference and subsequent loss of private control benefits. Finally, 'information rent theory' argues that, if a private firm has a single bank, it will obtain firm-specific private information for its own benefit only, and will not wish to share such sensitive information with other banks. If the firm has multiple banks, obtaining firm-specific private information is not plausible and there will be demand for, as well as supply of, high quality financial reports (Bigus & Hillebrand, 2017).

Two other incentives that may impair the quality of the private firm financial reporting are tax and dividend incentives. According to Healy and Palepu (2001) managers may have incentives to use accounting choice for tax minimization purposes. Although private owners have strong incentives to engage in tax minimization, this does not necessarily imply conscious efforts on the part of private firms to lower reported income, as lower income has both tax costs (e.g., threat of tax audits), and non-tax costs (e.g., debt covenant violation). On the other hand, making earnings less informative by engaging in tax manipulation is less of a concern for private firms, since these firms rely less on earnings to communicate firm performance compared to their public firm counterparts. In the US small firm context, differences exist between tax accounting and financial accounting. Use of accelerated depreciation is the best example for this difference. Thus, it is possible to minimize taxes by taking advantage of incentives in the tax code and still produce reliable GAAP financial statements.

With respect to dividend incentives, the standard signaling models propose that firms manage their dividend policy to alter market prices (e.g., Miller & Rock, 1985). Given that private firms do not have publicly traded securities, the market valuation argument is less applicable as a dividend incentive. However, external financing constraints may play a role in shaping dividend incentives, as private firms cannot influence market participants' beliefs by using dividends as a signaling device. Furthermore, loan covenants may hinder dividend distributions. Future research can examine how the owners' incentives for tax minimization conflict with the incentives for furnishing high-quality financial reports.

The next Section surveys the existing literature following the theoretical frameworks developed above in order to take stock of the literature as supporting or refuting a particular theory.

4. Survey of financial reporting literature in the private firm setting

4.1. Empirical literature on the demand for financial reporting in private firms

Gassen and Fülbier (2015) find that firms with larger shares of creditor financing in countries with weak debt contracting report a smoother earnings stream because of an increase in bankruptcy risk emanating from volatile earnings. Peek, Cuijpers, and Buijink (2010) find that creditors of public firms demand conditional conservatism, whereas shareholders of public firms do not. On the other hand, public shareholders demand greater symmetric timeliness than private shareholders. These findings highlight the importance of investor and creditor protection. In line with the demand hypothesis, Hope, Thomas, and Vyas (2013) also find that public firms exhibit greater reporting conservatism than their private firm counterparts. Wang, Xiao, and Zhu (2015) find that private firms with new long-term debts report more conservatively than those with fewer, or no, new long-term debts in response to creditor information demand. They also find that private firms with new long-term debts that are headquartered in provinces with few market activities report more conservatively than those in more marketized regions.

The aforementioned studies considered manufacturing firms to investigate the research questions. However, private banks also face demand for high-quality accounting information from regulators. The extent of the effect of regulatory frameworks on financial reporting in private banks varies among different regimes. For example, all US banks are subject to stringent regulatory examinations and bank regulations require them to comply with GAAP in preparing financial statements. Moreover, private banks need to report their financial accounts through standardized regulatory bank filings (Hope et al., 2013).

4.2. Empirical literature on the supply of financial reporting by private firms

Do private firms provide financial statements that are of superior quality compared to their public firm counterparts? Earnings management incentives in public firms are exacerbated by managers' heightened focus on the share price and short-term performance matrix, by lower managerial ownership, and by litigation risk in the event of failing to meet market expectations. Since private firm ownership is more concentrated and the shares are not traded on the stock market, this view suggests that private firms have fewer incentives to manipulate earnings. Beatty, Ke, and Petroni (2002) find that public US banks are more likely to meet earnings benchmarks than private banks. They further find that public firms utilize their loan loss provisions (LLPs), security gains, and discretionary loss decisions to avoid small earnings reductions. Beatty and Harris (1999) find that public banks are more likely to engage in earnings management than private banks. They further find that the portion of public banks' current period securities gains and losses attributable to earnings management is more positively associated with following periods before securities gains and losses. Givoly, Hayn, and Katz (2010) find that private firms with public debt are less likely to manage earnings than public firms. Kim and Yi (2006) find that the magnitude of discretionary accruals is greater for publicly traded firms than for privately held firms, supporting the notion that lack of stock market incentives dampens the degree of earnings management by private firms. Ding, Liu, and Wu (2016) find that better earnings quality increases private firms' access to debt financing and lowers their cost of debt in China.

