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Discussion of 'Disclosure and the cost of capital: what do we know?'

Stephen Cooper*

This paper is a valuable summary of the work that has been produced on how accounting, and particularly the disclosures in financial statements, affects cost of capital. Much of this research has been produced by Professor Botosan herself and I congratulate her on this paper and her past research. I support her conclusions that improved disclosure reduces cost of capital, partly because I believe that the research is compelling, but also because of my own observations about how the lack of transparency in accounting influences investment recommendations of UBS analysts and investment decisions of portfolio managers.

Although cost of capital is clearly a key driver of equity values, it is one of the most difficult components to measure. Professor Botosan rightly points out the limitations of a CAPM approach to determining cost of capital, particularly that beta may not capture all of the risk factors priced by the market. CAPM can be extended to multifactor models, which conceivably could include accounting disclosure related variables; but there is no theoretical basis for determining what the factors should be or how they should be priced. The UBS approach to cost of capital, like most applied in practice, is based upon CAPM. However, we do not apply this in a rigid manner and believe that analyst judgment is important in determining a discount rate, just as it is in estimating future cash flows. While beta may be a key factor in calculating cost of capital, analysts are free to adjust the beta to a value that they consider better reflects the level of risk actually priced by market participants and also to adjust the resulting cost of capital (or valuation) for further factors that are considered relevant. Such adjustments could and often do take account of the quality of disclosure and accounting transparency.

The focus of research on the impact of disclosure on cost of capital is one of relative differences in the cost of capital of companies. Therefore it is not so important that accurate absolute measures of cost of capital are obtained. For this reason the

inherent difficulty of using a traditional dividend discount model approach (or variations thereon) would not seem to impact the research as much as one might have expected. As long as the models can successfully differentiate relative differences in discount rate then successful investigation of the impact of disclosure should be possible. However, one must caution against taking even these cost of capital measures without question. Consensus analyst forecasts are generally assumed to be optimistic and long-term growth rates given by analysts are, I believe, often unreliable. Also, there is no standard definition of pro forma or adjusted earnings that forms the basis for consensus forecasts. We know that different brokers and indeed different analysts supply data prepared on a different basis. This is evident if one examines the detailed historical data provided by individual analysts, where differences can be significant. Professor Botosan points out the possibility of measurement error if the market and analysts hold different beliefs, but emphasises that this is only a problem if the error is systematically related to the variables of interest. One cannot be sure whether this is the case or not, however, in my experience because model errors can be sector related and because disclosure could be sector related as well; this is an area that deserves further investigation.

Analysts are frequently critical of the lack of disclosures in financial statements. Too often companies provide the bare minimum disclosure that is required by accounting standards without considering what disclosures are actually necessary to fully understand their results and financial position. Presumably this is a trade-off between the perceived disadvantages of disclosure, including the communication of information that might be useful to competitors and the flexibility non-disclosure gives in terms of managing the information flow and consequently managing investor perceptions and the advantage of a lower cost of capital.

A search in the UBS database of over 300,000 analyst reports reveals many cases where accounting disclosure had an impact on investment recommendations and valuations. The following is a typical comment: '...our rating reflects the risks

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presented by the company's low accounting transparency and lack of detailed disclosures on operational details'. In this case the impact on valuation was unspecified but in some cases analysts are more specific. For example, '...our €61 price target is after applying a 5% discount to reflect concerns on accounting transparency'. Although in this case the adjustment is to the valuation directly, in effect the analyst is raising the discount rate. Allowing for typical equity duration, the cost of capital effect being priced is perhaps 20bp to 30bp.

There are also many incidents that I have encountered where analysts and investors are clearly influenced by lack of accounting transparency. In a recent case an investor refused to invest in a company due to uncertainty over the assumptions used to measure the pension liability. This liability was highly material, but there was no disclosure of the longevity assumption underpinning the calculation. Given the known variations in longevity assumptions applied in practice, and the material impact this can have on the liability, the investor was reluctant to commit funds without such disclosure. In a separate example, an analyst was struggling to reconcile amounts in the financial statements in relation to deferred taxation. The amounts disclosed were not analysed sufficiently to identify what impact the deferred tax accounting was having on performance metrics. This not only led to a lack of confidence that reported earnings represented the true profitability of the business, but also led to suspicion on the part of the analyst that this could indicate that perhaps other aspects of the financial statements were not as they seemed. Not surprisingly, this lack of accounting transparency influenced the analyst's view of the investment. Consequently, a lower valuation multiple was applied than perhaps otherwise would have been attributed to the company. Although in this case the analyst's caution was not explicitly reflected in a higher discount rate, the impact on value was the same.

Considering the attitude of UBS analysts to companies that have poor disclosure, and in view of the evidence from the research highlighted in this paper, I have no doubt that improved disclosure and better transparency in accounting does serve to increase market prices. What I am not sure about is the mechanism with which this actually occurs. For example, it may be that rather than disclosure influencing the cost of capital, perhaps it

influences perception of future cash flows, or at least the distribution of future cash flows. Analyst earnings forecasts are not necessarily true probability weighted average expected values. I believe there is a tendency for analysts to forecast the 'success scenario' and particularly to disregard low probability severely adverse outcomes. Although analyst forecasts may be their best estimate of the 'most likely' outcome because the distribution of possible outcomes may not always be symmetrical, then this may not be a true expected value. If the distribution is skewed to the downside then analyst forecasts are biased upwards. However, this bias may not true of the market as a whole, where low probability adverse outcomes are perhaps more efficiently priced. This may explain why dividend discount models often tend to produce high cost of capital estimates. Could it be that better disclosure gives the market greater confidence that a very unfavourable outcome (perhaps due to fraud) is less likely? After all, where disclosure is poor the question is always what negative information is being hidden rather than the opposite. If this is the case, then value may rise as disclosure increases because investors are modifying their assumptions about the probabilities of different pay-offs, rather than discounting cash flows at a different rate. Of course the net result is the same; better disclosure equals higher value.

I would greatly appreciate further research on the link between disclosure and cost of capital. It would be interesting to see what types of disclosure have greatest impact. For example, how does information disclosed about risks, the level of detail provided in segmental analysis or the quality of accounting policy disclosures impact the cost of capital? Also, there is the important question of how measurement as well as presentation impacts the view of investors. For example, does fair value measurement rather than a historical cost approach provide more relevant information to users and hence give greater confidence and reduce the cost of capital? Alternatively, does the greater volatility in reported earnings that likely results for a fair value approach perhaps have the opposite effect and result in a higher cost of capital?

Let us hope the transition to IFRS and the resulting change in both disclosure and measurement will provide researchers with a whole new dataset to use such that some of these question might be answered.