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evidence from finance directors

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Corporate disclosure, cost of capital and reputation: evidence from finance directors

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Abstract

The majority view of the executives interviewed is that disclosure reduces the cost of equity up to the point at which a good-practice level of communication has been reached, after which there is little further effect. Greater disclosure to rating agencies and lenders reduces the cost of debt. Attitudes towards more mandatory disclosure are mostly negative. The main perceived cost of disclosure is creating the information. The main benefits are promotion of a reputation for openness and of shareholder confidence, not a lower cost of capital. We suggest that a reputation for openness is valued because it enhances the company's overall reputation, which brings commercial benefits.

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1. Introduction

This paper presents evidence from interviews with 16 senior executives on the link between a company's disclosure level and its cost of capital. It also presents views more generally on the costs and benefits of the corporate communication process. The motivation for the research is articulated in a note that accompanies the Institute of Chartered Accountants in England and Wales' (ICAEW) 2003 publication *New Reporting Models for Business*. The note identifies as a key issue 'whether improved disclosure cuts the cost of capital. Although there has been research on this and it is often asserted as an indisputable fact, it is clear that not everyone is convinced... Practitioner input would be helpful' (ICAEW, 2004, 15). The paper contributes to our knowledge about how the goals of communications are perceived by the executives responsible. In particular, it is the first qualitative study to focus on the connection between disclosure and the cost of capital. We go into much more detail on this subject than do previous papers based on surveys and interviews, in which the disclosure-cost-of-capital question is only one of several examined. More generally, our study augments the evidence that exists about the costs and benefits of disclosure. Several previous studies have explored the process by which information is communicated, for example Holland (2006), but there is surprisingly little evidence from UK company managers on how they view the associated costs and benefits, and on how disclosure policy is determined.

Our questions elicited a diversity of opinions, and we present the findings in a manner that reflects the diversity. However, several results emerge clearly, in that they represent the views of substantial majorities of the interviewees. The headline finding is that, in the view of executives responsible for disclosure policy, the primary motive for voluntary disclosure is to enhance the company's reputation for openness, and not to reduce its cost of capital. The majority view is that additional disclosure beyond a good-practice level makes little difference to the company's cost of equity. Only one quarter of those interviewed believe

without qualification that disclosure reduces the cost of equity. But 56% believe that greater disclosure to bond rating agencies and bankers will reduce the cost of debt or increase its availability. 88% provide private information, not available to shareholders, to rating agencies and, to a lesser extent, to bankers. The primary motives for disclosure to the stock market are to promote the company's reputation for openness and to maintain confidence in the company among shareholders and others. These outcomes are seen by executives as important objectives in themselves. The majority of the executives believe that their companies are now operating with a high level of disclosure, and they do not support further increase in the disclosure required by regulation.

The executives' lack of emphasis on a lower cost of capital is consistent with the evidence from existing surveys, though it is a finding that has not been given prominence. For example, the US executives questioned by Graham, Harvey & Rajgopal (2005) rate a lower cost of capital tenth out of eleven possible motives for voluntary disclosure. The authors write in their introduction that, 'in short, disclosing reliable and precise information can reduce "information risk" about a company's stock, which in turn reduces the required return' (p. 5). The inference that the required return will be lower is natural, but it is not one to which the majority of the executives questioned by Graham et al attaches much importance. Our more in-depth evidence points to an explanation: although disclosure reduces information risk, the effect is perceived to be small once the company has reached a level of good-practice disclosure. Since most of the executives in our sample believe that their companies are operating at a good-practice level or better, they do not see a strong link between (further) disclosure and the cost of equity. So we find that there is a step change in the perceived effect of disclosure on the cost of equity once a good-practice level has been reached.

The finding that the primary motive for voluntary disclosure is to enhance reputation for openness is also consistent with the evidence in Graham et al (2005), and we suggest that

it deserves more attention. The benefit from a reputation for openness could simply be a higher share price due to reduced investor scepticism, as Lundholm & van Winkel (2006) contend. But, in addition, open and proficient corporate communication might be one of the ways by which a company's overall reputation for quality can be sustained. A good reputation helps in doing business and therefore brings commercial benefits.

The next section considers the theoretical and empirical debate on the link between disclosure and the cost of capital. Section 3 describes the research methods used and Section 4 presents the findings. The final section contains a summary and discussion.

2. Previous research on the link between disclosure and the cost of capital

We start with a note on terminology. By disclosure we mean the provision of information of all types by a company, both to the public at large and to restricted groups of information users. It is a matter of degree; a higher level of disclosure means that more and better quality information is provided. This leads to a state of affairs in which the company is more transparent. Voluntary disclosure means provision of information beyond the amount required by law and regulation.

One question is what benefit a company obtains from voluntary disclosure. A major benefit hypothesised is that greater disclosure implies a lower cost of capital, at least if one makes the familiar assumption that the aim, or an aim, of a company is to maximise its share price. This assumption is strongly supported by evidence on the views of UK finance directors in Barker (1998). Botosan (2006) provides a recent summary of the relevant theory and evidence from stock market data, so our comments will be brief. Provision of more information about the company reduces information asymmetry between the company and the stock market, i.e. principally analysts and fund managers. There are two main hypothesised processes by which reduced information asymmetry is predicted to reduce the cost of equity.

Within each of these are several formal models offering variants of the process. One process starts from the assumption that more information reduces estimation or information risk. That is, if analysts and fund managers have more information about a company, they will estimate future cash flows to equity with less uncertainty; the perceived distribution of the possible cash flows in at least one future period becomes less dispersed. If it is argued that estimation risk is, to an extent, a non-diversifiable risk factor, then standard asset-pricing theory predicts that investors will apply a lower discount rate to the cash flows. The effect in the stock market will be a higher share price for the company, other things equal. Whether estimation risk is diversifiable in theory depends on how it is modelled. If it *is* diversifiable, then the question remains as to why diversifiable risk should be priced.

A second hypothesised process is that the presence of more information in the public domain will reduce the expected losses from trading against investors with superior information. One prediction is that this will lead to a lower transaction cost of trading, in the form of a lower bid-ask spread. The lower spread will, in turn, result in a higher volume of trading, which will reduce the spread further. A lower transaction cost of trading implies a lower cost of equity, expressed gross of transaction costs. This is the process presented in Amihud & Mendelson (1986). A second effect is modelled by Easley & O'Hara (2004). In their model there are two groups of investors, one of which is better informed about all companies than the other. The less well-informed group ends up with a portfolio with a higher proportion of overvalued shares than does the informed group, an outcome which can not be prevented via diversification. So the cost of the presence of well-informed investors is impaired portfolio selection by the less-informed, rather than higher trading costs. The model predicts that the implied discount rate for a given share at its equilibrium price is positively related to the disparity of the information available to the two groups. Although most theories

predict a negative relation between disclosure and the cost of equity, there are some in which the predicted relation can be in either direction, as noted by Francis et al (2008).

The theoretical literature summarised above models effects of asymmetric information on share prices, via the discount rate. It does not analyse how much information a given company will provide, nor does it elucidate the process by which investors become informed. We return to these questions below.

There are several quantitative studies that test for a link between the level of disclosure and the cost of equity, using data from a number of countries. A numerical measure of each company's level of disclosure is regressed against an estimate of its cost of equity, controlling for other factors that might affect the cost of equity, such as the share's beta and the company's gearing and market capitalisation. The cost-of-equity estimates in the studies come from re-arranging the dividend-discount or abnormal-earnings models of equity value, so that the discount rate is inferred from the current share price together with the estimated expected cash flows to shareholders. Most of the results, though not all, indicate that there is a negative relation between the level of disclosure and the cost of equity for companies in a given country. There is also evidence that increases in disclosure result in greater trading of the shares and more scrutiny by analysts, both of which should in theory lead to a lower cost of equity. Two papers that do not provide clear support for the expected negative relation are Botosan (1997) and Botosan & Plumlee (2002), though Botosan (2006) in her review does not mention this.

Hail & Leuz (2006) argue that the amount of mandatory disclosure will reduce the cost of equity in the market as a whole, while voluntary disclosure will vary between companies and thus result in different costs of equity for companies in the market, all else being equal. They present cross-country evidence of a negative relation between disclosure requirements and the cost of equity, supporting their argument regarding mandatory

disclosure. Francis, Khurana & Pereira (2005) find a negative relation between the cost of equity and disclosure across countries at firm level, controlling for differences in national disclosure requirements. However, Daske (2006) finds no evidence of a lower cost of equity in German firms after they have adopted international accounting standards that are widely believed to require more informative reporting than do German accounting standards. Regarding debt, Sengupta (1998) finds that bond yields are negatively related to disclosure level, controlling for other factors affecting yields, and Mazumdar & Sengupta (2005) find the same result for the margins on bank loans.

Perhaps the main problem with the evidence from market data is that both the level of disclosure and the cost of equity are hard to measure. There is a specific worry about inferring the cost of equity from the current share price and estimates of expected cash flows to equity. In principle, greater disclosure could increase value because it causes investors to increase their estimates of expected cash flows, as noted by Cooper (2006). For example, investors may attach a lower probability to worst-case outcomes if the company becomes more transparent. In this case disclosure has no effect on the cost of equity, but it will appear to do so unless the expected cash flows used to infer the discount rate take account of the impact of disclosure on the expected cash flows. The same ambiguity arises in interpreting the belief of many company managers that disclosure supports the share price. A further worry is set out by Francis et al (2008). They present evidence that the amount of voluntary disclosure and the quality of earnings are positively related; that the cost of equity is negatively related to the quality of earnings; and that there is no empirical link between the cost of equity and voluntary disclosure, controlling for the quality of earnings. They therefore conclude that any negative relation between the cost of equity and voluntary disclosure is mainly accounted for by the quality of earnings, which is correlated with disclosure, rather than by disclosure itself. To summarise the evidence from market data: most studies find a negative relation between

the cost of equity and the level of disclosure, but there are doubts about whether this evidence shows that more disclosure causes the cost of equity to be lower.

