Cost of Capital and Earnings Transparency

Abstract
We provide evidence that firms with more transparent earnings enjoy a lower cost of capital. We develop an earnings transparency measure that captures cross-sectional and intertemporal variation in the extent to which earnings and change in earnings covary contemporaneously with stock returns. We find that firms with more transparent earnings have a lower cost of capital as reflected in cross-sectional variation in subsequent excess returns and mean differences in returns, after controlling for the Fama-French and momentum factors. We also find that more transparent earnings are significantly negatively associated with expected equity cost of capital. Prior research reports a significant relation between a value relevance measure, which bears some resemblance to our earnings transparency measure, and cost of capital. We show that these relations are not significant after correcting for cross-sectional correlation in residuals, which is consistent with the measure used in prior research lacking intertemporal variation.