CORPORATE GOVERNANCE AND CAPITAL COSTS

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Abstract: *The choice of the optimal debt-equity ratio, or the capital structure that minimizes the cost of capital and reduces the probability of bankruptcy, is emphasized as crucial to the corporate success. Through its instruments, corporate governance can reduce information risk and mitigate the agency problem, which provides the corporation with easier access to more favorable external sources of financing and contributes to minimizing the cost of capital. This paper aims to determine the impact of corporate governance on the cost of capital. The research results indicate that the quality of corporate governance at the corporate level and the protection of investors at the country level significantly determine the intensity of corporate governance impact on the cost of capital.*

Keywords: *corporate governance, cost of equity capital, debt costs, capital structure*

1. INTRODUCTION

Corporate governance is a comprehensive system of processes and procedures by which corporations are managed and controlled. Precisely such a system ensures the achievement of the set goals of the corporation efficiently and effectively. Good corporate governance should contribute to reconciling the interests of different stakeholders in corporations, as well as increasing the value and ensuring the long-term sustainability of the corporation. In the process of maximizing the value of the corporation, corporate governance should contribute to the efficient use of available resources and financing of investment projects from sources with the lowest possible cost of capital. Corporations with efficient corporate governance are associated with a greater degree of transparency and reduced risk of loss due to management opportunism, which makes them more desirable to invest and allows the corporation to access the capital market on more favorable terms. Consequently, the main purpose of this paper is to point out the specificity of the impact of corporate governance instruments on the capital structure, actually the cost of capital engaged from various sources.

2. CORPORATE GOVERNANCE FROM THE ASPECT OF CONTEMPORARY THEORIES OF CAPITAL STRUCTURE

Contemporary theories of capital structure are based on the theorem of Modigliani and Miller (MM) from 1958 [1], which is based on the understanding that, in the absence of market imperfections, capital structure is irrelevant to the cost of capital and the value of the corporation. MM have provided a starting point for a modern theoretical view of the issue of choosing the optimal capital structure, and factors that can explain why financing decisions are important. Generally speaking, two, in a way competitive, modern theories of capital structure have been set up: The Trade-off theory and the Pecking order theory [2].

According to the Trade-off theory, by balancing between tax savings, on the one hand, and the sum of bankruptcy and agency costs, on the other hand, a corporation can achieve an optimal capital structure that provides maximum corporation value [3] [4] [5] [6] [7]. In other words, the growth of debt ratio to a level that ensures equality of marginal costs and benefits of debt contributes to increasing the value of the corporation. It is especially emphasized that when setting the capital structure, it is extremely important to take into account the seriousness of the agency problem, especially because seeing the optimal capital structure is not the same from the point of view of shareholders and the point of view of managers [8].

Actually, depending on the performance of the corporation and the pressure from the corporate control market, managers may take a capital structure that is below or above the ex-ante optimal level for shareholders. The ex-ante optimal level of debt (for shareholders) represents the level of debt without taking into account the different tax treatment of debt and equity capital and taking into account the risk of financial difficulties. The importance and

strength of the impact of corporate governance instruments on capital structure are evidenced by research results which indicate that only the threat of hostile takeovers forces managers to increase the debt ratio in capital structure, but without determining how close or far such capital structure is to the optimal capital structure according to shareholders [9]. In addition, Bhagat and Jefferis point out that shareholders seek to maximize the value of the corporation through disciplinary instruments, forcing managers to choose the level of debt that maximizes the value of the corporation [10]. In addition, the system of corporate governance instruments contributes to reducing the cost of a suboptimal capital structure according to shareholders, because it encourages managers to use debt more and gradually change the capital structure, which in turn contributes to the growth of gross debt benefits and corporate values, of course with bankruptcy risk. It can be actually said from an agency perspective, that the choice of the optimal capital structure is closely related to the efficiency of corporate governance [11].
In the Pecking order theory, the price of certain sources of financing stands out as well as the fact that managers do not keep in mind the target level of debt in the capital structure, but follow a certain hierarchy according to the principle "cheapest sources have priority" [12] [13] [13] [14] [15] [16]. However, as managers have an active role in the capital structure decision-making process, they can strive to increase their benefits arising from the control of the corporation's operations that is the entrenchment effect. In addition, the Pecking order theory is based on the assumption of imbalance in the scope and quality of available information of managers and shareholders, in fact, the assumption that managers have more information on business risk and real value of the corporation compared to shareholders, which may result in agency problems. In such conditions, corporations prefer debt over equity capital, because shareholders, taking into account the agency costs, value shares less, which makes equity capital a less attractive source of financing for the corporation [17]. Consequently, an efficient corporate governance system, which mitigates the agency problem due to the effect of managerial entrenchment and information asymmetry, can contribute to changing the hierarchy of financing sources, actually it can make financing through the issue of shares become attractive for the corporation. Therefore, it can be expected that corporations that have a highly efficient corporate governance system are less likely to prefer debt to equity capital or are indifferent to the choice of funding sources.

