Earnings of private European firms are more reliable than those of public firms

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Credit: Paolo Tonato

Conventional wisdom indicates that market discipline and transparency ensures that financial data of public firms are more reliable for potential investors than financial reports from private companies. Contrary to this widely held belief, new research from the NYU Stern School of Business, University of Bolzano and Bocconi University finds that when comparing European public firms against private firms with similar organizational structures, private firms provide a higher "earnings quality" or EQ, which is a measure of the reliability of financial statements.

Using data over a nine-year period (2005-14), NYU Stern Professor Paul Zarowin, Bolzano Professor and NYU Stern Visiting Professor Massimiliano Bonacchi and Bocconi Professor Antonio Marra examined the EQ of nearly 400,000 European companies across 11 countries.

To effectively compare the EQ of public vs. private firms, the authors first organized the private firms into two categories: (1) standalone entities and (2) business groups. Because all public firms are structured as business groups, the authors compared the financial statements of public companies against those of private business groups, to control for non-market forces (Tax incentive and Stakeholder pressure for earnings quality) that differently affect private groups and standalone firms.

The co-authors conclude that:

- When comparing public firms vs. all private firms (both standalone and business groups), public firms have a higher EQ. However, when comparing public firms vs. private business groups only, private firms have a higher EQ.
- A notable exception to the rule is the United Kingdom, the most-developed market in Europe, where public companies prove to have more reliable earnings than private ones.

"In less-sophisticated capital markets, incentives to produce high-quality financial statements are not strong enough," explained Professor Zarowin. "Our research shows that public companies often over-report earnings to improve their short-term performance. Because of this trend, investors should be leery of public financial data in many European markets."

"US investors should look with more interest to private European companies," added Professor Bonacchi. "If policymakers want to reverse public firms' relatively low earnings quality, they should give more incentives (and more enforcement) to listed firms to report high-quality earnings, especially in less-developed markets."

"Unfortunately, the lack of available data in the private firms does not allow us to test the US setting," explained Professor Marra. "The United States has high-quality capital markets, but opportunistic reporting is prevalent there, so it is not clear whether similar results would be found."

The paper, "Organizational Structure and Earnings Quality of Private and Public Firms," was recently published in the September issue of the *Review of Accounting Studies*.

More information: Massimiliano Bonacchi et al, Organizational structure and earnings quality of private and public firms, *Review of Accounting Studies* (2019). DOI: 10.1007/s11142-019-09495-y

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