ISSN 2950-6816 *Journal of SACFIRE*
Volume 3 Issue I (2024)

THE IMPACT OF INTEGRATED REPORTING ON COST OF CAPITAL IN LISTED COMPANIES IN SRI LANKA

D. Gunathilaka[1], W.A.N. Priyadarshanie[2], J.A.T.S Jayalath[3]

[1,2,3]*Department of Accountancy, Faculty of Business Studies and Finance, Wayamba University of Sri Lanka*

[1]*dulakshigunathilake@gmail.com*, [2]*nadeesha@wyb.ac.lk*, [3]*Thirunijayalath@gmail.com*

ABSTRACT

This research delves into the emerging field of Integrated Reporting (IR), a comprehensive reporting tool encompassing both financial and non-financial aspects. IR is viewed as a pivotal advancement in corporate reporting, aiming to transform the way information is presented to stakeholders. The primary objective is to elucidate how a company creates value over time, presenting a more holistic view for investors. Despite being relatively new, IR has garnered substantial attention, particularly regarding its evidenced benefits and compliance with the IR framework. IR illuminates an organization's dependence on various forms of capital, enabling stakeholders to assess long-term viability and resource management. A crucial innovation within IR is "integrated thinking," fostering a multifaceted approach to decision-making, integrating financial, social, and environmental considerations into a unified report. It enhances the transparency which leads to reduce information asymmetry. This study explores the impact of IR on the Cost of Capital, with a focus on the Cost of Equity (COE), Cost of Debt (COD), and Weighted Average Cost of Capital (WACC). Employing a positivist research philosophy and deductive research approach, it utilizes regression analysis to achieve the research objectives. A sample of 30 companies listed on the Colombo Stock Exchange for the years 2018 to 2021 serves as the basis for analysis. Regression analysis investigates the impact of adopting IR on cost of capital of the companies. Results of the study suggests that adopting IR impacts on reducing the cost of debt significantly. However, adopting IR has no any effect on the COE and WACC. The study adds to the body of knowledge regarding the potential benefits of complying with the IR reporting framework. The study's findings could encourage managers in countries where IR is not mandated. Additionally, the results can add to the ongoing discussions on the advantages o f adopting IR for firms.

KEYWORDS: Cost of Capital, Cost of Debt, Cost of Equity, Integrated Reporting, WACC

1. INTRODUCTION

Integrated Reporting (IR) represents a significant leap in corporate reporting, encompassing both financial and non-financial dimensions. Its emergence over the past decade is hailed as a pivotal development in the corporate reporting sphere, altering the way information is communicated to stakeholders. The core objective of IR is to elucidate how a company creates value over time, especially for investors. Despite being a relatively new concept, IR has attracted extensive research attention, particularly regarding its evidence-based benefits tied to adherence to the IR framework. IR strives to showcase an organization's dependence on various forms of capital, spanning financial, intellectual, social, and more. This enables stakeholders to thoroughly assess a company's long-term sustainability and resource management. At the heart of IR lies "integrated thinking," promoting a comprehensive analysis approach that integrates financial, social, and environmental aspects into a unified report. While early adopters like South Africa, Japan, and several other countries have embraced IR in corporate governance, its adoption is not yet mandatory in many nations, including Sri Lanka. However, the benefits of preparing IR reports have explored in various terms including impact of IR on financial and market performance (Gunarathne & Priyadarshanie, 2022; Ranaweera & Jayawardhana, 2022; Wen et al., 2017). The impact of IR on cost of capital remains underexplored in the Sri Lankan context, motivating this study to investigate how integrated reporting quality influences on cost of capital of Sri Lanakan listed companies, addressing a crucial research gap.

