

**RELATIONSHIP BETWEEN CORPORATE GOVERNANCE AND  
COST OF EQUITY CAPITAL****Zandi G., Shahzad I.A., Bajaber N., Nowodziński P. Shahid M.S.\***

**Abstract:** The strategic planning of firms is highly dependent on capital investment, and corporate governance practices in firms play a critical role in seeking to invest with a risk reduction. Two emerging stock markets, India (NSE) and Pakistan (PSX), are selected to investigate the links of costs of equity capital with corporate governance. Therefore, the study's primary aim is to find out the relationship between corporate governance and cost of equity capital and the ways that can be helpful for firms to reduce risk. Data are collected from 260 firms in the chemical and pharmaceutical industries from 2011 to 2020. Dimensions used to measure the corporate governance index include committees' existence, size and composition of board, ownership structure, and CEO duality. The pooled OLS (fixed effect) regression model has been applied to estimate the coefficient regarding data collected from companies. Study results presented a comparison of firms with strong and weak corporate governance and concluded a higher cost of equity capital for the firms with weak corporate governance compared to others. Using PEG ratio to estimate the cost of equity model is regarded as most suitable for developed countries and is currently deployed in the current study. The study's major contribution is using cross-country data to conduct a preliminary investigation on the relationship between the costs of equity capital with corporate governance. The study findings are highly significant for developing and strengthening the corporate governance structure in companies and providing protection to shareholders' interests. The current paper has presented managerial implications and suggestions for policymakers and shareholders that, in return, are likely to boost assurance in the market.

**Keywords:** Cost of Equity (COE), Corporate Governance (CG), Emerging Markets (EM), Market-Book Ratio (MB), Organizational Performance (OP)

DOI: 10.17512/pjms.2022.26.1.24

*Article history:*

*Received* March 17, 2022; *Revised* April 28, 2022; *Accepted* June 08, 2022

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\* **Gholam Reza Zandi**, Associate Professor, Universiti Kuala Lumpur Business School, Malaysia; ✉ corresponding author: zandi@unikl.edu.my,

ORCID: 0000-0001-9517-8474

**Imran Ahmed Shahzad**, Assistant Professor, The University of Faisalabad, Pakistan; Skema Business School, Sophia Antipolis, France; ✉ e-mail: imran\_rana77@hotmail.com,

ORCID: 0000-0002-4027-2719

**Nadia Bajaber**, Assistant Professor, Economics Department, King Abdulaziz University, Saudi Arabia; ✉ e-mail: Nbajaber@kau.edu.sa,

ORCID: 0000-0002-8220-6189

**Pawel Nowodziński**, Associate Professor, Czestochowa University of Technology, Poland; ✉ e-mail: pawel.nowodzinski@wz.pcz.pl,

ORCID: 0000-0001-8706-9219;

**Muhammad Sadiq Shahid**, Associate Professor, Bahauddin Zakariya University, Multan Pakistan; ✉ e-mail: sshahidmalik@bzu.edu.pk

ORCID: 0000-0002-2383-6818

## Introduction

The impact of corporate governance on a company's strategic plan has become an important topic for practitioners, policymakers, researchers and academicians due to the recent financial downturn and its strong effect on businesses. Business literature shows that corporate governance is one the primary areas where stakeholders' concerns can be seen as the target of decision-makers, where risk management has been thought to be the first step. Along with many other factors, it also includes the disclosure of corporate matters plays an important role along with other factors like; "building trust, improving market liquidity, increasing demand for corporate stocks and helping transaction cost, reducing risks and cost of capital" (Temiz, 2021).

The steps taken are to be shared with others to ensure the in-time decision effects, which may produce confidence in related stakeholders (Srivastava et al., 2019; Jensen, C., 2018). Out of many decisions, "financing decision is one of the weighty strategic decisions of any company that drives their survival, support growth and pay for current operation" (Rashid et al., 2020). Further to this, it is pertinent to note that "the choice of debt versus equity is primarily fueled by cost of debt and cost of equity (Ke hereinafter) that are closely connected to corporate performance" (AlHares, 2019).

