Briefing

CORPORATE DISCLOSURE AND THE COST OF CAPITAL: THE VIEWS OF FINANCE DIRECTORS

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May 2007
The Centre for Business Performance promotes and funds, through the ICAEW’s charitable trusts, leading-edge research on performance-related issues of immediate and long-term importance to the business community. Its goal is to advance thinking and practice related to performance enhancement and value creation and to encourage discussion of new ideas by directors, entrepreneurs and others.
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Summary

This project investigates the views of finance directors (FDs) on the costs and benefits of corporate communications, with a focus on their views about the link between disclosure and the cost of capital. The focus on the cost of capital is motivated by the emphasis in previous research on the cost of capital as a primary route – perhaps 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. At the risk of neglecting this diversity, the majority views are summarised below.

There are two main findings:

- The majority of the FDs do not believe that there is a clear link between disclosure and the cost of equity. Only one quarter believe, without qualification, that more disclosure reduces the cost of equity. A further quarter believe that this is so only up to the point at which a good practice level of disclosure has been reached. Nearly two-fifths perceive no link between disclosure and the cost of equity in practice, probably because their companies already provide at least a good practice level of disclosure.

- The main benefits of communications are promotion of confidence amongst investors and of a reputation for openness. Whilst these effects could result in a lower cost of equity, they are seen by FDs as ends in themselves. Ten chose to describe the main benefit of corporate communications in terms of confidence, integrity, good citizenship or understanding.

In view of these findings, it should not be assumed that company executives regard the main goal of their disclosure efforts as a lower cost of capital.

Our other findings are as follows:

- The FDs see their companies as providing at least good practice communications, in line with what the market expects and with the practice of similar companies.

- Most companies either use the capital asset pricing model to estimate the cost of equity in-house, or they 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.

- 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.

- A small majority of the FDs believes that greater disclosure to rating agencies and bankers increases the availability of debt or reduces its cost.

- Nearly all of the sample companies disclose private information, beyond what they disclose to the stock market, to credit-ratings analysts and, to a lesser extent, to bankers. The Financial Services Authority’s rules for listed companies allow for selective disclosure of inside information to ratings analysts and bankers, though most of the private information they receive is probably not inside information in the sense of being likely to affect the share price.
• The main costs of communications are the cost of creating the information to be disclosed, and management time. However, companies withhold commercially sensitive information, and would probably regard it as a serious cost if they were forced to disclose (more of) such information.

• Most of the FDs are against the prescription of further disclosure by regulation.
1. Introduction

The project reported below investigates the views of senior executives, mainly finance directors, on the costs and benefits of corporate communications. The focus is on their views about the extent to which disclosure benefits the company by reducing its cost of capital. The evidence clarifies how the goals of communications are perceived by the executives responsible. The motivation for the research is well expressed in a note that accompanies the Institute of Chartered Accountants in England and Wales’ (the ICAEW) publication *New reporting models for business* on the ICAEW website. 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, p. 15).

A company’s cost of equity is the rate of return on the shares required by investors. Two routes have been suggested in the academic literature by which greater transparency might result in a lower cost of equity, in theory. First, greater transparency might reduce the risk of the shares as perceived by investors, in which case the rate of return they require might fall. The risk that disclosure should reduce is often called information risk. Second, greater transparency might lead to more trading in the shares, so that they become more liquid. Since the transaction costs of trading are lower for liquid shares, the required rate of return expressed gross of transaction costs should fall as transparency increases. Other benefits from corporate disclosure have been suggested but it seems fair to say that a lower cost of capital has been viewed as the main benefit, at least in terms of the effect of disclosure on a company’s market value.

There has been a fair amount of empirical research in recent years that tests whether greater transparency is associated with a lower cost of equity. The standard method is to take a sample of companies, estimate each company’s cost of equity, and assign a numerical measure to its level of disclosure. Regression is then used to test whether the cost of equity is related to the level of disclosure, controlling for other factors that might affect the cost of equity, such as the company’s size and gearing. The bulk of this quantitative evidence, though by no means all of it, does find a significant negative relation between the cost of equity – and the cost of debt – and the level of disclosure. In other words, greater disclosure is associated with a lower cost of capital. There is also evidence that increases in transparency 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.