A recent strand of literature (Zhou, 2017; Pirgaip and Rizvić, 2023; Sharif et al., 2021) has examined the relationship between IR adoption and the cost of capital providing empirical evidence of the benefits of IR in this regard. Most of the research dialogs about the relationship between IR and the cost of capital in developed countries and countries which is compulsory to follow IR reporting practice such as South Africa. However, no studies found in the Sri Lankan context to examine the impact of IR on cost of capital. To fill this void, our research looks at the impact of IR on the cost of capital for Sri Lankan listed companies collecting data for the period starting from 2018 to 2021. Thereby the objective of this study is to examine the impact of IR on the cost of capital in Sri Lankan listed companies.

2. LITERATURE REVIEW

2.1 Theoretical Review

This study is based on information asymmetry theory and agency theory. According to information asymmetry theory at least one party to a transaction knows relevant information while the rest do not. A study conducted by Kim and Verrecchia (1994), allows us to discuss the existence of buyers and sellers in the market with varying information processing capacities. The asymmetric distribution of knowledge among market actors, as noted by Akerlof (1970), presents a barrier to the seamless exchange of assets at efficient prices with minimal transaction costs. From Leuz and Verrecchia (2000) and Brennan and Subrahmanyam (1996) trading frictions are introduced by information asymmetry among investors, resulting in lower levels of stock liquidity and higher expected returns, which raises a firm's cost of capital. This is possible because the possibility of transacting with more informed counterparts necessitates investors seeking higher returns, causing future expected payoffs to be discounted at a higher rate (Easley & O'hara, 2004).

Agency theory is used to comprehend the interactions of agents and principals. In a specific commercial transaction, the agent represents the principle and is supposed to represent the principal's best interests without regard for self-interest. The conflicting interests of principals and agents may arise because some agents may not always behave in the best interests of the principle. Miscommunication and disagreement can lead to a variety of difficulties and unrest inside businesses. Incompatible aspirations can create a schism between each stakeholder, resulting in inefficiencies and financial losses. This raises the principal-agent issue. The agency theory serves as the foundation for this research. As explained by Jensen and Meckling (1976); Panda and Leepsa, Ross (2017) and Ross (1973) the idea aims to identify and resolve the agency dilemma that exists between the firm's owners and management.

2.2 Empirical Review

Cost of Capital

When making management and investment decisions, the cost of capital is extremely significant. It reflects the issues associated with asymmetric information. It encourages academic scholars to focus their efforts on analyzing the effect of voluntary information disclosure in lowering the cost of capital in order to minimize the agency problem. Elliot and Jacobson (1994), for example,

claimed that a significant volume of released information would help to cut capital costs. The Integrated Reporting Committee of South Africa (IRCSA, 2011) suggests in its discussion paper on IR that benefits accrue to companies that release IR information to external stakeholders because the leadership's ability to demonstrate its effectiveness, coupled with the increase in transparency, could result in a lower cost of capital to the organization. Zhou et al. (2017) were among the first to investigate the impact of IR on the cost of capital. Their findings imply that companies with high-quality IR have lower capital costs. Using empirical data and a sample of 995 companies from 27 countries, Garcia-Sanchez (2017) discovered a negative association between IR and the cost of capital. As a result, the study argued that corporations can influence their cost of financing by managing the market availability of their information. Therefore, it is hypnotized that;

H_1 - There is a negative impact of Integrated Reporting on Weighted Average Cost of Capital.

Cost of Equity

Most of the studies on financial disclosure show empirically how it reduces the cost of equity capital (Botosan, 1997, 2006; Botosan & Plumlee, 2002; Core, 2001; Diamond & Verrecchia, 1991; Francis et al., 2005; Hail & Leuz, 2006; Healy & Palepu, 2001; Leuz & Wysocki, 2008; Richardson & Welker, 2001). As noted by Zhou's (2017) empirical investigation of the value of IR to the capital market revealed that IR affects the market in at least two different ways. They looked into whether IR-offering businesses have lower equity costs and whether analysts' predicting accuracy can be impacted by the interpolation of IR with the IR framework. Therefore, it is hypnotized that;

H_2 - There is a negative impact of Integrated Reporting on Cost of Equity.