3. CORPORATE GOVERNANCE FROM THE ASPECT OF CAPITAL COSTS

The corporation operations are characterized by the ever-present agency problem, so it is emphasized that the goal of corporate governance is to protect the interests of external investors - shareholders and creditors, from the expropriation of their rights by managers or controlling shareholders [18]. It is actually believed that a quality corporate governance system can alleviate the agency problem in the shareholder-manager relationship and limit the expropriation of the rights of minority shareholders and, thus, affect the increase in the corporation value [19].
According to Contemporary understandings of the choice of capital structure, for composing the capital structure it is important to know the price of each source of financing, to establish a balance between marginal costs and debt benefits, or choose the cheapest sources of financing and maximize corporate values. As the intrinsic value of a corporation, determined by discounting future cash flows, increases only when the corporation invests capital at rates of return higher than the cost of capital, the value of the corporation can be expected to increase as the cost of capital decreases and vice versa [20].
Most corporations engage different sources of financing, which have different required rates of return from investors due to their different perceptions of risk. In fact, for a particular source of funding, the cost of capital depends on the rate of return that the corporation must provide for the owner of that capital, and the market value on the rate of return that the owner expects to achieve. As the rate of return that a corporation must provide for a capital owner is equal to the rate of return that the owner expects to achieve, so the market value of the security and the cost of capital of a particular source of financing can be viewed as two sides of the same coin (Figure 1) [21].

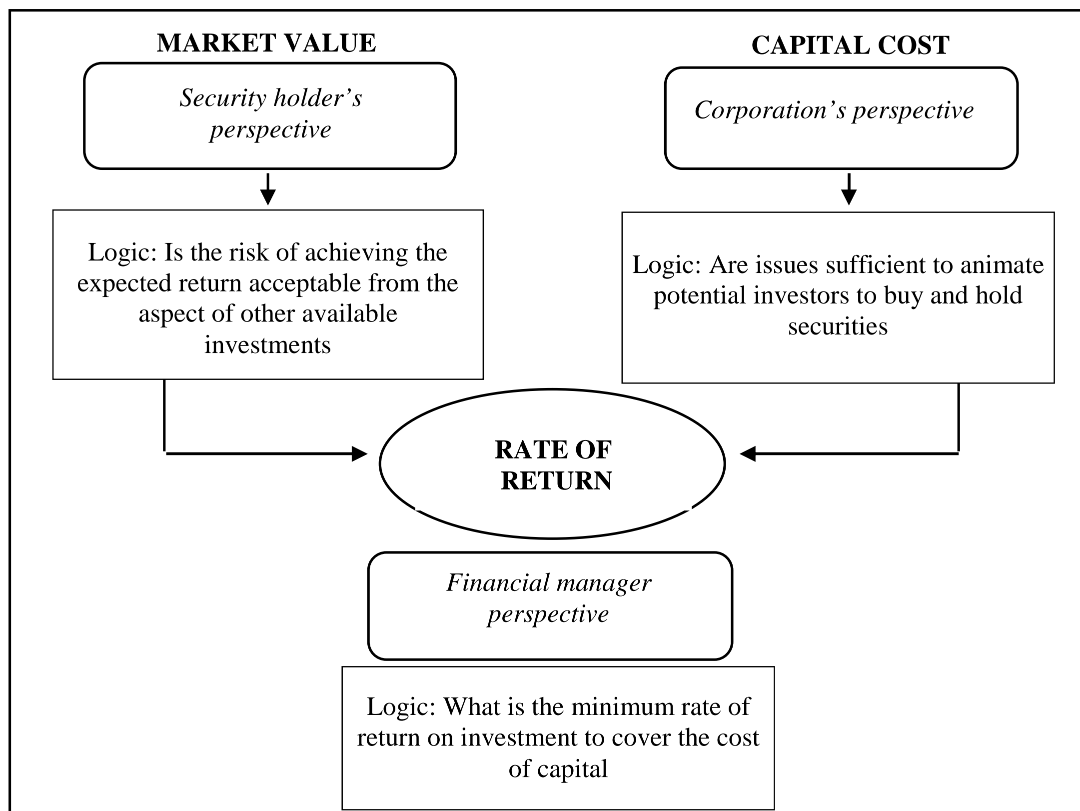

Figure 1: Interdependence of market value and capital cost [22]