Enhancement in projected cash flow due to the reduction of expropriation inside a company is argued as a source of the increased value of firm (Black et al., 2006; Anna Blajer-Gołębiowska (2010). Good protection from the investor is regarded as its main source in the literature. Moreover, in markets where corporate governance is still considered a novel topic, such as emerging corporate marketplaces, the impact of various features of equity cost as a source of capital is also explored (Reverte, 2009). Other than risk put on by managers and owners of firms that are likely to gain their interest by compromising the status of shareholders, agency risk is also considered an important derivative in the corporate sector. Hence, to protect the arbitrary decision-making of managers, the board's role is highly significant for shareholders. However, the comparison and measurement of management quality and actual value of firm are highly complicated for practitioners as there is generally a pattern of asymmetric information in the decisions of shareholders. At the same time, managers have more direct and reliable information due to their access to critical information regarding the company. This impacts cost of equity due to high agency risk (Hamza and Mselmi, 2017) and raise concerns about moral risk (Reverte, 2009).

To protect and monitor the appropriate use of investment, investors have realised the significance of establishing a strong mechanism to minimize agency risk. Internal Corporate Governance (CG) aims to guarantee the best outcomes for shareholders, management, and investors along with other stakeholders (Mayer, 1997). Company managers' behavioural equity and commitment to transparency, along with other regulations and rules, are laid out in this protection mechanism to best serve their

purpose. “These protection mechanisms are combined rules and regulations” (McKnight and Weir, 2009).

There are various definitions of Corporate Governance as explained by various practitioners and scholars. “The ways in which the provider of finance to corporations is guaranteed of getting a return on their investment in a firm” is the definition of CG as given by Ishleifer and Vishny (1997) Shahzad et al., (2018) defined various suppliers of capital including equity holders, debt holders and their representative including board directors along with management as a firm and considered them as a source of prime influence on acquiring and allocation of resources as well as distribution of rewards and overall firm’ performance (Shahzad et al., 2007; Shahzad, and Bhatti, 2008; Khalid and Urbański, 2021). The firm's ownership is regarded as a separate entity from the firm’s management in developed markets. Hence, managerial decision-making regarding resource allocation is considered the prime concern of investors and hence presents corporate governance as a control mechanism mechanism (Siekelova et al. 2020; Pavolová et al. 2021). An example of such control is observed among investors who like to take leverage from stock ownership and are more likely to invest in firms with uncertain corporate governance (Jurgelevicius and Tvaronavičienė 2021). Hence, it is vital to consider the importance of corporate governance in the South Asian region, including India and Pakistan, before examining the relationship between the cost of equity capital and corporate governance.

The high exodus rate of foreign capital and the Asian financial crisis have damaged India and Pakistan's stock markets, which are considered highly prominent emerging markets in the south Asian region. Hence, after the Asian financial crisis, companies listed in the stock exchanges of India and Pakistan have become highly concerned about the reforms required in the current perilous corporate governance mechanism and transparency. As most of the existing companies in both these regions are owned and managed by a few families, and thus corporate governance in companies of India and Pakistan is not quite transparent and effective, resulting in a low market rating of these firms. Due to centralized ownership of companies, the effectiveness of operation monitoring is hence challenged. However, this set-up has the benefit of minimizing conflicts among management and shareholders and thus helps resolve agency issues. Firms with weaker corporate governance will likely face additional agency issues as the managers acquire higher private benefits (Rais and Saeed, 2005). In addition, shareholders in such firms with maximum authority have control to exploit the interest of minority shareholders and fulfill their interests by influencing managers with their privilege of access and control over management (Kim, 2006; Choi et al., 2014).

