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Aims and Scope

The Journal of ARSYM (JARSYM) is a refereed bi-annual journal committed to publishing undergraduate research papers of the Faculty of Business Studies and Finance, Wayamba University of Sri Lanka. The JARSYM publishes theoretical and empirical papers spanning all the major research fields in business studies and finance. The aim of the JARSYM is to facilitate and encourage undergraduates by providing a platform to impart and share knowledge in the form of high-quality and unique research papers.

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- Priority is given to novelty, originality, and to the extent of contribution that would make to the particular field.

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Impact of the Quality of Accounting Information on Cost of Capital: Evidence from Top Manufacturing Companies in Sri Lanka & India

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ABSTRACT

Managers with different self-centred objectives could impact the quality of accounting by manipulating the financial information, ultimately leading to lessening the capital cost to be paid to the fund providers. Thereby, this paper explores the impact of accounting quality on the cost of capital of listed manufacturing companies. The study sampled the manufacturing companies listed among the top 20 companies on the Colombo Stock Exchange and National Stock Exchange, respectively in Sri Lanka and India, respectively. Further to the empirical investigations, they explored three proxies of accounting quality; quality of earnings, accruals quality, and accounting conservatism. This paper is based on the secondary data collected through the financial statements from 2012 – 2021 and analyzed using quantitative techniques, mainly using panel regression analysis to reach conclusions. Analysis of the sampled data revealed similar results for both countries. The results reveal that the quality of earnings has a significant negative impact on the cost of capital, while the quality of accruals has a significant positive impact on the cost of capital. However, accounting conservatism has no substantial impact on the cost of capital. The quality of earnings and accruals at Sri Lankan firms has a stronger influence on their cost of capital than that of Indian companies. Accordingly, the study indicates that maintaining a great extent of earnings quality aids in reducing the cost of capital while having a rigid policy to manage accruals quality could result in a high cost of capital for the firms.

Keywords: Accounting Conservatism, Accounting Quality, Accruals Quality, Cost of Capital, Quality of Earnings

1. INTRODUCTION

Corporate disclosures comprising monetary information are pivotal for the success of the contemporary business. It helps in minimizing the information asymmetry between the interest parties and the firm (Cuadrado-Ballesteros et al., 2016). Further, these practices enable businesses to develop trust and confidence among the capital providers towards the business by reducing the risk of their investment decisions (Madhani, 2008). In turn, it aids the firms to ease access to the required funds and enables them to expand their operations as they anticipated (Francis et al., 2005).

Enhancing performance through innovative approaches increases the contribution of business to the economy (Li et al., 2021). Moreover, it creates permanent and easy access to financing through a wide range of interest parties

comprising both internal and external sources (Didler et al., 2021). As the business grows larger, the inner sources will be insufficient to continue operations; encouraging them to raise funds through external parties in the form of equity investments or long-term debt; in turn making companies obligated to pay in return for each capital source (Rahaman, 2011).

Since the ownership of the listed companies is highly detached from the management, managers may attempt to manipulate the financial information to affect the decision-making process of the capital providers to raise more funds superfluously or lessen the capital cost to be paid (Bartov et al., 2002). Once the earnings are managed to hide the real outcomes, the quality of accounting information reduces as it misguides the decision-makers (Kim & Sohn, 2013). Convincingly, management might impact the accounting quality (Wells, 2020). Therefore, this study profoundly explores the effect of accounting quality on the cost of capital with special reference to the manufacturing companies among the top listed companies in Sri Lanka and India. Under the main issue, we first intended to examine the degree of accounting quality that exists within the top-listed manufacturing companies and the extent of the cost of capital they incur in financing the business operations. Then, the study explores whether the quality of accounting information has a substantial effect on the cost of capital for the top listed manufacturing companies in Sri Lanka and India.

