How Corporate Governance Practices Affect the Cost of Debt: A Cross-Country Comparison of Pakistan and India

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Abstract

This study empirically examines the association between corporate governance practices and the cost of debt in Pakistan and India. By law, both Pakistani and Indian firms are required to publish their annual reports with recommended Corporate Governance Codes. Corporate governance practices were pivotal in the U.S. stock market crash of 1929. In this study, we used data from 2014 to 2017 of published compliance from 100 nonfinancial companies in Pakistan and India. This study discloses the essentiality of better corporate governance to decrease the cost of debt and offers additional empirical evidence through a comparative analysis of the links between corporate governance and the cost of debt in Pakistan and India.

Keywords: corporate governance, cost of debt, Pakistan, India

Introduction

Many studies have organized in the field of corporate finance, which concentrated on significance of corporate governance and its impact on cost of debt in the last few decades. Although Denis, (2001) described the phrase "governance' had not invented two decades ago, it emerged in the latest business studies in which many scholars used the corporate governance term, gained the more popularity through popular press. The corporate governance practices had a powerful momentum in the crises of 1929-1933 in USA. This had taken eminence in 1992 within the two major books that were on the topic of corporate governance, first published in (sponsored by the American Law Institute) U.S., and second in the U.K. (Cadbury Report, 1992). Some major scams were appeared for US companies during the economic crisis of 2007-2008 due to agency problems and risks (Kirkpatrick, G. 2000). Many studies conducted in different nations since 1990's to control the behavior of top-level. Different authors introduced several principles of corporate governance in different dimensions e.g. Cadbury. A, 1992 was published in UK for the betterment of corporate governance practices and shadow of Greenbury Report, 1995, Hampel Report, 1998, Turnbull Report, 1999. The phrase corporate governance has also realized the serious debate, in the light of international settings as well as the international institutions have published corporate governance principles such as OECD (Organization for Economic Co-operation and Development) it established initially in 1999 and improved it in 2004. Due to well-known corporate financial scams around the world like Enron, WorldCom etc., the Sarbanes-Oxley Act was approved on July 30, 2002 in the United States. The Sarbanes-Oxley Act had a powerful influence on the US listed firms and financial markets as compared to other reports declared in the European regions (Schauten & Blom, 2006). Pakistan and India are not the exception to this trend, where the weaker implementation of governance codes and principles still need attention of regulatory bodies in Pakistan and India. Developments of corporate governance codes and principles in Pakistan and India were conducted in different phases. In Pakistan, Corporate Governance was firstly introduced in 1992 and with the passage of time; these codes are upgraded until 2012 by the SECP (Security Exchange Commission of Pakistan). Moreover, due to the similarity between Pakistan and the Anglo-American legal system, however, diffuse in ownership structure in Pakistan is opposite of the Anglo-American ownership structure.

In India, Corporate Governance Codes were revised in 2013 under clause 49. The basic purpose of this step was to introduce some progressive and transparent process, which is beneficial for the stakeholders. The objective of up-gradation is to betterment of the corporate governance activities in companies and provide protection to the stakeholders.

It is required to explain the concept of governance and its effect on stakeholders. Governance is a packed set of instructions that influences the choices made by the managers while separation is held between holding and management (Larcker et al.,2004). So many studies have investigated to determine the ties between governance and firm value and several researchers showed an important relation between firm value and governance proxies. The remarkable impact on the firm value and worth of corporate governance activities are due to several factors. Claessens & Yurtoglu (2013), opined that improved corporate governance favors greater enrichment to investing, low expense of equity, improved performance and furthermore, it is fruitful for all stakeholders. While the previous studies have found the relationship between the corporate governance and the cost of debt by taking two or three proxies of governance, moreover past studies do not have the comparison between the couple of regions. However, discrepancy exists in the prior studies regarding the effect of governance on the cost of debt. Only a few studies focus on the analysis of governance and cost of debt in developed economies but the impact on developing economies have been ignored. The previous studies in context of developed countries have only used few governance characteristics like the quality of external auditors, independent board of directors etc, rather than using quality of governance on broader scale. The current study investigates and measures the aspect of corporate governance through its number of characteristics and analyzed its relationship with debt cost by investigating a sample of 40 Pakistani Listed companies and 60 Indian Listed Companies from 2014 to 2017. (Schauten & Blom., 2006), who reported a negative relationship of quality governance and cost of debt, as investors are aware regarding firms' lower default risk and better corporate governance demand lesser return, which results in lower financing cost, conducted similar research.