However, evidence also exists supporting opportunistic reporting behavior by private firms. Using a sample of accounting information for both private and public firms in eight EU member countries, Coppens and Peek (2005) find that private firms manage earnings (avoid reporting losses) even in the absence of explicit capital market pressures to do so. However, this effect is less pronounced in countries where tax incentives reduce the benefits derived from opportunistic earnings management. Burgstahler et al. (2006) find earnings management in private companies to have been higher than in public companies in a sample of EU countries. Tax-book alignment increases earnings management for private firms, contrary to Coppens and Peek's (2005) findings. Although Hope et al. (2013) find that, on average, public firms have significantly higher accrual quality than private firms, accruals quality worsened in settings where the incentives for managerial opportunism dominate over signaling value-relevant private information (e.g., benchmark beating, seeking external financing, being audited by a non-Big 4 auditor, and no analyst following).

The incentives for earnings management in private firms can be attributed to tax and dividend incentives. Garrod, Kosi, and Valentincic (2008), using data from Slovenia, find that more profitable companies are more likely to write off assets to minimize tax payments. Szczesny and Valentincic (2013) report similar evidence from German SMEs. Kosi and Valentincic (2013) investigate the use of asset write-offs for tax minimization purposes in two different regimes: one that generates tax savings and one that does not; courtesy of regulatory change rendering asset write-offs as a non-tax deductible expense. They find that firms continue to use write-offs during the no-tax benefit regime, implying that obtaining tax savings is important for private firms, as is non-tax costs and benefits. This study makes a significant contribution to private firms' incentives for earnings management by providing a cleaner test of the tax minimization hypothesis. Studies on dividend incentives find that Finnish private firms adjusted their dividend policies in response to the tax reform of 2005 (corporate tax rate reduction from 28% to 26%), to benefit from the lower dividend tax rate. For example, Harju and Matikka (2013) reveal that owners of private firms shifted their personal income from dividends to salaries after the tax reform.

Section summary: The studies conducted in the EU provide overwhelming evidence that private firms manage earnings to a greater extent than their public company counterparts. Further research on this important issue is encouraged using data available from other jurisdictions to explore the effects of differences in institutional settings on the difference in financial reporting quality between private and public firms. This is important since the provision of credible financial statements reduces financing constraints and enhances investment efficiency (Chen, Hope, Li, & Wang, 2011; Hope et al., 2011).

5. Conclusion and implications

5.1. Conclusion

A major problem in the extant literature is that there remains uncertainty as to the purpose of financial reporting in private firms. Although current literature addresses issues around financial reporting, it does not consider the important interactions between the demand for, and supply of, financial reporting. Thus, this survey highlights the current theories used by researchers to examine a wide array of research questions pertinent to financial reporting for private firms and takes stock of them.

As elaborated in Section 3, the production of financial statements by private firms is dependent upon the interplay between demand and supply for such reporting. The demand for high quality financial statements will be higher when the Type II agency problem prevails. For example, controlling shareholders may try to expropriate resources from minority shareholders or owner-mangers may try to expropriate resources from creditors. On the other hand, lack of demand for high quality financial reports exists owing to the availability of private channels for communication (due to closely-held ownership structures), prevalence of the stewardship nature of managerial behavior, and lack of capital market incentives for earnings management. The incentives for supplying financial statements are shaped by the interplay between regulatory requirements (voluntary vs. mandatory) and managerial incentives to provide high quality financial reporting, such as debt contracting incentives. In addition, conflicting incentives from tax minimization and dividends also contribute to the demand and supply debate in private firm financial reporting.

In addition to the absence of a cohesive theoretical framework, the survey also identifies some other limitations in the extant literature. Earnings management and earnings quality measures used in private firm research are the same as those used in public firm research. It has been argued that these measures do not measure managerial discretionary accruals effectively and, hence, are questionable in measuring earnings management. It has further been argued that any financial figure could occur for two reasons: a firm's economic performance and measurement system, and the difficulty in disentangling the element of performance from the measurement system in these figures. Accordingly, the measures used to evaluate earnings management and earnings quality in private firms may not be totally reliable (Dechow et al., 2010).

