Available online at www.sciencedirect.com
ScienceDirect
The International Journal of Accounting 45 (2010) 443–464
The International Journal of Accounting

Disclosure and cost of equity capital in emerging markets: The Brazilian case

Alexsandro Broedel Lopes [a,*,1], Roberta Carvalho de Alencar [b]

[a] *University of São Paulo and Securities and Exchange Commission of Brazil, Brazil*
[b] *University of São Paulo, Brazil*

Received 2 July 2008

Abstract

In this paper, we conjecture that the weak association between disclosure and cost of equity capital found in the literature (Botosan, 1997) can be caused by the high-level corporate disclosure environment found in the United States. We hypothesize that in low-level corporate disclosure environments the variability in disclosure practices across firms will be larger than in the United States, and, consequently, the marginal effect of voluntary disclosure policies will be higher. Using a newly developed Brazilian Corporate Disclosure Index (BCDI), our results confirm this hypothesis. Disclosure is strongly associated with ex ante cost of equity capital for Brazilian firms. The results are more pronounced for firms with less analyst coverage and low ownership concentration, as expected.

JEL classification: M41; G30
Keywords: Disclosure; Cost of capital; Financial accounting; Emerging markets; Brazil

1. Introduction

There is an important strand of the financial accounting literature that investigates the relation between disclosure and cost of equity capital (Botosan, 1997; Botosan & Plumlee, 2002; Hail, 2002; Francis, Khurana, & Pereira, 2005; Chen, Chen, & Wei, 2003). The basic

* Corresponding author.
E-mail address: Broedel@usp.br (A.B. Lopes).
[1] Disclaimer: This paper does not reflect any official position of the Securities and Exchange Commission of Brazil.

0020-7063/$ - see front matter
doi:10.1016/j.intacc.2010.09.003

idea is that higher levels of disclosure contribute to a reduction in information asymmetry between managers and investors and, consequently, cause a reduction in the idiosyncratic component of cost of equity capital (Verrechia, 2001; Diamond & Verrechia, 1991). However, results of these investigations have not been conclusive (Botosan, 1997). Some authors (e.g., Hail, 2002) argue that the absence of statistical and economically significant associations between disclosure and cost of capital can be the result of measurement problems because both variables are not directly observed and proxies need to be used. In this paper, we investigate another possibility. We conjecture that the weak relation between firm-level disclosure measures and cost of equity capital is not significant in the United States because the overall disclosure level is already high and firm-level actions do not have a significant marginal impact.

Consequently, the weak association between disclosure and cost of capital observed in the United States may result from low variation in disclosure levels because the mandatory disclosure threshold is already high. We believe that firms' actual disclosure policies depend on their incentives. However, incentives only play an important role if the firm's chosen level of disclosure is superior to the minimum level required by the market regulator. If the firm's policy put its disclosure level below the minimum required level, then it has to be increased by force of regulation. Thus, if the minimum disclosure level is already high, many firms will not adopt their optimal policies and instead will adopt the minimum level. Consequently, the disclosure variation will be reduced in the whole sample of firms. Conversely, in environments where the required minimum disclosure level is not so high, it is more likely that firms will present a higher cross-sectional variation in actual (adopted) disclosure policies. Based on prior research (Lopes & Walker, 2008), this high variation in disclosure levels is what we expect to see in Brazil.

One could argue about the relevance of a single-country analysis. Recent cross-sectional studies (Francis et al., 2005) investigated the relation between disclosure indexes and cost of equity capital for a sample of firms extracted from 34 countries. We believe that more detailed within-country studies can complement the results of cross-country investigations. We believe there is considerable sample selection bias in the databases used in recent work. In Francis et al. (2005), for example, only 10 Brazilian firms are covered and there is no discussion about sample selection procedures and representativeness. Other studies that investigate corporate governance arrangements across a large number of firms have the same problem. Doidge et al. (2007) consider only 28 Brazilian firms of which 14 are cross-listed. Lang, Raedy, and Wilson (2006) only consider 1 Brazilian firm. We believe these small and biased samples can compromise the results.

To investigate our hypothesis, we built a detailed disclosure index and applied it to a more representative sample of firms listed in Brazil. To proxy for disclosure, we built the Brazilian Disclosure Index (BCDI), which measures disclosure across 6 components and 47 specific attributes. The index is applied to the 50 most liquid shares traded on the São Paulo Stock Exchange (BOVESPA) for the years 1998, 2000, 2002, 2004, and 2005. Our sample is very close to the Bovespa Index, which is composed of the most liquid shares. The index is based on a set of questions used in previous research (Botosan, 1997; Francis et al., 2005) and adaptations to reflect Brazilian regulations and accounting standards. Table 1 features the questionnaire and the percentage of positive answers. Our questionnaire was not sent to the firms or to analysts; rather, it is based on objective answers obtained from public sources of information — annual reports, websites, BOVESPA filings, and the files obtained from the