The research study has a broader empirical significance since it fills the empirical gap in the existing literature by being the pioneer study that compares and contrasts the effect of accounting information quality on the cost of capital of companies operating in the two South Asian countries [India, Sri Lanka] that are politically and economically connected. Moreover, the study is practically noteworthy for managers and policymakers to take initiatives to enhance accounting quality and control capital costs. The elimination of the information unevenness aids in eliminating the uncertainties faced by the fund providers, thus causing them to reduce their expected return due to the more profitable capital allocation. However, the study is limited to the notion of accounting quality instead of the existence of numerous factors which affect the firms' capital cost, while the existence of the disparity in measuring the accounting quality in the literature is another boundary of this study.

2. LITERATURE REVIEW

Investors are always sensitive to corporate disclosures because both financial and non-financial information aid in making informed decisions regarding capital investment (Iatridis, 2011). On the contrary, a lesser extent of corporate disclosures creates an asymmetry of information between management and fund providers, thereby simultaneously creating a risk to the fund providers as a result of making uninformed decisions about the capital allocation (Armstrong et al., 2011). This made fund providers expect a higher rate of return for the capital provided (Armstrong et al., 2011). Accordingly, the elimination of information unevenness aids in eliminating the uncertainties of the fund providers, thereby causing them to reduce their expected return (Diamond et al., 1991). One way to reduce information asymmetry is to increase the quality of accounting information (Brown & Hillegeist, 2007).

Despite the importance of accounting quality towards the reduction of the cost of attracting funds, this concept lacks a generally accepted definition (Pounder, 2013; Legenzova, 2016). Accounting information quality: according to Hribar et al. (2010), is the degree to which a firm's information accurately represents its current operational performance, allowing for the prediction of future performance and the evaluation of the firm's worth. Moreover, Callen et al. (2011) explained accounting quality as insight into future cash flows and the precision with which a firm's information is presented. Further, Francis et al. (2005) assert that dependability, relevance, conservatism, timeliness, smoothness, predictability, and persistence are some characteristics that are connected to the quality of accounting information. In this study, we will look into three aspects of the quality of accounting information, namely Quality of Earnings (QE), Accruals Quality (AQ), and Accounting Conservatism (AC), which are the most popular issues and the subjects of substantial research by contemporary scholars (Eliwa, 2016; Lara et al., 2011; Francis et al., 2008).

Despite the various explanations provided by numerous scholars in the past literature, there is no universally recognized measurement or indicator to reflect earnings quality or accruals quality (Abdelghany, 2005; Noronha et al., 2008). Greater extents of earnings quality and accruals quality are more relevant to decision-makers since they represent more precision of the financial performance of a firm (Teets, 2002).

The earnings of a firm often consist of both cash flows and accruals (Barth et al., 2001). Accruals can be viewed as a managerial strategy to produce greater accounting earnings that represent the success of the firm (Menicucci, 2019). Accordingly, the accruals reported by a company can be either normal accruals, which are related to actual earnings that are recorded in the accounting process but have not yet been realized, or abnormal accruals, which are errors that were either unintentionally made or frauds that were done on purpose to manipulate earnings, thereby improve the performance of the firm (Tiscini & Donato, 2012; Dechow & Dichev, 2002). As a result, the distinction between non-discretionary accruals and discretionary accruals can be determined as one of the imperative indicators of accounting quality (Menicucci, 2019). Consequently, the study utilizes earnings quality and accruals quality as key measurements of accounting quality.