There is less evidence on whether company executives or investors believe that disclosure reduces the cost of equity. Holland (2006) presents a detailed account of corporate communications, based in the first instance on interviews with the finance directors (FDs) of 25 large (mainly top 100) UK companies. The main benefit, though not the only one, does appear to be a lower cost of capital in his account. This can be seen by comparing his analysis of the market value of a company with his analysis of the cash flows. Market value is broken down into seven components, two of which are 'value of confidence in top management and the value-creation processes' and 'value of confidence in the quality of disclosure and its credibility' (p. 60). Since neither of these components has a corresponding cash-flow stream, their impact on value has to be via the discount rate, as the report observes (p. 62). Yet no direct evidence is presented on the extent to which the interviewees believe that disclosure reduces the discount rate. In fact a previous interview-based study, Holland (1998), identifies the primary benefit of corporate communications as 'developing informed, confident financial institutions in "least surprise" state' (p. 259). The role of corporate communications in 'maintaining confidence' amongst financiers is echoed in Weetman & Beattie's (1999) report based on interviews with fund managers, analysts and bankers. Mazzola, Ravasi & Gabbioneta (2006) discuss investor relations from the perspective of building reputational capital amongst analysts and investors, based on Italian evidence.

Survey evidence from Europe is contained in Marston (2004, 108), from 181 replies by either investor relations officers or FDs. She asks respondents whether they agree with the statement 'investor relations reduces the cost of capital'. The mean score is 3.77, between 'agree' (score of 4) and 'uncertain' (score of 3). This is the lowest score across five possible benefits of the investor relations programme listed in the survey. Eccles & Mavrinac (1995,

23) ask US corporate managers to rank the potential returns to improved disclosure on a scale of 1-7 where 1 = very strongly agree, 4 = no opinion and 7 = very strongly disagree. Increased credibility is ranked most highly (5.21) with increased share price next (4.66); a lower cost of capital is not on their list of possible benefits. Graham et al (2005) provide more recent evidence from the USA, based on 312 questionnaire results and 20 interviews. The survey respondents are asked to agree or disagree with 11 statements about the motives for voluntary disclosure (Graham et al, Table 11). The top three motives are that disclosure 'promotes a reputation for transparent/accurate reporting' (92% strongly agree or agree), that it 'reduces the "information risk" that investors assign to our stock' (82%), and that it 'provides important information to investors that is not included in mandatory financial disclosures' (72%). Only 39% agree that disclosure 'reduces our cost of capital', and 22% disagree; this is the least-supported of the 11 motives except for one. Thus, though a large majority thinks that disclosure reduces information risk, the majority also doubts whether it reduces the cost of capital.

The question of whether disclosure reduces the cost of capital is of interest in its own right, but it also matters in seeking to understand the market for company information, ie the determinants of the supply and demand for information, and the process by which investors become informed. Barker (1998) and Eccles & Mavrinac (1995) are explicit reports on views of the market for information from both the supply and demand sides, and the papers cited in the previous two paragraphs also contain much relevant information. The possible benefits of credible voluntary disclosure are summarised by Healey & Palepu (2001: 420-25). In addition to reducing the cost of capital, providing more information has been hypothesised to reduce the cost of raising external capital; reduce the likelihood of under-valuation and help to explain poor earnings performance; improve the efficiency of stock-based compensation for employees; reduce the threat of litigation; and signal the quality of management. In addition,

lower information asymmetry can be predicted to lead to a reduction of agency costs within the company. On the other hand, revealing more information could damage a firm's competitive position. Lundholm & van Winkel (2006) argue that the primary motive for disclosure is to support the share price, by minimising scepticism on the part of investors about the company's future prospects.

We asked our interviewees for their views on the costs and benefits of disclosure in general. This was to get a sense of how important the cost-of-capital benefit is in determining companies' disclosure policies in relation to other benefits and to costs. There is a good deal of evidence on the process of disclosure; rather less on how disclosure policy is determined. Holland (2006), for example, notes that 'the case data did not facilitate an understanding of exactly how [the] costs and benefits were traded off... in the search for a satisfactory or an optimal disclosure decision' (p. 34).

In conclusion, the majority of prior quantitative evidence supports the idea that disclosure reduces the cost of capital. But the limited survey evidence to date suggests that many managers are doubtful. As stated by the ICAEW (2004, 15), 'it is clear that not everyone is convinced by the [quantitative] research so far. Or maybe the reduction in the cost of capital found in the research, even if it is convincing in itself, is insufficient to compensate for the perceived disadvantages of disclosure.' Our paper provides more evidence about what managers themselves think about these questions.

3. Method

3.1 Selection of interviewees

Our research method was to gather information from confidential semi-structured interviews with FDs or directors of investor relations, who are knowledgeable about both their company's disclosure policy and its cost of capital. Easterby-Smith, Thorpe & Lowe (1991, 74) consider that semi-structured interviews are appropriate when 'it is necessary to understand the constructs that the interviewee uses as a basis for her opinions and beliefs about a particular matter or situation'. We therefore opted for interviews to allow the FDs scope to say what they wished and to enable the interviewers to probe further in order to obtain an enhanced understanding of the initial answers to the various questions.

We sought to interview representatives of listed UK companies of differing sizes and from a wide range of businesses. We decided that the ideal person to interview would be the FD as this is the person in charge of corporate reporting and disclosure policy. However, our past experience (reference omitted to preserve anonymity) indicated that gaining access to FDs is difficult and that directors of investor relations (IR) are also well informed and more likely to grant an interview. Therefore we decided in advance to target the FD within an organisation first but to interview the IR director if they were willing and the FD was not. As Buchanan, Boddy & McCalman (1988, 53-54) have argued, such an opportunistic approach is justified as data collection is 'constantly compromised by the practical realities'.

Our questions are listed in the Appendix. They were motivated by the literature review and were amended slightly after anonymous refereeing at the proposal stage. They were designed 'to allow the participants to interpret and describe the phenomena in their own way' (Holland, 2005, 250). There are five main areas of questioning of which four contain more than one question. The two introductory questions ask about the company's disclosure policy and how it estimates the cost of capital. These set the scene for the key research question: 'Do

you believe that improved disclosure reduces the cost of equity?' The next area of questioning relates to the link between disclosure and the cost of capital including both equity and debt. The final area relates to costs and benefits of disclosure in general. By careful design of the questions we were able to cover many of the issues raised in the academic literature but we decided not to prompt interviewees by referring to prior theoretical or empirical findings in the interview schedule. We sent the interview schedule in advance to respondents along with the request for an interview to enable them to feel comfortable with the proposed line of questioning and to prepare their thoughts. Saunders, Lewis & Thornhill (2007, 320) note that providing participants with a list of interview themes before the event may help to promote the credibility of the interviewers. Additionally it may also 'promote reliability and validity by enabling the interviewee to consider the information being requested'. The number of questions was deliberately restricted because we were aware of pressures on managers' time. Our request letter specified that the interviews would take around one hour, and it gave an assurance that responses would be anonymous in our reports on the project.

The interviews took place between November 2005 and June 2006. Our intended selection strategy was to obtain responses from a random sample of companies. We initially approached 18 UK listed companies selected at random from different size categories, by letter first, followed by one or more phone calls. This only yielded one interview, so we revised our strategy for gaining access to interviewees and decided to make use of contacts (Buchanan et al. 1988, 56-58). Initially we made use of prior research contacts. We contacted individuals who had responded to a questionnaire sent by one of the authors in 2003 (reference omitted to preserve anonymity), which proved a somewhat more successful tactic. There were 44 FD respondents to this questionnaire who were still in post and we contacted them by letter and follow-up email, which yielded six interviews. We also examined the list of 78 IR director/officer respondents to the questionnaire and approached six of these. We

selected those who were still in post, who had replied to the 2003 questionnaire and whose companies had also replied to a similar questionnaire sent out by one of the authors in 1989 (reference omitted to preserve anonymity). This resulted in two interviews with IR directors. Six interviews were then obtained through departmental or University alumni office contacts, and one FD responded to a request for help circulated on our behalf by the ICAEW in a newsletter. In the end we obtained interviews with 16 individuals, from 75 contacted by various means. This is a low conversion rate compared with previous interview-based studies.

Buchanan (1993, 297) makes a distinction between recruitment of interviewees as representative of an organisation and recruitment in a personal capacity. He argues that respondents recruited through representative recruitment 'speak for the organisation representing an *official* or "public" face', whereas personal recruitment yields respondents 'who speak for themselves and speak *of* the organisation'. Although we used different types of contacts to recruit interviewees, we had never met any of the interviewees before either in a research or social setting, apart from the fact that one of the researchers had been briefly introduced to one of the respondents at a university event. Additionally one researcher had conducted interviews at two of the companies before but with different people. Thus our interviewees can be categorised as representative of the organisation.

Nine of the 16 were serving FDs, four had been FDs within the last two years, and three were serving directors of investor relations. The four former FDs could have leaned towards speaking for themselves, but in fact three spoke as if they were representing the official face of their former organisation. The fourth, N in Table 1, was different; he mentioned after we had thanked him for his time that

> I don't think I'm a particularly standard example, of course I have the benefit of not currently being a plc director and therefore I am entirely free to express opinions because they cannot by definition be attached to any company.

It is possible that IR directors, as professional communicators rather than finance specialists, would be more likely to present the official line of their company and be less forthcoming when expressing opinions. But the IR directors we interviewed all had one or two professional qualifications in areas related to financial services (e.g. accountancy, banking, investment analysis) and they appeared to be comfortable in answering our questions about the cost of capital. The mean word count of their interview transcripts was shorter but not significantly so. In summary, we do not expect either our approach to obtaining interviews or the employment positions of the interviewees to lead to bias in the findings. We found it difficult to obtain interviews, but all those that we did obtain were informative and several executives were very forthcoming.

