Corporate Governance and Cost of Equity Paradox: A Case of Family Firms in Emerging Markets

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Abstract

Family owned firms (FOF) are the dominant part of business in all economies around the globe. The current study explores a new horizon and describes the paradox in connection with cost of equity (COE) and corporate governance index (CGI) in FOF of Pakistan. The panel data over the period of 2007-2016 are used in the study. The data are collected from annual financial reports of selected firms. Multiple regression models are applied to analyze the results. The study reveals a direct effect of CGI on CE. One unit increase in CGI causes 1.38 units decline in the CE. The study recommends that FOF should improve the CGI in order to control the COE.

Keywords: Corporate Governance index; Cost of Equity; Fixed Assets Backing; Leverage.

Introduction

The phenomenon of the corporate governance attracts great attention in these days. The study aims to fill the gap between theories' of corporate governance and results of empirical surveys by focusing on factors of COE. However, more than a few studies are undertaken on the capital structure, but useless attention is paid to the cost of equity in emerging markets. Rate of equity refers to the expected minimum arrival as reward for the capital endowed by the common stockholders of a firm. Correct assessment of a firm value of capital is very important for creation plenty

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of economic choices; like selection of capital structure, analysis of capital budgeting, firm valuation and performance analysis. The method in which corporation's area unit supports through a mix of debt and equity (capital structure), is studied extensively since the theorem of Modigliani and Miller (1958). The supposition concerning the capital structures of corporations roughly starts through the theorem in which the irrelevancy of the capital arrangement in a good market is expressed. In line with Modigliani and Miller (1958), it does not matter whether or not firms finance themselves with debt or equity. In an exceedingly good market, there are no agency prices, taxes, monetary distress prices and bankruptcy prices. The investor demands compensation for bearing risk. If spreading risk is not possible, there is greater chance that the COE increases (Clarkson et al., 1996).

Company's governance as a group of system defends themselves in conflict by insiders' expropriation (La Porta et al., 2000). Value of capital and company governance is stronger in favor of corporations among harsher agency issues. Better governance of the companies' result lowering the COE due to increasing confidence that leads to attraction of foreign investors (Chen at al., 2008). In particular, to assess the extent of corporate governance, the subsequent two sub-indexes area units are known; the primary one is called Disclosure and the secondary one is Board of Directors. Both these two sub-indexes contain four indicators. The structure of Corporate Governance Index in terms of Disclosure explains: do the firms offer statements according to standards of accounting principles. These accounting standards mainly drive from GAAP, IASB and IFRS. Does the firm make known information of executive compensation? Do the firms receive qualified auditing opinions on its monetary statement? Board of directors: do different individuals perform the roles of the board chairperson and CEO? Does the board contain 5 to 9 directors? Is there any lasting committee of audit? Are quite half of the board members outside the firm?

A firm with greater amount of tangible asset can have loans at relatively less interest rates (Shah et al., 2004). Fixed asset backing makes a company safer which reduces the cost of capital. Companies having a great quantity of rigid assets can simply increase debt at cheaper rates because of the collateral worth of those fixed assets (Rafiq et al., 2008).

Objectives of the study

The study´s objectives are as under:

- To examine the linkage among different variables of governance (GCI) and COE
- To provide some useful suggestion to policymakers for making improvements and reforms.

Literature Review and Hypotheses Development

In previous years, different studies have been conducted related to cost of equity with different variables in both domestic and foreign countries. Different researchers have found different results. Corporate governance and cost of equity requires greater attention specially in developing economy like Pakistan.

Chen et al. (2008) said that cost of capital and corporate governance was stronger in favor of firms with new harsh agency problems and the cost of equity was lower in those firms with better corporate governance by lessening the rate of external monitoring by external investors. External investors demanded high return in case of lower corporate governance index (GCI) as they need to spend more time as well as resources for monitoring management comparatively. They found that corporate governance was negatively related with cost of equity. Institutional investors were agreed to give a high quality of share with good corporate governance firms.

Hijazi and Bin Tariq (2006) analyzed the linkage of CGI and cost of equity capital. They indicated that large and small sized firm paid higher cost of capital as compare to average sized firms. Byun et al. (2008) explored the association between equity capital and company governance practices by using the data from 2001 to 2004. They said that good governance improved economic worth which resulted in lowering the price of equity investment. Lima and Sanvicente (2013) considered the quality of the cost of equity and business governance and concluded that the good corporate governance enhanced business profitability which allowed superior clearness and more security beside expropriation of wealth.

Li and Li (2016) analyzed the association between different factors of governance and cost of capital in term of equity. They found a powerful proof that the cost of equity decreased with the increase in excellent practices of corporate governance. The stock returns were pessimistically connected with corporate governance (Drobetz et al., 2004).

Varieties of literatures were studied on the linkage between different CGI and COE which produced mixed results. Based on above arguments, first hypothesis was designed as mentioned below:

H_0: There is no linkage between CGI and COE.