To compute the earnings quality, the author utilized two models; Jones's (1991) Model, which is used to calculate total accruals, and De Angelo's (1986) Model, which is used to separate normal accruals from abnormal accruals. The unsigned size of the abnormal accruals (discretionary accruals) will be used as the measurement of earnings quality. Both models can be represented as follows:

Jones Model – Calculation of total accruals

$$TA_{it} = \Delta CA_{it} - \Delta CL_{it} - \Delta CH_{it} + \Delta SD_{it} - DEP_{it}$$

Where, TA = Total accruals, ΔCA = change in Current Assets, ΔCL = change in Current Liabilities, ΔCH = change in Cash (liquidity), ΔSD = = change in

Short Term Debt (current debts), DEP = Depreciation Expenses, i = firm = current period of time

De Angelo Model – Separation of abnormal accruals

$$DA_{i,t} = \frac{TA_{i,t} - TA_{i,t-1}}{\mathrm{A_{i,t}}}$$

Where, DA = Discretionary accruals (abnormal accruals), TA = Total accruals, TA (t-1) = Total accruals (previous year) and A = Total assets, i = firm, t = current year

Modified DD Model

In addition, we used a modified version of Dechow and Dichev's (2002) model to assess accrual quality, which shows how closely accruals correspond to cash flow realizations. According to McNichols (2002), this is the best way to compute the accruals quality.

$$\frac{CUACC_{it}}{TA_{it}} = \frac{\beta_0 + \beta_1 CFO_{\mathrm{i,t-1}} + \beta_2 CFO_{\mathrm{i,t}} + \beta_3 CFO_{\mathrm{i,t+1}} + REV_{i.t} + PPE_{i.t} + \varepsilon_{\mathrm{i,t}}}{TA_{it}}$$

Where, CUACC = Current Accruals, $CFO_{\mathrm{i,t-1}}, CFO_{\mathrm{i,t-1}}, CFO_{\mathrm{i,t+1}}$ = cash flows from operation for the previous year, current year, and next year respectively, TA = Total Assets, REV = Net Sales, PPE = Property, plant, and equipment, i = firm, t = current year

We employed accounting conservatism as a third and last proxy to assess accounting quality, which is one of the common indicators of measuring accounting quality in the empirical studies conducted in the recent past (Eliwa, 2016; Hu et al., 2014). Conservatism is a method of minimizing cumulative earnings by slower recognition of earnings and prompt recognition of expenditure as well as valuing assets at a lower level and valuing liabilities at a higher level respectively (Givoly & Hayn, 2000). Moreover, conservative accounting results also offer investors better protection against various discretionary recognitions of managers (Francis & Wang, 2008; Ball et al., 2000). The author used the earnings per share (EPS) to the share price ratio, which is a widely accepted model to measure accounting conservatism (Chen et al., 2017; Khan & Watts, 2009; Zhong & Li, 2017), to compute the extent of accounting conservatism.

$$AC = \frac{EPS_{it}}{P_{i,t-1}}$$

Where EPS = Earnings per share, P = Price of a share, i = firm, t – 1 = previous year,

We, on the other hand, used the firm's cost of capital as the dependent variable. In the eyes of investors, the cost of capital is the needed return that investors demand in proportion to the risks that they must take (Easley et al., 2016). On the contrary, corporations viewed the cost of capital as the return expected by

investors on contributing their money to a business (Fama & French, 1999). The investments are anticipated to be financially worthwhile if the cost of capital is somewhat below the needed rate of return by the investor (McNulty et al., 2002; Anderson et al., 2000). Accordingly, managers should always make the return on investment exceed the cost of capital (Easley et al., 2016).

Although choosing a perfect measurement to evaluate the cost of different sources of funds is a commonly debated topic in the preceding literature (Pratt, 2003), most scholars used the weighted average cost of capital (WACC) method to compute the entire cost of capital of the firm (Gotti & Mastrolia, 2014; Ezat, 2019). Korwar & Raghunathan (1993) defined WACC as, by giving weights under the proposition of each source in total capital cost using market values, it is the weighted average amount of cost incurred for overall funds calculated using various sources of finance. We used the weighted average cost of capital, which is computed using the following formula, to measure the extent of the overall cost of capital of firms.

$$WACC = \frac{E}{V} \times R_e + \frac{D}{V} \times R_d \times (1 - Tc)$$

R_e= Cost of Equity, R_d = Cost of Debt, E = Market value of the firm's equity, D = Market value of the firm's debt, $V = E + D$, $Tc =$ Corporate tax rate

