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The Effect of Firm Size and Rate of Inflation on Cost of Capital: The Role of IFRS Adoption in the World

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Abstract

The objective of this research is to examine the role of IFRS adoption in the relation between firms' size and rate of inflation on cost of capital. Using a sample of 880 firm-year observations from 31 countries. This research finds that there is no evidence IFRS adoption has positive impact to reduce the cost of capital. This result shows listed firms in NYSE already made financial statement with complete information in a good quality standard. Since the firms should pay switching cost to change their financial statement's standard and countries need to make concurrent effort to improve their legal enforcement.

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Keywords: firms size, rate of inflation, IFRS adoption and cost of capital.

1. Introduction

Funding structure decisions have a significant role for company's financial management since it may result in a rate of return and future risk (Kumaladewi, 2011). This is a decision that minimizes the cost of capital to be borne by the company. Companies that have external funding needs will face obstacle regarding the high cost of capital by investors as a form of future risk due to market uncertanty (Kumaladewi, 2011). Komalasari and Baridwan (2001) examines the relationship between asymetry information and cost of capital, and they find there is a positive relationship between asymmetry information and cost of capital, low asymmetry information would reduce cost of capital.

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This issue arises due to incomplete financial statement disclosure, so there are some investors who do not understand some information from the company.

Grouping firms based on scale of the operation can be used by investors as one of the factors that determine investment decisions. Large companies generally have large total assets, so it would attract investors to invest as large companies have greater expected return and greater expected risks. In addition, creditors also have more confidence to lend their money into large companies because credit defaults will be smaller. On the one hand, companies have to compete for investment capital from investors, but the other macroeconomic conditions that occur in a country cannot be avoided, so it may affect transactions in the stock market or the capital market. Macroeconomic conditions are closely related to the current pattern of investment, one of which is the rate of inflation. Another factor that affects the cost of capital is the adoption of international financial reporting standards (IFRS). Saudagaran (2001) suggests the adoption of IFRS could enhance the comparability of financial statements; enabling multinational corporations transcend national boundaries. Capital requirements between large firms and small firms are different, because they depend on the operating activities of the company. Companies listed on the New York Stock Exchange (NYSE) are a company that has been at the top level. In a sense, higher total assets, financial audit teams using international auditors, as well as the preparation of the financial statements are at least using standards-based local American standards (U.S. GAAP).

However, despite the fact that all of the companies on the NYSE are big companies, there is a difference in total assets. Sun, Cahan, and Emanuel (2011) revealed that the local standard of America (GAAP) already has high quality standard, so that the role of IFRS adoption on enhancing earnings quality is not proven to be statistically significant on cross listed firms in U.S. stock markets. However, many previous studies such as those conducted by Li (2010) which state that mandatory IFRS adoption has lower the cost of capital significantly in the amount of 47 basis points. While the results of the study Daske, Hail and Leuz (2008) examined the effect of mandatory IFRS adoption on economic consequences, market liquidity, Tobins' q, and cost of capital in 26 countries. The evidence is that market liquidity increased after IFRS adoption, but the findings do not obtain evidence that IFRS adoption reduce cost of capital and increase capital assessment. This indicates that the role of IFRS still needs to be reobserved. This study examines the role of IFRS as an international standard that has been widely used by multinational companies to the relationship between firm size and rate of inflation on cost of capital.structure

2. Hypothesis.

2.1 Firm Size

According to Brigham and Houston (2001), a rapidly growing company must rely more on external capital. Bringham and Houston (2001) also revealed that the factors that generally affect the capital decisions are firm size, business risk, asset growth, profitability and ownership structure. Banz (1981) stated that small firms have a higher rate of return when compared to large firms, since small firms have a higher risk when compared to larger companies, so investors will demand a higher rate of return on small firms. Bhojraj and Sengupta (2003) stated that the bigger companies will have higher bond ratings due to low market risk that will reduce yield. In line with Khurana and Raman (2003) who obtain evidence of a significantly negative relationship that exists between the sizes of firms with bond yields. The company having greater total assets will offer a low yield or small because large-scale enterprises have a small risk compared to smaller companies. In addition, the company having greater total assets have good prospects in a relatively long period of time is more stable and more capable of generating profits than firms with total assets lower. Thus the first hypothesis is formulated as follows:

H1: Firm size is negatively related to cost of capital.

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