Cost of Debt

Muttakin (2020) conducted another study on the impact of IR on the cost of debt, confirming that companies that use IR have lower cost of debt than companies that do not, using a sample of 847 annual observations for companies listed 48 on the JSE from 2009 to 2015, because the use of IR helps companies to reduce the cost of information gathering and monitoring. This study looked at the relationship between borrowing costs and IR as well as the association between borrowing costs and financial reporting quality. It was confirmed in this situation that this relationship is stronger for organizations who

use IR. Furthermore, it may serve as a solution to the objectives of Directive 2014/95/EU, which requires European public interest corporations to disclose transparent information that clearly describes the company's strategy and business model in connection to the environment and society. Muttakin et al. (2020) discovered that companies who use IR have lower COD than those that do not in their analysis of South African companies from 2009 to 2015. The authors ascribe this conclusion to the advantages of IR in terms of lowering information gathering and monitoring expenses. Raimo et al. (2021) use annual content analysis to assess the quality of IR information and a panel regression model to assess its impact on COD using a sample of 133 EU enterprises from 2017 to 2019. Their research demonstrates a negative association between IR quality and COD, implying that organizations that publish high-quality IR can benefit from lower debt financing costs. Accordingly, it is hypothesized that,

H_3 - There is a negative impact of Integrated Reporting on Cost of Debt

3. METHODOLOGY

The methodology for this research follows a positivist research philosophy, employing a deductive research approach to test existing hypotheses. Quantitative research is the chosen method, emphasizing numerical data and a logical, objective stance. The research population comprises companies listed on the Colombo Stock Exchange, with a sample consisting of 30 listed companies for the years 2018 to 2021, selected through random sampling.

Data for the study is collected using a secondary data collection method, utilizing annual reports from 2018 to 2021 of the listed companies in Sri Lanka. The collected data is then analyzed using EViews, an analytical tool suitable for analyzing qualitative data sourced from annual reports.

This research employs statistical analyses and regression modeling to examine the relationship between Integrated Reporting (IR) and the Cost of Capital, focusing on the components of Cost of Equity (COE), Cost of Debt (COD), and Weighted Average Cost of Capital (WACC). The study aims to provide insights into the role of IR in financial decision-making and its impact on the cost of capital for listed companies in Sri Lanka.

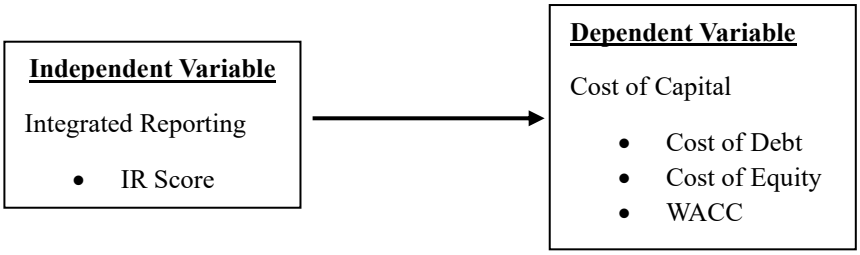

Figure 1: Conceptual framework
Source: Constructed by Authors

4. FINDINGS & DISCUSSIONS

4.1 Results of Regression

This study mainly used regression analysis to achieve its objectives.

Table 1: Results of Regression Analysis - Cost of Debt

Variable	Coefficient	t-Statistic	Prob.
C	0.317	3.343	0.001
IR Score	-0.269	-2.475	0.014
R-squared	0.049		
F-statistic	6.126		
Prob(F-statistic)	0.0147		

Source: EViews Output

When the F-statistical probability value is analyzed, it is shown that the entire model is significant at the 5% level of confidence, hence the F-statistical probability value is 0.014, indicating that the model is statistically significant. When R square is taken into consideration, all independent variables explain 4.9% of the dependent variable of integrated reporting. The intercept term (C) is 0.317175. This is the estimated value of the dependent variable (Cost of Debt) when all independent variables are zero. The coefficient for the IR Score is -0.269. This indicates a negative relation when a one-unit increase in IR Score is associated with a decrease of approximately 0.269 units in the Cost of Debt.