One remaining concern is that the focused nature of our enquiry might result in bias towards finding a link between disclosure and the cost of capital. Someone who did not think there was a link might have believed they had little to say, and so might have been less willing to be interviewed than someone who did think there was a link. As the majority of those interviewed turned out to be equivocal about the link, we suspect the bias is not large.

<<Table 1>>

Table 1 shows the market capitalisation and main businesses of the sample companies. All are registered in the UK and they are a fairly representative cross-section in terms of type of business. 13 are amongst the largest 300, though only five are in the top 100. This is a difference from Holland (1998; 2006), who samples mainly top-100 companies. Each interviewee is given an identification letter in Table 1 according to the size ranking of his company, and these are the letters that follow the quotations in Section 4 below. Table 1 also shows two estimates of the percentage free float for the shares, as companies with a larger

percentage free float, or lower managerial ownership, are expected to be more transparent, other things being equal (for example, Gelb, 2000).

Assuming that small companies provide less information than large ones, there should be more potential for a small company's policy on voluntary disclosure to affect its cost of capital, if either of the theories outlined in Section 2 applies in practice. We would expect estimation risk to be negatively related to the amount of information made available, and it is the case that the cost of trading is several times larger for a mid-size company around rank 500 than for a top-100 company. Thus, we expect that our inclusion of companies outside the top 100 will increase the probability that the FDs interviewed will perceive a link between disclosure and the cost of capital.

3.2 Interview process and analysis of information

The interviews lasted between 40 and 100 minutes; most were about an hour. They were recorded and we also took notes. Eight were face-to-face and eight were by phone; five were conducted by a single author and 11 by both authors. Our original intention was to carry out face-to-face interviews but this strategy had to be modified in view of the fact that some of our contacts were only willing to participate in a telephone interview. Face-to-face interviews provide a greater degree of social interaction between the researcher and interviewee than telephone interviews (Easterby-Smith et al, 1991, 76). From the point of view of busy company managers, telephone interviews are more flexible as they can be postponed at short notice by the interviewee and they ensure that the interviewers do not make wasted journeys. Although telephone interviews do not allow the interviewers to observe the body language and expression of the interviewee, we are confident that the data collected from these interviews are not substantially different from the data collected during the face-to-face interviews. The mean word count for the telephone interviews was 7,277 and

for the face-to-face interviews it was 6,767, with no statistically significant difference. The interviewees, as FDs or IR directors, were all familiar with conference calls as part of their job and one of the researchers had extensive experience of face-to-face and telephone interviewing. Apart from saving time and expense the telephone interviews were found to be superior in one respect. At the transcribing stage the tapes of the telephone interviews were far clearer with fewer words and phrases that were indistinct. Graham et al. (2005, 10) provides another example of a study using both face-to-face and telephone interviews.

Easterby-Smith et al. (1991, 108-112) suggest a staged approach to analysing interview data.[1] We used a version of this approach for our study. The first stage was familiarisation with the data. The transcripts were typed and we then checked them and edited them by listening to the tape and referring to our interview notes for clarification where the tape was unclear. Both authors read through the edited transcripts. At the reflection stage we summarised the transcripts question-by-question. The initial summarisation was carried out manually. For each question in our interview schedule the transcripts were studied and detailed notes were made on the views of the interviewees. The detailed notes were further condensed into brief summaries of each interview. The data were therefore condensed in a way that enabled us to establish a coding scheme for each question. We created ordinal categories for the responses to the main questions, established the main opinion of each interviewee on a given question, and produced summary tables showing how many of the interviewees subscribed to a given opinion. We then returned to the transcripts to check that our codings were correct, and finally reviewed the detailed notes and brief summaries.

The conceptualisation stage involved considering our results and comparing them to the theoretical insights and empirical findings contained in the literature review. All our interview questions were motivated by the literature review. Thus we were able to look both

for confirmation of existing theory and prior findings and also for greater insights into the theories incorporated in the interview questions. At this stage we identified some ideas from the interviews for further investigation. We entered the data into QSR NVIVO to enable us to follow up these ideas by carrying out searches of the data. The ideas were linked with prior literature in order to expand our coverage of relevant issues in the text and to obtain an improved understanding of the ideas themselves. ~~Finally a draft paper was presented at two conferences. Audience queries and comments were noted and were followed up by coding new nodes in NVIVO to see if any important new ideas emerged. After this stage we re-evaluated our findings to ensure that all significant new ideas had been identified and explained in our results section. We also sought feedback from our respondents in respect of one of the new ideas (see Section 4.3).~~

4. Findings

After reading and reflecting on the transcripts we developed ordinal categories for the responses regarding the main topics and questions asked. These findings are summarised in Table 2. For ease of interpretation, the view of each interviewee on a given topic is represented by one answer, so the answers in Table 2 always sum to the sample size. This approach required making a judgement about the interviewee's primary opinion about a topic, if he expressed more than one, but the primary opinion was usually obvious.

4.1 Background: disclosure policy

Companies must disclose information that is mandatory and may disclose information that is recommendatory or voluntary. Companies also make policy choices about the media used to disclose information, subject to legal requirements. The information search costs of

[1] Easterby-Smith et al. consider their approach useful in grounded theory studies. The current study was not designed as a grounded theory study as the research questions were strongly based on prior theories. However

investors are reduced if information is made freely available in a timely fashion. Eccles and Mavrinac (1995, 12) suggest that companies can improve the understanding of information users by modifying the media they use and 'reaching out more proactively to users'. Bearing this in mind our first question asked the interviewees to outline their disclosure policy in general terms.

The majority of the FDs see their companies as disclosing at or above the benchmark level of good practice for listed companies in their business. One FD seeks to be fully open, with nothing withheld: the aim is 'to establish a level of transparency which you could touch and feel and experience' (N). Seven more see their companies as operating a best-practice disclosure policy, above the level expected by regulators or the stock market, but with some commercially sensitive information withheld. 'We try and seem cutting-edge without going over the top' (B). Six companies aim for good-practice disclosure, in line with what is expected. This can be considerable; the annual report of one of the banks is 240 pages long (A). The remaining two companies disclose the minimum required by legislation.

Our sub-question asks what factors make a difference to disclosure policy in practice. For example a company might increase disclosure when its performance is expected to improve, to support the share price or signal the talent of management, or when it plans to raise more capital, to reduce the cost of raising capital. Healy & Palepu (2001, 430-431) note potential ambiguity in the results of empirical studies showing that greater disclosure is associated with more share trading or more analyst scrutiny or a higher share price. If companies decide to disclose more when the business is performing well, then it could be the good performance that causes greater interest from investors and a higher valuation, rather than greater transparency. However, no-one in our sample agrees with the suggestion that the degree of disclosure is linked to the company's performance, and several executives state that,

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the staged approach was useful for analysing our data .

if anything, it is more important to be open when performance is disappointing. One respondent's view is that increasing disclosure with good performance would 'look stupid' (N). The respondents' companies do not increase disclosure prior to a capital issue. Rather, their disclosure policy typically evolves gradually in line with legislation, with what competitors are doing and with the demands of the market. Concerns about commercial sensitivity were expressed in the context of disclosure policy but we defer discussion of this issue to Section 4.6 on the costs of disclosure.

4.2 Background: estimation of cost of equity

The Hermes Principles (Hermes Pension Management Ltd, 2002, 8) assert that the best companies are demonstrably aware of the importance of the weighted average cost of capital (WACC). They also note that although WACC can be a difficult number to calculate it is important that investors know that companies understand their cost of capital.

We find that it is common for companies to use estimates of the cost of equity from their broker or from analysts or other financial advisers, when calculating their WACC. Six of the companies rely solely on estimates from such external sources. Six produce estimates in-house and check these against external estimates. One interviewee said that he will contact analysts if the in-house estimates differ from the analysts' estimates, as he feels it is important for the two sets of estimates to be similar. All the six in-house estimates are from the capital asset pricing model (CAPM), and most of the interviewees believe that the external estimates are also from the CAPM. Of the remaining four companies, two use dividend yield and two do not estimate the cost of equity at all but use the cost of debt as their hurdle rate. These four are all relatively small, being in size rank 200 to 300, or smaller. Both dividend yield and the cost of debt are incorrect proxies for the cost of equity, in principle.

<<Table 2>>

The prevalence of the CAPM to estimate the cost of equity is in line with the findings of other recent investigations in the UK (Arnold & Hatzopoulos, 2000; McLaney et al, 2004; Rutterford, 2000) and the USA (Graham & Harvey, 2001). In addition, these studies find, as do we, that a variety of other methods are used by minorities of companies, not all of which are appropriate in theory. For example, Arnold & Hatzopolous report that 11% of their sample use the cost of debt as the company's hurdle rate and 6% use 'an arbitrarily chosen figure'. Studies have recorded that companies use external estimates of beta, but our finding that many companies rely on or refer to external estimates of the actual cost of equity is not noted in previous research. It may reflect a growth in the estimation of clients' cost of capital as part of the services offered by brokers and consultants.

Only eight (half) of the FDs regard the cost of capital as an important number, in frequent use by their company. Five view the cost of capital as moderately important, used infrequently. The lack of importance is thought to apply either because formal investment appraisal takes place infrequently, or because the result of a discounted cash flow (DCF) analysis is only one input in arriving at an investment decision. Three FDs believe the cost of capital is not an important figure; for example,

> We don't as a company pay a great deal of attention, for better or worse, to cost of capital... The returns we generate are very high; what we tend to be constrained on is the opportunities to buy land, secure planning and build... We have a single cohesive business and so we don't have to decide how we allocate our capital between various elements of our business (J).

A second company gives as a reason the fact that it has not issued equity for many years, and for the third, NPV analysis is not the only factor used when deciding to invest. The lack of

importance attached to the cost of capital by half the companies is a surprise, at least from the perspective of finance education in which it is an important concept. Whether or not DCF is important in managing the business, it remains the case that the cost of equity is one of the two variables that in theory determine the value of a company's shares, the other being the expected cash flows to equity.

