Theory of voluntary disclosure and cost of capital essay sample

Business, Company

\n[toc title="Table of Contents"]\n

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1. Abstract \n \t
2. Benefits of voluntary disclosure \n \t
3. Disadvantages \n \t
4. Disclosure decisions \n \t
5. Cost of capital and efficiency \n \t
6. Concluding observations \n \t
7. References \n

\n[/toc]\n \n

Abstract

This paper seeks to explore the relationship between the cost of capital and voluntary disclosures. The paper outlines the benefits of voluntary disclosure to firms, investors and the general economy and how these benefits are weighed. It describes the categories of voluntary disclosures and the factors considered in disclosure decisions. The paper will explain the term disclosure friction and there after show how this factor affects cost of capital. It also investigates the association between the risk related discount and the voluntary disclosure. The two equilibriums i. e. overinvestment equilibrium and the underinvestment equilibrium and how they are brought about will be explained. This paper will show the importance of linking cost of capital with efficiency and then conclude by making observations of the voluntary disclosure and cost of capital.

In the recent times, the relation between cost of capital and corporate

disclosure has been receiving a lot of attention from the regulators and academics. Disclosure can either be voluntary or mandatory release of information about the financial performance and positions of companies. Cost of capital can be described as the minimum return that is demanded by the investors so as to invest in new projects. The companies that disclose more information voluntary experience a lower cost of capital compared to those companies that do not disclose. At the economy wide level, voluntary disclosures by companies affect the average cost of capital and this has consequences on the ex-ante economic efficiency.

A voluntary Disclosure Agreement (VDA) allows the taxpayers to receive some benefits from proactively disclosing preceding period tax responsibilities in agreement with a binding agreement. The reason why most states offer disclosure agreements is as a way of encouraging companies to abide to the tax laws of the state and thus in response generate state revenue that may not have been generated if the company failed to disclose its liabilities. In other words the state can also be able to generate future revenue by encouraging companies to register in their current state for collection and remission of taxes

Within a formal model, the quality of disclosures may be an explanatory factor to cross-section of the expected returns. For the reason that the effect of disclosing affects all the companies at the time, necessarily there are no cross sectional differences between costs of capital in the non-disclosing versus the disclosing companies. When there is high disclosure friction, the companies that make more voluntary disclosure experience low costs of

capital. This is due to the connection that exists between updated estimates of the expected cash flows by the investors and the voluntary disclosures.

Benefits of voluntary disclosure

Most companies in the United States have been carrying out voluntary disclosure as it has been identified as a crucial area in the financial reporting research. Voluntary disclosures by companies can include providing information on strategies and characteristic of the company, the nonfinancial information like the socially responsible practices and also the financial information like the stock price information.

Voluntary disclosures are very beneficial to companies, the economy and mostly the investors because it helps the investors to make better decisions on capital allocation and it also lowers the cost of capital for firms and as such this benefits the economy. However, firms weigh the benefits brought by voluntary disclosure against costs which include costs in the procurement of information that is to be disclosed and the reduced competitive advantage .

Disadvantages

This method has a disadvantage of cost. The alternative in other words will always need the service provider of a third party who also needs a fee payable to their services and at some point the cost of compliance outweighs the benefits. Another disadvantage is the compliance burden whereby the taxpayer will get an increased compliance burden directly and continuously since there is no need for reporting and remitting taxes.

Disclosure decisions

All companies observe perfect signals on their individual cash flows. The factor model focuses on analyzing the information the individual component if the company's cash flows, excluding any information on the systematic components that would work to realize the risks in the system and hence reduce them. It is expected that the disclosures of a single firm would contain little information on the state of the economy as compared to the information on the company's own business. For those companies that are not very large compared to the economy, the impact of information on systematic risks would probably be little for the vast majority of the companies that are in existence.