In summary, the regression analysis suggests that there is a statistically significant (P value < 0.05) negative impact of the IR Score on the Cost of Debt. Specifically, as the IR Score increases, the Cost of Debt tends to decrease.

Table 2: Results of Regression Analysis - Cost of Equity

Variable	Coefficients	t-Statistics	Prob.
C	0.375	0.776	0.439
IR Score	0.381	0.690	0.492
R-squared	0.004		
F Statistic	0.		
Prob.	0.491		

Source: EViews Output

The F-statistic tests the overall significance of the regression model. The associated p-value (Prob. F-statistic) is 0.491, indicating that the model is not statistically significant. R-squared (0.004) represents the proportion of variance in the dependent variable (Cost of Equity) explained by the independent variable(s). In this case, it's very low (0.004) suggesting a poor fit of the model. The coefficient for the IR Score is 0.381. However, it is not statistically significant (p-value > 0.05), indicating that the IR Score does not have a statistically significant effect on the Cost of Equity based on this analysis.

Table 03: Results of Regression Analysis – WACC

Variable	Coefficients	t-Statistics	Prob.
C	0.489	1.083	0.281
IR Score	0.187	0.361	0.719
R-squared	0.001		
F-statistic	0.130		
Prob(F-statistic)	0.719		

Source: EViews Output

The percentage of the dependent variable's (WACC) variance that can be accounted for by the independent variable(s) is indicated by R-squared (0.001) indicating a poor fit for the model. The IR Score's coefficient is 0.187. However,

according to the results it is not statistically significant (p-value > 0.05), suggesting that the IR Score has no statistically significant impact on WACC.

4.2 Hypotheses Testing

To test the hypotheses regarding the relationships between IR Score and the variables WACC, COE, and COD, the coefficients and associated p-values of the regression analysis were considered.

$H_{1:}$ IR has a negative relationship with the Cost of Debt

Since the p-value associated with IR Score (0.014) is less than the common significance level of 0.05, the null hypothesis is rejected. This implies that, based on the given data and model, there is a statistically significant impact of IR on the Cost of Debt.

H_2: IR has a negative relationship with Cost of Equity

Since the p-value associated with IR Score (0.492) is greater than the common significance level of 0.05, the null hypothesis is failed to reject. This implies that, based on the given data and model, there is no statistically significant impact of IR on the Cost of Equity.

H_3: IR has a negative relationship with WACC

Since the p-value associated with the IR Score (0.719) is greater than the common significance level of 0.05, the null hypothesis is failed to reject. This implies that, based on the given data and model, there is no statistically significant impact of IR on WACC.

In simpler terms, the analysis indicates that there is a statistically significant negative relationship between the IR Score and the Cost of Debt. However, no significant relationships were found between IR Score and WACC, as well as IR Score and Cost of Equity.

This research shows that there is no significant negative relationship between the IR Score and WACC or the Cost of Equity while the IR Score and the cost of debt show a statistically significant negative relationship with the IR Score. Results are in line with other researchers (Zhou, 2017; Vitolla et al.,2019; Sharif et al., 2021). According to Zhou (2017) and Vitolla et al. (2019) there is a

negative coefficient and significant negative relation between the cost of equity and the IR score. Sharif et al. (2021) also concluded that there is a significant, negative relationship between IR and the implied cost of equity capital in the developed market.