4.3 Does improved disclosure reduce the cost of equity?

There was a wide range of opinion expressed about our central question but the majority of interviewees do not see a strong link between the level of disclosure and the cost of equity, given the disclosure levels of their companies. Only four believe that disclosure definitely reduces the cost of equity. Another four think that there is a certain level of disclosure which analysts and fund managers expect the company to meet. There would be little benefit in disclosing more than what was expected, but if the company were to fall short of the benchmark level, perceived uncertainty would increase materially, which would probably increase the cost of equity. For example,

> You either disclose enough, in which case I don't think disclosing any more has any impact, or you don't disclose enough, in which case I think you've got quite a problem and cost of capital will be a big issue... Given I've reached the step [of sufficient disclosure]... our cost of capital is much more determined by my and a few colleagues' relationships with our key shareholders. That's what makes the difference. If they trust me, and I keep talking to them, and they build up a feeling of confidence in the way we do things, I will go to them and be able to place [shares] with them... (M).

Six FDs think that there is a link between disclosure and the cost of equity in theory, but are not convinced that such a link exists in practice. However, all of them believe that their

companies are providing a good-practice level of disclosure or better. The remaining two believe that there is definitely no link. Six volunteered the view that other factors are much more important in determining the cost of equity. The other factors mentioned were either the underlying risk of the company or the profitability and prospects of the business. One of the two sceptics, L, believes that if investors perceive the company to be well managed, that will be reflected in the share price. The quality of communication itself makes little difference to the price, but adequate communication is necessary for investors to assess the management.

We asked the interviewees how they thought disclosure affected the cost of equity, in principle. Several were tentative in their replies to this question. The answers were either that it reduces the risk as perceived by investors, or that it increases demand for the shares and therefore increases the share price.

> If I said to you I'd got a note under this desk, would you like to buy it from me, how much would you bid me? It could be £5, £10, could be £50, £100, how much would you give me?... If I showed it to you, you could probably price it a lot better... If you can't see, you discount things too much (O).

In the context of questions about the link with the cost of equity, seven FDs note that it is important to maintain the confidence and understanding of investors in the company and its management.

> I do think that improved disclosure provides more comfort to investors... It helps with the investment decision and therefore they would probably accept a bit more risk through the transparency, so perhaps another way of saying that is [that] WACC is lower... If we calculate our WACC at 7.9 [per cent] and we were making a return of 8.0 but we were completely opaque then investors wouldn't want to buy the shares. Whereas if... [we were] absolutely transparent on everything and people understood every part of the business...

> they might be prepared to say, well I do accept that... So it may not reduce the WACC but it certainly reduces I think people's internal hurdle about whether you invest in the company or not (D).

Four FDs commented that too much disclosure could increase the cost of equity, either because it would increase share price volatility, or in one case because announcement of an intention to issue shares would cause the share price to drop and would therefore increase the cost of equity. Three of these FDs linked the possible increase in the cost of equity to unease about revealing commercially sensitive information.

We asked in addition whether greater disclosure leads to more liquidity in the shares, as hypothesised by Amihud & Mendelson (1986) and others. There was little support for this idea. Only one executive thinks that increased disclosure definitely leads to greater liquidity. So the main link with the cost of equity, to the extent there is one, is via reduced estimation risk.

The views of up to 14 of the FDs are represented in Figure 1; the definite exceptions are the two who think there is no link between disclosure and the cost of equity. The graph illustrates the idea that, for each company, there is a benchmark of good-practice disclosure, and if the company were to provide less than this, the perceived risk and discount rate applied by investors would increase sharply. There is a key step change in the strength of the link. The reason, presumably, is that once a benchmark level has been reached, investors become confident that the company is not hiding important price-sensitive information - except that which is considered to be too commercially sensitive - so that disclosing further information will not make much difference to estimation risk. The nature of the benchmark disclosure effort is specific to the company and its business, to some extent. Effort beyond the good-practice benchmark yields little further reduction in the cost of equity, and eventually yields very little or none beyond a level of best-practice effort. This last stage is inferred from the

fact that neither practitioners nor academics suggest that a premium for information risk is the major part of the cost of equity for listed companies. Therefore, even if investors had as much information as the managers, the company's cost of equity would not be much lower than under modern best-practice disclosure. ~~The break points in the graph are company-specific and are determined, according to the view being presented, by how the level of disclosure affects the riskiness of the company as perceived by investors, and therefore by how the level of disclosure affects the rate of return investors require.~~

Figure 1 represents the explicit view of the four executives who think that disclosure beyond a certain level has little effect on the cost of equity. At least five of the six who said that disclosure matters in theory but not in practice also hold this view. All six believe that their companies are operating at or above the relevant good-practice benchmark, so perhaps it is not surprising that they say that disclosure has little effect in practice, if they are thinking of further disclosure. They clearly attach importance to meeting the market's expectations regarding disclosure, and it is clear from other comments they made that poor disclosure is not a serious option. To check that our interpretation of the views of these six is correct, we sent them Figure 1 with an accompanying explanation, and asked them whether or not they agreed with it. Five replied that they did; the sixth did not reply. It seems almost certain that the four FDs who believe that disclosure definitely reduces the cost of equity in practice would envisage a reduction in the effect at higher levels of disclosure. For them, the relationship would be a downward-sloping convex curve, as is envisaged by Elliott & Jacobson (1994) in their account of the relation between disclosure and the cost of capital. For the four FDs who believe that disclosure beyond a certain point could increase the cost of equity, the curve or line will eventually turn upwards.

<<Figure 1>>

The above evidence is consistent with the findings of Graham et al (2005) that US executives do not regard reduction in the cost of capital as the primary motive for voluntary disclosure. Our evidence also indicates a likely reason for this view among some FDs, which is as follows. Although there is thought to be a link in theory, via reduced estimation risk, the impact of disclosure is not thought to be strong enough for it to make much difference to the estimated cost of equity in practice, given the company's existing level of disclosure. If some of the respondents to the survey of Graham et al (2005) believe, likewise, that the impact is weak in practice, it would explain why they answered both that disclosure reduces risk and that it does not reduce the cost of capital.

We asked what else a company could do to reduce its cost of capital, other than improve its disclosure. The consensus view is 'not very much'. Four interviewees think that the weighted average cost of capital could be minimised by optimising gearing. One from a smaller company thinks that obtaining a credit rating would reduce the company's cost of debt, but that it is too small at present to justify the cost of a rating.

The dominance of the CAPM in estimation of the cost of equity is a possible explanation for the prevailing scepticism regarding a link between disclosure and the cost of equity in practice. In the standard CAPM, only differences in companies' betas explain differences in the cost of equity across companies. It is not obvious *a priori* whether greater disclosure would be expected to increase or reduce a company's estimated beta.

4.4 Further detail on link with cost of equity

In theory, for there to be an effect of disclosure on the cost of equity, investors need to be confident that a given level of disclosure will be maintained in the future. Botosan & Plumlee (2002), using US data, find that the cost of equity decreases with the level of

disclosure in annual reports but increases with the level in quarterly reports, news announcements and other more timely disclosures. They point out that managers claim that a greater level of timely disclosures may increase the cost of equity capital, possibly because timely information promotes short-term trading which increases the volatility of the shares. They find no association between the cost of equity and the level of investor relations activities. This study suggests that the type of disclosure is important. One interpretation of the findings is that the cost of equity is sensitive to the firm's commitment to a future level of transparency, and that the annual report is the most reliable indicator of such a commitment, being less flexible than other types of disclosure, as suggested by Gelb (2000, 182).

We asked whether some methods of disclosure are more important than others in affecting the cost of equity. In view of the perceived absence of a strong link between the two, this question was probably treated by most FDs as asking which methods are most important in conveying information to the analysts and investors. Eight said that either presentations to groups of analysts and investors, or one-to-one meetings, are most important, while two view news announcements as primary.

> Most important is RNS [Regulatory News Service] announcements because they have the biggest effect on the share price, which drives the cost of equity. It's easy to tell from RNS announcements how transparent the company is. Minimalist is facts only, no comment and rely on 'magic circular phone calling' by the broker and PR consultant to fill in the story. Second level is facts plus opinion, but the opinion may be biased or strained. Third level is the full story, with no gaps, and opinion which is not too strong. Investors have the information to make their own judgement.' (N)

The remaining six said that all the channels are important or do not distinguish between them. 'They all matter if they're not there' (M). This evidence is broadly consistent with that of

Holland (1998, 2006) and others that face-to-face contact and the opportunity for questioning are seen both by companies and by investors as adding value. However, annual and interim reports have not become viewed as superfluous. Reports contain the 'bedrock' of factual information (C), though they are thought to be little read by professional investors and to be too complex in parts. Several FDs mention the central role of the website, noting that the contents of presentations are put onto the site on the same day as the presentation is given. One FD regards a company's website as an important pointer about the quality of its management: 'I look at a lot of companies' websites [and] the variation... is extraordinary, absolutely extraordinary' (L). It is clear from the FDs that the information and 'message' being conveyed have to be consistent across the channels. It is also clear that in nearly all of the companies considerable care and effort are taken over corporate communications, as has been well documented in previous research.

Our findings do not support the idea suggested above that disclosures via annual reports are viewed as more effective in reducing the cost of capital than other methods of communication. Most executives either regard presentations and meetings as the most important channels, or do not make a distinction.

Regarding the content of the information, as opposed to the channel of communication, the executives emphasise promoting understanding of the business and of the reasons for its results, rather than seeking to provide detailed explanations of the accounting numbers. By its nature, information to promote understanding is company-specific and heterogeneous in its content. No particular items of information are singled out as being especially important in their effect on the cost of equity. The view is that the information that should be highlighted and discussed is the information which is important in understanding the company's business.

