The Impact of Corporate Governance and Shareholder Monitoring Mechanisms on Cost of Debt: Empirical Evidence from Malaysian Listed Firms from 2003 to 2007

This paper investigates the effect of corporate governance and shareholder monitoring mechanisms on cost of debt of Malaysian listed firms. We develop a corporate governance index consisting 139 items in six broad categories for assessing the quality of firm corporate governance. We classify shareholder monitoring mechanisms into ownership concentration, family, insider and government ownerships. Using panel sample from 2003 to 2007, our regression results show that high corporate governance quality and ownership concentration lower firm cost of debt. Debt issuers value corporate governance mechanisms in the forms of board structure and procedures, board compensation practices, shareholder rights and relations, accountability, transparency and audit and social and environmental activities as integral components of a good corporate governance framework.

**Keywords:** corporate governance index; agency cost of debt; cost of debt; ownership structure; emerging market; Malaysia

**Introduction**

In this paper, our main objective is to investigate the impact of corporate governance and shareholder monitoring mechanisms on the cost of debt of Malaysian listed firms from 2003 to 2007. We also attempt to determine the type of corporate governance and shareholder monitoring mechanisms that could potentially lower cost of debt. We define corporate governance as “the ways through which suppliers of capital to corporations assure themselves of getting return on their investment” (Shleifer and Vishny, 1997: 737).

We posit that ownership structure represents an important aspect of shareholder monitoring mechanisms that could potentially complement or be a part of a holistic corporate governance framework. Prior studies on Malaysian listed corporations show that ownership structure is an important determinant of firm performance (Mohammed Haniffa and Hudaib, 2006;
Sulong and Mat Nor, 2008). In fact, corporate ownership structure is seen either as a potent governance mechanism or the source of corporate governance problems (Samad, 2004).

Our research is based on both the theoretical perspectives of debt agency costs and the traditional manager-shareholder agency costs. There is scarce literature on the impact of corporate governance and shareholder monitoring mechanisms on agency cost of debt. There is little, if any, empirical work on this issue, particularly in Malaysia. Theoretically, the value of corporate governance in public corporations is widely acknowledged. However, its contribution to value creation for the suppliers of finance remains a subject of an open empirical question.

Based on the traditional manager-shareholder agency theory debt issuers suffer from the adverse effects of managerial opportunism, asymmetric information due to separation of ownership and control (Jensen and Meckling, 1976), which increase the likelihood of default in debt commitment. As debt issuers do not have effective control on the use of funds they provide, they are exposed to the risk that opportunistic managers may possibly divert these funds from the intended objective.

Corporate governance mechanism such as effective board monitoring, external and internal audit may limit managerial tendency to pursue personal agendas such as empire building and wasting firm resources for personal benefits. Debt issuers rely on financial reports to assess the extent of default risk. In this instance, corporate governance serves as an oversight mechanism in financial reporting process, which assures the integrity of financial reports.

The link between ownership structure and debt issuers welfare from the perspective of debt agency cost is vague. On one hand, dominant shareholders may strive to maintain the benefits accruing from their control of the firm by reducing the agency cost of risk against debt issuers so that they can continuously enjoy lower cost of debt. Controlling owners may closely align their interest to wealth maximisation and have incentive to preserve their reputation in the debt market (Anderson, Mansi and Reeb 2003).

On the other hand, debt issuers may be adversely affected by entrenched controlling shareholders who indulge in risky investment to pursue ‘empire building’ (Jensen, 1986; Stultz, 19910), engage in tunnelling activities (Gilson, 2006), dilute debt issuers’ claim by issuing debt of
higher priority (Aslan and Kumar, 2009) and undertake acquisitions that increase leverage and affect debt seniority (Warga and Welch, 1993).

We collect a total of 505 firm-years observations for this purpose. We develop a comprehensive corporate governance index (the CG Index) for evaluating firm corporate governance quality. We find that corporate governance and concentrated ownership have inverse relations with the cost of debt after controlling for firm size, leverage, performance, market-to-book ratio, interest coverage ratio, economic growth, and industry and time effects.

We also observe that debt issuers appear to consider board structure and procedures, board compensation practices, accountability and audit, transparency and social and environmental practices and ownership concentration as integral elements of high quality corporate governance. Our finding reaﬃrms the argument that in reality ﬁrms adopt a range of governance mechanisms, each of which is consistent with maximising ﬁrm value (Coles, Daniel and Naveen, 2008). Our study also shows that the CG Index developed for this study is a valid instrument for assessing corporate governance practices.

Our research contributes to both theory and practice in four important ways. First, we provide systematic preliminary evidence linking corporate governance and shareholder monitoring mechanisms to cost of debt in an important emerging market. Second, our study contributes to the emerging literature that investigates the association between corporate governance, shareholder monitoring mechanisms and cost of debt from the theoretical perspectives of both debt agency costs and the traditional shareholder-manager agency conﬂicts. Third, we highlight that debt issuers do not only factor in ﬁrm corporate governance and shareholder monitoring mechanisms in their lending decisions and pricing of the debt, but also seem to value broad based corporate governance mechanisms to better protect their interest. Finally, our study shows that listed ﬁrms could beneﬁt from adopting the MCCG’s (2000) recommendations and other global standards of corporate governance.
Corporate Governance in Malaysia

Corporate governance in listed corporations started to receive prominent attention during the Asian financial crisis during 1997-1998. Many large listed companies collapsed during the crisis. Many firms were unable to withstand the financial crisis due to poor corporate governance and financial control (Mitton, 2002). The government responded to the various calls for corporate governance reforms by forming a High Level Finance Committee to conduct a detailed study on the state of corporate governance of listed firms. The study revealed that listed firms had poor corporate governance practices that enabled errant directors and controlling shareholders to expropriate wealth from the company during the financial crisis.

The Committee prescribed the MCCG in 2000, which served as guidelines for the directors to enhance checks and balances and self-regulatory mechanisms. The Committee placed utmost importance on the governance role of board of directors; thus, its recommendations principally focused on establishing various best practices for strengthening board structure and procedures (Liew, 2007). In 2001, the Malaysian Bourse adopted the MCCG (2000) in its listing requirements and imposed a mandatory obligation for public listed firms to disclose in their annual reports the way they have applied the principles of the MCCG (2000) and the extent of compliance with the best practices.

In recent years, the Malaysian Bourse, Securities Commissions and Companies Commission of Malaysia have stepped up enforcement and surveillance efforts and brought errant directors and firms to book. Other than beefing up enforcement actions, the regulators have also been providing training for corporate directors and market players on their responsibilities and the implementation of the MCCG (2000).

Ownership Structure in Malaysia

Ownership is highly concentrated in Malaysia and it is common to have listed firms that are closely controlled by a single shareholder (Claessens, Djankov and Lang, 2000). Share ownership in Malaysian listed firms tends to be concentrated in the hands of a relatively small number of individuals, families and the government or state enterprise (Shim, 2006). Many of the listed firms
including the conglomerates in Malaysia have evolved from traditional family-owned enterprises (Kean and Cheah, 2000). A recent study reveals that from the period 1999 through 2005 over 43 percent of the companies listed on the Malaysian Bourse main board are family-owned (Ibrahim, Samad and Amir, 2008).

