

# The Impact of Venture Capital Financing on Earnings Management and Earnings Quality

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## Abstract

This study expands the existing earnings management research by examining earnings data of private companies prior to and after receiving venture capital (VC) financing. Analyses are ran on a unique financial information database of 556 Belgian companies, receiving VC financing between 1988 and 1997. Each VC backed company is matched on size, industry and age with a non-VC backed company. Distributions of absolute earnings as well as earnings changes and univariate test-statistics suggest that VC backed companies manage earnings upward in the run-up to the VC financing. Additionally, multivariate regressions as in Teoh et al. (1998) confirm our univariate results, revealing a significant increase in discretionary current accruals levels up to the year of participation, followed by a significant reversal of these accrual levels in the post-investment years. Moreover, discretionary current accruals levels of the control sample are lower in the years prior to investment of their matched counterparts and are more stable in all observed years. This evidence is consistent with the signaling hypothesis stating that VC searching companies, on average, manage earnings upward to obtain financing more easily and/or at more favorable rates. Additionally, time-series regressions are applied to study differences in post-investment earnings quality. We show that the extent of earnings quality (i.e. timeliness of loss incorporation and degree of financial disclosure) is positively associated with the level of monitoring by VC investors. This evidence is consistent with our monitoring hypothesis: the closer VC financiers monitor their ventures after participation, the more this results in superior earnings quality of financial statement figures.

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