We also asked whether the effect of disclosure depends on establishing a sustained commitment to a given disclosure policy, and if so, how such a commitment could be established. Healy & Palepu (2001, 425) note that the credibility of disclosures is important, and an explicit commitment may assist credibility. There is general agreement that a company's disclosure arrangements should not be tampered with lightly, and that if some aspect is to be changed, then it should be done openly and the reasons explained carefully. For example, one interviewee related that one year his company decided to stop reporting the results of its Irish subsidiary separately and as a result he 'got a lot of negative comments from analysts for messing around with their lives' (D). Another told us that his company switched from quarterly to semi-annual reporting following the sale of a large US operation. The company had been expecting some resistance to this, so it had forewarned the market carefully, but in the event 'everyone was relieved... I take it that frankly quarterly reporting is a burden in our sector and doesn't add anything' (C).

Gietzmann & Ireland (2005) hypothesise that the relation between disclosure and the cost of equity is negative only among companies with relatively aggressive accounting policies. They present quantitative evidence from the UK in support of their hypothesis. However, our interviewees are doubtful about whether there is an interaction between accounting policy and the effect of disclosure. Seven think there is no interaction, six think there might be some and three are not sure. Most FDs volunteered the view that their company currently has little room for manoeuvre in choosing its accounting policies, due to tighter regulation in recent years and to higher expectations on the part of investors for homogeneity in financial reporting across companies. No-one thinks that aggressive accounting would be sensible for their company, even if it were possible, and some cited UK examples from the 1990s or earlier in which aggressive accounting had been a symptom of

trouble in the company. One FD suggested that ‘perhaps everybody’s WACC has been improved because of the level of disclosure and the rigidity of accounting policy’ (D).

None of the companies had provided an explicit written commitment or description of its overall disclosure policies. The view expressed to us was very much that the company’s policies are revealed by what it does, and that any deviation from the precedents it sets itself will quickly be spotted. A written statement is felt to be unnecessary and several interviewees think such a statement would also be unwise, providing a constraint or a hostage to fortune. There is one exception in our sample: a manufacturing company in a ‘dirty’ industry publicly provided a written environmental disclosure policy as this was seen as beneficial to the cost of capital.

When asked further about how their policies are set, most said that the policies had evolved gradually towards more openness. Only one could recall any sudden major change. He had been FD at the time of a company’s initial public offer following a buy-out. The decision was made at the time to set a policy of being very open. Two years later a new chief executive decided the company should be less transparent, at which time the interviewee had left the company. There is also one example in our sample of a specific change in policy to increase disclosure. This relates to a decision to report the company’s estimate of its cost of capital, and the use of the estimate in a new management compensation scheme.

4.5 Disclosure and cost of debt

We asked whether greater disclosure to a bond rating agency or a bank would affect the cost of a bond issue or bank loan. The answers varied as they did for equity. Nine of the interviewees said that providing more information would probably increase the availability of debt, or reduce the cost of debt, with only one saying it would have no effect and six not sure. Furthermore, 14 stated that their company provides private information to rating agencies or

lenders, i.e. more information than is provided to the equity market. Both the companies that do not provide private information are large banks. With these two exceptions, the remaining seven interviewees working for companies large enough to have issued bonds all said that they provide the rating agencies with the most information, on the understanding that it will remain confidential to the agency. So the agencies are apparently able to obtain more information than any other outsider, including analysts, fund managers and bankers. Five FDs from the bond-issuing companies also said that they provide their banks with some private information, not disclosed to shareholders, though not as much as they provide to the rating agencies. The seven companies without a credit rating borrow from banks and provide them with private information, for example monthly management accounts. The information provided to agency analysts and bankers is determined in part by what the company is asked for, and the focus of lenders is somewhat different from that of equity investors, with more emphasis on projections of future cash flows.

Several interviewees emphasised how thorough the rating agencies are. For example, according to G the questions are 'very profound and very detailed and can drive you a little bit crazy... The level of disclosure for the rating agencies is way beyond anything we do for anybody else.' Another FD feels that his company should not give agency analysts extra information, both on principle and because it leaves the company more vulnerable to downgrades. Bond investors themselves appear to depend mainly on ratings for their credit assessments. Some companies invite them to presentations and to meetings with fund managers, but often they do not attend. On the other hand, one interviewee mentioned that his company will mount a road-show for bond investors when launching a bond issue.

Our findings are consistent with US evidence indicating that there is a flow of private information from companies to rating agencies. Event studies have tested whether the stock market reacts to changes in credit ratings and to news regarding bank loans; a non-zero

reaction of the appropriate sign is consistent with the hypothesis that the rating agency or bank has obtained information not available to equity investors. In the USA there is a significant reaction to changes in ratings, which is stronger for downgrades (eg Jorion, Liu & Shi, 2005).

We find that five of the nine companies that have issued bonds and all seven companies that have not issued bonds provide lending banks with private information. This evidence is intriguing. Berry et al (1993) and Holland (1993, 1994) report on interviews with commercial bankers and with treasury officials at UK companies. The impression these studies convey is that, while large listed companies are at pains to maintain relations with a few core banks, they do *not* normally provide them with private information beyond that which arises from the banks' business dealings with the companies. In the USA there is a significant reaction to news regarding loans to smaller listed firms, below the median market capitalisation on the New York Stock Exchange (eg Slovin, Johnson & Glascock, 1992). Armitage (1995) finds no clear evidence of a reaction to news regarding syndicated bank loans to UK listed companies, though the vast majority of the borrowers in his sample are above the median market capitalisation on the London Stock Exchange. Possibly the drive for greater public transparency since the mid-1990s has induced companies to be more open with their banks.

Our evidence indicates that the ranking in terms of access to company information is, rating agencies first, banks second, and analysts and fund managers third. This is the reverse of what would be expected if disclosure does reduce estimation risk and if this results in a lower discount rate, since the cost of equity should be more sensitive to estimation risk than the cost of debt. We believe that the reason why rating agencies and perhaps banks can obtain private information from large companies is that it is easier for a single agent to be kept well informed than it is for many agents (see Boot, 2000, for a review). In particular, it matters to

companies that private information revealed to a rating agency or bank will stay private, as several FDs remarked. This fits with the view among all but one of our interviewees that some information should be kept secret from competitors. Since the mid-1990s it has become problematic to provide information to investors, or to certain investors only, without at the same time making the information publicly available. A further point is that, having made a decision to obtain or retain a rating or bank loan, the company is constrained to some extent to provide the information requested, since otherwise the rating or loan may not be forthcoming. It would be possible to try another rating agency or bank, but there would be some cost, and the alternative agency or bank might require just as much information. There is usually no similar tangible threat if a company does not provide certain items of information to analysts and fund managers.

4.6 Costs of disclosure

We asked next about the costs and benefits of disclosure, in general. Incremental creation and provision of information for disclosure purposes is seen as the main cost by nine interviewees; presumably, the bulk of this cost is staff time. The other main costs mentioned are management time, by three FDs, and release of commercially sensitive information, by one. Three interviewees do not see disclosure as having any significant cost. Thus, opinion varies on the extent to which the disclosure process calls for costly extra information to be produced. Here is the view of one FD who believes the burden to be appreciable.

> There is no doubt that there is a need to have a process in place just to get the information... and the onus is then on the verification and accurate presentation of the information... If I presented internally a balance sheet that didn't balance it would lead to some embarrassment but it wouldn't actually be a big deal, but if we produced an annual report with a balance sheet that

> didn't balance it would be very different. So there's a big quality-control cost involved and I think one of the problems with the external reporting now is that much of the information that's produced for external consumption is actually useless for internal management of the business, but nevertheless we still have to produce it (F).

Here is a contrasting view:

> We've got 150 operating companies [that produce financial statements every month]... So the normal management accounting process is fairly comprehensive. But what are these additional costs of disclosure? It's about the notes to the accounts that you require once a year, and it's about putting a good narrative around it once a year... It doesn't feel like a lot of money to get the basic wherewithal to explain all the other stories that we do (G).

Most companies do not attempt to estimate the financial cost of their disclosure efforts. The interviewee from one of the larger companies (D) said that their investor relations budget is about £0.75m pa.

Four interviewees volunteered that the corporate social responsibility (CSR) statement is especially costly, or would be if the company produced it. For example,

> We're a public company and there is a certain raft of controls which we're committed to which is fairly costly. Beyond that... the area I'm thinking of at the moment is the CSR report, and discussion of green issues and sustainability issues, there is an enormous amount of information that you could collate and present and report on. It wouldn't really earn us another pound of profit and we would need to create in effect another department to analyse and measure... things which we currently don't. So you are imposing

another raft of controls to working practices on an already busy workforce...

We may be a little wiser; I'm not sure we'd be any better off (J).

The attitudes towards disclosure of commercially sensitive information are interesting. We expected our interviewees to mention fear of competitive disadvantage as a cost of disclosure, but it is only cited once as the main cost. This is partly because the companies do not disclose information they regard as being too useful to competitors. All but one interviewee said that there is some information their company would not disclose. The types of information that are kept secret vary across the companies but include details of performance by business segment, subsidiary or country; specifics of pricing policies; details of particular contracts; investment in the marketing of brands; and details of products under development. Most interviewees acknowledge that there is a tension between disclosure and protection of sensitive information, although none see this as a serious problem. A typical view is that 'there is a trade-off, absolutely, but I think you can still give good disclosure without giving away commercially sensitive information' (C). The FDs are not persistently being asked questions that they do not wish to answer in presentations or in one-to-one meetings, though such questions are asked occasionally. Analysts and investors are aware that certain information is withheld and seem to accept where the boundary lies for a particular company. The evidence suggests that release of sensitive information would be seen as a major cost, were companies required or expected to disclose more than they do at present.