In the relevant reference literature, it is usually assumed that effective corporate governance contributes to improving business performance and reducing the cost of capital, and thus increasing the value of the corporation [23]. In other words, quality corporate governance leads to a reduction in the business risk of the corporation and the risk premium of the owner of the capital, and thus lower costs of individual sources of capital and lower total costs of capital. In addition, it is emphasized that "an effective corporate governance system, implemented at the corporate level and throughout the economy of a country, helps to ensure the level of trust necessary for the proper functioning of a market economy; in this regard, the cost of capital will be lower, and corporations will be encouraged to use funds as efficiently as possible" [24]. It is considered that quality corporate governance can positively impact the value of a corporation in two ways [25]:

- by increasing the expected free cash flow, as good corporate governance can lead to the reconciliation of different interests, reduce the level of private benefits that can be achieved by managers or controlling shareholders to the detriment of other stakeholders, and increase growth opportunities
- by reducing capital costs, as good corporate governance can reduce the risk of information asymmetry and expropriation of shareholder/minority shareholder assets by managers and controlling shareholders.

It is pointed out that the quality of corporate governance can be reflected in the amount of risk premium [26]. Thus, of the two corporations in all things equal except in the quality of corporate governance, and therefore in the degree of business risk, a corporation with better corporate governance and less risk should have lower capital costs and a higher value. In addition, they point out that efficient corporate governance, in terms of high transparency and better disclosure, contributes to reducing information asymmetry and uncertainty about the realization of future cash flow.

4. CORPORATE GOVERNANCE AND COST OF EQUITY CAPITAL

Corporate governance instruments can reduce the cost of equity capital in several ways. An efficient system of corporate governance instruments can contribute to the reduction of monitoring costs by shareholders and the reduction of the required rate of return because the increase in monitoring costs is compensated by the increase in the required rate of return [19]. In addition, a system of corporate governance instruments can limit opportunistic insider trading[1] and reduce information asymmetry, which in turn leads to lower costs of equity capital [27]. In addition, given the hypothesis of an inverse relationship between market conditions and the opportunistic behavior of managers or

[1]Opportunistic insider trading would involve a situation where, for example, managers or controlling shareholders, based on confidential information about the corporation's operations (based on private information on whether the value of shares and bonds is expected to rise or fall in the coming period) would buy or sell stock and bond.

controlling shareholders, poorer market conditions will lead to an increase in the degree of expropriation of shareholders'/ minority shareholders' assets. This situation can lead to an increase in the systematic and unsystematic risk of the corporation, which will be accompanied by an increase in the required rate of return by shareholders. In this regard, an effective system of corporate governance instruments, to the extent that it may discourage the expropriation of shareholders'/ minority shareholders' assets by managers or controlling shareholders, contributes to mitigating the inverse relationship between expropriation rates and market conditions and thereby reducing the required rate of return by shareholders [28].

Ashbaugh-Skaife and others examined the conditionality of the cost of equity capital by different characteristics of corporate governance in a sample of US corporations in the period from 1996 to 2002 [29]. They found that the quality of financial information, ownership structure, protection of shareholders' rights, and management structure determine the cost of equity capital, actually a strong corporate governance system has a negative impact on the cost of equity capital. Derwall and Verwijmeren found in a sample of 3,800 US corporations that good corporate governance results in lower systematic and unsystematic risk and lower costs of equity capital [30].

Mazzotta and Veltri found that the boards of directors of Italian corporations have a significant impact on mitigating agency problems and information asymmetries between majority and minority shareholders and that corporations that implement an effective corporate governance system have 5% lower costs of equity capital than corporations that implement an inefficient corporate governance system [31]. The conclusion that better corporate governance leads to lower costs of equity capital is also based on the results of research on a sample of corporations from Spain [32]. It was pointed out that agency risk related to the quality of corporate governance cannot be diversified, so shareholders of corporations with poor corporate governance not only expect lower future cash flow but also discount it at a higher required rate of return.