There has been less research on whether the executives responsible for communications policy believe that the main benefit is a lower cost of capital. Interview evidence from the UK indicates that executives regard communications as serving a number of purposes, including maintenance of confidence amongst investors and avoiding surprises. A recent US study, based on 312 questionnaire results and 20 interviews, finds that the best-supported motive for disclosure is to promote ‘a reputation for transparent/accurate reporting’ (Graham et al, 2005). A lower cost of capital is tenth on the study’s list of motives, out of eleven in total.
2. Research method

We conducted 16 semi-structured confidential interviews between November 2005 and June 2006. We initially approached companies selected at random from different size categories, by email or letter first, followed by a phone call. This yielded very few interviews, so we then contacted individuals who had responded to a questionnaire sent by one of the authors in 2003 (Marston, 2004), which proved a somewhat more successful tactic. Three interviews were then obtained through personal contacts and one finance director (FD) responded to a request for help circulated by the ICAEW. In the end we obtained interviews with 16 individuals, from 75 contacted. Nine were serving FDs, four had been FDs within the last two years, and three were directors of investor relations. Table 1 shows the market capitalisation and main businesses of the sample companies. All are registered in the UK, 13 are amongst the largest 300, and they span a wide range of businesses. 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 the Findings section.

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 one of the authors and 11 by both authors. The transcripts were typed and we then checked them and summarised them question-by-question. All our interviews were informative and several executives were very forthcoming.

One concern about our method is that it might bias the findings 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: Current or most recent company of interviewee

<table>
<thead>
<tr>
<th>Case reference</th>
<th>Size category</th>
<th>Main business</th>
<th>Position of interviewee</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>1 to 100</td>
<td>Banking</td>
<td>Director of Investor Relations</td>
</tr>
<tr>
<td>B</td>
<td>1 to 100</td>
<td>Food, drink, tobacco</td>
<td>Director of Investor Relations</td>
</tr>
<tr>
<td>C</td>
<td>1 to 100</td>
<td>Energy</td>
<td>Finance Director</td>
</tr>
<tr>
<td>D</td>
<td>1 to 100</td>
<td>Retailing</td>
<td>Director of Communications</td>
</tr>
<tr>
<td>E</td>
<td>1 to 100</td>
<td>Banking</td>
<td>Finance Director</td>
</tr>
<tr>
<td>F</td>
<td>100 to 200</td>
<td>Manufacturing</td>
<td>Finance Director</td>
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<tr>
<td>G</td>
<td>100 to 200</td>
<td>Manufacturing</td>
<td>Finance Director</td>
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<tr>
<td>H</td>
<td>100 to 200</td>
<td>Real estate</td>
<td>Finance Director</td>
</tr>
<tr>
<td>I</td>
<td>200 to 300</td>
<td>Manufacturing</td>
<td>ex Finance Director</td>
</tr>
<tr>
<td>J</td>
<td>200 to 300</td>
<td>House building</td>
<td>Finance Director</td>
</tr>
<tr>
<td>K</td>
<td>200 to 300</td>
<td>Real estate</td>
<td>Finance Director</td>
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<tr>
<td>L</td>
<td>200 to 300</td>
<td>Rail, road and freight</td>
<td>ex Finance Director</td>
</tr>
<tr>
<td>M</td>
<td>200 to 300</td>
<td>Asset management</td>
<td>Finance Director</td>
</tr>
<tr>
<td>N</td>
<td>300 to 400</td>
<td>Business support services</td>
<td>ex Finance Director</td>
</tr>
<tr>
<td>O</td>
<td>500 to 600</td>
<td>Business support services</td>
<td>Finance Director</td>
</tr>
<tr>
<td>P</td>
<td>1000 to 1100</td>
<td>Manufacturing</td>
<td>ex Finance Director</td>
</tr>
</tbody>
</table>

Note

We ranked all UK-registered listed companies, excluding investment vehicles, by market capitalisation as at 31 July 2006. Total number listed = 1,975, including companies on the Alternative Investment Market. The rank of each sample company determines which size category it belongs to. For example, a company ranked 250th by market capitalisation would belong to ‘size category 200 to 300’.
3. 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.

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

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

Background: company’s disclosure policy
The majority of the FDs see their companies as communicating at or above the benchmark level of good practice for 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.

Background: estimation of cost of equity
It is common for companies to use estimates of the cost of equity from their broker or from analysts or other financial advisers. Six of the companies rely solely on estimates from such external sources. Six produce estimates in-house and some check these against external estimates. One interviewee said that he will contact analysts if the in-house estimates differ from those of the analysts, 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. Both dividend yield and the cost of debt are incorrect proxies for the cost of equity, in principle.

Only half 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. 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).

Three said the cost of capital is not an important figure. 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. The lack of importance is perceived 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. But 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.

