The value relevance of disclosure: Evidence from the emerging capital market of Egypt

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Abstract

This study examines the value of voluntary and mandatory disclosure in a market that applies International Accounting Standards (IAS) with limited penalties for non compliance. The lack of enforcement creates an element of choice in the level of mandatory disclosure by companies. Using panel-data analysis, our empirical results show that, after controlling for factors such as asset size and profitability, mandatory disclosure has a highly significant but negative relationship with firm value. This result, although puzzling from a traditional perspective, is consistent with the predictions of analytical accounting models, which emphasize the complex interplay of factors determining disclosure effects. Our results also show that voluntary disclosure has a positive but insignificant association with firm value. This lack of statistical significance supports the view that there is a complex interplay of different factors determining the relationship between disclosure and firm value.

Keywords: Disclosure; Firm value; Cost of capital; Economic consequences; Egypt

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1. Introduction

Prior studies about the economic consequences of disclosure generally focus on voluntary disclosure and are mostly conducted in developed markets such as the United States, where strong enforcement mechanisms exist. In this context, companies tend to comply fully with mandatory-disclosure requirements and reveal additional information to the public on a voluntary basis. Empirical results on disclosure are generally consistent with finance-theory predictions that more public information enhances firm value by reducing the firm’s cost of capital, or increasing the cash flows that accrue to shareholders, or both. In addition, they suggest that the type of disclosure is crucial to any analysis as the market responds differently to different types of disclosure (Botosan & Plumlee, 2002). Prior studies, however, focus either on investigating the link between voluntary disclosure levels and stock liquidity (see for example: Healy, Hutton, & Palepu, 1999; Leuz & Verrecchia, 2000), or on testing the link between voluntary-disclosure levels and a proxy for the cost of equity capital (see for example: Botosan & Plumlee, 2002; Hail, 2002). There is little direct empirical evidence with regard to the relationship between voluntary disclosure and firm value in general and for emerging markets in particular.

Perhaps surprisingly, the literature on the economic consequences of mandatory disclosure is limited and somewhat ambivalent in its conclusions (Bushee & Leuz, 2005; Healy & Palepu, 2001). The effects of mandatory-disclosure requirements are potentially complex, since companies can respond to the imposed costs in various ways. As Bushee and Leuz (2005: 2–8) emphasize, if disclosure regulation means both mandatory-reporting obligations and the enforcement of these obligations, then companies can choose to comply with the mandatory regulations, trade in a different market, go private, or not seek a stock market listing. The impact of mandatory disclosure can be divided into direct and indirect effects. Direct effects arise from the cost of compliance with mandatory disclosure. Such costs may be sizeable if firms’ information systems need to be changed to gather additional data, if audit fees rise, or if the publication costs of annual reports increase.1 There are also indirect effects associated with mandatory disclosures arising from externalities. These externalities can be positive or negative and the question about whether the net externality is positive or negative is fundamentally an empirical matter (Bushee & Leuz, 2005: 237). A typical, positive externality in a perfectly competitive market could arise from increased liquidity and reduced costs of information, where a number of (compliant) companies could be used by investors as guides to assess the performance and risk of other firms. However, if markets are imperfectly competitive then increased disclosure can attract investors away from other firms, resulting in lower price efficiency. For example, if traders face additional costs in studying a firm’s disclosures as well as the extra costs of learning about a firm’s industry, then traders may face lower costs when studying firms in the same industry. In such a case, both positive and negative externalities may be present. When one firm spends

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1 For example, Bushee and Leuz (2005) show that when a regulatory change mandated that companies listed on the Over-The-Counter Bulletin Board (OTCBB) should comply with reporting requirements under the 1934 Securities Exchange Act, over 2600 (or 76%) firms did not disclose the required information and hence were removed from the OTCBB. Thus, for most of their sample firms, the costs of compliance with newly introduced mandatory disclosure appeared to outweigh the benefits and companies chose to exit the market.
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