



Cost of capital and earnings transparency[☆]



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ABSTRACT

We provide evidence that firms with more transparent earnings enjoy a lower cost of capital. We base our earnings transparency measure on the extent to which earnings and change in earnings covary contemporaneously with returns. We find a significant negative relation between our transparency measure and subsequent excess and portfolio mean returns, and expected cost of capital, even after controlling for previously documented determinants of cost of capital.

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1. Introduction

This study provides evidence that firms with more transparent earnings enjoy a lower cost of capital. Firms with more transparent earnings are those whose earnings better reflect changes in the economic value of the firm. We operationalize transparency by developing a measure based on the explanatory power of the returns-earnings relation, i.e., the extent to which earnings and change in earnings covary contemporaneously with stock returns. We find that firms with more transparent earnings have a lower cost of capital as reflected in subsequent excess returns and portfolio mean subsequent returns. We also find that firms with more transparent earnings have a lower expected cost of capital. Our findings are based on tests that include controls for growth and other firm fundamentals that are known to be associated with cost of capital.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) state that a key purpose of financial statements is to improve decision-making by investors, lenders, and other providers of capital. To the extent that a firm's financial statements, including its earnings, are more transparent, uncertainty regarding the value of its equity may be lower, and therefore it will enjoy a lower cost of capital. Arthur Levitt, former chairman of the Securities and Exchange Commission (SEC), embraces this notion by suggesting that “high quality accounting standards ... improve liquidity [and] reduce capital costs.”¹

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¹ Remarks by Arthur Levitt, Inter-American Development Bank, September 29, 1997.

We predict that earnings transparency is negatively associated with cost of capital. The basis for our prediction is the well-established positive relation between information asymmetry and cost of capital and our expectation that earnings transparency is negatively associated with information asymmetry. We expect a negative relation between earnings transparency and information asymmetry because when earnings transparency is low, some investors will engage in private information acquisition. Acquiring information about a firm's economic value beyond that reflected in earnings—which is low cost information about firm value—is costly. When this cost varies across investors, investors will differ in the extent to which they acquire information, which contributes to information asymmetry. Also, information asymmetry among investors can vary across firms such that it is negatively associated with transparency if investors' marginal acquisition costs are higher when there is less information about firm value beyond that reflected in earnings. However, ultimately it is an empirical question whether transparency is cross-sectionally negatively associated with information asymmetry. To the extent that earnings transparency is not negatively associated with information asymmetry, we will be unlikely to find a significant negative relation between earnings transparency and cost of capital.²

We base our measure of earnings transparency on the explanatory power of the returns-earnings relation because the relation measures the extent to which earnings captures changes in firm value. The intuition is that the higher is the explanatory power, the more earnings captures changes in firm value. Although investors can obtain information about changes in firm value from earnings or from other sources, our measure reflects only the extent to which earnings and change in earnings, and information correlated with earnings and change in earnings, explain returns.

Because both earnings transparency and cost of capital can differ across firms and vary over time, we base our earnings transparency measure on only current information and design the measure to permit cross-sectional and intertemporal variation. We permit intertemporal variation in our measure by estimating annual returns-earnings relations because there are several sources of intertemporal variation in earnings transparency that we expect to lead to economically meaningful variation in the cost of capital. One source is changes in accounting standards. We permit cross-sectional variation by exploiting industry and industry-neutral commonalities among firms in the returns-earnings relation, where industry-neutral commonalities are commonalities unrelated to the firm's primary industry. To exploit industry commonalities, we estimate annual returns-earnings relations by industry. To exploit industry-neutral commonalities, we estimate annual returns-earnings relations by quartile portfolios based on the residuals from the industry estimations. These portfolio estimations capture cross-sectional differences in the returns-earnings relation that are not captured fully by industry estimation. The portfolios are industry-neutral because each portfolio has the same industry composition. Our earnings transparency measure for each firm-year is the sum of the explanatory powers from that firm-year's returns-earnings industry and industry-neutral relations.

Application of accounting standards can result in variation in the explanatory power of the returns-earnings relation reflecting variation in earnings transparency as well as variation in firm fundamentals known to be related to cost of capital. For example, earnings captures poorly changes in firm value for growth firms because changes in internally generated intangible assets and growth options are not recognized in earnings. As a result, earnings of high growth firms are not transparent and high growth firms will have low explanatory power in the returns-earnings relation. However, growth is known to be associated with cost of capital regardless of whether earnings of high growth firms lack transparency. As a result, variation in our earnings transparency measure is likely correlated with intertemporal changes and cross-sectional differences in firm fundamentals such as growth. Therefore, detecting a relation between our earnings transparency measure and cost of capital could be attributable to earnings transparency or such firm fundamentals. To address this possibility, our tests include controls for growth and other firm fundamentals that are known to be associated with cost of capital.

If greater earnings transparency is associated with lower cost of capital, we should observe a negative relation between our earnings transparency measure and subsequent returns. We test whether this is the case using two approaches. The first tests for a relation between earnings transparency and subsequent excess returns, and the second tests for a relation between earnings transparency and portfolio mean subsequent returns. In our excess returns tests, we estimate cross-sectional relations between our earnings transparency measure and firms' subsequent returns in excess of returns predicted based on the Fama-French and momentum factors, which reflect known determinants of cost of capital. In our portfolio mean returns tests, we sort firms into portfolios based on our earnings transparency measure and test whether, after controlling for the Fama-French and momentum factors, mean returns are lower for higher transparency portfolios. If greater earnings transparency is associated with lower cost of capital, we also should observe a negative relation between our earnings transparency measure and a proxy for expected cost of capital. To test this, we estimate cross-sectional relations between our measure of earnings transparency and a proxy for expected cost of capital based on the Fama-French and momentum factors. We conduct our tests using a large sample of US firms over a 27-year period.

We find that our earnings transparency measure is significantly negatively related to subsequent excess and portfolio mean returns, which indicates that earnings transparency explains subsequent returns incremental to the Fama-French and momentum factors. We also find that our earnings transparency measure is significantly negatively related to our proxy for expected cost of capital, which indicates that earnings transparency and the combination of the Fama-French and

² Section 5 provides evidence that our earnings transparency measure is negatively associated with measures of information asymmetry used in prior research, which is consistent with the transparency measure reflecting intertemporal and cross-sectional variation in information asymmetry.

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