Relationship between Cost of Equity Capital And Voluntary Corporate Disclosures

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Abstract

The relationship between disclosure and cost of equity capital has always been interesting not only for managers, but for investors as well. Economic theory suggests that by increasing the level of corporate reporting firms not only increase their stock market liquidity, but they also decrease the investors' estimation risk, arising from uncertainty about future returns and payout distributions. Utilizing the Residual Income Valuation Model, the implied cost of capital is estimated for a sample of 121 Swiss listed, non-financial companies adopting a finite horizon version of the residual income valuation model. The results show that firms on the Swiss market can reduce their cost of equity capital by increasing the level of their voluntary corporate disclosures. The results persist even after controlling for various firm specific risks, such as firm size or financial leverage and regardless of company's reporting strategy (conservative or aggressive).

Keywords: Equity capital, Corporate disclosure, Swiss companies, Residual income valuation model, Accounting policy

1. Introduction

Understanding the relationship between the level of voluntary corporate disclosures and the cost of equity capital has always been interesting not only for managers, but also for investors. Prior theoretical work on asset pricing (Botosan, 1997) suggests that disclosure policy is negatively associated to a firm's cost of equity capital. In general, two literature streams support the negative relationship of increased disclosures to cost of equity financing. One is based on the improved stock market liquidity (Demsetz, 1968; Copeland & Galai, 1983; Glosten & Milgrom, 1985; Amihud & Mendelson, 1986; Diamond & Verrecchia, 1991); the other relies on the reduced non-diversifiable estimation risk (Botosan, 2006; Barry & Brown, 1985; Coles & Loewenstein, 1988; Handa & Linn 1993)

The former stream argues that if companies disclose more corporate information, they would also attract more long term investors. This in turn will positively influence the market price and the marketability of the firm's stock, thus reducing company's cost of equity financing. The latter strand focuses on investors' estimations of future cash flows. When determining the present value of their investments, investors focus on disclosed information to forecast