Most previous researchers discovered that improving the precision, reliability, and calibre of a company's accounting data results in a lower cost of capital (Lambert et al., 2007; Apergis et al., 2011; Turegun, 2020). Convincingly, accounting information has both direct and indirect impacts on the cost of capital choices of an organization. In an empirical investigation carried out in both Asia and Europe, Persakis and Iatridis (2017) found that there is an inverse association between earnings quality and cost of capital. Similarly, research studies conducted by Eliwa (2016) and Hsu and Yu (2015) also discovered that the quality of earnings has a significant and negative impact on the cost of capital of firms. On the other hand, the quality of accruals has a significant and positive impact on the cost of capital (Francis et al., 2008; Eliwa et al., 2016). Moreover, Li (2015), Lara et al. (2011), and Khalifa and Othman (2015) found a substantial negative relationship between accounting conservatism and the cost of capital.

However, most prior research studies which investigate the connection between the accounting quality and cost of capital concentrated on firms that operate only in a single country, and there are few studies carried out in the South Asian context. Therefore, the researcher exercises an effort to recognize the effect of the quality of accounting information on the cost of capital through this study alongside the intention of emphasizing the common or varying outcomes of the above association in Sri Lanka & Indian context.

3. METHODOLOGY

We adopted a quantitative design under the deductive approach, which is merely based on the positivist philosophy to carry out this research study. The population of the study comprises all the quoted limited public corporations

operating in India and Sri Lanka, out of which selected the manufacturing companies that are included in the top 20 list of the stock exchange of each country. Accordingly, the sample of this study comprises 13 quoted manufacturing companies out of the top 20 listed companies operating in Sri Lanka and 12 quoted manufacturing companies out of the top 20 listed companies operating in India.

Following a thorough examination of the preceding literature, the research is merely concentrated on three proxies: earnings quality (as measured by the Jones Model (1991) and DeAngelo (1986) models), accruals quality (as measured by the modified Dechow & Dichev (2002) Model), and accounting conservatism (as measured by the earnings per share to share price ratio) to measure the quality of accounting information while the cost of capital is simply computed using the weighted average cost of capital (WACC) of the selected enterprises (Chen et al., 2017; Gotti & Mastrolia, 2014). This research relied on secondary data to accomplish the study objectives since the required inputs were calculated using the figures gathered through the published and audited annual reports of the sampled companies from 2012 to 2021. A regression analysis was performed under the following model to determine the impact of accounting quality on the cost of capital of the respective firms.

$$WACC_{it} = \alpha_{it} + \beta_{1i}\mathrm{QE}_{it} + \beta_{2i}AQ_{it} + \beta_{3i}AC_{it} + \varepsilon_{it} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(1)$$

Where, WACC = Cost of capital, QE = Quality of Earnings, AQ = Accruals Quality, AC = Accounting conservatism, and e = error term. Under the above regression model, we anticipated testing the following hypotheses, which were constructed after a deep literature analysis.

- H_a - Quality of earnings (QE) is negatively significant in determining the cost of capital. (Persakis and Iatridis, 2017)
- H_b - Accruals quality (AQ) is positively significant in determining the cost of capital. (Eliwa et al., 2016).
- H_c - Accounting Conservatism (AC) does negatively significantly determine the cost of capital (Khalifa and Othman, 2015)

4. RESULTS AND DISCUSSION

First and foremost, we performed a descriptive investigation to recognize the level of cost of capital required to be paid by the selected manufacturing corporations in both countries, and the study outcomes are presented in Table 01. The study outcomes revealed that the top listed manufacturing companies in both Sri Lanka and India incur more than 10% cost of capital for the funds they obtained from external parties (investors and lenders). However, firms operating in India incur a higher cost of capital than the firms operating in Sri Lanka, indicating that capital providers of Indian manufacturing firms face a higher risk rather than the capital providers of Sri Lanka. Furthermore, the Sri Lankan manufacturing firms reported a significantly higher standard deviation of cost of capital compared to Indian manufacturing firms, showing that there is a high volatility of the cost of capital of the selected Sri Lankan firms, in turn revealing that quoted public corporations operating in the manufacturing sector

have different capital structures under different financing policies in Sri Lanka while public limited corporation operating in the manufacturing sector in India have a similar financing policy which led all of them to have a similar nature of the capital structure.

