

CORPORATE DISCLOSURE AND COST OF EQUITY: CASE OF MALAYSIAN LISTED COMPANIES

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ABSTRACT

Prior studies argue that information costs firm's capital due to the information asymmetry, and most of those research papers investigated develop countries. Malaysia, as an emerging market, offers its unique characteristic in terms of financial reporting regulation and is hugely influence by export-oriented firms. Therefore, this research aims to investigate whether information disclosure may affect the cost of equity of firms. We investigate this hypothesis by using all Malaysian listed firms excluding the finance, services, and utilities companies over 3 years period of 2010-2012. We use robust panel regression where the values are based on White robust standard errors that control for heterocedasticity errors. Overall, our findings are consistent with previous research that higher level of disclosure might discount the firm's cost of equity, suggesting that firms should disclose more information for better cost of capital. At the end of our research, we explain our findings using two perspectives which are: information cost and agency cost.

INTRODUCTION

With the sophistication in the business environment, information in corporate disclosure is becoming more important to business communities. The users of financial reports are more demanding and requesting better information of the company's performance. These users focus on the quality and timeliness of the relevant information in corporate disclosure for better decision making. The purpose is plain and simple: to attract cheaper external financing. Yosha (1995) found that firms may prefer bilateral to multilateral financing arrangements, in order to avoid disclosure which might leak to competitors. In the presence of a cost differential between these forms of financing, the higher quality firms (those with more to lose from disclosure) prefer bilateral financing. Francis (2005) concluded that firms with

greater external financing needs have higher voluntary disclosure levels, and that an expanded disclosure policy for these firms leads to a lower cost of both debt and equity capital. Additionally, Hope et al (2011) found that firms with greater financial reporting credibility experience significantly lower perceived problems in gaining access to external finance. Further, the impact of financial credibility in reducing financing constraints in the presence of a controlling owner is more pronounced in countries with weaker creditor rights. In Malaysia context, large companies ponder the impacts of the disclosure to contingency liabilities and information asymmetry issue (Hashim and Salleh, 2007; Abdullah and Ismail, 2008), especially after the Asian financial crisis in 1997 (Ghazali and Weetman, 2006). Ho and Wong (2001, 2004) surmised that the extent of disclosure and transparency information has been highlighted to aid in turning the quality of investment and external financing decision, where corporate disclosures might reduce information asymmetries among firms and outside investors. This would lead companies to have cheaper financing.

The purpose of this study is to investigate the relationship between disclosure and cost of equity. Cost of equity is important for firms as it forms part of the total cost of capital and often considered in decision making process (Cotner and Fletcher, 2000) especially decision regarding investment. According to Beneda (2003), cost of equity is important because it forms a basis of comparison in evaluating investment opportunities. Therefore, it is imperative that firms maintain their cost of equity at a reasonable level because if it is too high, the firm has to loss its prospective investment. Meanwhile, disclosure shows the information of firms about items that is included in the financial statement through notes to financial statement (Shaw, 2003). Corporate disclosure emphasizes on financial data within the framework of generally accepted accounting principle.

The association between corporate disclosure and cost of equity is related to the information asymmetry. Botosan (1997) and Botosan and Plumlee (2002) found a

negative relationship between corporate disclosure and cost of equity because that the higher disclosure reduces information asymmetry leads to a reduction in transaction costs and reduce estimation cost. This implies that corporate disclosure is important to reduce the cost of capital of firms.

This study aims to contribute to the body of knowledge about the influence of the disclosure level on the cost of equity capital. The information disclosure in the annual reports may influence the outside investors in determining the share price. This study investigates how the information disclosure is capitalised and thus influence the cost equity capital. The second contribution of this study is to investigate the influence of the firm's characteristics towards the cost of equity capital. The different characteristics of the firms may have a different impact on the cost of equity capital. The information gathered in the study may help the management in formulating suitable management strategies regarding the firms' future development, planning and external equity financing.

