Title: Paid-in Capital, Earned Capital, and Cross-sectional Differences in Financial Risk

Abstract:

We examine whether the distinction between two components of equity – paid-in capital and earned capital – is associated with cross-sectional differences in financial risk to claimants (e.g., shareholders and creditors). We define financial risk as the likelihood that a claimant will not receive the expected stream of future cash flows underlying its claim. We find that, after controlling for the amount of debt in a firm’s capital structure, the amount of paid-in (earned) capital in its capital structure is positively (negatively) associated with idiosyncratic common equity risk, credit risk, and the likelihood of business failure. Our findings indicate that although paid-in capital and earned capital are similarly classified as equity for financial reporting purposes, they exhibit opposite relations to financial risk from one another, which, in turn, raises the question of whether this distinction is under-emphasized in financial accounting.