Private Equity Investments and Disclosure Policy

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Abstract

We investigate whether a firm's disclosure policy is affected by the changing corporate setting and intensified corporate governance associated with private equity (PE) investments.

First, we argue that a firm discloses more information to the outside world when raising PE finance. The information asymmetry problem that typically arises between a better-informed entrepreneur and outside PE investors gives rise to the lemons problem. In an attempt to resolve this problem, the best entrepreneurs signal their superior quality, and increased disclosure might be a valuable instrument to do so. Various studies have shown that financial figures are key determinants in screening and selecting portfolio companies, especially in Continental Europe. High quality entrepreneurs will showcase their financial reporting openness and professionalism to outsiders by increasing their disclosure levels. We therefore expect to find increased disclosure of financial information in the year before firms get PE.

Second, we argue that portfolio firms' disclosure policies are affected by PE investors' governance. This argument originates from the well-illustrated phenomenon that PE investors are close monitors of their portfolio firms. These monitoring efforts are particularly driven by the agency problem between PE investors and entrepreneurs-managers. As a response to this agency problem, PE investors are intensively involved in their portfolio firms' day-to-day activities and contract a substantial number of controls like cash flow and control rights contingent upon observed performance measures. This strong PE investor involvement results in a substantial change in governance and positively affects the professionalism the firm is operating with. We hypothesize that this intensified governance and professionalization is noticeable in the way financial reporting is conducted and, as such, is manifested in a higher disclosure of financial information to outsiders.

For a unique large hand-collected sample of Belgian unquoted firms receiving PE financing, we observe a significant switch to increased financial disclosure in the pre-investment year, consistent with the hypothesis that entrepreneurs attempt to reduce information asymmetries inherent to the PE application by increasing their disclosure levels. Further, we document that from the PE investment year onwards, the governance and professionalization impact of PE investors affects their portfolio firms' financial disclosure positively. Finally, differentiating on investor type (government versus non-government related) reveals no overall effect on disclosure, both in the pre- as in the post-investment years. Results are robust to various sensitivity checks.