This is an area which would be worth exploring further. Most FDs clearly regard good or even best-practice communication as being compatible with non-disclosure of sensitive information. Yet presumably such information would be useful in assessing and valuing the company. Eccles and Mavrinac (1995) find that executives believe their companies are more transparent than do analysts and fund managers, and argue that a 'communications gap' exists between companies and investors. Holland (2006, ch. 3, 15-42) describes the preferences of

companies for secrecy and for private disclosure (in meetings) over public disclosure. But what lies behind these preferences? A preference for secrecy is inconsistent, on the face of it, with the majority view in our sample that disclosure, within limits, is a 'good thing'. We know little about how the line is drawn between what can and can not be revealed, nor about how attitudes are shaped regarding what counts as 'good disclosure'.

Our findings on the costs of disclosure are only partly consistent with those of Graham et al (2005, 60). They find that the most-supported concern is 'setting a disclosure precedent that may be difficult to continue' (agreed by 70% of survey respondents). 'Giving away company secrets' comes next (59% agree), followed by avoidance of 'possible lawsuits if future results don't match forward-looking disclosure' (46% agree). Our interviewees appreciate that if they decide to disclose more then they will be expected to continue to do so, but they do not view this as a reason not to disclose more. Concern about legal liability was only mentioned explicitly by three FDs. This is probably because the UK environment is less litigious than that in the USA. Four FDs mentioned concern about the prospect of having more targets and projections for the company to meet. The cost of producing the information, which, including management time, is the main cost according to 12 of our executives, is not mentioned at all in Graham et al's study; it is not one of the putative limits to disclosure listed for respondents to agree or disagree with. Holland (2006, 36) lists the perceived costs of communication in the UK as proprietary costs, including possible competitive disadvantage, and information-production costs. Our evidence indicates that FDs see the latter as more serious than the former.

4.7 Benefits of disclosure

The FDs mentioned a variety of benefits from disclosure. Most of our interviewees used the terms disclosure and transparency synonymously although one commented that

‘transparency in my view does not come from more disclosure, it comes from sensible disclosure’. Four said that the main benefit is a lower cost of capital or support for the share price, which *could* be interpreted as the same thing. Ten think either that being transparent promotes integrity within the company and in its dealings with stakeholders (two); or that it promotes confidence on the part of shareholders and other stakeholders (five); or that it is part of what is expected of a good corporate citizen (two); or that it helps non-executive directors to understand the business (one). These perceived benefits share the idea that transparency is seen by outsiders to the company as a sign that it operates a reputable, well-managed business. Several interviewees used the phrase that they want to ‘tell it as it is’, and to be seen to be doing this. One thinks that by being open FDs

> will actually live happier and more honourable lives, because they know that they are not, every moment of their lives, playing a game with their financial public relations... Now wouldn’t you much rather like to believe that all the senior management professionals running corporate Britain had that as their ethos rather than, how do I bend the rules and avoid saying what I don’t want to say? (N)

Other, secondary, benefits mentioned are that dialogue with analysts and shareholders helps the company to obtain information about developments in its markets; that good communication helps attract good graduates; that it reduces political or regulatory risk; that it promotes competition among lenders; that it raises the cost of doing business for competitors; and that ‘the press tend to sniff around a lot more if they think there’s a great secret they can unearth’ (D). One respondent (A) notes that the cost of capital can fluctuate for business reasons, such as mergers and acquisitions. He believes that it is desirable to avoid such fluctuations and that this can be achieved by ‘good information flows’. Two interviewees said that their companies are against disclosure and do not see any benefit from being open. No

company had tried to quantify the benefits of disclosure, because it is seen as too difficult to do so.

A conclusion from the above is that, for the majority of companies, a lower cost of capital is not perceived as the main benefit from disclosure. Rather, being open according to the standards of the day is, or has become, part of what a company has to do to maintain confidence and a good reputation amongst financiers and other stakeholders. 'Good disclosure is what's expected of a modern company' (I). The standards of the day are set partly by law and regulation but also by what analysts and others expect of listed companies; by what competitors are doing; by the nature of the company's business; and by developments in communications, for example the arrival of the internet. Maintaining a good reputation amongst investors may support the share price and this is, of course, consistent with obtaining a lower cost of equity. But our understanding of the interview evidence is that a lower cost of capital is seen by the majority as a possible beneficial side-effect of a good reputation, and that a good reputation is an objective in itself. Ten of the executives chose to describe the main benefit of corporate communications in terms of confidence, integrity, good citizenship or understanding. Our evidence is consistent with that of Graham et al (2005) for the USA, that the commonest motive for disclosure is promotion of a reputation for transparency. Similarly, Eccles and Mavrinac (1995, 22) report that 'the most significant benefit from improved disclosure is increased management credibility in promoting quality disclosure'. The emphasis on shareholder confidence is consistent with the view of Lundholm & van Winkle (2006) that the purpose of disclosure is to support the share price by reducing scepticism about the company's future prospects (i.e. cash flows).

Roberts et al (2006) focus on the impact of corporate communications with financiers on the internal information flows and culture of the company, arguing that meetings are a 'ritual subjection to the values of shareholders' (p. 291). Although we did not ask about the

effects of communication with outsiders on internal management, several executives made comments consistent with the idea that the two are linked. For example, one of the FDs who describes the main benefit of disclosure as promotion of integrity explains that the reason is that disclosure 'breeds integrity within the organisation' (E). The FD from one of the two companies that definitely dislike disclosure told us that one reason for the dislike is that the directors know the company could do more to maximise profit, but do not wish to be put under more pressure to do so (K).

4.8 Attitudes to additional disclosure

Our final question was about our interviewees' attitudes to possible regulatory requirements for more disclosure in the future, for example in the operating and financial review (OFR). All but one of the interviews were conducted after December 2005 when the UK Chancellor of the Exchequer announced the abolition of the statutory OFR before the new law had come into operation. 12 FDs commented on the OFR. Ten are positive about it, of whom four think that the contents should be prescribed by legislation and six that the contents should be left open. For example, F's view is that 'self-respecting companies' produce OFRs but that 'our preference is to operate in a regime of voluntary good practice'. Two are against a mandatory OFR. Of the remainder, one FD is neutral about more disclosure, one is against a rule-based approach generally, and two think that the existing regulations regarding disclosure are too onerous. So the majority view is that regulation regarding disclosure has gone far enough, since only four FDs are in favour of greater prescription.

Those who favour a prescriptive OFR believe that, without prescription, information of value to outsiders will not always be provided.

> I sat on the Board of XXX and one of the people sitting in the room, a non-executive director, told me as cool as a cucumber that he was very concerned

> about publishing the OFR next year, the top ten key performance indicators which he and his management team used to run his business, because of the fact that it would disclose to the world important commercial information... Just try and get your head around that, in terms of what shareholders should or should not be allowed to understand. If you have a legitimate set of performance indicators, which you've carefully chosen, which are by definition the pulse of the business... then of course you should be sharing with shareholders what they are (N).

However, many who are positive about disclosure also express unease in various ways about further regulation. The objections to further prescription in the OFR are reluctance to disclose targets regarding key performance indicators (KPIs) and to disclose forward projections of financial variables, and generally a feeling that prescription would force companies into a straightjacket and may sometimes hinder communication:

> My own view is to have legislation that says you must give forward-looking statements encourages banal legally protectable forward-looking statements that are actually of very little real value... and similar to where we are moving on an accounting regulatory form that says tick boxes (P).

Disclosure 'should be principles-based and market-based... the judgement of directors, with the requirements of investors [in mind], in my view is the key to relevant and reliable disclosure' (H). A focus on short-term targets is undesirable: 'Investors have a right to know what the business is trying to achieve, what management thinks the business can do, but over a medium-to-long-term basis rather than a quarter-to-quarter focus. And that's the risk with KPIs' (B).

There is a feeling that accounts have become too complex. 'We as a company are no longer in a position to judge whether our accounts comply with all regulations. We just don't

have the experience and we rely on our auditors' (J). Again: 'The Chairman... actually said, I think we should put a note in note 26 that said, if you've got this far and you send in a business card we will enter you in a draw for a magnum of champagne. And he was quite serious' (M). Three interviewees singled out the notes regarding pension liabilities or derivatives as having become impossible to understand. Four commented that the introduction of International Financial Reporting Standards has created more uncertainty, at least in the short term.

Another worry is that further disclosure would put the company at a competitive disadvantage, as noted above. 'One of our competitors is a private American company and... what we know about them factually you could write on the back of a postage stamp' (G). 'There are always people when you disclose things who are looking for the opportunity to use it in a way that's either positive for them or negative for you' (E). Two FDs mentioned concern about increased enquiries from the Inland Revenue.

For at least the last 15 years, part of the mission of the UK's Accounting Standards Board has been to make accounts more representative of economic reality and to reduce the scope for manipulation. The International Accounting Standards Board, established in 2001, shares these aims. Our findings have some relevance for the standard setters. All the executives we interviewed perceive that the practice of financial communication by UK companies, both mandatory and voluntary, has become more open and more exacting for companies in recent years. Changes in regulation are perceived to have been a major force in creating an environment in which good-practice disclosure has become normal and expected. The FDs noted this change whether or not they approved of it. We believe that the majority think that the change has resulted in a modest reduction in companies' cost of capital, though the main benefit has been improved shareholder confidence. On the other hand, there are instances of mandatory disclosure requirements that are seen as too complex for users and

indeed for some of the companies required to produce the information concerned. The majority view is that further disclosure by good-practice companies would be unlikely to make much difference to their cost of capital.

4.9 Findings by interviewee

Table 3 presents some of the findings by interviewee rather than by topic. The purpose is to show whether each FD's view on the link with the cost of capital is connected either with his company's disclosure policy or his personal attitude to disclosure. If the amount of benefit from disclosure is seen primarily to reflect the degree of its impact on the cost of capital, we would expect the FD's view of the impact on the cost of capital to be correlated with both his company's disclosure policy and his view of the benefit of more disclosure. The interviewees are listed by the size of their companies, and the table shows the average of the free float estimates, a numerical score of their answers regarding the company's disclosure policy (1 = best practice), their attitude towards more disclosure (1 = most in favour), and the link with the cost of capital (1 = link thought to be strongest).

