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Discussion of "Financial reporting frequency, information asymmetry, and the cost of equity" ☆

Rodrigo S. Verdi *

MIT Sloan School of Management, 100 Main Street, E62-666, Cambridge, MA 02142, United States

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ABSTRACT

Fu, Kraft and Zhang (2012) use a hand-collected sample of firms with different interim reporting frequencies from 1951 to 1973 to test whether higher reporting frequency is associated with lower information asymmetry and a lower cost of equity capital. Their results suggest that firms with higher reporting frequency (e.g., firms reporting quarterly as opposed to annually) have lower information asymmetry and a lower cost of equity capital. In this discussion, I expand on FKZ by elaborating on their hypothesis development and research design, and providing suggestions for future research.

1. Introduction

Fu, Kraft and Zhang (2012, FKZ hereafter) use a hand-collected sample of firms with different interim reporting frequencies from 1951 to 1973 to test whether higher reporting frequency is associated with lower information asymmetry and a lower cost of equity capital. Their research design is comprehensive in terms of the proxies used to capture theoretical constructs and the estimation techniques. Specifically, they use price impact and the bid-ask spread as proxies for information asymmetry; realized returns, expected returns based on CAPM and the Fama-French three-factor model, and earnings-to-price ratios serve as proxies for the cost of equity capital. In addition, they use four different estimation methodologies—OLS, firm fixed-effects, 2SLS, and a matched sample. Overall, their results provide strong evidence that firms with higher reporting frequency (e.g., firms reporting quarterly as opposed to annually) have lower information asymmetry and a lower cost of equity capital.

In this discussion, I expand several aspects of FKZ. In Sections 2 and 3, I discuss FKZ's contribution to the existing literature and discuss some distinctions between the predictions regarding information asymmetry vis-à-vis the cost of equity capital. I then turn to empirical issues. In Section 4, I discuss the advantages and limitations of FKZ's setting, highlight some key aspects of their different research methodologies, and discuss FKZ's results and the inferences that can be drawn from the paper. In Section 5, I suggest some avenues for future research in this area. Section 6 concludes.

2. Relevance to the literature

FKZ study the impact of reporting frequency on information asymmetry and the cost of equity capital. One important challenge for their paper is to establish a contribution beyond the extensive literature that studies the economic consequences of (i) reporting *quality* and/or (ii) *disclosure* frequency with respect to information asymmetry/cost of capital.

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* Tel.: +1 617 253 2956.
E-mail address: rverdi@mit.edu

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In terms of reporting *quality*, at the theoretical level the distinction between reporting quality and reporting frequency is subtle. That is, in the majority of cases the theoretical predictions are very similar as long as both reporting frequency and reporting quality reduce uncertainty about firm value (e.g., Leuz and Verrecchia, 2000, footnote 1). Further, increasing reporting frequency also implies, almost by definition, increasing reporting quality (weakly), as investors could always ignore the additional (interim) reports and rely on the annual report. Thus, at the theoretical level the distinction between reporting frequency and reporting quality is small, and the empirical evidence on the economic consequences of reporting quality is fairly exhaustive (Botosan, 1997; Leuz and Verrecchia, 2000; Francis et al., 2004, 2005; Core et al., 2008; Ng, 2011; among others).

As for *disclosure* frequency, prior literature focuses on increases in the frequency of voluntary disclosure such as management forecasts (e.g., Brown et al., 2005; Van Buskirk, 2012) whereas this paper studies increases in mandatory financial reporting frequency. This is akin to the literatures that study disclosure quality and reporting quality separately. While one would expect voluntary and mandatory disclosure to be related, empirical evidence on this topic is still an open issue (e.g., Francis et al., 2008).

Thus, a quick read of FKZ might give the impression that the evidence in their paper is already known in the literature. However, despite the similarities, I believe FKZ investigate an important and unique setting that has relevant implications for academics and standards setters. Specifically, several countries still require only annual reports and could consider increasing the required reporting frequency. Thus, the question studied in FKZ is relevant and can contribute to this debate. For example, it is unclear whether a firm can achieve the economic benefits documented in FKZ simply by improving reporting quality without changing its reporting frequency (e.g., by reducing earnings management while reporting annual earnings). Similarly, it is unclear whether increases in disclosure frequency via other disclosure channels would yield the same outcomes documented in FKZ (e.g., by reporting annually but issuing monthly or quarterly guidance). Thus, I find the evidence in FKZ yields implications not otherwise found in the literature.

3. Hypothesis development

With regard to hypothesis development, there are two aspects of FKZ's hypotheses that deserve more discussion. The first is the relation between reporting frequency and information asymmetry with an emphasis on short-term vs. long-term effects. The second involves the conceptual differences between the effects of reporting frequency on information asymmetry vs. the cost of capital.

The paper's first hypothesis focuses on the relation between reporting frequency and information asymmetry. FKZ motivate the tension in this hypothesis based on the literature that allows private information acquisition and processing to be endogenous to financial reporting. For instance, Kim and Verrecchia (1994) show that public disclosures can lead to *increases* in information asymmetry because certain types of investors are better information processors and profitably trade on public disclosures at the expense of less informed investors. It is important to note, however, that this literature focuses on short-horizon effects. That is, informed investors benefit from public disclosures in the short run, which could lead to an increase (as opposed to a decrease) in information asymmetry. There is no discussion in FKZ about how increases in reporting frequency could lead to long-term increases in information asymmetry. Further, to the best of my knowledge, the prior literature also does not support such an argument.

The distinction between short-term and long-term effects is important in the context of FKZ for two reasons. First, FKZ measure information asymmetry annually instead of daily around the public disclosure. In other words, the empirical implementation makes the tension in the first hypothesis weak. That is, it is unlikely that the predictions in the private information acquisition/processing literature would apply to annual measures of information asymmetry. Most importantly, one could argue that if the authors were able to measure information asymmetry in short windows around public disclosures, the results in the paper would be the opposite: the authors would find an increase in information asymmetry around interim reports (see Lee et al., 1993).

Second, FKZ interpret their results as suggesting that increasing financial reporting frequency from annual to quarterly reporting decreases information asymmetry. However, if a regulator were to mandate extreme levels of reporting frequency (e.g., monthly or weekly reports), as discussed above, one could document the opposite effect. This could occur because (too) frequent disclosure events could induce several short-term increases in information asymmetry that could offset the long-term decreases documented in FKZ. Consistent with this conjecture, Van Buskirk (forthcoming) studies whether monthly disclosures are associated with lower information asymmetry, but little evidence is found in support of this hypothesis. Thus, one needs to be careful in extrapolating the FKZ results beyond the reporting frequency studied in their paper.

My second observation regarding FKZ's hypothesis development is that there could be a more detailed discussion of the conceptual distinctions between the predictions about information asymmetry vs. the cost of capital. In other words, it is not clear from FKZ whether these hypotheses are interrelated or mutually exclusive. In fact, there are arguments in the literature that could permit scenarios in which FKZ could find results for both hypotheses, only one of the hypotheses, or neither of them.

Suppose reporting frequency is negatively associated with information asymmetry. In this case, one could still predict a negative or no relation between reporting frequency and the cost of capital. For example, Lambert et al. (2012) develop a model that shows that information asymmetry would only translate into cost of capital effects in imperfectly competitive markets. In other words, in perfectly competitive markets one might find a relation between reporting frequency and information asymmetry, but not a relation between reporting frequency and cost of capital. In contrast, in imperfectly competitive markets differences in information asymmetry would also translate into cost of capital differences (Armstrong et al., 2011; Akins et al., 2012).