The aim of the study is to disclose a link between Governance and Cost of Debt by using the panel data for Pakistani and Indian listed firms. This study includes the dependent variable i.e. number of shareholders who actively contribute in the corporate governance i.e. board size, independent board members, independent audit members, insider shareholders, CEO duality and institutional shareholdings (sum of five largest shareholders). the control variables include leverage (defined as the ratio of debt to total assets), firm size (natural log of total assets) and return on asset.

The topic of corporate governance is more critical due to the separation between the owners and their agents, which is called the agency problem. This problem exists because the company is not managed by the owners; rather it is managed by top-level management (Managers) who have been delegated these powers by the shareholders of the firm. This arrangement is an agreement between the shareholders and managers that managers will provide their services and they are getting remuneration from the shareholders.

The first agency theory was introduced by the (Berle, 1932; Jensen, 1976) that leads to the separation between shareholders and management. These theories describe that agent and owner link exists, when investors or shareholders give power to (another person) management for making the decision (the agent), the shareholders or owners appoint the agent to operate an action because the owners or shareholders have no time or ability to operate the business. The agency theory deals with the conflicts and concerns of agents and agreement relationships in order to overcome the costs that are related with a condition of decision-making.

Agent and principal theory display that financing is a tying device for the cutoff in agency costs, which is a link to the free cash flow (Jensen, 1986). Other studies discussed that agency cost increases due to the management's entrenchment also have an negative impact on a firm's prospects of security of equity financing. With the support of these research questions, the emergence of agency theory, there are several clashes that emerged between shareholders and their management privileged because they have different interests. The dominant points of the agency theory, principles and agents have a different objective.

Another definition was introduced by the Organization for Economic Co-operation and Development (OECD) in 1999. In contrast, they turn construction the entrenched managers divert from the free cash flow for the follow up of personal objectives at the expense of value maximizing. Effective corporate governance decreases these contradictions and gives the protection to the investor at the country level, thus it increases the performance of the corporate, ultimately affect the reduction of cost of equity (La Porta, 2000).

Moreover, the bondholders can reduce the agency risk that is expected, which also shows that there should be a relative impact on corporate governance and debt financing (Chava et al., 2010). Furthermore, that owner can also pay to the agent and give the assets for the utilization in the corporate for earning return against their investment that the agent itself will not able to take some actions against owner or shareholders. Besides, the given study has shown that "worthy" corporate governance practices are not common, but varies from country to country (Black et al., 2012).

The main external governance of a firm mechanism is relevant to the market for firm control and the law system. Many studies published for corporate governance, some of them are more well defined than others. Governance can perform an important role in the three main aspects of the firm to reduce agency costs, capital cost, further it restricts the managers to use company assets for personal use (Claessens & Yurtoglu (2013). It does not only depend upon the internal but also have an effect on the external variables (Durnev & Kim, 2005). Many rules and regulations are available in the books for the better control of the organization as well as to restrict the opportunistic behavior of the top-level management. Increase in the fiscal reporting scams such as practiced by Vivendi universal, world com, Ahold or Parmalat, Enron and recently in Pakistan UBL etc.

The latest financial scam emerged in the stock market by the stockbrokers those were invested Rs.7 billion inappropriate manners of clients over the past six months. Another recent financial scam emerged in the UBL bank of Pakistan in March 2017. This scam has a worth of Rs.12 billion and most importantly, the CEO of the certain bank was involved in that scam. Further in another region of India a financial fraud eminent recently Satyam scam, the story about this scam is that it was the biggest scam in corporate scandals. In this scam, the company chairman was involved and confessed by the chairman in front of CBI that he manipulated the profit margin from 2003 to 2008. Charge sheets made by the police over three officials those were involved in this activity in 2015.

Corporate governance can be more effective in restraint the information regarding the financial frauds (Persons, 2005). The prior literature discloses that corporations with developing and controlled corporate governance standards, prohibited insider trading, while corporate governance is an undeveloped and uncontrolled mechanism, (Crespi & Oliver, 2015).

Over debt burden may restrict managers to calculate the net present value of future projects. The important role of the debt is related to the issue of agency problems. The diminishing role of debt also evaluated in the study of (Grossman & Hart 1982), even when the principals are liable for selecting the firm capital formation. When managers choose the mix financial resources likely debt and equity. Managers had only to pay attention to the profit maximization rather than other objectives. Overinvestment is a probability of bankruptcy to curb it, (Jensen, 1986) opined that principals can increase the debt portion and decrease the choices of managerial choices over free cash flow.

