**Disclosure Level and Cost Equity: A Theoretical Framework**

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**Abstract**

Nowadays the users of financial reports are more demanding and requesting better information of a company’s performance. With the sophistication in the business environment, disclosure is becoming more important to business communities. The impact of information disclosure in the annual reports to the cost of equity capital is of significant interest to managers. This paper review literatures from many theoretical papers and empirical studies the effect information disclosure on cost equity capital. Many theories being discuss in this paper such as agency cost theory, signaling theory, capital markets transaction hypothesis, and positive accounting theory. Many empirical studies proved that disclosure reduce cost equity capital by reducing the information asymmetry and increasing the companies’ liquidity.

Keywords: disclosure, cost equity, liquidity, agency cost, capital market

**1.0 Introduction**

Nowadays the users of financial reports are more demanding and requesting better information of the company’s performance. With the sophistication in the business environment, disclosure is becoming more important to business communities. The subjects of the timely and quality information are relevant to the business environment. Good disclosure will foster a healthy relationship of company performance and improve corporate governance. Some companies provide disclosure to differentiate their products and while others disclose accounting information to acquire external financing. As a result, large companies in Malaysia are especially concerned about the impacts of the disclosure which in turn might indicate their awareness (Hashim and Salleh*,* 2007, Abdullah and Ismail, 2008*)*. They are aware and concerned about the poor disclosure images when they communicate about them and thus become more sensitive to different pressure groups and legislators.

The extent of disclosure issues has been highlighted in corporate scandals such as WorldCom and Enron which had applied unethical ways to cheat the stakeholders of those companies, employees, creditors, the government and shareholders (Unermana and O’Dwyerb, 2004). Such misleading financial reporting has called for institution attention to reform corporate governance. In Malaysia, it has been observed that poor quality of disclosed information significantly affects the firm’s profitability and subsequently leads to an increase in legal and non-legal problems. The National Economic Action Council (NEAC) has recommended that the Malaysian capital market can be improved through transparency, accountability and corporate governance (Ghazali and Weetman, 2006). The Domestic Trade and Consumer Affairs Minister has stated that the outside investors’ confidence can be enhanced through a high quality of corporate reporting (Accountant Today, January, 2007).

During the Asian financial crisis in 1997, Malaysia revealed serious weaknesses in its corporate governance practice including the lack of transparency, disclosure and accountability (Rahman and Ali, 2006). The extent of disclosure and transparency information has been highlighted to aid in turning the quality of investment and external financing decision. (Ho and Wong, 2001, 2004). The Malaysian government has taken several steps in enhancing the investment climate by promoting capital fund growth. The steps included internalisation of the financial activity, deregulation of the financial markets, and rapid advanced in the technology for the Malaysia capital market (Wong, 2006). As of 31 December 2009, 974 companies have been listed in Bursa Malaysia and these numbers are expected to increase in the coming years (Bursa Malaysia, 2009).

The Malaysia Accounting Standard Board (MASB) encourages listed companies to provide more disclosure (Abdullah and Ismail, 2008). Under the Financial Reporting Standard 101, the companies are encouraged to provide a financial review and additional information in the annual report (FRS 101, Para 99, pp 40). Furthermore, Jaffar et al. (2007) stated that professional accountancy bodies have taken a number of measures to improve the quality of reporting. For instance, the National Annual Corporate Awards (NACRA) is organised together with the Malaysian Institute of Management (MIM), Malaysian Institute of Certified Public Accountants (MICPA) and Malaysian Institute of Accountants (MIA) to promote high quality and transparent financial reporting in Malaysia. The main objectives of the awards are to promote greater and more effective communication by organisations through the publication of timely, informative, factual and reader-friendly annual reports and to recognise and encourage excellence in the presentation of financial and business information.

Some studies have found that the disclosure is associated with liquidity (Abdullah and Ismail, 2008) and sales growth (Yau et al., 2009) for Malaysian companies. The empirical evidence of disclosure towards the companies’ performance can attract outside investors as an alternative investment opportunities (Suijs, 2007). Disclosures in the annual reports reduce information asymmetry to the outside investors and allow them to predict better future earnings (Lundholm and Myer, 2002). Healy and Palepu (2001) who had reviewed a paper on disclosure literature stated capital market transaction hypothesis as one of the factors the firms disclose more. They stated that firms that have the incentives to disclose more information could enjoy a lower cost of capital by reducing the cost associated to information risk. Prior studies show that the higher level disclosures have a significantly negative association to the cost equity capital (Botosan, 1997, 2000).