Companies make decisions on whether to release private information on receipt. As it is in the DJK, most disclosures are truthful however the companies do not credibly communicate any absence information endowment. The companies take a set of possible prices as given before they disclose. The market price is offered when no additional signals can be revealed. The market price is equivalent to the trading value of the firms that do not disclose or zero if the trading value of the firm is negative which means the company is not being financed. Companies disclose and maximize the value of their owner if the learn of their information and if the market price is greater than the price that is being offered and above this, all firms then decide to disclose voluntarily. Disclosure friction captures information asymmetry between the outside investors and companies.

In order to avoid situations of multiple equivalent equilibria, those companies that do not expect to be financed due to disclosure do not disclose especially

if there is a cost of disclosure. It then follows that the companies that do not disclose might not be financed. This results to two equilibrium candidates as follows:

- Over investment equilibrium: occurs when all companies invest and get positive prices if they did not disclose.
- Under investment equilibrium: occurs when companies that did not involuntary or voluntary disclose are not financed.

Companies can choose to provide disclosures that are informative or noisy disclosures. Informative disclosures can easily be understood the people who receive it while the noisy one cannot be understood. The investors may also not get the information from company's disclosures either because they cannot understand the information in them or because they do not pay attention to when the information is released. The probability of the information not being received may also be interpreted as due to the quality of accounting in the accounting standards. Companies may go ahead to report the mandatory disclosure and then give additional financial disclosures that cannot guide investors to understand the released information. Association of voluntary disclosure with discount

Even though voluntary disclosure and discount are related positively in most cases, there are other situations where the relationship is negative. Considering the effect of change in the probability friction where a company is not informed. The failure of a firm to voluntarily report could either be caused by the unwillingness of the company to provide bad news or the company is genuinely not informed. The increase in the probability friction causes an increase in the threshold beyond which the company will disclose

voluntarily.

An increase in the probability function will decrease the likelihood of a company's disclosure directly or indirectly. An increase in the probability friction has little effect on discount because it has no effect on ex ante distribution of investor risk preferences or the cash flow of a company. Combination of the effects means that there is no relation between probability friction and discount.

The association of voluntary disclosure and discount in price differs depending on the nature of the factors affect discount and disclosure variation. For the factors that are directly associated with the riskiness of the company's cash flow and the appetite for risk by the investors, contrary to the expressed expectations, the association will be positive. The positive association between discount in price and voluntary disclosure on the cost of capital is that, discount is equal to the cost of capital where the expected cash flow of a company is fixed.

Cost of capital and efficiency

It is important to link efficiency to cost of capital as it acts measure which can be observed empirically in the evaluation of a new accounting regulation. Average cost of capital can be termed as proxy for the economic efficiency in times where the disclosure friction is high. The cost of capital indicates how good the financial markets are at diversification of idiosyncratic risks.

Without considering the under diversification ex-ante assumption and instead, fully consider the diversified investors ex-ante, it is irrelevant to

measure the economic efficiency using the average cost of capital. Otherwise, when disclosure friction is comparatively low, average cost of capital can be low because the non-disclosing companies are being financed even though not connected to the economic efficiency of the under investment equilibrium.

Concluding observations

- When disclosure friction is high, companies that disclose experience lower costs of capital compared to the companies that do not disclose. However, more voluntary disclosure increases the cost of capital for both the non-disclosing and disclosing companies.

- The cost of capital for the disclosing companies decreases in the expected cash flows.

- An increment from low to high disclosure friction means that there is an increase in the aggregate investment.

- The economies that have high disclosure frictions experience over investment while the ones with low disclosure frictions experience under investment.

- Investors prefer securities that have low risk estimation, low transaction costs and those that have less information unevenness.

- If the disclosures mitigate an estimation risk, information asymmetry and transaction costs, it results to a negative relation between cost of capital and disclosure.

- Additionally, in cases where disclosure results to higher information

asymmetry, a good association between cost of capital and disclosure is observed. .

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