The results of research on a sample of Korean corporations indicate that good corporate governance practices are negatively related to the cost of equity capital [33]. In addition, the protection of shareholders' rights stands out as a characteristic of corporate governance practices that has the most significant impact on reducing the cost of equity capital, therewith the board of directors and disclosure policies also having a significant impact. Similarly concluded by Chen and others, because the results of their research indicate that shareholders value more corporations with better corporate governance future cash flows are discounted at a lower rate [34]. Thereby, in developing countries, which are characterized by weak legal protection of investors, corporations that want to reduce the cost of equity capital should pay special attention to corporate governance instruments.

5. CORPORATE GOVERNANCE AND DEBT COST

When it comes to debt costs, the question is often asked how important the quality of corporate governance is for creditors, since they can directly limit the opportunistic actions of managers through contractual provisions and protective covenants. The effect of corporate governance is actually considered to be less direct in protecting the interests of creditors due to direct protective covenants [35]. The reference literature points out that the effects of corporate governance on debt costs are particularly pronounced in a situation where agency debt costs are very high and when the corporation is facing bankruptcy [36]. Creditors know how to value the quality of corporate governance, because, from their perspective, good corporate governance can reduce agency debt costs and reduce interest rates in several ways [37]:

- implementing a strong corporate governance system can reduce the likelihood that a corporation will face financial difficulties, encouraging managers to dispose of the corporation's assets efficiently and effectively,
- the credibility of accounting information based on which creditors can assess the quality of the corporation's operations can be significantly improved in the conditions of application of an efficient system of corporate governance and
- good corporate governance can help alleviate the problem of information asymmetry between the corporation and creditors.

The assumption of a negative correlation between the quality of corporate governance and the required risk premium for creditors has been tested empirically several times. Anderson and others provide evidence that bondholders are willing to reduce the required risk premium for corporations with effective monitoring by the board of directors and audit committee, as this increases the integrity of the corporation's accounting disclosures [38]. Confirmation that a stronger degree of management oversight by the board of directors is associated with a high credit rating and lower debt costs was provided by Ashbaugh-Skaife and others in a sample of US corporations [39]. They pointed out that the credit rating of the corporation is negatively related to the number of blockholders and the degree of power of the CEO, and positively related to the degree of financial transparency, protection of shareholders' rights regarding takeover defense, overall independence, and expertise of the board.

In a sample of corporations that were included in a report by the Financial Accounting Foundation (FAF) between 1987 and 1991, Sengupta noted that corporations with high-quality disclosures have lower effective interest rates when issuing bonds, which is explained by the fact that the policy of timely and detailed disclosure reduces the perception of creditors about the risk of default [40]. In a sample of 300 European corporations, Blom and Schauten found that corporations with a strong corporate governance system had 1.4% lower debt costs than corporations with a weak corporate governance system [41]. In French corporations, it has been observed that the quality of corporate governance

and auditing has a significant effect on reducing debt costs [42]. Namely, the degree of managerial supervision by the board of directors, together with the degree of independence of the board of directors and institutional protection of investors, significantly affect the reduction of debt costs.
In Brazilian corporations, more efficient corporate governance is associated with lower debt costs and a higher debt ratio in the capital structure [43]. Similarly, in South Korean corporations, the improvement of corporate governance practices is associated with a reduction in the risk of default and debt costs [44]. In South Korea, it was also confirmed that dividend policy, protection of shareholders' interests, and the audit board, as characteristics of corporate governance practices, play a significant role in reducing debt costs.

6. CONCLUSION

Theoretical views and results of empirical studies suggest that corporations with a quality corporate governance system have a lower estimated business risk and can access different sources of financing at lower costs. From the shareholders' point of view, the low risk of the corporation's operations will be reflected in the discount rate that they will apply when discounting future cash flows, so the corporation will have equity capital at a lower price. Also, if corporate governance contributes to reducing the risk of default and bankruptcy of the corporation, creditors will be willing to reduce the required risk premium so the corporation will have cheaper debt financing available.
Consequently, it can be said that corporate governance has a significant impact on reducing the cost of equity capital and debt. This impact can be of varying intensity due to differences in the quality of corporate governance at the corporate level and investor protection at the country level. Namely, it was noticed that quality corporate governance and strong investor protection at the country level serve as a complement to each other in the impact on equity capital costs, actually weak investor protection at the country level can reduce the efficiency of corporate governance in reducing shareholder risk premium. When it comes to debt costs, it has been observed that good corporate governance reduces debt costs in countries with weak investor protection, but not in countries with a strong legal system, quality disclosure practices, and superior government performance.

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