The Malaysian regulatory framework has emphasised companies to disclose more voluntary disclosure rather than compliance statutory regulation to create shareholder value and thus this could reduce the cost equity capital. For emerging markets, the voluntary disclosure can be viewed as a form of private ordering between companies and investors to arrange disclosure items and disclosure quality without recourse to formal legal institutions and lead to efficient capital market (Lin, 2009).

**2.0 Literature Review**

**2.1 Agency Cost Theory**

The agency problem arises in the firm when the owners or savers who invest their money in firms do not play an active role in the business management. The owners delegate their responsibilities to the managers to operate their business. The managers could lead to expropriating the owner’s fund in a firm for their own pockets. For example, if the owners or savers buy the shares of the firms, the managers can use that money from owners to acquire perquisites, pay excessive compensation and make investments or decisions that can harm the interest of the outside investors (Jensen and Meckling 1976).

 Healy and Palepu (2001) have suggested several ways to overcome this agency problem. First, the optimal contract between the managers and investors such as the compensation agreement and debt contract help to secure the interest of equity holders and the debt holders. These contacts require mangers to disclose relevant information. As a result, this will enable the investors to monitor the compliance of contracts to evaluate whether the managers manage the firm’s resources efficiently. The second mechanism is the board of directors who are appointed by the shareholders can monitor and discipline the management on the behalf of outside holders. For example, the outside directors should ensure the managements act accordingly to improve financial reporting quality (Cheng and Courtenay, 2006). Lastly, the financial analyst and rating agencies can act as information intermediaries to uncover misappropriation of management. This will lead to market corporate control such hostile takeover and proxy contest to mitigate agency problems between the insiders and outside investors.

The voluntary disclosure can also be considered to reduce agency cost resulting from the emergence of information asymmetry between the contracting parties. Disclosure information enables shareholders to monitor managers through monitoring and bonding activities. Watson et al. (2002) points out that those managers have the incentives to try and convince shareholders to act optimally and of the disclosure means of achieving this.

The agency costs may differ in the companies that have different corporate environments such as leverage, size and listing status. Ball and Foster (1982) explain that the highly leverage firms tend to disclose more information to satisfy the needs of the loan holders and trustees. This will reduce the uncertainty of outside investors towards highly leverage firms that disclose more and thus reduce the cost capital. This is also related to the firms’ size, when larger firms tend to employ more leverage to use higher amounts of fixed interest securities as a financing technique because of the tax advantages. Lastly, Ahmed and Courtis (1999) found that the listing firms have a positive association to the disclosure level because listing firms reflect their responsive corporate reaction to regulatory requirements for more information.

**2.2 Signaling Theory**

In economics, the signaling theory is precisely known as the contract theory which was developed by Spence (1973) to explain how the employee coveys the capabilities to his employer; but it can also help to explain company disclosure. According to Watson et al. (2002, page 291), “signaling is a reaction to informational asymmetry in market; in this case, the company has the information and not the investors.” The information asymmetry can be reduced when one party has more information signal to others. The managers in the high rating firms can differentiate their companies than lower rating firms by increasing the companies’ disclosure. In order for the signal to be successful, the information received by the recipient must be credible. The information is considered to be credible when the true quality of information is verifiable.

The role of information is important to signal an increase the firms’ securities price and this leads to a reduction in the cost equity of capital (Greenwald et al., 1984; Easley and O’Hara, 2004). Leland and Pyle (1977) explain the role of signals during the Initial Public Offering (IPO). They show that high rating firms should always send clear signals to the market when going public such as disclosing the firms’ financial strength, equity holdings, market portfolio and risk. To be reliable, the signal must be too costly to be imitated by their competitors or other companies. Without the signal sent to the market, the adverse selection problems appear in the market during the process of IPO.

A number of literatures have revealed corporate disclosure as a communication tool to signal the value of relevant information about future earnings. Gelb and Zarowin (2002) and Lundholm and Myers (2002) found that greater disclosure is associated with stock prices that are more informative about future earnings. Hussainey et al. (2003) and Schleicher and Walker (1999) found that the greater non-financial disclosures in the annual reports are associated to the stock market ability to better anticipate future earnings. Schleicher et al. (2007) found a positive relationship between narratives disclosure in the annual reports and share price anticipation of earnings for loss making firms. Hussainey and Aal-Eisa (2009) conducted a similar study and found the same results for the decline of earning growth firms.