Government ownership presents a unique feature of corporate ownership structure in Malaysia, in addition to the typical family-control structure. The involvement of the government in businesses can be attributed to the historical and political developments of Malaysia especially after the implementation of the New Economic Policy (NEP) beginning 1971. The aim of the NEP was to achieve 30 percent of corporate ownership and management for Bumiputera by 1990. The implementation of the NEP has caused the transfer of ownership and control of companies in major industries such as plantations, mining as well as banking sectors from the foreigners to the government (Ali, 2002). The government had established various state agencies to facilitate the achievement of this national agenda.

Beginning 1980s the government has aggressively embarked on privatisation of key state companies but at the same time remains as a major shareholder in those privatised firms (Abdul Rahman, 2006). This privatisation exercise coupled with the NEP have further entrenched the government involvement in the corporate sector. Following the Asian financial crisis in 1997, the government established its investment arm company known as Khazanah Nasional Berhad, which is a major shareholder of a few large listed firms.

McConaughy, Walker, Henderson and Mishra (1998) concede that prior studies on ownership structure yield inconclusive results, which according to them is due to limitation of ownership concentration that does not address the issue of shareholders’ identities. Thus, this study examines ownership concentration and three ownership identities namely family, insider and government shareholdings, which represent the shareholder monitoring aspects of corporate governance.
Hypothesis Development

Corporate Governance and Cost of Debt

Theoretically, debts issuers may be adversely affected by the agency conflicts between shareholders and managers. When managers are left to their own devices they tend to resort to opportunistic behaviour to pursue personal agendas at the expense of shareholders. They may also withhold value relevance information from shareholders and manipulate financial reports in order to enjoy higher compensation. Debt issuers are very concerned about the extent of default risk in a firm. They use financial reports to assess the default risk. Managerial opportunism and asymmetric information and questionable accounting practices increase the default risk. In the event of higher likelihood of default debt issuers impose higher risk premium to compensate them for the potentially risky investment.

Effective corporate governance mechanisms can reduce default risk by enhancing monitoring of managerial opportunistic behaviour, influencing the integrity of financial accounting reports and alleviating the extent of information asymmetry between firms and their lenders. If debt issuers anticipate rampant managerial opportunism and higher information asymmetry they will demand a higher yield on firms’ debt (Myers and Majluf, 1984; Anderson et al., 2004).

Bhojraj and Sengupta (2003) examine the link between corporate governance mechanisms and bond ratings and yields in a sample of US firms during 1991-1996. They find that firms having greater institutional investor ownership and stronger outside directors’ control enjoy lower yields and superior bond ratings. However, as institutional ownership gets concentrated, firms have lower ratings and higher yields. Anderson et al., (2004) investigate the relationship between audit quality attributes and cost of debt of 500 Standard and Poor’s companies during 1993-1998. They observe that bondholders feel assured of the integrity of the firms’ accounting information when there is an effective board and audit committee’s monitoring. Hence, they are willing to reduce their risk premium, allowing firms to enjoy lower cost of debt.

Pittman and Fortin (2004) examine the relationship between external auditor reputation and firms’ cost of debt in a sample of U.S. firms that went public during 1977-1988. They find that firms that retained Big Six auditors show a lower average cost of debt, implying that debt issuers
consider auditor’s reputation is an important in determining the quality of financial information. Using firm-level data from the Investor Research Responsibility Center (IRRC) for the period of 1990-2000, Klock et al., (2005) investigate the link between a various anti-takeover mechanisms, shareholder protection factors and the cost of debt. They find strong anti-takeover governance factors lower the cost of debt and vice-versa, suggesting that the anti-takeover provisions are beneficial to protect bond holders’ interest.

Blom and Schauten (2006) empirically investigate the impact of corporate governance on cost of debt based on the idea that the former is an important factor in the assessment of risk profiles and default risk. The risk profile determines the required return by debt issuers. The results show that firms with strong corporate governance have lower cost of debt. Piot and Missonier-Piera (2007) in their study of French firms report that corporate governance quality and auditing structure of public firms have a significant reducing effect on the cost of debt. Board involvement in the monitoring of corporate governance issues, the monitoring power of institutional investors and board independence have significant reducing effects on cost of debt.

In South Korea, Byun, (2007) investigates the effect of corporate governance practices on the default risk and cost of debt. They observe that dividend policies, shareholder rights protection and audit committee reduce cost of debt. The link between quality corporate governance and cost of debt is more pronounced in larger firms than smaller firms in South Korea.

The theoretical argument and findings of the empirical studies, discussed above lead to the following hypothesis:

\[ H_1: \text{Cost of debt is negatively related to corporate governance quality} \]

*Shareholder Monitoring Mechanisms and Cost of Debt*

We classify shareholder monitoring mechanism into four categories namely concentrated, family, insider and government ownerships so as to accurately reflect the ownership structure of Malaysian listed firms as identified in prior studies.
Concentrated Ownership and Cost of Debt

The active monitoring hypothesis posits that concentrated owners have mostly undiversified investments; hence they have less incentive to ‘exit’ the firm and extract benefits from the firm for which it might impair their own wealth. They need to monitor the management in order to limit managerial opportunism. The shared benefits hypothesis posits that debt issuers feel secure due to the concentrated owners’ active monitoring; hence, they are willing to impose lower risk premium effectively reducing cost of debt. Concentrated owners may also attempt to reduce the agency risk against lenders so that they can continue to enjoy cheaper cost of debt.

In contrast, concentrated ownership may have the tendency to indulge in ‘empire building’ (Jensen, 1986; Stultz, 1990), engage in tunnelling activities (Gilson, 2006), dilute debt issuers’ claim by issuing debt of higher priority (Aslan and Kumar, 2009) and undertake acquisitions that increase leverage and affect debt seniority (Warga and Welch, 1993). In this instance, the default risk is higher prompting the lenders to impose higher cost of debt. Cremers, Nair and Wei (2007) in their study of 1,218 U.S. traded-quoted bond yields from 1990 to 1997 observe that concentrated ownership is associated with higher (lower) yields if the firm is exposed to (protected from) takeovers. The finding implies that bondholders are more wary of takeover risk in the presence of strong shareholder governance.

Pham, Suchard and Zein (2008) observe that the presence of higher institutional blockholders leads to lower cost of capital. Piot and Missonier-Piera (2007) in their study of 102 French listed firms for the period 1999-2001 show that the monitoring power of institutional block-holders have a reducing effect on the cost of debt. In China, Wang and Zhang (2008) observe that an increase in a dedicated group of institutional investors’ shareholdings mitigates information asymmetry and lowers cost of debt.

A few studies demonstrate that concentrated owners are detrimental to the interest of debt issuers. Bhojraj and Sengupta (2003) in a study of a 1,005 U.S. listed firms between 1991 and 1996, observe that firms with concentrated institutional shareholders suffer from lower ratings and higher bond yields. Boubakri and Ghouma (2010) observe that bondholders in both East Asian (including Malaysia) and Western European countries view concentrated equity holders as
detrimental to their interest. Lin, Ma, Malesta and Xuan (2010) document a similar finding in their study of Western European and nine East Asian countries including Malaysia during the 1996-2008. Cost of debt is significantly higher in firms that have wider divergence between the largest ultimate owner’s control rights and cash-flow rights.