H_1: There is a linkage between CGI and COE.

Research Methods and Analytical Techniques

The study aiming to analyze linkage between CGI and COE of non-financial family owned (NFFO) companies in Pakistan. The data sample consists of four sectors named as Textile Spinning, Textile Composite, Sugar Industry and Cement Industry. Fourth eight NFFO companies twelve from each sector are selected on assets based selection criteria for the period of 2007 to 2016. The data are gathered from published annual financial reports and business recorder.

Description of Variables in Study

The following variables are used as mentioned below in Table 1:

Table 1: Variables Description

Variables	Proxies/ Measures
Dependent Variable	a. Measured in terms of Capital
a. Cost of equity (EQ)	Assets Pricing Model (CAPM)
Independent Variable	
b. Corporate governance (CG)	b. Corporate governance index
Control Variables	
c. Fixed Assets Backing (FA)	c. Fixed assets / total assets
d. Leverage (LE)	d. Total liabilities / Equities

Specification of model used in the study

The current study applies the multiple regression model approach (MRMA) to analyze the effect of corporate governance index (CGI) on cost of equity capital on sampled firms. This type of techniques are appropriate for analysis (Hall et al., 2004; Rafiq et al., 2004; Shah et al., 2004).

$$EQ_{it}=\beta_0+\beta_1(GC_{it}) +\beta_2(FA_{it})+\beta_3(LE_{it})+Eit----------------------(1)$$

Where; EQ = Equity cost , LE = Leverage, GC = Corporate Governance, FA = Fixed Assets Backing, β_0, β_1, β_2, and β_3 = Coefficients and e = error term.

Empirical Results

Table 2 shows the results of correlation analysis and descriptive statistics of variables under current study. Corporate Governance (GC) and Leverage (LE) and Fixed Assets Backing (FA) are negatively correlated with Equity cost (EQ).

Table 2: Correlation Analysis and Descriptive Statistics

Variables	EQ	GC	LEV	FA
EQ	1			
GC	-0.2278	1		
LEV	-0.0585	-0.0220	1	
FA	-0.1465	-0.0467	-0.0154	1
Mean	2.4954	0.8166	2.0096	0.6862
Median	1.2230	0.8500	1.4989	0.5584
Maximum	17.4300	1.9980	11.7760	8.4085
Minimum	1.0120	0.1100	-30.8018	2.0010
Std. Deviation	3.2489	0.5945	3.2622	1.1494

A weak negative correlation exists between all the variables. From the table it can be seen that the mean value of EQ is 2.49 with the maximum and minimum values of 17.43 and 1.01, respectively. The value of standard deviation (3.25) of EQ indicates a close link of the data to the mean value. The mean value of CG is 0.82 ranging from 0.11 to 0.85. The average value of LEV (FA) is 2.00 (0.69).

Table 3: Regression Analysis

Var	Coe	SE	TS	P (value)
Constant	3.1523	0.4591	6.8656	0.0000***
GC	-1.3851	0.2354	5.8834	0.0000***
FA	-0.4367	0.1212	3.6006	0.0004***
LEV	-0.0504	0.0427	-1.1807	0.2383
R-Square	0.8702			

Table 3 displays the regression analysis results for the impact of corporate governance index on cost of equity. There is significant negative impact of corporate governance index (coefficient = -1.38, p = 0.00) on cost of equity at the significance level of 0.01. The results are in line with Chen et al. (2008) and Li and Li (2016). The negative coefficient means that one unit increase in corporate governance index causes 1.38 units decline in the cost of equity. Fixed assets backing have significant negative impact on cost of equity. The outcomes are in line

with Rafiq et al. (2008). One unit increase in FA causes 0.44 percent inclination in EQ. Higher Fixed asset backing makes a company safer which reduces the cost of capital. The value of R-squared showed that corporate governance index, leverage, and fixed assets explain 87 percent variation in cost of equity.

Discussions and Conclusions

Governance is vital important for all stakeholders. La Porta et al., (2000) defines corporate governance as a set of system that protects the external investors (outsiders) from the expropriation of internal investors (insiders). According to Chen et al., (2008) cost of equity capital and corporate governance is stronger in favor of firms with new harsh agency problems, the cost of equity is lower in those firms, which have better corporate governance by lessening the rate of external monitoring by external investors. Cost of equity (COE) is considered as a vital module in today's emerging markets. Correct assessment of the cost of equity is essential for making many financial decisions. Because it is the element that decides how much amount should be invested in a specific project. The objective of present study is to examine the effect of CGI on COE.

The empirical results indicate that there is negative linkage exist between the coefficient of COE (coefficient = -1.38, p = 0.00) and CGI. This statistically significant empirical result support the hypothesis-1 and confirms a negative relation between variables of the study. The study recommends that family owned firms (FOF) should improve the corporate governance index in order to control the cost of equity (COQ). The managers of corporate sectors especially from the non-financial family owned (NFFO) firms can use the results of this study to control cost of equity capital through good governance.

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