Objective

The objective of this paper is to examine the relationship between corporate disclosure and firm's cost of equity in Malaysia.

LITERATURE REVIEW

Corporate disclosure is critical for the functioning of an efficient capital market. It has been widely used by management to communicate firm information to the outside investors. Companies supply disclosure through regulated annual reports, consisting of corporate background, summary of historical performance, key non-financial analysis, projection, financial statements, footnotes, management discussion, and other regulatory filings. In addition, several firms provide extra information, such as management forecasts, analysts' presentations, press releases, CSR reports, union workers activities, internet sites, and other corporate reports. The purpose is simple and straightforward: to show the real condition of the corporate.

Most of the theories relating to disclosure predict a negative relationship between the disclosure and the cost of capital (i.e., Healy and Palepu, 2001; Easley and O'Hara, 2004; Barth et al., 2013). Some of the empirical findings, such as Diamond and Verrecchia (1991), Botosan (1997), Easley and O'hara (2004), and Riedl and Serafeim (2011) suggest that increased disclosure reduces firm's cost of capital by reducing the information asymmetry. There are two streams of studies that support the negative relationship between the disclosure level and the cost of capital. The first stream is represented by Amihud and Mendelson (1986) and Diamond and Verrecchia (1991), who stated that the firm's securities

have a higher cost of equity capital with the bid-ask spreading more on asset pricing because investors demand compensation for the added transaction cost. The adverse selection component and cost of equity can be reduced by disclosing more of the firm's information. When the investors have more precise information, they are willing to place a large order in a particular firm's stock than they otherwise would. This will result in a high demand for the firm's securities which will increase the firm's stock price with a reduced cost of capital.

The second stream of theoretical research suggests that the increased disclosure can reduce estimation of risk pertaining to the parameter of the payoff distribution for a firm (Barry and Brown, 1985; Clarkson et al., 1996). Klein and Bawa (1976) were the first researchers who used the estimation risk in their study and this was then followed by Barry and Brown (1985), Handa and Lin (1993), Clarkson et al. (1996), and others.

There are relatively limited empirical studies towards the effects of the disclosure of information on the cost equity capital. Botosan (1997) examined a direct association between the disclosure level and the cost equity capital for 122 firms in the manufacturing industry. She constructed her own disclosure index to be used as a proxy for the disclosure level. She found little evidence of association between the level of information disclosure and the cost of cost of equity capital. However, she documented that the firms that had a low analyst's following had a strong negative association between the level of information disclosed and the cost equity capital. Hail (2002) conducted a similar study by using 27 items of disclosure by the Swiss Banking Institute as a proxy for disclosure level of information. He found a negative association between the disclosure level and the cost of equity capital for 73 non-financial firms listed on the Swiss Exchange. Botosan and Plumlee (2002) used the Association for Investment Management and Research (AIMR) disclosure rankings which were annual report disclosures, other publication disclosures (timely in nature) and investor relations activities to find evidence in the association towards cost equity capital. They found that the greater the annual report disclosures the cost equity of capital decreased, but the more timely disclosure of information increased the equity capital. They did not find any evidence of association between the investor relations activities and the cost equity capital. Relating to the role of quality information, Easley and O'Hara (2004) demonstrated that the quality of information could affect the asset's price and the cost equity capital. The more precise the public (private) information, the cost of equity capital decreased (increased) (Botosan et al., 2004).

We believe that financial reporting and disclosure will continue to be a rich field of empirical enquiry. This research takes the context of Malaysia in investigating the link between corporate disclosure and cost of equity. We revisit and extend prior research of Embong et al (2012)

that found there is a significant negative relationship between disclosure and cost of equity capital for large firms and not significant for small firms. The managers of firms could strategize the firm's disclosure policy by taking into consideration that the benefit of disclosure in reducing the cost of equity may depend on the size of the firms. Instead of taking cost of capital into our research account, we specifically investigate the cost of equity; a contribution of this research to body of knowledge.