Table 4: The summary of the hypotheses testing

Hypothesis	Supported or not supported
H_1: IR has a negative relationship with Cost of Debt	Supported
H_2: IR has a negative relationship with the Cost of Equity	Not Supported
H_3: IR has a negative relationship with the WACC	Not Supported

Source: Constructed by Authors

5. CONCLUSION

This study aims to identify the impact of adopting integrated reporting on the cost of capital of Sri Lankan listed companies in terms of COE, COD and WACC. Utilizing a quantitative research method and data from 30 listed companies in the Colombo Stock Exchange for the years 2018 to 2021, the study explores the relationship between IR and the Cost of Capital, specifically examining the COE, COD and WACC. Regression analysis further explores these relationships, with the results suggesting that the cost of debt has a statistically significant negative relationship with the IR Score. However, there is no any impact of IR on cost of equity and WACC. Comparing findings with prior research, this study aligns with previous studies showing a negative relationship between IR and the cost of debt. IR enables companies to reduce debt cost by making high-quality disclosure in pertinent areas of operation, strategy, risk, and how firms create value over time encouraging lenders to provide funds. This study inspires companies that have not produced IR to accelerate the reduction in the cost of debt. Consequently, this study can help practitioners to take policy decisions regarding IR adoption and regulators can promote IR implementing policies and providing guidelines. Future research should investigate knowledge on the cost of capital implications of IR adoption consider classifying the samples based on the quality of IR adoption and extent of the adoption (full adoption, partial adoption, and non-adoption).

REFERENCES

Akerlof, G. A. (1978). The Market For "Lemons": Quality Uncertainty and the Market Mechanism, *Elsevier eBooks* (pp. 235–251). https://doi.org/10.1016/b978-0-12-214850-7.50022-x

Baiman, S. &. (1996). the relation among capital markets, financial disclosure, production efficiency, and insider trading. Journal of Accounting Research, 34, 1–22.

Barth, M. E. (2017). The economic consequences associated with integrated report quality: Capital market and real effects. Accounting, Organizations and Society, 62, 43-64.

Bhekisisa N. Ngcobo, M. S. (2021). Effects of integrated reporting on the cost of capital and analysts' forecasts errors: A study of Johannesburg Stock Exchange listed mining firms. Journal of Economic and Financial Sciences, 11.

Botosan, C. A. (2002). A re-examination of disclosure. Journal of Accounting, 21–40.

Brennan, M. J., & Subrahmanyam, A. (1996). Market microstructure and asset pricing: On the compensation for illiquidity in stock returns. *Journal of Financial Economics*, 41(*3*), 441–464. https://doi.org/10.1016/0304-405x(95)00870-k

Busco C., F. M. (2013). Integrated Reporting: Concepts and Cases that Redefine Corporate. Springer.

De Villiers, C. R. (2014). Integrated reporting: insights, gaps and an agenda for future research. Accounting, Auditing and Accountability Journal, 27 (*1*), 1042-1067.

Easley, D. &. (2004). Information and the cost of capital. The Journal of Finance, 1553–1583.

Easley, D., & O'hara, M. (2004). Information and the cost of capital. *The Journal of Finance*, *59*(4), 1553–1583. https://doi.org/10.1111/j.1540-6261.2004.00672.x

Eccles, R. &. (2010). One report. Integrated reporting for a sustainable society. John Wiley & Chichester.

Eliwa, Y. A. (2021). ESG practices and the cost of debt: Evidence from EU countries. Critical Perspectives on Accounting, 79

Elliot, R. K. (1994). Cost and benefits of business information disclosure. Accounting Horizons, 8(4), 80–96.

García-Sánchez Isabel-María, N.- G. L. (2017). Integrated information and the cost of capital. International Business Review.

García-Sanchez, I. M.-G. (2017a). Integrated Information and the cost of capital. International Business Review, 26(5), 959-975.

García-Sanchez, I. M.-G. (2017b). Integrated Reporting and Stakeholder Engagement: The Effect on Information Asymmetry. Corporate Social Responsibility and Environmental Management, 24(5), 395-413.

