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Idiosyncratic information and the cost of equity capital: A meta-analytic review of the literature

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ABSTRACT

This paper provides a quantitative review of the literature on the repercussions of idiosyncratic information on firms' cost of equity (CoE) capital. In total, I review the results of 113 unique studies examining the CoE effects of information *Quantity*, *Precision* and *Asymmetry*. My results suggest that the association between firm-specific information and CoE is subject to moderate effects. First, the link between *Quantity* and CoE is moderated by disclosure types and country-level factors in that firms in comparatively weakly regulated countries tend to enjoy up to four times greater CoE benefits from more expansive disclosure—depending on the type of disclosure—than firms in strongly regulated markets. Second, a negative relationship between *Precision* and CoE is only significant in studies using non-accrual quality proxies for *Precision* and risk factor-based (RFB)/valuation model-based (VMB) proxies for CoE. Third, almost all VMB studies confirm the positive association between *Asymmetry* and CoE, but there is notable variation in the conclusions reached when *ex post* CoE measurers are used.

1. Introduction

Extensive literature in accounting and finance investigates the extent to which idiosyncratic information affects price formation and return structures in capital markets. This strand of research commonly tests the proposition that firms with high (low) quality information environments should enjoy relatively low (high) cost of equity (CoE) capital. Specifically, it is conjectured that firms can lower their CoE if they disclose more value-relevant information to investors (*Quantity*), provide information of higher accuracy (*Precision*) and disseminate information more widely between investor groups (*Asymmetry*). While analytical works have modelled these propositions elegantly (e.g., Diamond and Verrecchia, 1991; Easley and O'Hara, 2004; Lambert, Leuz, & Verrecchia, 2012), the empirical evidence regarding their predictions is mixed (e.g., Core, Guay, & Verdi, 2008; McInnis, 2010; Mohanram and Rajgopal (2009)).

Given, on the one hand, that the proper measurement of a firm's CoE (*alias* expected rate of returns) is an ongoing debate in itself (e.g., Botosan and Plumlee, 2005; Easton and Monahan, 2016), and, on the other hand, that proxies for the information attributes (*i.e.*, *Quantity*, *Precision*, *Asymmetry*) are large in number, as informed by both accounting and finance research, the empirical literature is voluminous and the conclusions reached vary widely depending on the proxies used by researchers. With that in mind, the main objective of this paper is to offer a systematic review of the extant literature to examine the reasons underlying the variation in results. In particular, this review meta-analyses the associations of *Quantity* and *Precision* with CoE and provides a descriptive

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summary of extant findings on the link between *Asymmetry* and CoE.^{1,2} To the best of my knowledge, this is the first study to quantitatively summarize all the links between idiosyncratic information and CoE within a unified framework. As such, it complements narrative literature reviews on this topic (e.g., Artiach and Clarkson, 2011; Beyer, Cohen, Lys, & Walther, 2010; Healy and Palepu, 2001; Kothari, So, & Verdi, 2016) and extends Souissi and Khelif (2012) who focus on disclosure (*Quantity*) effects only.³

2. Theoretical background and research hypotheses

To facilitate the structure of this review, I present a conceptual framework based on which I select the studies in my sample (see Fig. 1). The direct links between *Quantity*, *Precision*, *Asymmetry* and CoE are widely consistent with analytical work (e.g., Easley and O'Hara, 2004; Clarkson, Guedes, & Thompson, 1996; Lewellen and Shanken, 2002) and substantiated by empirical evidence. Next, I provide a succinct narrative review of some notable studies examining the CoE effects of firm-specific information in order to pinpoint prevailing debates in the extant work, reveal commonly used information proxies, and offer guidance towards the creation of meaningful sub-groups in later analyses.