METHODOLOGY

Sample

Our sample is listed companies in Bursa Malaysia, and it is limited only to industrial based companies. We exclude financial, services, and utilities companies because their sales are irregularly disclosed. Moreover, companies in the finance sector are governed by the Banking and Financial Institution Act and have different regulations compared to others sectors. This study only covers the companies that ended their accounting reports as of 31st December annually. We differentiate between consumer based industry and other industrial firms. We also remove any firms that have missing data throughout the nine-year period. At the end, our final sample comprises 248 firms with the total pooled observations of 744 firm years over the period of 3 years with complete data.

The share prices and interest rates, which are used to determine the cost equity capital, are retrieved from worldscope and Bank Negara Malaysia website. The disclosure level data are collected from annual reports of the companies. While the other remaining three control variables such as leverage, size and liquidity are collected from World scope and DataStream.

Methodology

The cost of equity

Following Botosan (2000), the cost of equity (K_e) used in this research is measured based on the CAPM. The traditional Capital Assets Pricing Model defines expected returns as the sum of the expected risk free rate, the product of a firm's estimated risk free rate, the product of a firm's estimated market beta and the expected market risk premium.

$$K_{e,i} = R_f + \beta(R_i - R_f)$$

The risk free rate is equivalent to the one year of conventional interbank interest rate announced by Bank Negara Malaysia (Malaysian the Fed). The market returns is calculated based on lognormal of firm's prices of today divided by firm's prices of yesterday. The market beta is taken by regressing the Bursa Malaysia index under Jensen Alpha model.

Baseline Model

Prior research in estimating the cost of information showed there are four factors that could affect the firm's cost of equity, namely, leverage, size, and liquidity. The basic function is given as below.

$$K_e = f(\text{leverage, size, liquidity})$$

In measuring the firm's size, this research used the log of Market Capitalization. Meanwhile, other control variables was developed by following previous research in cost of capital (Botosan, 1997; Botosan, 2002), where leverage was measured by interest bearing debt divided by total equity. Meanwhile, liquidity is measured by (Quick ratio): cash and equivalents plus receivables over total current liabilities. Hence, the empirical regression model is as follow.

$$K_e = \beta_0 + \beta_1 \text{Leverage}_{i,t} + \beta_2 \text{Size}_{i,t} + \beta_3 \text{Liquidity}_{i,t} + \varepsilon_{i,t}$$

Estimation Models

This research aims to investigate the role of corporate disclosure on cost of equity. This research follows Botosan (1997) in measuring the corporate disclosure ($DISCLOSE_{i,t}$). It consists of 35 items (see Appendix), where a score of "1" is given for every item disclosed and a "0" is given for every item that is not disclosed. The choice of the use of the dichotomous procedure is based on the fact that it is currently the most appropriate measurement tool available and widely used in the financial reporting literature. The score for each item will be added and equally unweighted with the possible score for each company to derive a final score for each company. The weighted score measure has some arbitrariness issues (Cooke, 1989; Healy and Palepu, 2011). Assigning weight to a disclosure item is deemed to be subjective and furthermore, this method has also been criticized due to the fact that it is difficult to identify users' preference for items of disclosure. There are several reasons for using a dichotomous (unweighted) disclosure score in preference to a weighted disclosure score. The dichotomous method of scoring has been used in empirical studies such as Cooke (1989) and Collett and Hrsaky (2005). Interestingly, some studies found almost identical results, when weighted or unweighted methods were used to capture the disclosed information that appeared in Annual Reports (Choi, 1974; Chow and Wong-Boren, 1987). In the end, the disclosure score index is calculated as follows:

$$DISCLOSE_{i,t} = \frac{\sum SCORE}{35}$$

Therefore, we introduce the corporate disclosure on our baseline model. The final model is as follow.

$$K_e = \beta_0 + \beta_1 \text{Leverage}_{i,t} + \beta_2 \text{Size}_{i,t} + \beta_3 \text{Liquidity}_{i,t} + \beta_4 \text{Disclose}_{i,t} + \varepsilon_{i,t}$$