**2.3 Capital Markets Transaction Hypothesis**

Healy and Palepu (1993. 1995) hypothesise that outside investors’ perception of companies are important to corporate managers to acquire leverage or to issue additional equity capital. Those corporate managers have superior information compared to outside investors regarding the companies’ future prospect since they are hired because they have expertise in managing the firms' investment and operating strategies. They gain this expertise through formal education, work experience in the industry, and investment in company-specific information. The information asymmetry between the managers and outside investors cannot be resolved and this will make it costly for the external financing (Myers and Majluf, 1984). The managers who anticipate making market capital transactions have the incentives to reduce the asymmetry problems by using disclosure strategy and subsequently the cost of capital will fall. Increase voluntary disclosures can help investors understand managers' business strategies.

The outside investors demand high expected require rates of return for bearing information risk when there is an information asymmetry between managers and the investors (Barry and Brown, 1985, 1986; Merton, 1987). Manager can enjoy lower cost of capital by reducing the information risk associated with higher voluntary disclosure in the annual reports. This disclosure does not lead to increased physical transactions costs but instead gives rise to a transfer of wealth across investors. However, this solution is not possible because of costs associated with credible information disclosure.

There are some empirical evidences that show the voluntary disclosure policies associated with the firms’ new capital. Lang and Lundholm (1993) examined cross-sectional variation in the analysts' published evaluations of firms' disclosure practices with firms’ characteristics. They found that the analyst’s rating disclosures were higher for firms issuing securities in the current or future period. In a subsequent paper, Lang and Lundholm (1997) examined the corporate disclosure activity around seasoned equity offerings. Beginning six months before the offering, the issuing firms dramatically increased their disclosure activity, particularly for the categories of disclosure over which firms have the most discretion. Finally, the firms that are associated with increases in analyst disclosure have an abnormally high frequency of subsequent public debt offers (Healy et al., 1999).

**2.4** **Positive Accounting Theory**

This theory predicts the managers’ actions for choosing the accounting policy when markets are in a semi-strong efficient form; there are significant costs in writing and enforcing the contracts and political costs arising out of the regulatory process (Watt and Zimmerman, 1978). The main idea of this literature is to explain the role of contracting and political consideration in explaining the manager accounting policies when there are agency and asymmetry problems. Two contracts are examined which are debt contracts (contract between company and its lender) and compensation contract (contract between the manager and shareholders).

The extent of whether managers change accounting policies or make accrual provisions to lower the cost of violating debts covenants written in the term accounting numbers, to increase the value of earning-based bonuses under compensation contracts, or to reduce the likelihood of implicit or explicit taxes has been tested in the empirical studies. Researchers found that companies that use accounting methods to manipulate earnings are small and have relatively high leverage. The companies’ accrual decisions appear to be affected by compensation contracts.

While most researchers of the accounting theory focus on the association between the compensation contracts and accounting policy, some of them view the choice of accounting policies as part of the contracting processes itself. Several researchers argue that the use of the accounting information in lending and compensation contract should be viewed as endogenous (Holthausen and Leftwich, 1983; Watts and Zimmerman, 1990; Smith and Watts, 1992; Skinner 1994). As a result, the optimal compensation contract and accounting policy are influenced by the types of companies’ assets and its investment opportunities. Watts and Zimmerman (1983) examine the role of the voluntary interim reporting as an ex ante contracting to prevent management opportunistic behaviours. The role of ex ante in the contraction process is also examined by other researchers (Zimmer, 1986; Christie and Zimmerman, 1994; Skinner, 1994).

It is difficult to interpret empirical accounting theory because there are several regularities regarding the companies’ accounting policies (Holthausen and Leftwich, 1983; Watts and Zimmerman, 1990). One of the examples is that the size is viewed proxy for political sensitivity. However, this could also be viewed for other proxies such as accounting policies, oil and gas industry and others. Also, as Healy and Palepu (1990) and DeAngelo et al. (1996) viewed, the management’s accounting decision for distress firms with highly leverage may in part reflect to preserve cash and change in investment opportunities.