The implementation of international standards of corporate governance and creating an international harmony of corporate governance system among firms in the Asian market is forced after the serious episode of the Asian financial crisis. These standards were adopted from developed markets, including the addition of audit committee in the board structure and reforming the board. In addition, to empower

minority investors and increase the activity of shareholders as participants, audit committee is considered a critical element of board structure as per the criterion of international benchmarked specification of CG. These changes also include the variation in the regulation of audit committees as well as other governance regulations (Choi et al. 2014). Thus, it is highly significant to study the role of audit committees in the region with these changes implemented compared to other countries' firms.

Likewise, after the Security and Exchange Commission of Pakistan (SECP) introduced the Governance Code 2002 for firms listed on the stock exchange, corporate governance and its role in firm' performance, as explained earlier by Shahzad et al., (2018) has become an important topic for investigation among researchers. However, in India, the code for Corporate Governance was developed based on the recommendations presented by Kumarmangalam Birl. At the same time, the SEBI previously took initiatives in 1998 with the development of a voluntary code and started firm's monitoring of CG. Along with the worse impact of the Asian Financial Crisis on the performance of firms (Shahzad et al., 2020; Shahzad, et al., 2018) in south Asian region, the political instability and the inadequate capital structure of firms in Indian and Pakistani region such as high dependence of Indian businesses on debt also serve as the prominent determinant of low equity valuation of firms. Despite the fact that entities and regulators in Pakistan are making efforts to improve the overall corporate governance system, the economy of Pakistan is dominant with family-owned businesses. These families are well known for influencing bureaucratic and other controlling regulators. Hence, government efforts are considered corrupt and faulty with a paternalistic attitude. This weak measure with strong control of families neglected the significance of board restructuring in business, resulting in an increased price-to-earnings ratio. However, most of the research conducted in this region ignored the significance of board structure and its impact on the cost of equity as a source of capital. Spending of capital by various firms has been discussed in the existing body of literature, indicating a negative impact on firms' spending when managed by bad governance and vice versa. Hence, a strong relationship between Cost of Equity capital and Corporate governance mechanisms is inferred (Hsieh and Bedard, 2018).

To measure the impact of CGP on cost of equity capital, this paper has considered various determinants and studied their various relationship as presented in the literature. Factors used to measure Corporate Governance include board composition, size and CEO duality. In addition to this committee's existence, the composition of committees and ownership structure defined corporate governance in a firm and are regarded as the source of finding the role of governance on cost of financing. These factors provide significant information on how the cost of financing through the equity market of India and Pakistan is lower in firms with strong good governance. To illustrate the mechanism of corporate governance, a sample size for 2011-2020 is selected with a significant background. Moreover, data sampling and estimation

of models used for data analysis are based on the previous studies in the Asian corporate market, including family-owned and reliance on debt capital, while studying the mechanism of GC. In addition, the fact that the equity values of firms in Pakistan and Indian markets are discounted by financiers and serve as a problem. The implication of corporate governance only after the Asian financial crisis is considered a root cause of this problem. As in Pakistan, corporate governance in firms was implemented in 1999. After the Asian financial crisis, its impacts are short-lived for the region. As strengthening the company's strategic value and reducing risk for financiers are considered key pros of strong GC, economic circumstances need to research the relationship of cost of equity capital with corporate governance should be explored and enrich the body of literature.

#### ***Objectives of the study***

The objectives are based on the relationship between corporate governance and cost of equity and are stated as; (1) To investigate the effect of Corporate Governance on Cost of Equity and (2) To investigate the effect of corporate governance, including the structure of board, self-regulating of board committees and structure of ownership in the firm on Cost of Equity. The current report has been categorized into five important sections. The first section of the study introduces the topic of investigation and study objectives, while section II discusses the existing literature on variables under study. The methodology used for data analysis in the current study is presented in section III. The discussion section analyzes the results of the present study with the existing research that is presented in section IV. The implications of study and suggestions for financiers in Pakistan and India are presented along with valuable findings of the study in the last section.