RESULTS AND DISCUSSIONS

Descriptive Results

Table 1 shows the summary of statistic for our sample of 248 firm across the three-year period. The mean values were calculated for each variable to facilitate comparison among firm's average. These mean values are provided including its median and standard deviation values. We provide also the statistical test for difference in the mean value for each variable. The mean value of the cost of equity for companies was about 6%, and its median was 4.23%. This implies that the values were most likely distributed normally. Similar conclusions were found on disclosure, leverage, size, and liquidity. The means were 23.8, 20.8, 2.267, and 1.883, respectively. Meanwhile, the median values were also almost similar to its means, where there were 21.905, 19.565, 2.175, and 1.01 for disclosure, leverage, size, and liquidity, respectively. This normal distribution is supported by the value of its standard deviation were it shows the values of those variables were not much deviated from its means.

Meanwhile, our t-test shows the variables are significant different from to another. For instance, there is significant difference between cost of equity and all the variables except the leverage. Even though, there is no significant difference between leverage and cost, we still can ignore the results because cost and leverage are actually relationship between dependent variable and its regressors. There is no multicollinearity issue in this conclusion. The rest, as depicted by Table 1, it implies no multicollinearity found in this research.

Size and Disclosure

Table 2 shows the descriptive of firm's size and its disclosure. It shows interesting findings where the percentage of disclosure and companies' size has an inconsistent result. When the firm is a small size firm, it has tendency not to disclose all the information. This can be seen at our Table 2, where most of small firms disclosed only up to 20 items. Meanwhile, the bigger size of small firms (Rm101mil – Rm 200mil), disclose around 11 to 30 items. Only 3 firms from that cluster disclose more than 30 items. Medium size firm (Rm 201mil – Rm 300mil) normally distributed from less than 10 items, 11-20 items, 21-30 items, and 31-35 items. There is no tendency of these medium size firms to disclose or not to disclose the firm's information. Lastly, big size firms have tendency to disclose all the information. Perhaps, these big size firms, which relatively have more leverage compared to others, have obligation to report to many stakeholders (many banks, financial institution) in many countries for the financing reporting purpose.

Estimations

Table 3 shows the results of our estimation. Referring to the R2 and adjusted R2, the regression model indicated

that cost of equity was well explained by the regressors such as disclosure, leverage, size, and liquidity. The R2 and adjusted R2 were 0.223 and 0.178, respectively. This means that only 22.3 percent of the variation of the cost of equity capital in the analyzed companies was explained by the variation of disclosure level information, leverage, firm's size, and liquidity. The F-Test concludes that the model is robust enough.

Table 3 shows also that all of control variables contribute negatively. However, it is only liquidity that has significant influence on cost of equity, but not leverage and size. The value of liquidity coefficient is also relatively big, -0.981. This means high liquidity may reduce the cost of equity of a firm. This is in line with prior research such as Diamond and Verrecchia (1991).

corporate disclosure contributes negatively and statistically significant on the cost of equity. The coefficient value is -0.102, and its standard error is 0.209. This implies that the more a firm discloses information regarding firm's activities, the lower the cost of equity of firms. This findings support our hypothesis that there is a negative and significant relationship between corporate disclosure and cost of equity. This result is consistent with prior research such as Botosan (1997), Botosan (2002), or in Malaysia context, it is in line with Embong et al (2012).

Robustness Test

We further investigate the role of corporate disclosure on firm's cost of equity by separating fast moving consumer goods firms (hereafter FMCG) with non FMCG-based industrial firms. FMCG companies have a tendency to have higher cost of equity compared to non-FMCG. Therefore, we have two subsets of samples.

