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Disaggregation, auditor conservatism and implied cost of equity capital: An international evidence from the GCC☆

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ABSTRACT

This research investigates the association between discretionary disaggregation in mandatory risk disclosures, auditor conservatism and the implied cost of equity capital. Based on a sample of financial firms from the six Gulf Cooperation Council (GCC) countries in the period 2007–2011, we find that the implied cost of equity capital is significantly negatively associated with discretionary disaggregation in mandatory market risk disclosures after controlling for firm-specific characteristics and country-specific institutional factors. Furthermore, the interaction between auditor conservatism and disaggregation in firms' mandatory risk disclosures is negatively associated with the implied cost of equity capital, suggesting that the firm disclosing more disaggregation in mandatory risk disclosure enjoys greater reduction in the implied cost of equity capital when audited by a conservative auditor. These findings are robust

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when subjected to a series of sensitivity tests. Collectively, these results demonstrate that more discretionary disaggregation in risk disclosures provides more private information to investors.

1. Introduction

Recent economic reforms enacted by the Gulf Cooperation Council (GCC) have attracted foreign investors to GCC stock markets (Balli et al., 2011).[3] These reforms have increased the number of listed firms in GCC stock markets from 399 to 702 between 2000 and 2011, and inspired the revival of the auditing profession (Al-Shammari et al., 2008; Chen et al., 2011). Like most emerging markets, the GCC's financing markets are considered to be a banking-oriented system (Al-Yahyaee et al., 2011). However, the increasing interest by international investors in GCC equity markets, which provide tax haven opportunities and a strong return in capital markets (Bley and Saad, 2012), signifies that corporate disclosure is important as a means of accessing equity financing and for creating greater transparency for private debt financing (Francis et al., 2005; Lo, 2014). For instance, Bley and Chen's (2006) document in 2004 indicated that foreign portfolio investors alone obtained profit in the range of US$150–170 billion from GCC stock markets.

At issue is whether and the extent to which quality, disaggregation disclosure levels and having a conservative auditor help decrease information asymmetry. In this study, we investigate the effect of discretionary disaggregation in mandatory risk disclosures (disaggregation thereafter), auditor conservatism and the implied cost of equity (ICOE thereafter) on GCC financial firms. First, we examine whether disaggregation disclosure provides investors with more private risk information and whether this decreases the ICOE. Second, we investigate the role of auditor conservatism in the relationship between discretionary disaggregation in mandatory risk disclosures and the ICOE.

A survey of analysts, the US Financial Accounting Standards Board and the International Accounting Standards Board (FASB/IASB) (2009), highlights that of accounting information into components results in the provision of comprehensive and useful information to stakeholders leading to enhanced transparency, particularly in regard to prediction of a firm's future cash flows. However, the degree of disaggregation in mandatory disclosure is subject to discretion and will ultimately depend on the capacity, incentives and opportunities available to management (Securities and Exchange Commission [SEC] 2011; IASB, 2005). The International Financial Reporting Standard (IFRS 7): Disclosure of Financial Instruments states that "an entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this IFRS, how much emphasis it places on different aspects of the requirements and how it aggregates information to display the overall picture without combining information with different characteristics." (p. 20). Specifically, IFRS 7 requires the firm to not disclose information on an aggregated basis if, in so doing, it obscures important differences between individual transactions or associated risks. For example, IFRS 7 requires firms to not aggregate market risk exposures from an area of hyperinflation with market risk exposures from an area of very low inflation. Thus, Schipper (2007) suggests that disaggregation should be required by standard setters to the extent that it improves investors' predictions of a firm's performance. Several research studies suggest that disaggregated disclosures in financial statements may mitigate effects on the mispricing of earnings, improve alternatives for investors' disclosures and reduce uncertainties. For example, Lail et al. (2009) find that the persistence of accruals differs from the persistence of cash flow; therefore, they suggest that standard setters may focus on improving disaggregation about accruals. This

[3] The Gulf Cooperation Council (GCC) is an economic corporation established in 1981 to strengthen the social and economic development of the six countries in the Arab (Persian) Gulf region. The council consists of Oman, Bahrain, Kuwait, Qatar, the Kingdom of Saudi Arabia (KSA) and the United Arab Emirates (UAE). The reforms presented for investing in financial sectors are fiscal discipline, low interest rates, minimum translation of costs and uncertainty about capital repatriation, and new laws and governance to protect property rights, reduce corruption and ease ownership restrictions.