#### **Literature Review**

Corporate governance is believed to reduce agency costs in the framework of agency theory and in COEs by reducing the risks observed by investors (Lambert et al. (2007). According to Zandi et al. (2020), an enhancement in cash would increase the corporate agency cost so directors could apply cash flows to their interests than corporate shareholders. The theoretical framework developed by Lambert et al. examines the relationship between the two Well-connected accounting information systems and COE capital. Reviewing Lambert et al.'s (2007) framework, "The quality of the accounting information system has a significant impact on the cost of capital. It also it is observed that the quality of the CG affects the decision making of the company, including cash flow and dividends, etc." Garmaise and Liu further assumed as "good governance, which focuses on fraudulent management, broadens organizational disclosures about systemic risk and tests this hypothesis in an international setting" (Garmaise and Liu 2005). Similarly, Albuquerque and Wang (2008) explore the fragility of shareholder security, which increases management's incentive to overinvest, which in turn increases share value volatility and firm volatility. In addition, Suchard et al. (2012) explained as "higher insider ownership, institutional majority shareholders, and board independence reduce firm risk

perceptions, leading investors to demand lower ROI. They also document that CG maximizes shareholder wealth by reducing external financing costs.” Among the most significant benefits were those incentives offered by a company to its employees, which positively and directly affect employee performance (Zandi et al., 2018).

“Cost of equity is one of the primary determinants of the source of financing” (Abdeljawad and Nor, 2017). Mulyati (2017) defines as “the minimum rate of return required by the investors. Ke includes basic riskless return and premium for additional risks.” The same has been advocated by Bartkowiak and Borkowski (2010). Sharpe, 1964). Additionally, “by having a look at the global corporate failures, include the likes of World Com and Enron, forward the idea of CG with an objective to separate management from ownership control.” La Porta et al. (2000) report that “corporate governance includes mechanisms through which outsiders preserve themselves against the insider’s expropriation.” Extend; “the broader objective of CG covers the control of asymmetric information among stakeholders.” It is pertinent to mention to quote here, “after controlling for several risk variables”, Chen et al. (2009) report “a significant negative association between corporate governance and risk management in emerging markets.” Ashbaugh-Skaife et al. (2006) found as “ownership structure, shareholders’ rights and board structure having close tie corporate experience” In many developing economies of the world, Khlif et al. (2019) reported that “internal control significantly moderates the negative relationship between corporate governance and cost of equity”. Some authors like Saha and Kabra (2020) reported “a relationship between corporate governance and risk to be complementary for Anglo-Saxon countries, while the same is insignificant for social market system.” Further to this, Zhu (2014) suggested “companies high on corporate governance practices report lower risk in markets with stronger legal system, extensive practices and high governance quality.” AlHares (2019) reports a negative relationship between corporate governance index and cost of capital in Organization for Economic Co-operation and Development countries. Earlier, it was claimed by Justyna Tanaś, Maria Trojanek (2014), Bulathsinalage, and Pathirawasam (2017).

Many studies have aggregated composite GC indices (Mazzotta and Veltri, 2014). Chen et al. (2011) found as “companies with good investor protection practices had significantly lower implied COE than companies with ineffective investor protection after controlling for the following risk factors, price momentum, forecast bias of analysts and the effects of the industry and the year. In addition, they point out that shareholder protection rights significantly reduce the capital of the COE.” Chen et al. (2009) found as “corporate governance practices have a negative impact on COE capital in emerging markets, and the impact of corporate governance is more pronounced in markets where legal investor protection is relatively poor.” Therefore, “the quality of corporate governance and the quality of shareholder legal protection appear to be substitute for each other in reducing COE. Further, institutional



investors are willing to buy more shares of CG-quality companies” (Lima and Sanvincente, 2012). Teddy et al. (2016) document a “negative correlation between the quality of the CG and the COE; In particular, disclosure is considered to be the most important factor affecting COE, and the investment premium that investors pay is higher in emerging markets than in developed markets.” The following hypotheses have been postulated:

H1: Corporate Governance has a significant positive impact on the firms’ cost of equity capital.

H2: Board structure has a significant positive impact on the firms’ cost of equity capital.

H3: Ownership structure has a significant positive impact on the firms’ cost of equity capital.