The largest companies have the most open disclosure policies, as would be expected, although two of the smaller ones also see themselves as best-practice companies, and both have a high free float percentage (100% and 85%). The main point is that neither the company's disclosure policy nor the executive's attitude to more disclosure is significantly correlated with his view on the link with the cost of capital (confirmed by a Spearman rank correlation test). Of the four FDs most favourably disposed towards disclosure, only one thinks that more disclosure would reduce the cost of equity, and of the five who are definitely against increased mandated disclosure, two think that it would reduce the cost of equity. Of the eight executives who describe their company's policy as best practice, four think that greater disclosure does not reduce the cost of equity in practice. The evidence in Table 3

confirms that, in most cases, the impact on the cost of capital is not the primary consideration; it drives neither the company's actual disclosure policy nor the individual executive's attitude towards greater transparency.

A further point from Table 3 is that there is no association between the size of the company and the perceived strength of the link between disclosure and the cost of equity. So it is not the case that disclosure is perceived to make more difference for smaller companies, contrary to what might have been expected (Section 3).

As an aside, it can be seen that our sample includes one champion of disclosure, N, a former FD, with scores of 1 under all three headings, and one champion of secrecy, K, an in post FD, with three scores of 3. N clearly enjoyed the opportunity to put the case for transparency. K's answers represented the culture of his company more than his personal views. K's company had large family shareholdings, reflected in a relatively low free float of 65%.

<<Table 3>>

5. Summary and discussion

Summary. The purpose of this study is to find out more about the link between disclosure and the cost of capital, as perceived by FDs and investor relations directors of listed companies of various sizes. The focus on the cost of capital is motivated by the emphasis in previous research on the cost of capital as a primary route - or as *the* primary route - by which disclosure policy affects company value.

A feature of our findings is that opinions differ on most of our questions. However, the majority views can be summarised as follows. The FDs do not think that there is a clear link between disclosure and the cost of equity, beyond a good-practice level of disclosure.

Only one quarter believe without qualification that more disclosure reduces the cost of equity. 63% believe that it does so in practice only up to the point at which a good-practice level of disclosure has been reached, and that their companies already provide at least a good-practice level. The majority view is thus that there is a step change in the effect of disclosure on the cost of equity. Increasing disclosure up to the good-practice level has an appreciable effect, but the effect of further disclosure beyond this level is marginal.

The main benefits of disclosure are seen as promotion of confidence amongst investors and of a reputation for openness. While these effects could result in a lower cost of equity, they are seen by FDs as ends in themselves. 63% choose to describe the main benefit of corporate communications in terms of confidence, integrity, good citizenship or understanding. Only one quarter regard the main goal of their disclosure efforts as a lower cost of capital. Reports of some of the above views can be found in previous studies, notably Graham et al (2005), but our evidence makes it clearer what FDs are saying about the purpose of disclosure, and highlights the reputational benefit.

The majority of quantitative studies find a negative relationship between disclosure and the cost of capital. Our evidence does not imply that these findings are incorrect. We have merely sought to establish and elucidate the beliefs of senior executives responsible for disclosure policy. Perhaps the quantitative evidence is as yet too recent or inconclusive for it to have had much impact on the views of practitioners.

All but two of the FDs see their companies as providing at least good-practice disclosure, in line with what the market expects and with the practice of similar companies. The larger companies aim for best-practice disclosure. Both mandatory and voluntary disclosure are seen as having become more exacting in recent years. These findings fit well with the evidence from other recent studies documenting the care taken over the communications process by listed companies.

Most of the sample companies either use the CAPM to estimate the cost of equity in-house, or simply ask analysts. The use of external estimates is noteworthy. Only half of the sample view the cost of capital as an important number for their business. This is a surprise given the prominence of discounted cash flow in finance education, and the fact that in principle the discount rate has a major impact on the company's market value. The most important forms of communication for reducing the cost of equity involve face-to face contact with fund managers and analysts, via presentations and one-to-one meetings.

We asked about disclosure and the cost of debt. Nearly all of the sample companies disclose private information, beyond what they disclose to the stock market, to ratings analysts and, to a lesser extent, to bankers. Our evidence confirms that rating agencies have privileged access to information. However, the statements that banks obtain private information are somewhat surprising, as previous research indicates that large UK listed companies do not normally disclose more to bankers than to fund managers and equity analysts. 56% of the interviewees believe that greater transparency towards rating agencies and bankers increases the availability of debt or reduces its cost, though 38% are unsure about whether greater transparency would reduce the cost of debt.

The main cost of disclosure is seen as the cost of creating the information to be disclosed, cited by 56% of the interviewees, followed by management time, cited by 19%. The emphasis on the cost of provision is stronger in our sample than in existing evidence, which finds that concerns about setting a precedent and about commercial sensitivity are at least as important (Graham et al, 2005; Holland, 2006). Our interviewees generally do not believe that what they disclose puts them at a competitive disadvantage. But this is because there are industry-specific rules of thumb about what is and is not revealed. Companies withhold some types of commercially sensitive information, and the FDs do not view this as inconsistent with their belief that their companies maintain good- or best-practice disclosure.

They do not feel under much pressure from analysts or fund managers to disclose more, and they would probably regard it as a serious cost if their companies were forced to increase their disclosure of sensitive information. Three quarters of the FDs are against the prescription of further disclosure by regulation.

Discussion. The views of most of the FDs might appear to contradict both most of the existing theory, which predicts a negative relation between the cost of equity and disclosure, and the majority of the quantitative evidence to date, which finds such a relation in the data. However, the contradiction is not as pronounced as it might appear. First, the majority of the FDs think that disclosure does reduce the cost of equity, but only up to a (good-practice) point of disclosure which their company has already reached. This is not necessarily inconsistent with the theory either that more information reduces estimation risk, or that it reduces the cost of trading. In both cases it is plausible to envisage diminishing returns to the provision of more information. Our evidence could also be consistent with the existing quantitative evidence. A clear theme in the interviews was that provision of company information to the UK stock market had increased substantially since the mid-1990s, due to regulatory changes and higher expectations on the part of analysts and fund managers. There is no quantitative study of the association between the cost of equity and disclosure using UK data entirely from the late 1990s onwards. It is possible that such a study would find no association, or find none amongst larger companies (say, the top 500).

Another interpretation of our findings is that the FDs are reporting what they observe in their own experience. The cost of equity can not be observed directly and it is hard to measure, as is the level of disclosure. So it is hard for an FD to be sure that there is a link between the two. In contrast, the cost of debt, or at least the promised interest margin, can be observed directly. This could explain why the executives perceive a clearer link between

disclosure and the cost of debt, even though theory would suggest that disclosure has more effect on the cost of equity. In addition, most companies use the CAPM to estimate the cost of equity. It is by no means obvious that greater disclosure would eventually result in a lower beta estimate from historic data, even if investors were, in fact, to apply a lower discount rate to value the company. The FDs, or some of them, might be construed as saying that they don't see a link between disclosure and the cost of equity as estimated by the CAPM. However, none of them said this explicitly. What most did say, or confirm in our follow-up question, is that they had reached a level of disclosure beyond which any further reduction in the cost of equity would be small.

The quantitative studies that find that disclosure reduces the discount rate do not use the CAPM: they infer the discount rate from the share price. None of the FDs mentioned this academic evidence, though we did not ask them about it. They may have been more convinced about a link between disclosure and the cost of equity if the academic evidence were better known.

A further point is that the FDs might have been reluctant to admit that there were substantial *additional* benefits to be had from greater disclosure. It could be seen as tantamount to saying that they were not doing their jobs properly, unless they could point to substantial additional costs to set against the benefits. It is hard to know how much weight to attach to this. It would be interesting to know if the users of information - the analysts and fund managers - shared the perception of the FDs that there were few further gains to be had from disclosure beyond the levels of current best practice.

Another question for further research is why many executives regard promotion of confidence amongst investors and a reputation for openness as the primary benefits of corporate communication. Holland (2006) and Graham et al (2005) suggest that the gain from more openness is a lower cost of capital. Yet the FDs of good-practice companies are

doubtful. Why is it important, if not to reduce the cost of capital? How do the communication efforts made by 'self-respecting' companies contribute to market value? No doubt part of the answer is that they reduce investor scepticism, as Lundholm & van Winkle (2006) believe. But there may be more to it. A company's reputation and that of its brands can be very valuable intangible assets, as is recognised in the literature on competitive advantage and on the theory of the firm. A good reputation indicates quality and reliability; a higher probability of successful delivery of a product or service, as in Tadelis (1999). This helps to attract and retain customers, to raise external capital, and in other ways. More radically, one explanation for the existence of companies is that they are entities that can earn a reputation for fair play. Firms exist because a good reputation facilitates doing business, according to this view (Kreps, 1990). It seems reasonable to suggest that developing a reputation for transparency enhances the company's reputation more generally. We would expect a company that is fair in its dealings with its customers and other stakeholders to be open and frank.

This suggestion provides a commercial motivation for voluntary disclosure and can explain why most executives view enhancement of the company's reputation for transparency as the number one motive for disclosure. If it is accepted, it provides a different motive for voluntary disclosure from those reviewed by Healy & Palepu (2001) and listed in Section 2. The benefit from an enhanced reputation that we are thinking of is not that it reduces the perceived riskiness of the future cash flows, nor that it induces investors to expect higher cash flows because they are less sceptical, nor that the company will have a more accurate market value. The benefit is improved competitive advantage and ease of doing business. A topic for further research would be to examine further how and why greater transparency promotes a company's reputation and helps it to do business.