The empirical evidence discussed above suggests that concentrated ownership has some bearing on the cost of debt and provides support for the hypothesis below. However, the direction of the association is not indicated in view of the vague theoretical explanation and insufficient direct empirical evidence to establish a clear direction.

\[ H_2: \text{Cost of debt is related to concentrated ownership} \]

**Family Ownership and Cost of Debt**

Family ownership can be a powerful governance mechanism to curb managerial opportunism and promote long-term survival of the firm. Family owners exert control over the firm’s management and they will refrain from undertaking activities that could potentially impair their wealth; thus, alleviating agency conflicts between equity and debt issuers; thus, reducing the cost of debt.

Private benefits hypothesis, on the other hand, suggests that family ownership could create a conflict between family controlling shareholder and debt issuers (Anderson et al., 2003). Family owners have the incentive to expropriate wealth from debt issuers by investing in riskier projects. In this situation, shareholders benefit from most of the gains when the riskier projects pay off but the debt issuers bear most of the cost (Jensen and Meckling, 1976). Debt issuers protect their interest by insisting on protective covenants and oversight mechanisms. But, the covenants are usually difficult to enforce and the oversight mechanisms are costly and imperfect (Anderson et al., 2003); prompting the debt issuers to demand higher risk premium leading to higher cost of debt.

Anderson et al., (2003) investigate the founding family ownership and its effect on the cost of debt of 252 Standard & Poor’s 500 industrial firms during 1993-1998. They find that founding family ownership lowers cost of debt. Their finding indicates that debt issuers are willing to demand low risk premium because they view founding family ownership as a potent monitoring mechanism to protect their interest. However, this finding may be unique to the U.S. market
because it has a strong investor protection law (see La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1999). Debt issuers may be comfortable with the presence of founding family ownership provided they may also get effective legal recourse against any form of wealth expropriation by the family owners.

Ellul, Guntay and Lel (2006) examine the impact of founding family ownership on the 325 firms’ cost of debt under different investor protection environments from 1998 to 2002. They observe that family firms originating from low investor protection environments suffer from high debt cost whilst firms originating from the high legality countries benefit from lower debt costs compared to non-family firms.

Lin et al., (2010) examine the link between ownership concentration in family firms and cost of debt. Their study reveals that family firms with concentrated ownership have significantly higher cost of debt. The effect is amplified when the CEO of firms is a member of the controlling family, the borrower has poor financial transparency, a lower credit rating, a higher credit risk and during financial crises. They also find that the collateral and loan covenants together with strong legal rights and efficient debt enforcement minimise the impact of excess controls on cost of debt.

Boubakri and Ghouma (2010) investigate the effect of family ownership on the cost of debt. They find strong evidence that family control is perceived as a potential risk of expropriation by both bondholders and rating agencies.

The findings of Boubakri and Ghouma (2010) and Lin et al., (2010) are clearly in contrary to the study of Anderson et al., (2003) and Ellul et al., (2006). Their evidence points out that the presence of family owners is likely to harm bondholders in other markets than the U.S. These findings on East Asian markets seem to corroborate the finding of La Porta et al. (1999) in which the presence of family owners in those countries with weak investor protection regime is likely to harm other stakeholders, including debt issuers.

The theoretical argument and findings of the empirical studies, discussed above lead to the following hypothesis:

\[ H_3: \text{Cost of debt is positively related to family ownership} \]
Insider Ownership and Cost of Debt

The convergence-of-interest hypothesis posits insider ownership promotes goals congruence and lowers agency cost because insiders are not only managers but also owners of the firm. Owner-managers avoid value destruction activities in order to protect their mainly undiversified shareholdings. In contrast, based on the entrenchment hypothesis controlling insiders may be entrenched; hence, they are likely to engage in activities that are detrimental to the interest of debt issuers (Jensen and Meckling, 1976). Debt issuers may charge a higher level of cost of debt for taking the risks linked to insider ownership.

Pham et al., (2008) find that the insiders’ tendency to protect firms’ investment reduced the perceived risk of a firm, thereby prompting investors to accept a reduction in the risk premium leading to a lower cost of capital. The studies of Anderson et al., (2004) and Fields et al., (2010), on the other hand, show that insider ownership is not related to the cost of debt.

In view of the limited empirical evidence and inconclusive findings, we propose the following hypothesis:

\[ H_4: \text{Cost of debt is related to insider ownership} \]

Government Ownership

Government ownership participation in listed firms is common in Malaysia. Government owners may perform a stewardship role and prominent monitors of the management behaviour (Ang and Ding, 2006). The government represents a wider interest of the society; hence, they need to ensure that their investment in listed entities is profitable. In view of these factors, debt issuers may be willing to impose lower charge on the funds provided.

Government owners, on the other hand, have been viewed as being inefficient mainly due to the difficulty to manage the conflicting priorities. They need to balance between the objective of social welfare maximisation and the firm’s objective of profit maximisation. Further, Putterman (1993) posits that government-owned firms face free rider problem in monitoring firms’ performance. In Malaysia, government-owned firms are generally less profitable and efficient than other listed firms due to the existence of political patronage and rent-seekers’ mentality (Gomez
and Sundaram, 2002). In this situation, debt issuers may view investment in government-owned firms as risky and seek compensation in the form of higher risk premium, leading to higher cost of debt.

Boubakri and Ghouma (2010) in a study of selected East Asian (including Malaysia) and Western European countries observe that government ownership does not have any effect on firms’ yield spreads. Further, government ownership is positively related to bond ratings implying that rating agencies do not view government as an additional potential risk factor of expropriation; instead, their presence increases bond ratings. Vining and Boardman (1992) find that government-owned firms are less efficient than privately owned firms prompting debt issuers to demand higher risk premium to compensate them for this potentially risky investment.

The theoretical arguments and limited empirical findings, discussed above, lead to the hypothesis below.

\[ H_0: \text{Cost of debt is positively related to government ownership} \]

Research Methodology

Sample
Our sample comprised 101 firms listed on the Main Board of the Malaysian Bourse between 2003 and 2007. We exclude all finance-related firms, banks, insurance, and unit trusts companies from the sample because they have different regulatory requirements and framework, financial reporting standards, compliance (Claessens et al., 2002) and materially different types of operations (Mohd Ghazali and Weetman, 2006).

Variables
Cost of Debt. Following Byun (2007), Fields et al., (2010); Piot and Missonier-Piera (2007); Pittmann and Fortin (2004), we use interest rate as proxy for cost of debt. We compute interest rate by dividing interest expenses by average short-term and long term debt for a given year. We use one measure of cost of debt only due to the unavailability of data to compute alternative measures such as yield spread and credit ratings.
**Corporate Governance.** We use the CG Index to assess corporate governance quality. We develop the CG Index based on the MCCG’s (2000) principles and best practices and related prior studies (e.g. Black, Jang and Kim, 2006; Byun, 2007; Chen, Chen and Wei, 2009; Donker and Zahir, 2008; Patel and Dallas, 2002). Our CG Index consists of 139 items in six categories: board structure and procedures, board compensation practices, shareholder rights and relations, accountability and audit, transparency and social and environmental. Table 1 shows the definition of each category of the CG Index.