Table 4 shows that the R2 squares of the models, FMCG and non-FMCG, are relatively good. The R2 for FMCG model is 0.267, meanwhile non-FMCG is 0.121. The F-values of both models are also significant at 1% level. Similar with above results, the control variables do not affect cost of equity significantly except the liquidity. Liquidity contributes negatively and statistically significant to cost of equity with the coefficient value of -0.857. Corporate disclosure shows a negative and significant influence on cost of equity. This implies that for FMCG firms, higher level of disclosure may lead to lower level of cost of equity.

The same conclusion is found in non-FMCG results. The control variables are negatively related to cost of equity with the values of -0.07, -4.363, and -1.095 for leverage, size, and liquidity, respectively. Yet, it is only liquidity has significant effect on cost of equity at significant level of 10%. Corporate disclosure level of non-FMCG firms has a negative and significant influence to cost of equity. The value is -0.041 meaning that for each item increases 1, it will reduce the cost of equity to 0.041. This is tally with our previous findings. In short, even though we separate the firms of FMCG and non-

FMCG, the conclusion remains the same. The level of disclosure may lead to lower level of cost of equity.

Discussion

The results of regression show that the disclosure level of information in the annual report of consumer products industry had a significant negative relationship with cost equity capital. After we differentiate between FMCG-based industry and non FMCG-based industry, the conclusion remains the same: the corporate disclosure may lower firms cost of equity. There are two arguments to explain our finding, which are (1) information cost, and (2) agency cost perspective.

The information cost arises from information differences and conflicting incentives between principal (entrepreneur) and savers. Empirical papers, such as Akerlof (1970), Botosan (1997), and Healy and Palepu (2001) explained that when disclosure is imperfect, investors bear risks in forecasting the future payoffs from their investment. If this risk is non-diversifiable, investors will demand an incremental return for bearing the information risk. As a result, firms with high levels of disclosure, and hence low information risk, are likely to have a lower cost of capital than firms with low disclosure levels and high information risk. This explains our findings that there is negative and significant relationship between corporate disclosure and cost of equity.

In agency cost perspective, there is a consequence arises because savers that invest in a business typically do not intend to play an active role in its management that responsibility is delegated to the agent (entrepreneur). The cost arises because if savers acquire an equity stake in a firm, the agent can use those funds to make investment or operating decision that are harmful to the interest of savers. Alternatively, if savers acquire a debt stake in a firm, the entrepreneur can expropriate the value of the investment by issuing additional more senior claims, by paying out the cash received from savers as a dividend, or by taking on high risk capital projects (see Smith and Warner, 1979). To avoid this issue, savers need to reduce this agency cost by having all information from the agent. Savers will increase the cost of capital as the trade-off of feeling insecure of no full-information available. This also explains our findings that a firm with low disclosure would be punished with higher cost of equity. Note this research is consistent with Botosan (1997), Riedl and Serafaim (2011), and Embong et al (2012).

CONCLUSION

The main objective of this study is to examine the relationship between the extent of disclosure level of information in the annual reports and cost equity capital for companies listed under the consumer products industry and industrial products industry. Four hypotheses were developed in this study. First, this study examined

whether there was a negative relationship between the disclosure level and the cost equity capital. Second, this study investigated whether there was a positive association between the level of leverage and the cost equity capital. Third, this study investigated if there was a negative association between the firm's size and the cost equity capital. The last hypothesis was to examine whether there was a negative relationship between the liquidity and the cost equity capital.

The findings of this research show that the disclosure level of information in the annual reports had a negative relationship with the cost equity capital for companies listed under consumer products industry, which supported Hypothesis 1. The results showed that the disclosure level variable had a significant effect at 5% level with the cost equity capital of companies. This means that companies could enjoy lower cost equity by providing more disclosure in the annual reports. This is consistent with prior studies such as Botosan (1997), Riedl and Serafaim (2011), and Embong et al (2012). Meanwhile, most of the control variables had no significant relationship with the cost equity capital except for liquidity which had a significant negative relationship with the cost equity capital.