Managers find their interests, when the select the equity financing choices. When they made such settlement with the creditors in term of payment of a return on debt and this activity lead to the firm's bankruptcy. In this matter, managers lose their public relations and credibility.

Berlin & Loeys (1988) agreements will be more powerful in the data condition more distinctly. For example, the studies find out that cost of independence of the board will increase with the disharmony between the shareholders and the bondholders' clashes by the closeness to failure of payment due to leverage (Bodie, 1978; John, 1993).

Further, prior literature concludes in the study of (Williamson, 1979) that transaction cost is more relevant to the governance structure for the issuance of the equity as compared to the debt, so the more effective and stronger governance structure is necessary for the equity of firm.

Bhojraj & Sengupta (2003) opined that connection between corporate governance and security evaluations and yields. The connection between security yields and appraisals and governance, the creators embraced two broadly utilized measures: institutional possession and the extent of outcasts on the board. Allam (2018) indicated that big board's enhance firm value, whereas, the effect of other governance characteristics changes with the state of economic conditions for companies in UK. Assenga et al. (2018) stated that the separation of CEO and board chairman roles improves financial performance for businesses in Tanzania. Asante-Darko et al. (2018) found that board characteristics does significantly affect firm value in Ghana. It can be observed from the literature review that there is a gap for nexus between effective governance practices and debt cost in under-developed countries and no study has been conducted for Pakistan and India. Moreover, there is no study which provides a comparative analysis of this relationship between Pakistan and India.

H_1: Better governance leads to lesser cost of debt for Pakistani and Indian listed companies

Research Method

In this study we used data from 2014-2017 with published compliance from 100 non-financial companies of Pakistan and India. Further, 60 firms were taken from the top 100 Indian firms, those were registered in the Indian stock exchange and 40 firms were taken from the top 100 Pakistani firms as these firms were registered in the stock exchange. The population of this study was 200 firms. Random sampling technique used for the selection of sample from both stock exchanges.

$$\mathrm{Cod}_{it} = \beta_0 + \beta_1(\beta 1)_{it} + \beta_2(\mathrm{OWN})_{it} + \beta_3(\mathrm{CED})_{it} + \beta_4(\mathrm{BSize})_{it}\,\beta_5(\mathrm{FS})_{it} + \beta_6(\mathrm{LVG})_{it} + \beta_7(\mathrm{ROA})_{it} + \beta_8(\mathrm{ISH})_{it} + \beta_9(\mathrm{A1})_{it} \,..1$$

The problem of Endogeneity is a major issue for social scientists when they perform econometric analysis. Social science is associated with the behavior of the people and it is difficult for social scientists to understand the behavior of people. It is not possible in social sciences to construct a laboratory and conduct analyses within a controlled environment like in natural sciences. Therefore, sometimes the analyses in social sciences are biased due to Endogeneity issues. The effects of Endogeneity result in biasness of empirical estimations due to errors. There important cause of Endogeneity is that when the researcher self-select the sample instead of random sampling. The second main reason of Endogeneity is that the researcher omitted some related variable or may be due to the measurement errors. The Solution for this problem is to search an instrumental variable and employ the two stage least square (2SLS) regression model or the Generalized Method of Moments (GMM) regression model as appropriate.

Result and Discussion

The results have been presented for both countries in the following sections which describes the relation between corporate governance and cost of debt. This section discusses the association in debt cost and governance for Pakistani firms. Table 2. gives results for the PCSE regression model which determines the link between debt cost and governance variables. The model is significant for this regression equation as the p - value is less than 5% and the model is significant. The results depict that variable of internal shareholding is positive and significantly correlated with debt which means that

Table 1. Variable Measurement

Sr. No	Variable Name	Measurement
1	*COD*	Calculated by the annual interest expense divided by the average annual debt of the firm.
2	*BI*	Measured as the Independent Board Members Divided by total board members multiply by hundred to get percentage of independent Board Members.
3	*OWN*	Ownership structure is measured by the total five largest shareholders divided by the total equity and multiply hundred to get the percentage of the largest shares holders (institutional shares holders).
4	*CED*	The binary number measures CEO duality if the CEO has held both chairs of Chairman and the CEO at the same time it leads to Zero otherwise equal to 1.
5	*Bsize*	To be taken all board of directors of firm.
6	*FS*	Firm Size calculated by the method of log of total asset.
7	*LVG*	Leverage is used for the firm that a firm how much ability to pay its debt is calculated by the Total Debt divided by total assets.
8	*ROA*	Measured as net income divided by the total assets multiply
9	*ISH*	Internal shareholders is calculated by the shares held by the internal management divided by total shares multiply by hundred to get percentage of the internal shareholding.
10	*AI*	Independent Directors in Audit Committee measured by independent directors divided by Total Directors in Audit Committee.