H4: Independence of committee significantly impacts the cost of equity capital.

### Research Methodology

The current study has included chemical firms and pharmaceutical companies in India and Pakistan to study their corporate governance. Based on the availability of firms in those two industries, the quality of corporate governance is examined and evaluated surrounding five important dimensions of corporate governance: protection of shareholder’ rights, corporate disclosure, committee for audit, dividend policy and board of directors. As the corporate governance in Pakistani and Indian firms is highly affected by agency risk due to differences among individual investors and institutional investors that have minimal to no legal protection compared to Anglo-Saxon markets, GC index is used to measure the quality of corporate governance in firms in these regions. The use of GC index has been argued by various scholars to indicate the benefits of its usage (Byun et al., 2008; Reverte, 2009). Hence, in the current data sampling of firms, a dummy variable named DUAL has been introduced that measures the key role of chief executive that has been individualized from the role of chairman in firm *i* as compared to others, and it eventually assisted in building individuality of dual roles of CEO (duality).

The current study has made a perception about the quality of corporate governance in a firm where the company board includes both audit and nomination committees. The assumption is based on the evidence of improved corporate governance quality in co-occurrence of both nomination and audit committees. Hence, based on existing literature, the current study has introduced a dummy variable (AUDNOM) that takes value 1 if both nomination and audit committees co-exist in firm *i* or otherwise.

This variable is considered for the apprehension of stimulus provided by both committees. The quality improvement in corporate governance of firms with the independence of board committees is evident in previous studies, which indicate a positive connection between corporate governance independence of board committees. Thus, the calculations of outside director percentage in a firm are calculated in the current study using variable (INDCOM). Another dummy variable DINDCOM is also introduced along with INDCOM taking value 1 if INDCOM and

0 present firms  $i$  has strong governance for weak governance. These previously mentioned five dimensions of corporate governance are combined to create variable governance measure (GOVSCORE). Higher level quality governance in firm  $i$  takes value 1, while low-quality governance in firm  $i$  takes value 0. The cost of equity capital is to be measured as below formula;

$$COE_{it} = \sqrt{\frac{eps_{it+2} - eps_{it+1}}{P_{it}}} \quad (1)$$

Previously, the Asset Pricing model, including size of firm, market-to-book ratio and beta, is used by Fama and French (1993) to measure companies' COE capital. Hence, the current study uses the same three proxies to state the relationship between these providers and cost of equity capital. In the current study,  $eps$  is used to indicate earnings per share for firm  $i$ , in year 1 to year  $t$ , while  $P_{it}$  firm  $i$ 's stock market price at period and  $t$  is the cost of equity capital for firm  $i$ .

For the estimation of the coefficient, the pooled OLS regression model has been applied as follows;

$$COE_{it} = \beta_0 + \beta_1 BETA_{it} + \beta_2 MB_{it} + \beta_3 SIZE_{it} + \beta_4 PB_{it} + \beta_5 ROA_{it} + \beta_6 LEV_{it} + \varepsilon_{it} \dots\dots\dots(2)$$

Equation 1 is used to calculate firm  $i$ 's cost of equity capital for firm. The end market value of equity for firm  $i$  is divided by end book value of firm  $i$ 's equity is presented by  $MB_{it}$ , and the estimation of beta for 7 years before the year of observation is presented.

As per previous literature studies (Frank and Goyal, 2009; Rajan and Zingales, 1995), four control variables are used in the current research model, indicating robustness. These controlled variables include (1) ROA is the return on assets, which decreases the cost of equity capital when it shows an elevation (2) Price-to-book ratio (PB): the cost of equity is lower in the occurrence of a higher price-to-book ratio (3) Leverage (LEV) has a direct relationship with the cost of equity and hence higher leverage results in higher cost of equity and (4) Firm size (SIZE).

