

Accounting and Finance - New Perspectives

The Impacts of Accounting Information on the Cost of Capital of an Organization.

Dr. Omah Chioma Patience

Department of Accounting, Faculty of Management Sciences,
Ignatius Ajuru University of Education, Rumuolumeni, Port Harcourt,
Rivers State, Nigeria.

Accounting Information

The relationship between accounting information and the cost of capital is demonstrated to be a fundamental issue in the accounting literature (Agrawal and Cooper, 2017) and has captured much more space in finance literature. Arthur Levitt, the former chairman of the United States Securities and Exchange Commission (SEC), suggested that high-quality accounting standards reduce the cost of capital as investors with high-quality information can make better investment decisions (Easton, 2004). Andre, Flip and Moldovan (2016) suggested that high-quality accounting information reduces uncertainty and that investors and firms attach much importance to such information. Accounting information available in financial reports is used to measure firms' risk factors and estimate their expected returns (Gebhardt, Lee, & Swaminathan, 2001).

By using accounting information systems, decision-makers obtain useful information and use it in decision-making and strategy-building to achieve organizational goals and objectives, which should increase the company's performance. One of the key decisions a firm has to make is the fundamental determination of its cost of capital. This has a substantial impact on both the composition of the firm's operations and its profitability since shocks to anticipated cash flows are reflected in the firm's cost of capital. Many studies have spent tons of ink coming up with proposals leading to a lower cost of capital. Argue that it is the environment of a firm, which is described by many parameters, such as accounting standards, market microstructure, and information coming from the firm reports, that influences the accounting type of information that determines the firm's cost of capital and, consequently, its stock price.

Accounting information reduces information asymmetries, which lead to adverse selection in transaction activities in the stock market as well as enhances liquidity, which lowers the discounts at which firms must issue capital. Argue that accounting information tends to compensate shareholders through stock returns by reducing their exposure to investment risks. Research in asset-pricing models has not, so far, modeled explicitly the accounting information environment in determining the firm's required return, though it argues that more factors other than market risk could be equally responsible for determining a firm's financial aggregates. Accounting information is judged to be of high value because it affects the market's ability to direct firms' capital allocation choices. Moreover, higher accounting information improves the coordination between firms and investors concerning capital investment decisions, resulting in an increase in expected cash flows without a commensurate increase in the covariance with the market, which is expected to harm the firm's cost of capital.

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Cost of Capital

During the 1970s researchers shifted the use of accounting information from the prediction of systematic risk to the cost of capital (Armstrong, Core, Taylor & Verrechia, 2011). Various studies such as Claus, and Thomas (2011); Easley, and O'hara (2004) and Eliwa, Haslam and Abraham (2016) found that accounting information can explain variations in the cost of capital. The cost of capital has long remained the center of attention in finance. Fama, and French (2004) stated that estimating the cost of capital and its relationship with a firm's fundamental characteristics is a central theme in finance and capital markets research in accounting. Although under investigation for more than six decades, a unified model for the relationship is yet to be developed. However, the latest development in the cost of capital determination is the implied cost of capital (ICC) which uses discounted cash flows and market prices to derive the implied rate of return required by the investors. ICC estimates are less noisy than the cost of capital measured with the capital asset pricing model (CAPM) or the Fama–French three-factor model. The ICC model, due to its complexity, has not been applied to the majority of emerging markets. In Pakistan, only Balsam, Krishnan, and Yang (2003) have applied ICC to determine the relationship between the implied cost of equity and the corporate life cycle. This gives an edge to this study's use of the technique in the context of the emerging market of Pakistan. One of the essential agents of economic growth is the capital market.

Based on reforms introduced by the Securities and Exchange Commission of Pakistan (SECP), the Government's investment-friendly policies, and the country's macroeconomic indicators, Morgan Stanley Capital International (MSCI) upgraded Pakistan from the status of Frontier Market to that of emerging Market in 2017. The SECP and the Pakistan Stock Exchange (PSX) are in continuous communication with MSCI to highlight reforms in the pipeline and recent capital market achievements to meet the demands of the market's changed status. According to a press release from the World Bank on October 24th, 2020, due to regulatory reforms, Pakistan now ranks as one of the world's top ten business-climate improvers and is 108th in the global ease of doing business index.

The reforms undertaken by SECP have significantly improved the investment climate of the country. Now Pakistan is attracting investment (foreign as well as domestic) that is enhancing growth opportunities. In this context, a study that brings insight into Pakistan's emerging equity market is indispensable. In particular, this study seeks to analyze the impact of the qualitative attributes of accounting information as outlined in SFAC No. 8 on the cost of capital for the non-financial firms listed on the PSX. This analysis is carried out by investigating the following: (1) the impact of the qualitative attributes of accounting information on the cost of capital, and (2) the presence of any systematic pattern in risk-adjusted portfolio returns, in order to determine whether the qualitative attributes of accounting information are genuine risk factors priced into the equity market of Pakistan (Haque & Sarwar, 2013).

Previous Studies

In Pakistan, several studies have found an association between accounting information and the cost of capital. These studies have examined various accounting variables including leverage, earnings volatility, size of firm, dividend yield, payout ratios, and asset growth (Irfan, Nishat, & Sharif, 2002); book value per share, earnings yield, and dividend yield (Khan, Gul, Rehman, Razzaq, & Kamran, 2012); operating cash flow per share, capita employed per share, earnings per share and book value per share (Asif et al., 2016); price-to-earnings ratio, earnings per share, leverage, return on assets, current ratio, and price-

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to-earnings ratio (Muhammad & Ali, 2018). The broad finding of these studies was that accounting variables are relevant and important to explaining the cost of capital in Pakistan.

Brief Findings Made

The findings so far made in this study showed that an increase in expected cash flows, coming from improvements in the quality of accounting information, leads to a reduction in the firm's cost of capital.

Conclusions

This academic study developed to analyze the association between accounting information and a firm's cost of capital and to verify or not previous empirical findings by the authors. The findings showed that, even in a CPM world, an increase in expected cash flows, coming from improvements in the quality of accounting information, leads to a reduction in the firm's cost of capital. Overall, the study provides a direct link between accounting information and the cost of capital that does rely on the fact that accounting information along with improvements in its quality has real effects on capital allocation that governs a firm's cost of capital in Nigeria.

Recommendations

Recommendations are proposed. First, the quality of accounting information should be analyzed precisely so that investors can manage their portfolios effectively. Failure to analyze properly the impact of these factors will lead to poor decisions regarding investment and portfolio management. Second, stock analysts should evaluate these factors when assessing the performance of quoted stocks in order to provide prudent equity recommendations to investors. The reporting quality should be made a required element of all audit investigations.

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