Table 01. Descriptive Statistics – the Cost of Capital

	N	Mean	SD
Sri Lanka	130	0.1123	0.34
India	120	0.1325	0.04

Source: Survey results 2022

Next, we performed a descriptive investigation to recognize the level of accounting quality in both countries, and the study outcomes are presented in Table 02. Accordingly, the mean value of quality of earnings of the selected manufacturing corporations in both countries has reported a value equal to or less than 0.02, indicating that the value of non-mandatory accruals of the sampled companies is less than 2% of the value of the company's total assets. Accordingly, the sampled manufacturing companies operating in both countries have a lower extent of discretionary accruals, thereby showing a greater extent of quality of earnings. However, the Indian manufacturing corporations have more earnings quality than the Sri Lankan manufacturing firms as the mean value of discretionary accruals is less than 1% in Indian firms.

Moreover, the mean value of the accrual quality of the selected manufacturing corporations in both countries reported a score less than 0.10, signifying that the value of total accruals of the sampled companies is less than 10% of the value of the company's total assets, thereby showing a higher extent of accrual quality in manufacturing companies operating in both countries. However, when comparing the mean values, it revealed that India has a higher level of accruals quality than Sri Lanka.

Furthermore, the mean values of accounting conservatism showed that Indian manufacturing corporations have less accounting conservatism than the quoted manufacturing companies in Sri Lanka, thereby indicating a less level of verification of transactions before reporting in the context of India. However, the standard deviation of all the variables showed a significant level of volatility among the accounting quality in the sampled companies during the considered period. Remarkably, both countries have a similar level of volatility in accounting quality.

Table 02. Descriptive Statistics – Accounting Quality

		Earnings Quality		Accruals Quality		Accounting Conservatism	
	N	Mean	SD	Mean	SD	Mean	SD
Sri Lanka	130	0.021	0.141	0.070	0.139	0.127	0.191
India	120	0.009	0.132	0.086	0.114	0.032	0.039

Source: Survey results 2022

Thereafter, we performed the regression analysis to identify the impact of accounting quality on the cost of capital. Because this study involves observations gathered during a given period for the same organizations, we used panel data regression analysis to achieve the objectives. The Hausman

Test test outcomes are presented in Table 03. Accordingly, we selected to perform the panel data using a random effect model for both countries as test results reported a significant value of more than 0.05 for both countries.

Table 03. Hausman Test

	Chi – Sq.	d. f.	Probability	Random / Fixed
Sri Lanka	0.33	1	0.9547	Random
India	0.03	1	0.9984	Random

Source: Survey results 2022

After selecting the random effect model, we conducted the panel data regression, and the outcomes are presented in Table 04.

The regression outcome confirmed that the Quality of Earnings (QE) has a negative coefficient value of less than 0.10 alongside a significant value which is less than 0.05 in both countries, indicating that there is a substantial and inverse association between earning quality and cost of capital.

This shows that once the quality of earnings increases, the cost of capital of the respective firms will be dropped. Next, The Accruals Quality (AQ) showed a positive coefficient value greater than 0.06 alongside a significant value which is less than 0.05 in both countries, indicating that there is a substantial and constructive association between accruals quality and cost of capital. This shows that once the accruals quality increases, the cost of capital of the respective firms will also be increased.

At last, the accounting conservatism showed no substantial impact on the cost of capital of the respective firms in both countries as the regression outcomes reported a significance value greater than 0.05 for both countries.

