Financial Statement Comparability and the Cost of Equity Capital

(First Author) Jungeun Cho*
(Corresponding Author) Hyunjung Choi**
Doocheol Moon***

Abstract: This study examines the effect of financial statement comparability on the cost of equity capital. Greater financial statement comparability lowers the cost of acquiring and analyzing information for investors and increases the quantity and quality of information (De Franco et al. 2011; Kang et al. 2013). Further, comparable information helps investors identify and understand economic similarities and differences across companies and thus make more efficient investing decisions (FASB 2010). Therefore, investors are more likely to demand relatively lower expected returns, resulting in lower cost of equity capital.

Using a sample of firms listed on the Korean Stock Exchange over the period from 2007 to 2010, we find that greater financial statement comparability with industry peer firms reduces the cost of equity capital. In addition, we show that the effect of financial statement comparability on the cost of equity capital is more pronounced for firms in highly competitive industries where competition acts as an effective external governance mechanism. Our findings suggest that financial statement comparability plays an important role in reducing firms' financing costs for investors and contributes to

*Assistant Professor, College of Business Administration, Pukyong National University (E-mail: jecho@pknu.ac.kr)
**Post-doctoral researcher, Business Research Institute, Yonsei University (E-mail: hyunjung choi@yonsei.ac.kr)
***Professor, School of Business, Yonsei University (E-mail: dmoon@yonsei.ac.kr)
efficient allocation of capital.

**Keywords:** financial statement comparability, cost of equity capital, industry-level competition

## I. Introduction

This study examines the effect of financial statement comparability on the cost of equity capital. Prior studies document the significant impact of information quality on the cost of equity capital (Botosan 1997; Botosan and Plumlee 2002; Bhattacharya et al. 2003; Easley and O’Hara 2003; Francis et al. 2004; Leuz and Verrecchia 2005). Many researchers have investigated the relation between the quality of financial information and cost of capital, arguing for an inverse relationship between accounting information quality and the cost of equity capital. When investors are provided with poor quality of financial information due to high information asymmetry, they demand higher expected returns to protect themselves from the information disadvantage. This leads to a higher cost of equity capital for companies.\(^1\)

Therefore, firms with high quality financial disclosure may lower cost of equity capital by reducing information asymmetry.

Recent empirical evidence suggests that financial statement comparability contributes to reduction of the cost of acquiring and analyzing information and higher quantity and quality of information. Financial statement comparability is defined as the extent to which companies’ accounting systems reflect economic events to financial statements (De Franco et al. 2011). When two firms have comparable accounting system, they present similar financial statements for a given set of economic events (FASB 2010).

Since the main purpose of financial reporting is to provide useful information to the public, comparability is an important qualitative characteristic of accounting information.\(^2\) The Statement of Financial

---

\(^1\) Cost of equity capital indicates the required rate of return for the level of risk that investors perceive.