**Does improved disclosure reduce the cost of equity?**

There was a wide range of opinion expressed about our central question
but the majority of the FDs do not see a strong link between the level of
disclosure and the cost of equity. 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 most of the interviewees how they think disclosure affects 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
tings too much.’ (O)
Several FDs noted 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 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 believe that too much disclosure can 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.

We asked in addition whether greater transparency leads to more liquidity in the shares. There was little support for this idea. Only one executive believes that transparency definitely leads to greater liquidity.

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 communications, and if the company were to provide less than this, the perceived risk and discount rate applied by investors would increase sharply. The nature of the benchmark communication effort is company-specific, 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 the ‘information risk premium’ 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 communication. 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 return investors require.

Figure 1: Effect of disclosure on the cost of equity
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 it is not surprising that they said that disclosure has little effect in practice. 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 is 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. 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. But the main idea in Figure 1 is that, beyond a certain point, further disclosure has little effect on the cost of equity.

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 transparency will be maintained in the future. It has been suggested that the annual report is the most reliable indicator of a firm’s commitment to a future level of disclosure. To investigate this, 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 market. 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. The remaining six said that all the channels are important or did not distinguish between them. ‘They all matter if they’re not there’ (M).

This evidence is broadly consistent with that of Holland (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 mentioned 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 nearly all of the companies take considerable care and effort over corporate communications, as has been well documented in previous research.

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. There was 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).

None of the companies had provided an explicit written commitment or description of its 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 it would also be unwise, providing a constraint or a hostage to fortune. 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.

**Disclosure and cost of debt**

We asked whether greater disclosure to a rating agency or bank would affect the cost of a bond issue or a bank loan. The answer was a clearer ‘yes’ than was the case 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 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 interviewees working for companies large enough to have a credit rating 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. The 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 their 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 roadshow for bond investors when launching a bond issue.

Most of the private information disclosed to ratings analysts and bankers is probably not inside information in the sense of information which would be likely to affect the share price if known to the market. But the regulations applying to a listed company do allow it to delay publication of inside information ‘such as not to prejudice its legitimate interests’, and to disclose it selectively to certain parties who then owe ‘a duty of confidentiality,'
regardless of whether such duty is based on law, regulations, articles of association or contract’ (Listing Rules, Disclosure and Transparency Rule 2.5.1(b), Financial Services Authority, 2007). The list of permissible recipients of selectively disclosed inside information in Rule 2.5.7 includes bankers and credit-rating agencies.

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, followed by management time (three) and release of commercially sensitive information (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 FD 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)

Attitudes towards commercially sensitive information are interesting. Release of such information was only cited once as the main cost of disclosure. But this is partly because the companies generally 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 transparency 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. 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. Holland (2006, ch. 3) 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’.

Benefits of disclosure

The FDs mentioned a variety of benefits from 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-executives 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 believes that, by being open, executives:

‘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 were that dialogue with analysts and shareholders helps the company to obtain information about developments in its markets; that good communications 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). 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 primary motive for disclosure is promotion of a reputation for transparency.

**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). 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’. Of the remainder, one FD is neutral about more disclosure, two are against a mandatory OFR, 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. However, many who are positive about transparency also expressed 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). Some interviewees singled out the notes regarding pension liabilities or derivatives as having become impossible to understand. Several 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 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 communication 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’ costs 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 costs of capital.

Findings by interviewee

Examination of the findings by interviewee shows that neither the relevant company’s disclosure policy nor the executive’s attitude to more disclosure is correlated with his view on the link with the cost of capital. 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 believe that it would reduce the cost of equity. Of the eight executives who described their company’s policy as completely open or best practice, four think that greater disclosure does not reduce the cost of capital in practice. This evidence confirms that, for most FDs, 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.
4. Conclusion

Our key findings are that the main benefit from corporate communication is seen by FDs as promotion of confidence and a good reputation. A lower cost of capital is seen as secondary, and if the company already maintains a level of good practice disclosure, FDs doubt whether greater transparency would reduce the cost of capital any further. Reports of these views can be found in previous studies, but our evidence makes it clearer what FDs are saying about the purpose of communications.

A 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. Why are they important, if not to reduce the cost of capital? Are the communication efforts made by ‘self-respecting’ companies seen as contributing to market value? Another interesting question is how the boundary is set between what is disclosed and what is withheld. It appears that the market expects a certain amount secrecy; a company can have a good reputation for openness without being entirely open.
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Authors’ acknowledgement

We are grateful to the executives we interviewed for their time and for their engagement with our questions; to two anonymous referees for comments which led us to improve the briefing; to financial support provided by the Institute of Chartered Accountants in England and Wales’ charitable trusts; and to Gillian Knight at the ICAEW for her help with the project.