Source: The variable measurement method utilized by Ashbaugh-Skaife et al., 2006

firms that have higher managerial shareholdings suffer from increased debt cost. The variables of the board and audit committee autonomous are also significantly and positively interrelated with debt cost. ROA and leverage are significantly and inverse relation with debt cost which indicates that firms having higher ROA and leverage enjoy

Table 2. Regression with Panel – Corrected Standard Errors (PCSE)

Cod	Coefficients	Std. Err	Z	p>|t|	[95% Conf.	Interval]
BS	0.003	0.002	1.460	0.143	-0.001	0.007
CED	-0.011	0.006	-1.650	0.100	-0.023	0.002
OWN	0.011	0.029	0.390	0.693	-0.045	0.067
ISH	0.109***	0.061	1.790	0.074	-0.010	0.228
ROA	-0.013*	0.004	-3.320	0.001	-0.019	-0.005
AI	0.041*	0.010	4.040	0.000	0.021	0.060
BI	0.055*	0.010	-5.390	0.000	-0.075	-0.035
LVG	0.021*	0.006	-3.330	0.001	-0.033	-0.009
FS	-0.007	0.011	-0.630	0.530	-0.029	0.015
_CONS	0.067	0.042	1.570	0.116	-0.016	0.150

Source: Processed Data, 2020

benefit of lesser cost of debt. These results are related to the findings of (Butt & Hasan, 2009) for Pakistani firms.

Endogeneity has been tested by the implementation of the two stage least squares (2SLS) regression model by selecting board independence as an endogenous variable and board size as the instrumental variable. The p values for Durbin and Wu-Hausman tests of Endogeneity are greater than 0.05, so this study cannot reject the null hypothesis that variables are exogenous. This study concludes that the problem of Endogeneity does not exist in the regression model and the results of the PCSE model are more suitable in this scenario.

The section provides results for Indian firms, links in Corporate Governance variable and debt cost. Those depicted in Table 3., Board size, CEO duality, ownership concentration, board independence and audit committee independence significantly and negatively affect cost of debt for Indian firms. It means that the firms which have larger board size, ownership concentration, board independence, audit committee independence and presence of CEO duality enjoys benefits of lesser debt cost. The outcomes of this study are related to the findings. The p values for Durbin and Wu-Hausman tests of Endogeneity are greater than 0.05, so this study cannot reject the null hypothesis that variables are exogenous. This study concludes that problem of Endogeneity does not exist in regression model and results of PCSE model are more suitable in this scenario. The combined results of PCSE regression models for Pakistan and India are depicted in Table 4.

The Table 4. depicts that variables of board size, CEO duality and ownership concentration results in lesser cost of debt for Indian firms, whereas, these variables have insignificant impact for Pakistani firms. The variable of internal shareholdings have positive association with COD for Pakistani firms, whereas, it has insignificant relation for Indian firms. The variables of board independence and audit committee independence have positive relationship with COD for Pakistani firms and negative relationship with COD for Indian firms. These results depict that governance practices are comparatively lesser effective in reducing cost of capital for Pakistani firms. The governance practices quite effective in reducing cost of debt for Indian firms which means that corporate governance systems are comparatively more developed in India, Whereas, Pakistan still need to improve the structure of corporate governance. These finding shows that Pakistani firms internal shareholdings is positive and significant

Table 3. Regression with Panel

Cod	Coef.	Std.err	T	p>|t|	[95% Conf.	Interval]
BS	-0.005**	0.005	-1.020	0.039	-0.016	0.005
CED	-0.025**	0.020	-1.270	0.010	-0.065	0.013
OWN	-0.036*	0.008	-4.130	0.000	-0.053	-0.018
ISH	-0.005	0.063	-0.080	0.940	-0.130	0.120
ROA	>-0.001	0.032	-0.010	0.995	-0.063	0.063
BI	-.025**	0.078	-0.330	0.034	-0.178	0.127
AI	-.023**	0.018	1.220	0.022	-0.014	0.059
LVG	<0.001	0.024	0.000	0.999	-0.048	0.048
FS	0.003	0.006	0.460	0.643	-0.009	0.016
_CONS	0.112	0.073	1.530	0.127	-0.032	0.256