We do not assign any weight to the categories and items of the CG Index because there is no proven weighting system that is globally accepted (Donker and Zahir 2008) and lack of theoretical basis for assigning weight for each category (Black et al., 2006). To avoid biasness that may arise in scoring the corporate governance items, we design the CG Index based on facts, such as whether the firm indicates the number of board meetings held in a year.

**Table 1 Definition of Corporate Governance Categories of the CG Index**

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of items</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board structure and procedures</td>
<td>68</td>
<td>The structural elements of the board and the process of governing by the directors</td>
</tr>
<tr>
<td>Board compensation practices</td>
<td>14</td>
<td>The practices adopted by the board in determining and deciding the remuneration for the directors</td>
</tr>
<tr>
<td>Shareholder rights and relations</td>
<td>6</td>
<td>The empowerment of shareholders and shareholder communication</td>
</tr>
<tr>
<td>Accountability and audit</td>
<td>17</td>
<td>The accountability mechanisms and process of the board of directors</td>
</tr>
<tr>
<td>Transparency</td>
<td>23</td>
<td>The ability of stakeholders to assess the true position, prospect and performance of the company</td>
</tr>
<tr>
<td>Social and environmental</td>
<td>11</td>
<td>The company’s ethical and socially responsible activities</td>
</tr>
</tbody>
</table>

We apply a dichotomous procedure in scoring firm corporate governance. We give a “1-point” score for each item that is in line with good corporate governance practices as indicated on the CG Index and otherwise, we give a “0-point” score. For example, if a firm has a policy on environmental responsibility, we award a “1-point” score. We compute the sum of scores for each of the six corporate governance categories and the total score combining all six categories. This
total score reflects an aggregate ranking for all six categories. Finally, we derive the corporate governance score of each firm by dividing the overall score with the maximum score (139) and convert the score to a percentage form. A high corporate governance score (CGSC) implies a high quality of corporate governance. As the CG Index is self-developed we also assess its validity and the stability of our scoring.

Assessment of Validity of the CG Index. We subject our CG Index to a pilot test on ten company annual reports for the purposes of examining the extent of variations in corporate governance practices between different firms, ensuring that the items of the CG Index are not vague and subjective, eliminating any redundant items and finally, ensuring its overall functionality. Based on the pilot test findings we amend a few statements that have unfamiliar or inappropriate words or syntax and delete a few repetitive items.

Consistent with the approach of Botosan (1997), we employ Cronbach’s alpha coefficient test of internal consistency in order to verify the reliability and validity of the CG Index. The overall Cronbach’s alpha coefficient of the CG Index is 0.89, indicating that our CG Index has good internal consistency and is a reliable instrument for evaluating corporate governance quality.\(^2\)

We adopt the test-retest method of kappa coefficient as in Dunn (1989) and Fleiss (1981) to assess the reliability and stability of the corporate governance scores. The assessor reads the ten annual reports twice and scores the corporate governance items on two separate occasions. We analyse the scored items from the two separate occasions together using the kappa coefficient method. We find that the two scores are highly similar or consistent as evidenced by the kappa coefficient values of at least 0.60\(^3\).

Shareholder Monitoring Mechanisms. The second set of independent variables consists of the ownership concentration and three ownership identities namely family, insider and government shareholdings. This set of independent variables represents the shareholder monitoring aspect of corporate governance. We rely on prior studies such as Anderson et al., (2003), Ang and Ding (2006), Mohd Ghazali and Weetman (2006) and Shim (2006) for the determination of the types of shareholder monitoring mechanisms.
Ownership is defined as the amount of equity shares an ultimate owner holds in the sample firms. Ownership data are manually collected from the sections on the analysis of shareholdings and director’s reports of firms’ annual reports. Consistent with prior studies, this study utilises the actual percentages of each shareholder monitoring mechanism. Similar to the approach of Chu and Cheah (2006) and Mohammed Haniffa and Hudaib (2006) ownership concentration is defined as the sum of ownership percentage of non-family shareholders who hold a minimum five percent of the total equity of the firm.

The literature does not provide commonly accepted definition, measure or criterion for identifying a family ownership (Anderson et al., 2003). We identify family relationship based on the information provided in the section on director’s profile of firms’ annual reports. We measure family ownership as the cumulative percentage of family members’ equity ownership.

Following Mohammed Haniffa and Hudaib (2006) we define insider ownership as the cumulative percentage of executive directors’ equity shares. In line with Mohd Ghazali (2006), we exclude the shares held by independent non-executive directors because they are expected to play a monitoring role and minimise self-interested behaviour of the executive management.

Based on the studies of Ang and Ding (2006) we define government ownership as the sum of ownership percentage of government institutions and government-controlled bodies. Following Chu and Cheah (2006), we define government institutions and government-controlled bodies institutions established under the Parliament Act of Malaysia.

**Control Variables.** The control variables that we select are standard for the literature that examines the link between corporate governance and cost of debt. All numeric control variables are in natural log form except GDP Rate. We log transformed these variables because they are not normally distributed. *Size* is a natural log of total assets in millions of Malaysian Ringgit. *Leverage* is a natural log of the ratio of the long-term debt to total assets. *Return on asset* is a natural log of the operating income to total assets ratio. *Market-to-book ratio* is a natural log of market value of common stock to book value of common stock ratio. *Interest coverage ratio* is a natural log of income before interest and tax to interest expense ratio. *GDP rate* is the gross
domestic product rate of Malaysia for each year under observation. It is a proxy for the general macroeconomic situation and growth that could possibly affect cost of debt. As our sample consists of companies from all the nine industry sectors of the Malaysian Bourse we include a dummy variable to control for possible variation in the cost of debt across industry. 

*Industry dummy* is a dummy variable equal to one if the industry is construction, consumer products, hotels, industrial products, plantation, properties, technology, infrastructure project or trading/services, otherwise equal to zero. All the nine industry sectors are represented in our sample. Following Certo and Semadeni (2006), we include year dummy variable because our data set is cross-sectionally dominated. *Year dummy* is a dummy variable equal to one if the year is 2003, 2004, 2005, 2006 or 2007, otherwise equal to zero.

**Model.**

We test our hypothesis using one basic specification that relates the corporate governance scores and the four types of shareholder monitoring mechanisms to firm cost of debt. We also control the effects of company size, leverage, and return on assets, market-to-book ratio, interest coverage ratio, industry and time. According to our theoretical framework, the hypothesis on corporate governance effect on cost of debt is supported when $\beta_j$ is negative and significant. Further, the hypotheses on shareholder monitoring variables are supported when $\beta_k$ is significant. The first model is as follows:

$$\text{IntRate}_{jt} = \beta_0 + \beta_1 \text{CGSC}_{jt} + \sum_{k=1}^{4} \beta_k \text{OWN}_{jk} + \sum_{i=1}^{9} \beta_i \text{Control}_{ji} + \mu$$

We also examine the individual effect of corporate governance categories and shareholder monitoring mechanisms on the cost of debt. Hence, consistent with previous studies (e.g. Blom and Schauten, 2006; Byun, 2007; Chen et al., 2009), we analyse the individual score of each of the six corporate governance categories and the four type of shareholder monitoring mechanisms against the cost of debt. The second model is defined as follows:
We use pooled generalized least squares (FGLS) panel data estimation procedure because our data suffer from both heteroskedasticity and autocorrelation problems. We detect substantial skewness and/or kurtosis in the distributions of the overall corporate governance scores (CGSC) and all the control variables except GDP rate. To address the non-normality of distribution problems and influence of outliers we transform CGSC and all our control variables into natural algorithm.