The results of this study confirmed that the disclosure level in the annual reports is significantly negatively related to the cost equity capital. The negative relationship is consistent with the theories and ideas that the information disclosures reduced the information asymmetry to the outside investors and managers. The firms that disclosed more also reduced uncertainty of the outside investors regarding the true parameters of the payoff distribution for the firms. This would help managements in formulating management strategies regarding the companies' future development, planning and external equity financing.

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FIGURES AND TABLES

Table 1
Descriptive Statistic

For the t-test, figures in the parenthesis are standard errors; We conducted paired t-test to examine the significant difference between two variables. *, **, and *** denotes statistical significant at the 1%, 5%, and 10% level, respectively

	Mean	Media	Std. Dev	COST	DISCORE	LEVERAGE	SIZE	LIQUIDITY
COST	6.0088	4.235	8.82402					
DISCORE	23.8095	21.9048	10.45285	-0.351**				
LEVERAGE	20.8341	19.565	11.31392	0.059	0.131			
SIZE	2.2627	2.175	0.57908	(0.358)	(0.209)	0.18		
LIQUIDITY	1.8825	1.01	2.58542	-.339**	.494***	(0.133)	0.017	
				(0.016)	(0.001)	(0.133)	(0.133)	(0.458)
				-0.277**	-0.143	-0.116	-0.116	(0.458)
				(0.042)	(0.190)	(0.237)	(0.458)	

Table 2
Size and its Corporate Disclosure

Size is calculated based on market capitalization. We divided into 5 level of sizes, and 4 types of disclosure items. Note that there are 35 item of disclosure in total for our content analysis of corporate disclosure

	Number of Items disclosed				Total
	0-10 Items	11-20 Items	21-30 Items	31-35 Items	
RM 1 mil -RM 100 mil	13	55	11	9	88
RM 101 mil - RM 200 mil	4	18	21	3	46
RM 201 mil - RM 300 mil	4	7	9	6	26
RM 301 mil - RM 400 mil	0	6	12	1	19
> RM 401 mil	0	13	29	27	69
Total	21	99	82	46	248

Table 3
Model Estimations

The regression is performed using panel regression. The figure stated are the coefficient values, except numbers in parentheses which are standard error. The dependent variable is the cost of equity excess value of firms. The control variables are leverage, size, and liquidity. The main independent variable is corporate disclosure. The model is as follow:

$$K_e = \beta_0 + \beta_1 \text{Leverage}_{i,t} + \beta_2 \text{Size}_{i,t} + \beta_3 \text{Liquidity}_{i,t} + \beta_4 \text{Disclose}_{i,t} + \epsilon_{i,t}$$

DISCORE	-0.102**
	[0.209]
LEVERAGE	-0.04
	[0.011]
SIZE	-1.537
	[1.794]
LIQUIDITY	-0.981**
	[0.322]
CONSTANT	18.271***
	[7.662]
R²	0.223
adjusted R²	0.178
F-Value	3.12***

Table 4
Robustness Test: FMCG and non-FMCG

The regression is performed using panel regression. The figure stated are the coefficient values, except numbers in parentheses which are standard error. The dependent variable is the cost of equity excess value of firms. The control variables are leverage, size, and liquidity. The main independent variable is corporate disclosure. The model is as follow: $K_e = \beta_0 + \beta_1 \text{Leverage}_{i,t} + \beta_2 \text{Size}_{i,t} + \beta_3 \text{Liquidity}_{i,t} + \beta_4 \text{Disclose}_{i,t} + \epsilon_{i,t}$

	FMCG	Non-FMCG
DISCORE	-0.292***	-0.041**
	[0.159]	[0.171]
LEVERAGE	0.01	-0.07
	[0.015]	[0.051]
SIZE	-2.203	-4.363
	[1.874]	[3.143]
LIQUIDITY	-0.857**	-1.095*
	[0.414]	[0.615]
CONSTANT	17.805***	20.373***
	[4.061]	[7.262]
R²	0.267	0.121
adjusted R²	0.183	0.102
F-Value	3.18***	2.602***