Source: Processed Data, 2020

Table 4. A Comparative Analysis Based On PCSE for Pakistan & India

	Pakistani Firms Results		Indian Firms Results	
COD	Coefficients	p>|t|	Coefficients	p>|t|
BS	0.003	0.143	-0.005**	0.039
CED	-0.010	0.100	-0.025**	0.010
OWN	0.011	0.693	-0.036*	0.000
ISH	0.108*	0.074	-0.004	0.940
ROA	-0.012*	0.001	>-0.000	0.995
AI	0.040*	0.000	-0.025**	0.034
BI	-0.055*	0.000	-0.226**	0.022
LVG	-0.021*	0.001	<0.001	0.999
FS	-0.007	0.530	0.003	0.643
cons	0.067	0.116	0.112	0.127

*Significant at p-value < 1%, ** Significant at p-value < 5%,*** Significant at p-value <at 10%

interlinks with the cost of debt, while it has negative and insignificant relation with the cost of debt in India. Independent directors in the board and in audit committee have positive relation with the cost of debt in Pakistani firms and negative relation in the Indian firms. In Pakistani firms, CEO duality, return on assets, leverage and firm size has negative correlation with the cost of debt as value of their coefficient is -.010553, -.012507, -.0210605, -.0071002 respectively. In contrast the Board Size, Ownership Structure, Internal Shareholding, Audit Independence, Board Independence are positively correlated with the cost of debt under the coefficient values .0033892, .0112641, .1089, .0405505, .0552356, discretely. Return on the assets, Audit independence, Independent Board Members, Leverage, these proxies have less than 1% significate value. On the other hand, the Indian firms have Board size, CEO duality, ownership concentration, board independence and audit committee independence significantly and negatively affect cost of debt for Indian firms with respect to coefficient values -.0055616, -.0257139, -.036004, -.004822, -.0001989, -.025745, -.022697 respectively. The four proxies have less than 5% significant p value such as board size, CEO duality, Independent Board Directors, Independent Audit committee. So that if the Indian firms increase the independent directors in the board and in audit committee their cost of debt will cut. (Butt and Hasan, 2009) low-level of corporate governance leads to high cost of debt in Pakistan. However, after many amendments in the corporate governance codes, Pakistani firms failed to cut the cost of debt. Because Pakistani corporate governance codes are not implementing properly. So the investor knows about the risk of the investment. Moreover, when the codes will not give protection to investor wealth, the investor will not invest money in our country and this will lead to poor economic condition.

Conclusion

This paper concluded that corporate governance has an important influence on the cost of debt for Pakistani and Indian listed companies for period of 2014 to 2017. The results of this study disclose that governance practices have a significant effect in reducing cost of debt for Indian firms which means that corporate governance practices are very strong in Indian economy are the firms with stronger governance enjoy benefits of lesser debt cost as suggested by different corporate governance theories like agency theory, stewardship theory etc. The results for the relationship of governance with debt cost for Pakistani firms are not encouraging as some of governance characteristics have insignificant association with cost of debt, whereas, some of governance characteristics have positive relationship which means that due to those governance practices; companies suffer from higher cost of debt instead of having benefits of lesser financing cost.

These results are valuable for policy makers and decision makers in Pakistan and India. The governance rules and their implementation should be improved in India further as it provides benefits to firms in terms of lesser cost of capital, Whereas, Pakistan still needs to develop the governance rules and codes and their implementation needs to be further strengthened in order to get benefits of lesser cost of capital. Therefore, Pakistani legislatures can be inspired to relax the board member provisions (minimum 7 member), specifically for smaller firms as it may cost effective and may make it easy to external financing at a lower cost. Finally, director ownership, in the firms' board are positively and significantly associated with firm-level of COD. This implies that firms can minimize director ownership to attract external financings at a lower cost. Hence, policy makers may encourage firms to further improve their CG structures in order to attract foreign investors.

The future research can analyze this relationship with larger sample size of firms and for extended time periods. The comparative analyses for financial firms of Pakistan and India can also be conducted. Moreover, the comparative analyses for a sample from Asian countries with sample from European countries can also be conducted.

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