We also examine multicollinearity between explanatory variables using correlation analysis. Multicollinearity affects the accuracy and predictive ability of the regression analysis because the standard error of the regression coefficients will be inflated. We find that correlations between the explanatory variables are relatively low, suggesting that multicollinearity might not severely influence our regression results. Multicollinearity may be a problem when the correlation exceeded 0.80 (Gujarati, 2003). However, we find that the overall corporate governance score is highly correlated with the scores of the individual categories of the CG Index. We exclude corporate governance score from the analysis of individual effect of corporate governance categories on the cost of debt.

**Results**

Table 3 presents the overall and yearly descriptive statistics of the variables. Panel A provides the means, standard deviations, minimum and maximum values of all the variables based on pooled data. Panel B provides the annual mean values of all variables. Overall, corporate governance score ranges from 41.26 to 86.71 with a mean and median of 61.08 and 60.43, and a standard deviation of 6.35. Based on the full sample on average firms have adopted slightly above 60 percent of the desirable corporate governance practices. There is a considerable variation in firm corporate governance scores. Whilst there are firms that have commendable standard of
corporate governance some have a rather deplorable quality as evidenced by the lowest score of 41.26.

Table 3 Descriptive Statistics

Panel A: The pooled sample

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean Value</th>
<th>Standard Deviation</th>
<th>Minimum Value</th>
<th>Maximum Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>0.09</td>
<td>0.04</td>
<td>0.00</td>
<td>0.21</td>
</tr>
<tr>
<td>Corporate governance score</td>
<td>61.08</td>
<td>6.35</td>
<td>41.26</td>
<td>86.71</td>
</tr>
<tr>
<td>Board structure and procedures score</td>
<td>63.47</td>
<td>7.53</td>
<td>38.24</td>
<td>86.76</td>
</tr>
<tr>
<td>Board compensation practices score</td>
<td>35.21</td>
<td>17.48</td>
<td>0.00</td>
<td>92.85</td>
</tr>
<tr>
<td>Shareholder rights and relations score</td>
<td>62.67</td>
<td>9.79</td>
<td>33.33</td>
<td>100.00</td>
</tr>
<tr>
<td>Accountability and audit score</td>
<td>78.28</td>
<td>10.31</td>
<td>35.29</td>
<td>94.12</td>
</tr>
<tr>
<td>Transparency score</td>
<td>77.15</td>
<td>6.66</td>
<td>52.17</td>
<td>95.65</td>
</tr>
<tr>
<td>Social and environmental score</td>
<td>14.92</td>
<td>18.19</td>
<td>0.00</td>
<td>90.91</td>
</tr>
<tr>
<td>Ownership concentration</td>
<td>56.65</td>
<td>15.73</td>
<td>11.23</td>
<td>87.64</td>
</tr>
<tr>
<td>Family ownership</td>
<td>20.75</td>
<td>22.19</td>
<td>0.00</td>
<td>70.17</td>
</tr>
<tr>
<td>Insider ownership</td>
<td>25.28</td>
<td>21.57</td>
<td>0.00</td>
<td>72.67</td>
</tr>
<tr>
<td>Government ownership</td>
<td>11.98</td>
<td>17.24</td>
<td>0.00</td>
<td>83.01</td>
</tr>
<tr>
<td>Size</td>
<td>2227.00</td>
<td>43.41</td>
<td>545.57</td>
<td>67724.60</td>
</tr>
<tr>
<td>Leverage</td>
<td>2.37</td>
<td>1.03</td>
<td>1.89</td>
<td>20.55</td>
</tr>
<tr>
<td>Return on assets</td>
<td>0.06</td>
<td>0.01</td>
<td>0.05</td>
<td>0.84</td>
</tr>
<tr>
<td>Market-to-book ratio</td>
<td>1.50</td>
<td>0.10</td>
<td>0.92</td>
<td>34.05</td>
</tr>
<tr>
<td>Interest coverage</td>
<td>5.52</td>
<td>4.20</td>
<td>7.10</td>
<td>278.69</td>
</tr>
<tr>
<td>Transparency score</td>
<td>5.52</td>
<td>0.96</td>
<td>5.20</td>
<td>7.10</td>
</tr>
</tbody>
</table>

Panel B: Means for the annual observations from 2003 to 2007

<table>
<thead>
<tr>
<th>Variable/Year</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate</td>
<td>0.10</td>
<td>0.09</td>
<td>0.09</td>
<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td>Corporate governance score</td>
<td>58.2</td>
<td>60.41</td>
<td>61.50</td>
<td>62.47</td>
<td>62.96</td>
</tr>
<tr>
<td>Board structure and procedures score</td>
<td>59.87</td>
<td>62.58</td>
<td>63.77</td>
<td>65.23</td>
<td>66.01</td>
</tr>
<tr>
<td>Board compensation practices score</td>
<td>33.88</td>
<td>35.00</td>
<td>35.99</td>
<td>36.28</td>
<td>34.87</td>
</tr>
<tr>
<td>Shareholder rights and relations score</td>
<td>63.20</td>
<td>63.70</td>
<td>61.88</td>
<td>62.38</td>
<td>62.21</td>
</tr>
<tr>
<td>Accountability and audit score</td>
<td>74.72</td>
<td>77.64</td>
<td>79.03</td>
<td>79.80</td>
<td>80.02</td>
</tr>
<tr>
<td>Transparency score</td>
<td>75.25</td>
<td>76.63</td>
<td>77.57</td>
<td>77.96</td>
<td>78.35</td>
</tr>
<tr>
<td>Social and environmental score</td>
<td>10.80</td>
<td>13.50</td>
<td>13.95</td>
<td>16.47</td>
<td>19.89</td>
</tr>
<tr>
<td>Ownership concentration</td>
<td>56.94</td>
<td>57.13</td>
<td>56.24</td>
<td>56.19</td>
<td>56.74</td>
</tr>
<tr>
<td>Family ownership</td>
<td>20.97</td>
<td>20.79</td>
<td>20.52</td>
<td>20.61</td>
<td>20.83</td>
</tr>
<tr>
<td>Insider ownership</td>
<td>25.88</td>
<td>25.51</td>
<td>24.84</td>
<td>24.74</td>
<td>25.40</td>
</tr>
<tr>
<td>Government ownership</td>
<td>12.92</td>
<td>12.77</td>
<td>12.29</td>
<td>11.48</td>
<td>10.44</td>
</tr>
<tr>
<td>Size</td>
<td>1892.70</td>
<td>2048.26</td>
<td>2136.65</td>
<td>2394.97</td>
<td>2661.78</td>
</tr>
<tr>
<td>Leverage</td>
<td>0.63</td>
<td>0.58</td>
<td>0.55</td>
<td>0.55</td>
<td>0.53</td>
</tr>
<tr>
<td>Return on assets</td>
<td>0.06</td>
<td>0.06</td>
<td>0.06</td>
<td>0.06</td>
<td>0.07</td>
</tr>
<tr>
<td>Market-to-book ratio</td>
<td>1.64</td>
<td>1.43</td>
<td>1.16</td>
<td>1.40</td>
<td>1.83</td>
</tr>
<tr>
<td>Interest coverage</td>
<td>17.60</td>
<td>15.24</td>
<td>12.10</td>
<td>14.12</td>
<td>16.79</td>
</tr>
<tr>
<td>GDP rate</td>
<td>4.2</td>
<td>5.20</td>
<td>7.10</td>
<td>5.20</td>
<td>5.90</td>
</tr>
</tbody>
</table>
Annual trend shows that corporate governance score ranges from 58.2 in 2003 to 62.96 in 2007. These results indicate that on average firms have shown steady but little improvement of about 8.17 percent in their corporate governance quality during the five-year period. It seems that despite the efforts expended to enhance the awareness of directors on the importance of corporate governance, in general, some firms are still falling behind the desirable standards.