There are other deficiencies that could reduce the reliability of the findings of the studies. Many of the studies that are surveyed have not considered endogeneity issues where appropriate. This limitation may hinder the accurate interpretation of reverse causality. In addition, as private companies are not required to follow financial reporting standards in most regimes, the reliability of the financial figures available for research is questionable. Furthermore, the databases used to derive financial figures have not been used as often as public firm databases, and one should be skeptical in interpreting the findings of the research studies that used these databases.

5.2. Implications for future research

There is lack of empirical research which examines the interplay between demand for, and supply of, private firm financial reporting. Therefore, the extant literature has not been able to answer the question: what is the purpose of preparing financial statements. Although some studies investigate incentives behind financial reporting in the private firm context, no attempt has been made to understand the complex interactions in different circumstances. For example, future research should examine what incentives private firm mangers have to produce financial statements in voluntary vs. mandatory regulatory environments. In addition, this stream of research should also consider the costs and benefits of preparing financial statements within the demand and supply framework.

From an accounting perspective, it is of vital importance to gain further understanding of the issues around reducing agency costs and information asymmetry in the context of private firms. It is also necessary to extend the academic discussion on increasing the investment efficiency and information value of the financial statements of private firms. These discussions may lead to a reduction in the prevailing finance constraints of private firms, and to an expansion of private firms' operations that would ultimately contribute to economic development.

As private firms do not trade stocks in public, market betas cannot be computed. However, alternative finance providers, such as creditors and other stakeholders of private firms, may want to ascertain the risk associated with these firms. Academic researchers may use accounting betas[8] as a proxy for market betas to ascertain risk and uncertainties in private firms. The findings of this type of empirical research may inform providers of finance to private firms about the risk of and returns on their investments. The requirement of the provision of additional information and personal guarantees in the US for small firm loans creates a further avenue for future research. For example, researchers can examine the effect of a personal guarantees have on the reliability of the information submitted to the lender.

There are no mandatory requirements or guidelines for best practice in corporate governance applicable to private firms in most countries. This survey highlights that there are inconsistent empirical findings around earnings management practices, information asymmetry, and agency issues in private firms. Further studies need to be conducted to understand governance practices in private firms. A comprehensive understanding of governance issues related to financial reporting behavior will inform regulators of the need for, and nature of, regulations or guidelines for best practice governance in private firms.

As there is lack of publicly available information in the private firm context, it is important to produce reliable financial information to other stakeholders such as suppliers, customers and other interest groups. The stakeholders expect signals from insiders about potential future losses. Thus, timely loss recognition is important in the private firm scenario. Hui, Klasa, and Yeung (2012) support conservatism in private firm accounting – "We note that for private firms, accounting conservatism could be even more important given that these firms do not have publicly available signals of firm performance, such as stock returns" (p.117). Future research could also test this hypothesis for private firms to discern whether these stakeholders rely on financial reporting by private firms for contracting purposes.

5.3. Implications for regulations

Although private channels of communication may be used to obtain financial information to reduce agency costs, these channels may not be available to all stakeholders. More importantly, the information provided may not be reliable and assured, as in the case of public financial statements. As there is investment efficiency in high-quality financial reporting and external auditing in private firms (Chen et al., 2011; Hope et al., 2011), establishing a regulatory environment should be considered. However, the scale of operations in some private firms and the cost of preparing these reports should not be overlooked. For small companies, bankers and others rely on income tax returns in addition to or as a substitute for financial statements. If the banker requires tax returns, the private company is less likely to manage earnings if it also has to meet loan covenants. It is an important consideration in the US and is most likely why the US may never impose a regulatory requirement similar to the SEC to private companies.

As presented above, the incentives for presenting financial reports are quite distinct between public and private firms. Despite these differences, financial reporting in private companies in many countries has been similar to that of public companies. Although the use of a particular basis of accounting standards in preparing financial statements is not mandatory for private companies, most managers in these firms use the accounting standards prescribed for public companies. Reporting practices for private companies are different under different regimes. Two opposing arguments can be provided. On one hand, it can be argued that the financial reporting of private companies do not satisfy the requirements of stakeholders, and it is time for regulators in different regimes to regulate private firm financial reporting environment. On the other hand, the regulatory requirements largely depend on the stakeholder requirements. Thus, policy makers should assess the requirements of stakeholders in different regimes with respect to their small private business financial reporting environment before designing the regulations.

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