**2.5 Disclosure Level and Cost Equity Capital**

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ENHANCE PUBLIC DISCLOSURE

Reduced information asymmetry between investors

Reduced information asymmetry between managers and investors

 Increased market liquidity for securities

 Reduced estimation risk

REDUCED COST of EQUITY CAPITAL

**Figure 2.1 Disclosure Benefit Framework** (Botosan, 2000)

Disclosure has been widely used by management to communicate firm information to the outside investors. Most of the theories relating to disclosure predict a negative relationship between the disclosure and the cost of capital (Healy and Palepu, 2001). Some of the empirical findings suggest that increased disclosure reduces firm’s cost of capital by reducing the information asymmetry (Diamon and Verrecchia, 1991; Botosan 1997). There are two streams of studies that support the negative relationship between the disclosure level and the cost of capital. The first stream is represented by Amihud and Mendelson (1986) and Diamond and Verrecchia (1991), who have stated that the firm’s securities have a higher cost of equity capital with the bid-ask spreading more on asset pricing because investors demand compensation for the added transaction cost. The adverse selection component and cost of equity can be reduced by disclosing more of the firm’s information. When the investors have more precise information, they are willing to place a large order in a particular firm’s stock than they otherwise would. This will result in a high demand for the firm’s securities which will increase the firm’s stock price with a reduced cost of capital.

The second stream of theoretical research suggests that the increased disclosure can reduce estimation of risk pertaining to the parameter of the payoff distribution for a firm (Barry and Brown, 1985; Clarkson et al., 1996). Klein and Bawa (1976) were the first researchers who used the estimation risk in their study and this was then followed by Barry and Brown (1985), Handa and Lin (1993), Clarkson et al. (1996), and others.

These researchers estimated the parameters of return distributions based on the economic data of a firm. The economic data of a firm includes the firm’s return history and other information about the firm. Barry and Brown (1986) and Handa and Linn (1993) used the Bayesian model to extract information available concerning securities to determine the uncertainty of the true parameter of the payoff distribution for the firm. They concluded that the estimation risk cannot be diversified away when there is a variation of information across assets. This risk differs from the traditional Capital Asset Pricing Model (CAPM) formula to estimate market beta where beta is known to investors.

There are relatively empirical studies towards the effects of the disclosure of information on the cost equity capital. Botosan (1997) examined a direct association between the disclosure level and the cost equity capital for 122 firms in the manufacturing industry. She constructed her own disclosure index to be used as a proxy for the disclosure level. She found little evidence of association between the level of information disclosure and the cost of cost of equity capital. However, she documented that the firms that had a low analyst’s following had a strong negative association between the level of information disclosed and the cost equity capital. Hail (2002) conducted a similar study by using 27 items of disclosure by the Swiss Banking Institute as a proxy for disclosure level of information. He found a negative association between the disclosure level and the cost of equity capital for 73 non-financial firms listed on the Swiss Exchange.

Botosan and Plumlee (2002) used the Association for Investment Management and Research (AIMR) disclosure rankings which were annual report disclosures, other publication disclosures (timely in nature) and investor relations activities to find evidence in the association towards cost equity capital. They found that the greater the annual report disclosures the cost equity of capital decreased, but the more timely disclosure of information increased the equity capital. They did not find any evidence of association between the investor relations activities and the cost equity capital. Relating to the role of quality information, Easley and O’Hara (2004) demonstrated that the quality of information could affect the asset’s price and the cost equity capital. The more precise the public (private) information, the cost of equity capital decreased (increased) (Batosan et al., 2004).

**3.0 Conclusion**

Economic theories suggest that any increase in the disclosure of information reduces the firm’s cost of capital. The positive accounting theory explains that managers use information disclosure as investment opportunities for the firms. This supports many other theories such as stock compensation hypothesis, management signaling hypothesis, capital markets’ transaction hypothesis and other theories that increase disclosure and reduce information asymmetry for the outside users. These will increase the security value by preventing a disvalue and any adverse selection problems of the securities. Under the agency theory, the disclosure helps mangers to reduce the agency costs between the management and shareholders and the shareholders and debt holders.

Specifically increasing voluntary disclosures in the annual reports serve to the reduce information asymmetry between the managers and investors and thus reduces the companies’ cost equity capital. Theoretically, the reduction of information asymmetry can reduce the cost of equity capital in two ways. First, the investors demand a risk premium of the information risk. An increase in the disclosure information reduces the information risk, which in turn reduces the risk premium effectively causing a lower cost of equity. As a result, the information disclosure lowers the transaction cost of investors by increasing the liquidity of the market and the demand of the firms’ securities. Second, the level of disclosure reduces uncertainties of the outside investors regarding the true parameters of the payoff distribution for the firm. Most of the researchers found that firms that disclosed more information benefitted in the reduction of the cost of equity capital by reduce information asymmetry and increase market liquidity.

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