Turning to the categories of the CG Index, overall, firms show reasonably good scores in all categories except for board compensation practices and social and environmental. Firms show a steady but only slight improvement over the five-year period in board structure and procedures category as evidenced by the small difference in the mean scores from 59.87 in 2003 to 65.23 in 2007. These results suggest that more effort needs to be expended to further improve this most important aspect of corporate governance in Malaysian listed firms. The performance in this category is disappointing despite of great emphasis placed by the regulators and the MCCG (2000) on strengthening board monitoring.

Firms’ performance in board compensation practices is poor. In Malaysia, board compensation practices are unregulated; hence firms may be taking advantage of this situation. This result suggests that more effort needs to be expended to encourage firms to improve their compensation practices. Firms demonstrate poor performance in social and environmental practices as evidenced by a relatively low average score of 14.92. On average, firms show steady but little improvement over the five-year period. The low level of social and environmental practices is comparable to a similar prior study of Mohd Ghazali and Weetman (2006).

Interest rate ranges from 0.10 to 0.21, with a mean of 0.09. Total assets ranges from RM43.41 million to RM67.72 billion, with a mean of RM2.27 billion. Leverage ranges from 1.03 to 20.55, with a mean of 2.37. Return on assets ranges from 0.001 to 0.844, with a mean of 0.06. Market-to-book ratio ranges from 0.10 to 34.05, with a mean of 1.5. Interest coverage ratio ranges from 7.10 to 278.69, with a mean of 5.52.
Shareholder Monitoring Mechanisms

Table 3 panels A and B provide the pooled sample and annual descriptive statistics results of the shareholder monitoring mechanisms respectively. Overall, ownership concentration ranges from 11.23 percent to 87.64 percent, with a mean of 56.65 percent and a standard deviation of 15.73. Annual trend shows little variation in the concentration of ownership over the five-year period.

Based on the full sample family ownership varies from 0 to 70.17 percent, with a mean of 20.75 and a standard deviation of 22.19. Annual statistics show that family ownership percentage does not change much at all from 2003 to 2007. Insider ownership ranges from 0 to 72.67 percent, with a mean of 25.28 and 25.72 percent and a standard deviation of 21.57. These results are comparable to those of prior studies. There is also no drastic change to the pattern of insider ownership from 2003 to 2007.

Overall, government ownership varies from 0 to 83.01 percent, with a mean of 11.98 percent and a standard deviation of 17.24. Government ownership also shows a declining trend during the five-year period understudy. The mean of government ownership drops from 12.92 percent in 2003 to 10.44 percent in 2007. Sulong and Mat Nor (2008) observed the same declining trend when they compare the mean of government ownership percentage in 2002 with the mean value in 2005. Overall, our results further confirm that corporate ownership structure in Malaysian listed corporations is highly concentrated and can be categorised into concentrated, family, insider and government ownership.

Table 4 Model 1 presents the regression results on the impact of the log of corporate governance score, ownership concentration, family, insider and government ownerships on the cost of debt after controlling for the effects of firm size, leverage, firm performance, market-to-book ratio, interest coverage ratio, gross domestic product rate, industry sectors and time period. Corporate governance has a significant inverse relationship with the cost of debt at one percent level; thus, supporting hypothesis 1. Our result indicates that firms having higher corporate governance quality has lower cost of debt. Our result supports the theoretical proposition that high quality corporate governance can serve as an effective control mechanism; thus, reducing debt issuers’ exposure to the risks associated with the managers’ self-interested behaviour.
Table 4: FGLS regression results of cost of debt on corporate governance scores, shareholder monitoring mechanisms, corporate governance categories and controls

<table>
<thead>
<tr>
<th>Variables</th>
<th>Cost of Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Model 1</td>
</tr>
<tr>
<td>Log corporate governance score</td>
<td>-.119</td>
</tr>
<tr>
<td></td>
<td>(-3.98)*</td>
</tr>
<tr>
<td><strong>Corporate Governance Categories</strong></td>
<td></td>
</tr>
<tr>
<td>Board structure and procedures score</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Board compensation practices score</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholder rights and relations score</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Accountability and audit score</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Transparency score</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Social and environmental score</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Shareholder Monitoring Mechanisms</strong></td>
<td></td>
</tr>
<tr>
<td>Ownership concentration</td>
<td>-.001</td>
</tr>
<tr>
<td></td>
<td>(-2.82)*</td>
</tr>
<tr>
<td>Family ownership</td>
<td>.002</td>
</tr>
<tr>
<td></td>
<td>(3.30)*</td>
</tr>
<tr>
<td>Insider ownership</td>
<td>-.001</td>
</tr>
<tr>
<td></td>
<td>(-1.69)</td>
</tr>
<tr>
<td>Government ownership</td>
<td>.003</td>
</tr>
<tr>
<td></td>
<td>(4.12)*</td>
</tr>
<tr>
<td><strong>Control variables</strong></td>
<td></td>
</tr>
<tr>
<td>Log Total assets</td>
<td>-.003</td>
</tr>
<tr>
<td></td>
<td>(-3.04)*</td>
</tr>
<tr>
<td>Log Leverage</td>
<td>.005</td>
</tr>
<tr>
<td></td>
<td>(2.74)*</td>
</tr>
<tr>
<td>Log Return on assets</td>
<td>.001</td>
</tr>
<tr>
<td></td>
<td>(.19)</td>
</tr>
<tr>
<td>Log Market-to-book ratio</td>
<td>.005</td>
</tr>
<tr>
<td></td>
<td>(2.85)*</td>
</tr>
<tr>
<td>Log Interest coverage ratio</td>
<td>.000</td>
</tr>
<tr>
<td></td>
<td>(.55)</td>
</tr>
<tr>
<td>GDP rate</td>
<td>-.004</td>
</tr>
<tr>
<td></td>
<td>(-2.99)*</td>
</tr>
<tr>
<td>Ind. Dummy Included</td>
<td>Yes</td>
</tr>
<tr>
<td>Yr. Dummy Included</td>
<td>Yes</td>
</tr>
<tr>
<td>Chi-Square</td>
<td>443.15</td>
</tr>
<tr>
<td>Prob &gt; Chi-Square</td>
<td>.000</td>
</tr>
</tbody>
</table>

Note. The z-statistics are reported in parentheses below coefficient estimates.
* \( p < .01 \)  ** \( p < .05 \)
Next, we find that ownership concentration has a significant negative link with the cost of debt, thus, supporting our hypothesis 2. Debt issuers seem to regard that concentrated ownership as an organisational attribute that better protects their interest. As predicted, family and government ownerships are found to have significant positive relationships with the cost of debt; hence, lending supports to our hypotheses 3 and 5. Debt issuers seem to consider family and government owners as detrimental to their interest; hence, they demand higher risk premium to compensate them for the potentially risky investment. Insider ownership is not significant in explaining the cost of debt; thus, we reject hypothesis 4.