Gunarathne, A., & Priyadarshanie, W.A.N (2022). The impact of integrated reporting on firm performance: Evidence from listed companies in Sri Lanka. *The Journal of ARSYM*, *03*(II), 119–133. https://fbsf.wyb.ac.lk/wp-content/uploads/2024/02/JARSYM-V3-Issue-II-9.pdf

Healy, P. M. (2001). Information asymmetry, corporate disclosure, and the capital markets: A review of the empirical disclosure literature. Journal of Accounting and Economics, 405–440.

Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, *3*(4), 305–360. https://doi.org/10.1016/0304-405x (76)90026-x

Kim, O., & Verrecchia, R. E. (1994). Market liquidity and volume around earnings announcements. Journal of Accounting and Economics, 17(1-2), 41–67. https://doi.org/10.1016/0165-4101(94)90004-3.

Lee, K. &. (2016). the association between integrated reporting and firm valuation. Review of Quantitative Finance and Accounting, 47, 1221-1250.

Leuz, C., & Verrecchia, R. E. (2000). The Economic Consequences of Increased Disclosure. *Journal of Accounting Research*, *38*, 91–124. https://doi.org/10.2307/2672910

Mohammad Badrul Muttakin, Muttakin, M. B., Mihret, D., Lemma, T. T., & Khan, A. (2020). Integrated reporting, financial reporting quality and cost of debt. Emerald Insigh. Retrieved from https://www.emerald.com/insight/1834-7649.htm

Panda, B., & Leepsa, N. M. (2017). Agency theory: Review of theory and evidence on problems and perspectives. *Indian journal of corporate governance*, 10(*1*), 74-95.

Phillips, D. W. (2011). Benefits of comprehensive integrated reporting. . Financial Executive, 27(2), 26-30.

Pirgaip, B., & Rizvić, L. (2023). The Impact of Integrated Reporting on the Cost of Capital: Evidence from an Emerging Market. *Journal of Risk and Financial Management*, 16(*7*), 311. https://doi.org/10.3390/jrfm16070311

Pistoni, A. S. (2018). Integrated reporting quality: An empirical. Corporate Social Responsibility and Environmental Management, 489–507.

Raimo, N. A. (2022). Integrated Reporting Quality and Cost of Debt Financing. Journal of Applied Accounting Research, 122–38.

Ranaweera, D.C.P. and Jayawardhana, J.R.N.N. (2022). Impact of Integrated Reporting on Firm Performance in the Listed Companies in Sri Lanka. Wayamba Journal of Management, 13(2), p. 256-276. Available at: https://doi.org/10.4038/wjm.v13i2.7576.

Richardson, A. J., & Welker, M. (2001). Social disclosure, financial disclosure and the cost of equity capital. Accounting, organizations and society, 26(7-8), 597-616.

Rizvi´c, B. P. (2023). The Impact of Integrated Reporting on the Cost of Capital: Evidence from an Emerging Market. Journal of Risk and Financial Management.

Rizvic, L. (2022). The Examination of the Relationship Between Integrated Reporting and Cost of Capital: Evidence from Borsa Istanbul. Ankara, 76.

Sharif, H. P., Johari, J., Fadzilah, W., & Theng, L. W. (2021). Impact of Integrated reporting quality disclosure on cost of equity capital in Australia and New Zealand. *Indonesian Journal of Sustainability Accounting and Management*, *5*(2). https://doi.org/10.28992/ijsam.v5i2.400

Cooray, T., Gunarathne, A. N., & Senaratne, S. (2020). Does corporate governance affect the quality of integrated reporting? Sustainability, 12(10), 4262.

Vitolla, F. R. (2020). 'Board characteristics and integrated reporting quality: An agency theory perspective. Corporate Social Responsibility and Environmental Management, 1152–1163. Retrieved from https://doi.org/10.1002/csr.1879

Wen, L. P., Angeline, Y. K. H., & Simon, L. C. H. (2017). Integrated Reporting and Financial Performance. *Management and Accounting Review*, 16(*2*), 101. https://doi.org/10.24191/mar.v16i2.647

Zhou, S. S. (2017). 'Does integrated reporting mater to the capital market? Abacus 53, 94–132.