SMOOTH ACCOUNTING METHODS MAY REDUCE COST OF CAPITAL FOR NASDAQ FIRMS

FAYETTEVILLE, Ark. – With new questions about business accounting practices arising daily, many people see accounting and investing as scary and unpredictable. But for NASDAQ firms, increased earnings predictability – or the manager’s ability to meet analysts’ earnings forecasts – can lower the firm’s cost of capital, according to University of Arkansas researcher Carolyn Callahan.

“We found that there is a reward for earnings predictability on the NASDAQ,” explained Callahan. “That reward is that the cost of equity capital is minimized relative to bid/ask spreads.”

Callahan, Doris M. Cook professor of accounting, conducted her research on 247 NASDAQ firms along with John Affleck-Graves of Notre Dame and Niranjan Chipalkatt of Ohio Northern University. Details of their research appear in the current issue of the Journal of Accounting Research, published by the University of Chicago Press.

The researchers looked at firms that had been active for at least 10 years. They studied 2,941 quarterly earnings announcements to determine if earnings predictability affected the bid/ask spread associated with these firms. Although previous researchers had found an adverse impact associated with the quarterly earnings announcements, Callahan found no evidence of these
changes in firms with more predictable earnings patterns. The researchers found that firms with lower earnings predictability had a higher cost of equity capital throughout the non-announcement period as well.

“There is a real economic incentive for managers to keep earnings predictable,” Callahan explained. “When there is a regulatory acceptable choice between accounting methods, it is to the company’s advantage to use a smooth method, which means that it increases earnings predictability. The more predictable the earnings patterns, the lower the equity cost, because the market dealer doesn’t face as much risk.”

The NASDAQ market is a dealer’s market, comprising more than 600 securities dealers. Unlike the New York Stock Exchange (NYSE), the NASDAQ market does not operate as an auction market. Instead, NASDAQ dealers compete against each other to post the best quotes or “bid/ask” prices.

Securities are any investment instruments, such as stocks, bonds or Treasury notes. A “bid” is the amount a dealer is willing to pay for a security, while an “ask” is the price requested by the seller. The difference between these is called a bid/ask spread. Higher spreads imply a higher cost of equity capital for a firm, according to the researchers.

The cost of equity capital is the cost a company pays to attract investors to invest in their stock and to keep them interested in retaining their investment. When the cost of equity capital is low, a company does not have to expend so much, and the capital is retained within the firm.

“These are very complex processes, and as business has become more complex, it has become more important for investors to do their homework,” Callahan said.

In the wake of increased complexity, the job of the manager has changed. Managers must provide information to multiple constituents with conflicting goals and make decisions on minimizing cost and maximizing revenue that will produce the best result for shareholders. For example, managers must provide useful information to shareholders, but they must safeguard critical information from competitors.

“Contrary to public perception, not all managers lack integrity, but those are the ones that get all of the press,” Callahan said. “Information disclosure has a double edge, but investors frequently don’t see that. A good manager understands the informational needs of multiple constituents with conflicting goals much better than some academics or the general public and can make sound choice that enhance or increase shareholder wealth.”