In terms of control variables, firm size has a significant negative relationship with cost of debt. This result is in line with the theoretical expectation that larger firms enjoy greater stability and therefore may have a lower cost of debt. Leverage exhibits a significant positive relationship with the cost of debt, which is in line with the theoretical expectation that the higher financial leverage increases the cost of debt. The log of market-to-book ratio has a significant positive association with the cost of debt suggesting that debt issuers associate high-growth firms (having high MTB ratio) with greater risk; thus, they impose higher cost of debt. We find that GDP rate has significant negative relationship with the cost of debt, which means it is cheaper to go for debt financing during booming economy period. Surprisingly, in this study, firm profitability and the log of interest coverage ratio are not statistically significant in influencing the cost of debt.

Table 4 Model 2 reports the results of the regression of the individual effects of corporate governance categories and shareholder monitoring mechanisms on the cost of debt after controlling for the influence of a set of control variables. Board structure and procedures, board compensation practices, accountability and social and environmental activities are significant in explaining the level of cost of debt. All categories are significant at one percent except for accountability and audit category, which is significant at five percent level.

Shareholder rights and relations category is not significant, implying that shareholder rights and relations category does not influence the level of cost of debt. This finding indicates that debt issuers do not view this category of corporate governance as effective in protecting their interest because it is solely meant to safeguard shareholder interest.
Discussions

*Corporate Governance and Corporate Governance Categories*

In this paper, we investigate the effects of corporate governance and shareholder monitoring mechanisms on firm cost of debt. We test both the traditional manager-shareholder agency conflicts and the agency cost of debt between the managers, shareholders and debt issuers. Our empirical results indicate that corporate governance is an important element in debt pricing. Debt issuers are willing to accept lower risk premium from firms that have high quality corporate governance; thus, effectively lowering cost of debt.

We find support for the theoretical proposition that high quality corporate governance can alleviate asymmetric information, managerial opportunism and default risk. Our finding suggests that debt issuers are sensitive to corporate governance practices and structures that protect their interest. This finding is also consistent with the view that corporate governance can improve the quality of managerial decision-making and lead to better firm performance; implying that better firm performance results in lower cost of debt (Monk and Minnow, 1995).

In terms of the individual effect of a specific category of the CG Index, we find that debt issuers value an effective board monitoring. As they mainly rely on financial reports to assess the extent of default risk debt issuers are appreciative of the board characteristics and practices that affect the credibility of financial reporting process and the extent of managerial opportunism. Debt issuers are also sensitive to the responsibility and commitment of the board to ensure that the remuneration of executive directors is not excessive and open to manipulation. They are willing to impose lower cost of debt if firms have compensation practices that do not only promote the interest of the suppliers of finance but also transparent. In view of this result we suggest that Malaysian firms and regulators take immediate and concrete steps to improve this important aspect of corporate governance.

We also observe that accountability and audit category is significant in explaining the cost of debt. In line with theoretical expectation, debt issuers are concerned with the credibility of financial reports, which could influence the extent of default risk. They rely on accounting numbers to assess the extent of debtors’ compliance to debt covenants and to monitor lending agreements.
(DeFond and Jiambalvo, 1994). Hence, our finding supports the important role of an independent audit committee and external auditors in enhancing board accountability and by extension reducing cost of debt.

Our study also shows that transparency category has a reducing effect on firm cost of debt. Greater transparency mitigates information asymmetry, which is a great concern to suppliers of finance. Firms that are more willing to share timely, accurate and complete information are perceived to have low likelihood to suppress value-relevant unfavourable information that could increase the default risk of the firm. Our result underscores the point that disclosure or transparency is regarded as one of the important dimensions of corporate governance.

We also document an interesting and surprising finding on social and environmental practices. It seems that investment in improving employee’s welfare and environmental protection practices lowers cost of debt. Our result implies that debt issuers are willing to lower their risk premium for firms that invest in activities or practices that protect stakeholders’ well-being. A decrease in risk premium suggests that investment in social and environmental activities is value-enhancing for firm. As our study highlights that promoting social and environmental welfare is an important determinant of cost of debt, we urge Malaysian firms to improve their performance in this category.

Finally, we find that shareholder rights and relations category does not have any significant effect on firms’ cost of debt, implying that debt issuers do not view this factor as beneficial to them. Rightfully, debt issuers might not appreciate this aspect of corporate governance because it is exclusively meant to protect the rights and interest of shareholders.

In summary, our study reaffirms the role the MCCG (2000) in improving Malaysian firms’ corporate governance standard. We also underscore the point that debt issuers are concerned with firms’ corporate governance quality in evaluating financing decisions and pricing of debt. As such, MCCG (2000) does not only benefit equity investors but debt issuers alike.
Shareholder Monitoring Mechanisms

Our study shows concentrated ownership has a negative association with the cost of debt. Family and government ownerships, on the other hand, are found to have significant positive link with the cost of debt; thus, supporting our hypothesis 3 and 5.

The inverse relationship between ownership concentration and the cost of debt indicates that firms having concentrated owners experience a lower cost of debt. Our result indicates that the active monitoring and shared benefits hypotheses are more dominant in Malaysian corporate environment. Debt issuers share the benefits of the concentrated owners’ monitoring role and in exchange the debt issuers are willing to impose lower risk premium. Alternatively, concentrated owners resort to self-protection due to an inadequate investor legal protection (La Porta et al., 1999). Shareholders that are not accorded sufficient legal protection against misappropriation by firm management will resort to self-protection by becoming controllers themselves.

Contrary to the findings of Anderson et al., (2003) and Ellul et al., (2006), we observe that family ownership has an increasing effect on the cost of debt. Our finding is similar to Lin et al., (2010) and Aslan and Kumar (2009) in which they found that family firms have high cost of debt. One possible reason for this finding is that due to the potential use of family owners’ voting power to encourage management to undertake risky investments or engage in ownership changes debt issuers feel that their interests are harmed. Family shareholders reap most of the benefits when the riskier projects yield positive returns but debt issuers bear most of the cost (Jensen and Meckling, 1976).

One apparent cost or drawback of risky projects is that they increase the likelihood of default and bankruptcy. Hence, given this potential conflict of interest with the family owners and the increased possibility of default debt issuers impose lending agreements and loan covenants to protect their interest. However, in general, debt covenants are rarely effective in completely eliminating shareholder-debt issuers conflict (Anderson et al., 2003). In Malaysia, the covenants may not be successfully enforced due to the relatively weak legal protection accorded to investors (La Porta et al., 1999). Therefore, in return for accepting such risks and the trouble to successfully
defend their interest against expropriation by family owners debt issuers require higher risk premium for the funds provided.