**Data collection process**

The reason for choosing 260 listed firms from Pakistan and India from 2011 to 2020 is the period that the latest CG data are available. CG characteristics are derived primarily from sample company annual reports, while analyst consensus forecasts for company betas, share prices, market capitalization, and ratios of MB and other Market information sources come from the DataStream database. On the one hand, the data on the characteristics of corporate governance are concentrated in the previous section, "The analysts included in the companies in the sample also made forecasts of earnings per share for the next one and two years to calculate COE determined because it is Easton" (2004).



### Research Results and Discussion

The governance characteristics, the COE and the risk variables are described in Table 1, with the sample subdivided into companies with strong and weak governance (CG measure, GOVSCORE). Mazzotta and Veltri (2014) show that there is a difference in the mean between strong and well-governed companies. It is worth promoting this method to test the sensitivity of samples. As shown, in Pakistan and India, the average board size of companies with strong governance (9,135; 11,280 members) is slightly higher than that of companies with poor governance (7,503; 8,334 members). The surveyed samples tend to be internally dominated companies; inside directors are more frequent than outside directors. Surprisingly, more than half of the directors of the companies surveyed were external (53.3%; 60.9%), and the average percentage of independent directors on the board was higher in companies with strong governance (64.0%; 65,345) than in companies with weak governance (40.4%; 58.17%). The president and the CEO dominate the companies with a strong government (0.635;) and companies with a weak government (0.042). In addition, the mean (0.152) for the entire sample of companies indicates that about 85% of the companies in the samples have double CEO status, as family owners often run companies, so its president is also the CEO.

**Table 1. Results**

| Variables |        | Whole Sample | Strong governance | Weak governance | Difference | Whole Sample | Strong governance | Weak governance | Difference |
|-----------|--------|--------------|-------------------|-----------------|------------|--------------|-------------------|-----------------|------------|
| BOSIZE    | Mean   | 8.089        | 9.135             | 7.503           | 1.632      | 9.231        | 11.820            | 8.340           | 3.48       |
|           | StdDev | 2.448        | 2.904             | 2.370           |            | 1.807        | 1.953             | 1.600           |            |
| BRDIND    | Mean   | 0.533        | 0.640             | 0.404           | 0.284      | 0.642        | 0.654             | 0.581           | 0.205      |
|           | StdDev | 0.172        | 0.103             | 0.153           |            | 0.209        | 0.185             | 0.174           |            |
| DUAL      | Mean   | 0.152        | 0.635             | 0.042           | 0.593      | 0.183        | 0.540             | 0.136           | 0.414      |
|           | StdDev | 0.359        | 0.486             | 0.201           |            | 0.304        | 0.257             | 0.285           |            |
| AUDNOM    | Mean   | 0.674        | 1.000             | 0.287           | 0.713      | 0.702        | 1.000             | 0.364           | 0.636      |