To the extent that disclosure is thought to affect the cost of equity, what matters is for the company to have reached a level of good-practice disclosure. The judgement about what

constitutes a good-practice level is informed by feedback from analysts and investors, and by observation of the disclosure practices of firms in the same sector. We hypothesise that executives will feel the same about the link between level of disclosure and the company's reputation for transparency. What is most important, in terms of the reputational benefit from voluntary disclosure, is for the company to be seen to be 'in the club' of companies that are meeting the prevailing market expectations regarding corporate communications. At the same time, it appears that the market expects a certain amount of secrecy; a company can have a good reputation for openness without being entirely open. Hence, another area for further research is how the boundary is set between what is disclosed and what is withheld.

Appendix

Topics proposed for discussion (sent to interviewees in advance)

1. Background on the company's disclosure policy.

   How is your policy formulated?

   What factors make most difference in practice? For example, is it the case that a decision to improve disclosure is more likely to be taken when the company's performance is expected to improve?

2. Background on how the company estimates its cost of capital.

3. Do you believe that improved disclosure reduces the cost of equity?

   If yes, how do you believe that the link works?

   What else can the company can do to reduce its cost of equity?

4. We wish to explore the link between disclosure and the cost of capital. For example:

   Companies provide information of various types and via several channels, eg annual report, news announcements, meetings with analysts and investors. Are some types of information more important than others for the cost of capital?

   Does choice of accounting policy interact with disclosure policy to affect the cost of capital?

   Does the effect of disclosure on the cost of capital depend on establishing a sustained commitment to improved disclosure? If so, how is such a commitment established?

   Would better disclosure be expected to reduce the cost of a bond issue? a bank loan?

   Does the company disclose non-public information to lenders?

Are there disclosure decisions targeted towards lenders rather than equity investors?

5. Costs and benefits of disclosure in general.

What do you perceive to be the main costs?

What are the main benefits, other than possibly reducing the cost of capital?

Do you attempt to measure the costs and benefits from time to time?

What is your attitude to moves towards requiring increased disclosure by listed companies, for example in the operating and financial review?

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Table 1

Current or most recent company of interviewee

Case reference	Size category	Free float Stoxx (%)	Free float Data-stream (%)	Main business	Position of interviewee
A	1 to 100	100	100	Banking	Director of Investor Relations
B	1 to 100	72	71	Food, drink, tobacco	Director of Investor Relations
C	1 to 100	100	93	Energy	Finance Director
D	1 to 100	100	83	Retailing	Director of Communications
E	1 to 100	100	94	Banking	Finance Director
F	100 to 200	100	89	Manufacturing	Finance Director
G	100 to 200	80	74	Manufacturing	Finance Director
H	100 to 200	74	69	Real estate	Finance Director
I	200 to 300	100	82	Manufacturing	Ex Finance Director
J	200 to 300	N/A	92	House building	Finance Director
K	200 to 300	N/A	65	Real estate	Finance Director
L	200 to 300	47	N/A	Rail, road and freight	Ex Finance Director
M	200 to 300	100	62	Asset management	Finance Director
N	300 to 400	100	100	Business support services	Ex Finance Director
O	500 to 600	N/A	85	Business support services	Finance Director
P	1000 to 1100	N/A	70	Manufacturing	Ex Finance Director

Note

The case companies are ranked by market capitalisation as at 31 July 2006. Size category is based on the market capitalisation of UK-registered listed companies, excluding investment vehicles. Total number listed = 1,975, including companies on the Alternative Investment Market. Free float data are from Datastream as at 30 December 2005, as available. Free float Stoxx is the percentage of market value used in calculating the weight of the share within a Stoxx index. Free float Datastream is the item NOSHFF: the percentage of total shares in issue available to ordinary investors; total shares less ‘strategic holdings’.

Table 2
Summary of main findings by topic

The view of each interviewee on a given topic is represented by one answer, so the number of answers always sums to 16.

Assessment of disclosure policy	
Completely open	1
Best practice but not completely open	7
Good practice, in line with peers	6
Minimum: what regulation requires	2
Estimation of cost of equity	
In-house, using CAPM	6
From external analysts	6
Dividend yield	2
Hurdle rate is cost of debt	2
Importance of cost of capital estimate	
High: used a lot	8
Medium: used occasionally	5
Low	3
Does improved disclosure reduce the cost of equity?	
Yes, definitely	4
Yes but not beyond a certain level of disclosure	4
Yes in theory but not materially in practice	6
Probably not	2
Most important types of disclosure for cost of capital	
Financial reports	0
News announcements	2
Presentations to analysts and investors	5
One-to-one meetings	3
All types or no clear distinction made	6
Does choice of accounting policy interact with disclosure policy to affect cost of capital?	
Yes	0
Possibly	6
No	7
Don’t know	3
Does improved disclosure reduce the cost of debt?	
Yes	9
No	1
View not clear	6

Table 2 cont.

Does the company disclose private information to lenders?	
Yes	14
No	2
Main costs of disclosure	
Management time	3
Costs of creating incremental information	9
Gives commercially sensitive information to competitors	1
No major costs	3
Main benefits of disclosure	
Lower cost of capital	3
Supports share price	1
Promotes integrity: culture of openness is beneficial	2
Promotes confidence in company on the part of shareholders	5
Good citizenship	2
Helps non-executive directors to understand the business	1
No major benefits	2
Attitude to more disclosure, for example in OFR	
Positive re OFR and in favour of prescription re contents	4
Positive re OFR but against prescription re contents	6
Neutral	1
Against mandatory OFR or against rule-based approach	3
Current disclosure regulations are too onerous	2

Table 3
Some findings by interviewee

Size rank and case reference	Free float	Score of company's disclosure policy	Score of attitude towards more disclosure	Score of view on link with cost of equity
A	100	2	2	1
B	72	1	2	3
C	97	1	1	2
D	92	1	2	3
E	97	1	2	2
F	95	1	2	3
G	77	1	1	3
H	72	2	2	1
I	91	3	3	2
J	92	2	3	3
K	65	3	3	3
L	47	2	1	3
M	81	2	2	2
N	100	1	1	1
O	85	1	3	1
P	70	2	3	3

Note
Free float is the average of the two estimates in Table 1, if available. Disclosure policy score is derived from 'Assessment of disclosure policy' (Table 2): 1 = completely open, and best practice; 2 = good practice; 3 = minimum. Score on attitude to disclosure is from 'Attitude to more disclosure': 1 = positive re OFR and in favour of prescription; 2 = positive re OFR and against prescription, and neutral; 3 = against mandatory OFR or rule-based approach, and current disclosure regulations are too onerous. Score on link with cost of equity is from 'Does disclosure reduce the cost of equity?': 1 = yes, definitely; 2 = yes but not beyond a certain level; 3 = yes in theory but not materially in practice, and no link.
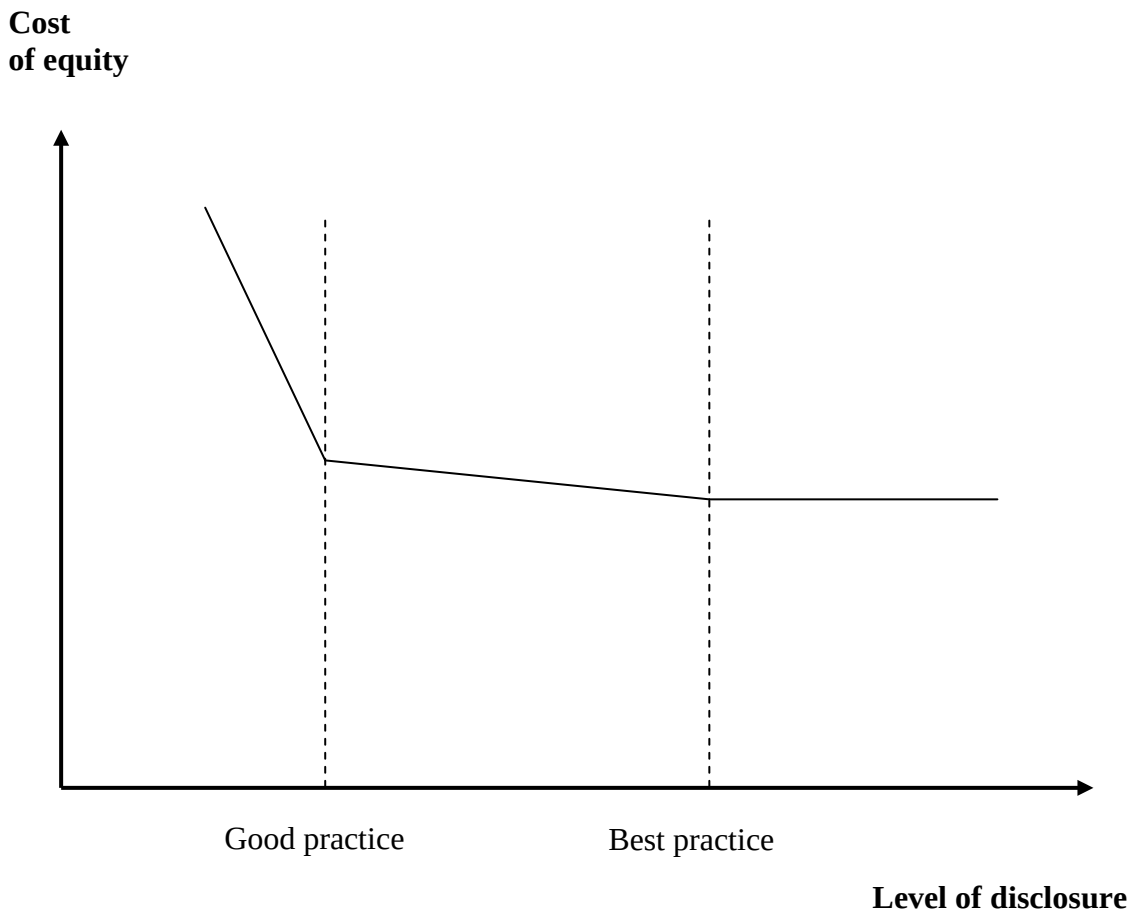
Figure 1
Effect of disclosure on the cost of equity