We also observe that government ownership has a positive relationship with the cost of debt, implying that debt issuers are not confident that this form of shareholder monitoring mechanism is able to protect their interest. Alternatively, government owners seem to be an undesirable form of monitoring mechanism from the perspective of debt issuers, perhaps, due to several reasons such as the conflicting objectives of social welfare maximisation and profit maximisation (Mak and Li, 2001), political motives (Wurgler, 2000) and interferences (Tian and Estrin, 2005) and free-rider problems (Putterman, 1993), which make them inefficient monitors. Our results also implies that although the Malaysian government has taken steps to improve the performance of the companies that they have stakes, it is still inadequate to produce a significant positive impact from the perspective of debt issuers.

Another possible reason for this finding can be attributed to the agency conflicts between the government owners and their agents who are appointed to manage such investment and directly exercise governance role (Xu and Wang 1999). In Malaysia, the government’s involvement in listed firms is predominantly made and managed through its investment arm body, Khazanah Nasional. This investment body has its own professional managers or bureaucrats who are appointed by the Finance Minister. The government then relies on these so-called professionals to manage its investment and to produce better corporate governance and financial performance, effectively establishing an agency relationship.

As in any agency relationship, the government may suffer from agency conflicts, which negative effects may be permeated to other investors such as debt issuers. The agents of the government do not necessarily share the same aspiration as the government in terms of optimising its investment and monitoring of other salaried managers. In addition, the agents may not be able to effectively alienate themselves from the potential political interferences of powerful government leaders due to rent-seekers mentality as suggested by Sundaram (1986). In view of these issues, the government owners will not be effective monitors, leading to higher cost of debt.
In sum, our study has confirmed the philosophy that debt issuers include firms’ corporate governance quality in their investment decision and they are also sensitive toward the type of shareholder monitoring mechanisms that could potentially affect their interest. In particular, debt issuers in Malaysia seem to value high corporate governance quality and concentrated ownership in their assessment of financing decision.

Conclusion
In this study, we document a few interesting findings. First, our findings suggest that despite numerous efforts undertaken to strengthen the standard of corporate governance ever since the financial crisis in 1997-1998, Malaysian listed firms are still lagging behind in terms of board compensation practices and social and environmental activities. There is much room for improvement in these aspects of corporate governance, which both the regulators and firms should give greater attention to.

Overall, the standard of corporate governance is fair and has not improved much during the five-year period under investigation. Firms have been performing well in enhancing accountability and audit aspects of corporate governance. Further, we find that firms fared reasonably well in various aspects of board monitoring, but there is still much to do to further strengthen this most important aspect of corporate governance.

Second, we find that corporate governance is of a great concern to debt issuers. They are willing to accept lower risk premium from firms that have robust corporate governance mechanisms; thus, effectively lowering cost of debt. They appear to consider board structure and procedures, board compensation practices, accountability and audit, transparency and social and environmental as integral components of a good corporate governance framework.

Third, we observe that all shareholder monitoring mechanisms except insider ownership have significant links with the cost of debt. However, only ownership concentration has a reducing effect on cost of debt. Debt issuers seem to regard concentrated owners as effective monitors of their interest. Fourth, family and government ownerships do not appear to have any reducing
impact on firm cost of debt. Our findings suggest that debt issuers consider family and
government owners as detrimental to their interest.

Fifth, our study underscores the point that in a corporate governance study involving
Malaysian listed firms it is important to consider firm ownership structure as an integral component
of firm corporate governance framework. Ownership structure represents the shareholder
monitoring aspect of an effective corporate governance framework. Our results also highlight the
importance of distinguishing the various types of ownership, which allows an analysis of the impact
of each ownership identity on cost of debt.

Finally, our results show that the CG Index is a valid instrument for assessing corporate
governance quality. It is more holistic that specific governance attributes because the six
categories capture many of the crucial aspects of corporate governance. In addition, the CG Index
can be of practical use in assessing firm corporate governance quality as a part of an investment
screening process.

Notwithstanding the positive findings we acknowledge a few limitations of our study, which
provide avenues for future research. First, our study examines Malaysian firms only; hence, we
are unable to observe the effect of country-level legal protection of investors on firm cost of debt.
It is likely for firm-level governance and country-level shareholder protection to be substitutes for
each other in reducing firm cost of debt. Corporate governance can have greater effect on cost of
debt in countries that provide relatively poor legal protection for investors.

Second, in terms of family ownership we utilise the percentage of equity shares held by
family members only. In Malaysia, many listed firms are managed by founding family members
who hold influential top management positions. Founding family members in management
positions are able to exert greater influence over the allocation of resources and decision making.
Hence, there could be possible differential impact between firms having family owners but they do
not get involve in top management positions and firms with founding family members holding vast
management control.

Finally, in relation to social and environmental activities, firms may not disclose their actual
and complete corporate social responsibilities in the annual reports. As such, some aspects of
CSR may not be captured by the CG Index and statistical analysis. On a related point, whilst we claim that our CG Index is more comprehensive, it does not necessarily mean that we have included all possible corporate governance practices. But, at least we have attempted to include a great number of best practices in relatively broader categories in the CG Index.

Going forward we suggest that future research investigates the impact of corporate governance and shareholder monitoring mechanisms on the cost of debt under different investor protection environments including those emerging economies. Next, future research may investigate the possible differential impact of family ownership when the founders or their family members’ serve as CEO or top management positions compared to when the family firms hired outside CEO. Founders may bring unique, value-adding skills to the firm, whilst the founders’ descendents may detract from performance, probably because they get into the top positions as a result of family ties rather than merits. Hence, there could be potential differential effect on firm cost of debt between family members who are merely having equity ownership and those that have ownership and control as well as those that serve in management positions.

Finally, future research may examine the important role of ethical value of directors as an integral element of an effective corporate governance framework. It is reasonable to expect that establishing various corporate governance mechanisms alone is not sufficient to prevent future corporate scandals if the directors and top management team continue to behave unethically.

Endnotes:

1. According to Torii (1997), Bumiputera means “sons of the soil” in Bahasa Malaysia, the national language of Malaysia. The term Bumiputera is meant to distinguish Malays and the indigenous people from other ethnicities such as Chinese, Indians and other immigrant population.
2. We find that the alpha coefficient value of each category is at least 0.70, suggesting that the items included under each category are reliable measures of firm corporate governance practices. An alpha of 0.70 indicates that the correlation is attenuated very little by random measurement error i.e. the scale has good internal consistency (Pallant, 2002).
3. Kappa values greater than or equal to 0.75 represent excellent agreement beyond chance, values between 0.40 and 0.75 may be taken to represent fair to good agreement and values below 0.40 or so may be taken to represent poor agreement beyond chance.
4. We utilize Breech-Pagan and Wooldridge tests for examining heteroskedasticity and autocorrelation problems respectively.
5. A normally distributed variable should have skewness and kurtosis near zero and three, respectively (Mohammed Haniffa and Hudaib, 2006).
6. Ownership can change via merger and acquisition, which requires shareholders’ approval. Whilst mergers and acquisition may serve shareholders’ interest, it does not necessarily benefit debt issuers (Asquith and Wizman, 1990; Warga and Welch, 1993).
References


