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Cost of Capital for Exempt Foreign Private Issuers: Information Risk Effect or Earnings Quality Effect? It Depends☆

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Abstract

We examine whether the information risk accompanying Foreign Private Issuers' (FPIs) exemptions from the U.S. Securities and Exchange Commission (SEC) reporting requirements is associated with capital market penalties (measured by a higher cost of equity capital) and, further, the extent to which this information risk is mitigated by earnings quality. Our overall results indicate that exempt FPIs exhibit a higher cost of equity capital than reporting FPIs, and this relation still persists after controlling for earnings quality. Furthermore, we partition our sample into firms from strong and weak investor protection environments. Interestingly, similar to the results in Francis et al. (2008), for FPIs from strong investor protection regimes we find no difference in the cost of capital between exempt and filing FPIs, even after controlling for earnings quality. To the contrary, for FPIs from weak investor protection regimes, we find that the exemption is associated with a higher cost of equity capital, and that earnings quality does not significantly reduce the premium paid by these issuers.

JEL classifications: G300; L210; M410
Keywords: Cost of capital; Information risk; Financial disclosure quality; Earnings quality; Bonding; Cross listing; SEC 1934 Exchange Act; Rule 12g3-2(b) exemption; Foreign private issuers

☆ Data availability: The data are available from public sources identified in the text.
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1. Introduction

Foreign companies that want to access capital in the United States (U.S.) must register with the Securities and Exchange Commission (SEC) pursuant to Rule 12(g) of the Exchange Act of 1934.[1] Section 13 of this Act identifies the extensive and costly reporting requirements for foreign private issuers (FPIs)[2] cross-listing their shares in the US.[3] Rule 12g3-2(b) of the Exchange Act provides exemptions from the periodic reporting requirements of Section 13 for FPIs that meet certain thresholds[4] or that are not listed on a major stock exchange (Mahoney, 2009). Issuers that request and are granted an exemption disclose significantly less information to U.S. capital market investors and offer fewer enforcement remedies to investors than do issuers that report to the SEC pursuant to Section 13.

Previous theoretical research generally predicts that firms with lower information risk (i.e., higher quality disclosures) will be associated with a lower cost of capital (Diamond & Verrecchia, 1991; Easley & O'Hara, 2004; Lambert, Leuz, & Verrecchia, 2007). However, empirical evidence on this association is mixed (Bhattacharya, Ecker, Olsson, & Schipper, 2012; Botosan & Plumlee, 2002; Francis, Nanda, & Olsson, 2008; Kim & Shi, 2011). Even more importantly, the available evidence is limited to samples of only U.S. firms. In this paper, we seek to provide empirical evidence of the association between information risk and cost of capital using a sample of international firms from over 50 countries.

Furthermore, in a recent paper, Francis et al. (2008) examine the relations among voluntary disclosure, earnings quality and cost of capital for a sample of 677 U.S. firms, and find that while more voluntary disclosure is associated with a lower cost of capital, the negative association between disclosure and cost of capital becomes insignificant after controlling for earnings quality. Our study examines whether this more "primitive" effect of earnings quality on cost of capital extends to firms from countries outside the U.S., using a sample of international FPIs, which previous literature indicates to be characterized by within-sample differences in earnings quality (Gotti & Mastrolia, 2012a).

However, when examining firms from multiple countries, the relations among the cost of capital, information disclosure, and earnings quality may be different for FPIs from strong versus weak home-country investor protection regimes (Habib, 2007). For this reason, we also partition our sample between FPIs from strong versus weak home-country investor protection regimes and separately test the relations among the cost of capital, information risk, and earnings quality for each subsample.

Our sample includes all FPIs that are either exempt or reporting to the SEC from 2000 to 2006.[5] We estimate the cost of equity capital using the issuer's implied expected rate of return (Easton, 2006; Easton, Taylor, Shroff, & Sougiannis, 2002; O'Hanlon & Steele, 2000). In the additional analyses section, we also calculate each sample firm's annual ex-post return to equity investors and the total cost of capital using the weighted average cost of the equity and debt capital (WACC).

[1] Release No. 34-51893; International Series Release No. 1291.

[2] See the definition of foreign private issuer at Exchange Act Rule 3b-4(c) (17 CFR 240, 3b-4(c)).

[3] These reporting requirements include supplying a Form 20-F each year to the SEC; a Form 20-F offers investors a great deal of financial and operational information in a common format.

[4] Under Rule 12g3-2(b), FPIs can request an exemption if they have total assets of less than $10 million, more than 500 owners worldwide, and less than 300 owners in the United States.

[5] The list of exempt FPIs has not been released by the SEC after this date.