2.1. Information quantity and cost of equity

Literature on estimation risk demonstrates that if the amount of information about a firm is low, investors have difficulties to accurately estimate the return and cash flow parameters of this particular firm. This parameter uncertainty makes such firms a riskier investment vis-à-vis otherwise comparable firms, and hence induces higher CoE (e.g., Clarkson et al., 1996; Lewellen and Shanken, 2002). A significant proportion of the literature examines the association between *Quantity* and firms' CoE, with 56 such papers analyzed in this study. One stream of research uses simple proxies—such as firm age or period of listing—as measures of information quantity and shows that these proxies are negatively correlated with CoE (e.g., Barry and Brown, 1984, 1985; Clarkson and Thompson, 1990; Kumar, Sorescu, Boehme, & Danielsen, 2008; Zhang, 2006). A second stream uses firms' disclosure levels as proxies for *Quantity* and ample evidence exists confirming a negative association with CoE (e.g., Baginski and Rakow, 2012; Botosan, 1997; Campbell, Chen, Dhaliwal, Lu, & Steele, 2014; Cao, Myers, Tsang, & Yang, 2017; Healy, Hutton, & Palepu, 1999; Francis, Khurana, & Pereira, 2005; Fu, Kraft, & Zhang, 2012; Kothari, Li, & Short, 2009; Ng and Rezaee, 2015). Thus, I formulate Hypothesis H1:

H1. The larger (smaller) the quantity of available information about a firm, the lower (higher) its CoE.

2.2. Information precision and cost of equity

In a seminal paper, Easley and O'Hara (2004) demonstrate that a firm's CoE decreases with the accuracy of available information about the future value of the firm. Essentially, this means that investors demand to be rewarded for bearing uncertainty about a firm's prospects stemming from imprecise information given to them, implying that firms that disclose higher quality information to investors can benefit from reduced CoE. This proposition is thoroughly researched in the literature (e.g., 38 papers are assigned to this link in my analysis) and the extant work can be categorized into two major strands: *accounting/earnings quality* and *security analyst forecast-based* studies.

The first stream is pioneered by Francis, LaFond, Olsson, and Schipper (2004) Francis et al. (2004, 2005). The authors examine the association between the quality of accounting information and CoE, and demonstrate that firms' CoE decreases as their earnings quality measures increase (e.g., accrual quality, value relevance). However, in an influential paper, Core et al. (2008) strongly question the validity of these early results. Despite continuous evidence for the proposition that earnings/accounting quality is negatively related to CoE (e.g., Aboody, Hughes, & Liu, 2005; Barth, Konchitchki, & Landsman, 2013; Hou, 2015), this link is challenged in a number of papers (e.g., Cohen, 2008; Khan, 2008; McInnis, 2010).

The second stream of research uses security analyst forecasts to proxy for information precision. Extant literature argues that the less uncertainty exists about the prospects of a firm, the greater the consensus among security analysts and the more precise their forecasts (e.g., Barry and Brown, 1985; Barron and Stuerke, 1998; Barron, Kim, Lim, & Stevens, 1998). Botosan and Plumlee (2013) provide evidence that total analyst forecast precision (AFP) is negatively associated with CoE. Botosan, Plumlee, and Xie, 2004 decompose total analyst forecast precision into private and public information components and show that public (private) AFP is negatively (positively) associated with CoE. Interestingly, Barron, Sheng, and Thevenot (2012) find that for firms with

¹ Meta-analysis is a statistical approach that summarizes empirical findings of multiple studies. Meta-analysis techniques require the use of effect size which—in meta-analytic accounting research—is commonly the study's Pearson *r* correlation coefficient between the dependent and independent variable of interest (Hunter et al. (1982), Khelif and Chalmers (2015)).

² Given vast variation in research designs between studies examining the impact of *Asymmetry* on CoE (e.g., some studies use yearly, others monthly data; some focus on portfolio-level, other on firm-level) a meta-analysis is not feasible; hence, I focus on descriptive statistics only when examining this link.

³ Similar to this study, Souissi and Khelif (2012) also meta-analyze the link between disclosure and CoE; however, my analysis differs from theirs in that it operates a larger sample (56 vs. 22 studies), covers a longer sampling period (1997–2010 vs. 1997–2017) and analyses substantially more firm-years (342,116 vs 9,553). Furthermore, I include both mandatory and voluntary disclosure studies, while Souissi and Khelif (2012) focus on voluntary disclosure only.

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