Table 04. Regression Analysis

	Sri Lanka			India		
	Coefficient	Std. Error	Probability	Coefficient	Std. Error	Probability
Constant	-0.011	0.057	0.843	0.110	0.009	0.000
AC	0.000	0.001	0.625	0.051	0.036	0.158
AQ	0.136	0.047	0.004	0.068	0.036	0.032
QE	-0.069	0.035	0.050	-0.042	0.018	0.024

Source: Survey results 2022

According to the above analytical results, both countries reported a negative coefficient value with a probability value less than 0.05 for earnings quality, indicating that there is a substantial and inverse association between the quality of earnings and the weighted average cost of capital. Accordingly, the first alternate hypothesis is accepted, and the null hypothesis is denied. Therefore, it can be stated quality of earnings has a substantial and negative impact on the cost of capital of the manufacturing companies operating in both Sri Lanka and India. The study findings are in line with the findings of Persakis and Iatridis (2017), Eliwa (2016), and Hsu and Yu (2015), who also discovered that the quality of earnings has a substantial and negative impact on the cost of capital of the corporations.

Moreover, both countries reported a positive coefficient value with a probability value less than 0.05 for accruals quality, indicating that there is a substantial and positive association between the accrual quality and the weighted average cost of capital. Accordingly, the second alternative hypothesis is accepted, and the null hypothesis is denied. Therefore, it can be stated that accruals quality has a substantial and constructive impact on the cost of capital of the top listed manufacturing corporation in both Sri Lanka and India. The study findings are similar to the findings of Eliwa et al. (2016) and Francis et al. (2005), who also discovered that accruals quality has a substantial and positive impact on the cost of capital of the corporations. However, when comparing the coefficient of QE, the quality of earnings and quality of accruals of Sri Lankan manufacturing firms have a strong influence on the cost of capital rather than the Indian manufacturing companies.

At last, both countries reported a positive coefficient value with a probability value greater than 0.05 for accounting conservatism, indicating that there is no substantial association between accounting conservatism and the weighted average cost of capital. Accordingly, the third alternate hypothesis is rejected, and the null hypothesis is accepted. Therefore, it can be stated that accounting conservatism has no substantial impact on the cost of capital of top-listed manufacturing companies operating in both Sri Lanka and India. The study findings are contradicted by the findings of Khalifa and Othman (2015), Lara et al. (2011), and Li (2015), which found a substantial and negative association between accounting conservatism and cost of capital.

5. CONCLUSION

We intended to uncover the truth behind the relationship between accounting information and cost of capital while using top-listed manufacturing companies. The study adopted a quantitative design under the deductive approach to achieve its main intentions. The study was carried out using only the data collected from the secondary sources, and a regression analysis was mainly utilized to accomplish the aims of the study. The findings of the study revealed that QE is negatively significant in determining the cost of capital in Sri Lanka and India. Besides, manufacturing firms in both countries that are focusing on efficient management of the cost of capital can derive their strategies to enhance the quality of earnings that will be beneficial to achieving the organizational goals. Moreover, the AQ positively and significantly impact determining the cost of capital, which supports the findings of Francis et al. (2005). Further, when comparing the coefficient of QE and AQ, the quality of earnings and accruals quality of Sri Lankan firms have a strong influence on their cost of capital than the Indian companies. Finally, the findings confirmed that there is no substantial association between accounting conservatism and the weighted average cost of capital among manufacturing companies in Sri Lanka and India. The outcomes of this paper will encourage managers to maintain a high earnings quality to reduce the cost of capital. However, having a rigid policy to manage accruals quality could be resulted in creating a high cost of capital for the firms. Thereby, the management has to be attentive when making policy decisions related to accruals quality. Further, the findings widen

the avenues for investors, analysts, or bankers who have an interest in financial data with the ultimate objective of earning a return, to consider the quality of the financial information when making investment decisions in the future.

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