|          |        |        |        |        |        |        |        |        |        |
|----------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
|          | Median | 1.000  | 1.000  | 0.000  | 1.000  | 0.305  | 1.000  | 0.000  | 1.000  |
|          | StdDev | 0.469  | 0.000  | 0.454  |        | 0.527  | 0.000  | 0.359  |        |
| INDCOM   | Mean   | 0.467  | 0.621  | 0.345  | 0.276  | 0.486  | 0.703  | 0.402  | 0.301  |
|          | Median | 0.546  | 0.600  | 0.333  | 0.267  | 0.406  | 0.618  | 0.394  | 0.224  |
|          | StdDev | 0.145  | 0.078  | 0.098  |        | 0.089  | 0.280  | 0.148  |        |
| GOVSCORE | Mean   | 2.278  | 4.000  | 1.042  | 2.958  | 4.079  | 4.684  | 2.640  | 2.044  |
|          | Median | 3.000  | 4.000  | 1.000  | 3.000  | 3.860  | 4.128  | 1.109  | 3.019  |
|          | StdDev | 1.249  | 0.000  | 0.627  |        | 0.844  | 0.612  | 0.600  |        |
| COE      | Mean   | 0.167  | 0.193  | 0.156  | 0.037  | 0.428  | 0.648  | 0.368  | 0.280  |
|          | Median | 0.140  | 0.162  | 0.133  | 0.029  | 0.263  | 0.482  | 0.209  | 0.273  |
|          | StdDev | 0.115  | 0.150  | 0.094  |        | 0.503  | 0.708  | 0.308  |        |
| BETA     | Mean   | 0.799  | 0.982  | 0.567  | 0.415  | 0.806  | 0.973  | 0.580  | 0.393  |
|          | Median | 0.783  | 1.024  | 0.658  | 0.366  | 0.684  | 0.429  | 0.436  | -0.007 |
|          | StdDev | 2.820  | 1.934  | 3.739  |        | 0.906  | 0.880  | 0.946  |        |
| SIZE     | Mean   | 14.783 | 15.621 | 13.982 | 1.639  | 16.783 | 18.621 | 14.680 | 3.941  |
|          | Median | 14.847 | 15.783 | 13.801 | 1.982  | 14.349 | 15.078 | 12.709 | 2.369  |
|          | StdDev | 1.313  | 0.833  | 1.205  |        | 0.463  | 0.795  | 0.685  |        |
| MB       | Mean   | 1.830  | 1.639  | 2.057  | -0.418 | 2.176  | 2.436  | 2.010  | 0.426  |
|          | Median | 1.301  | 1.180  | 1.559  | -0.379 | 1.490  | 1.256  | 0.783  | 0.473  |

|  |        |       |       |       |  |       |       |       |  |
|--|--------|-------|-------|-------|--|-------|-------|-------|--|
|  | StdDev | 1.597 | 1.833 | 1.583 |  | 0.782 | 0.739 | 0.628 |  |
|--|--------|-------|-------|-------|--|-------|-------|-------|--|

Additionally, companies with strong governance across the sample have an audit and nominating committees, while companies with weak governance drop significantly to 28.7%. Finally, the average percentage of independent directors on the relevant representative committees of the board is higher for companies with strong corporate governance and vice versa. Therefore, the highest score for corporate governance could be 5, but the maximum value found in this sample was 4, with companies with strong governance being significantly more valuable than those with weak governance (mean: 1.042). Overall, the governance quality for the sample was 2,278. The number of companies with strong governance is 16.43%, companies with weak governance represent 45.25% of the sample, and companies with medium-quality corporate governance represent 38.29% of the sample. Paradoxically, the difference between the average strong and weak COE capital has a positive value, meaning that companies with strong governance have higher COE capital. The overall results show that Indian companies have higher corporate governance characteristics (on average) than Pakistani companies.

The results in Table 2 are obtained from the pooled OLS model (2), where a regression of the COE capital is performed on the BETA, SIZE and MB indices, respectively. The results show a moderately positive correlation between BETA and capital COE, while SIZE and MB are negatively correlated with capital COE, which is consistent with previous literature (Fama and French, 1993). Therefore, according to the evaluation criteria of Botosan and Plumlee (2005), the COE capital estimate can be a good representative of the company's COE capital.

**Table 2. Results for Pakistani and Indian Markets**

| Constructs | Pakistan     |         | India        |         | Full sample  |         |
|------------|--------------|---------|--------------|---------|--------------|---------|
|            | Coefficients | P value | Coefficients | P value | Coefficients | P value |
| Intercept  | 2.476        | 0.000   | 2.4765       | 0.067   | 0.3114       | 0.043   |
| Beta       | 0.015        | 0.932   | 0.019        | 0.075   | 0.052        | 0.04    |
| Size       | -0.152       | 0.000   | -0.007       | 0.100   | -0.037       | 0.009   |
| MB         | -0.003       | 0.408   | -0.190       | 0.000   | -0.143       | 0.000   |
| LEV        | -0.111       | 0.235   | -0.184       | 0.131   | -0.109       | 0.039   |
| PB         | 0.133        | 0.457   | -0.377       | 0.114   | -0.163       | 0.239   |
| R-squared  | 0.297        |         | 0.176        |         | 0.251        |         |

Table 2 shows the results obtained from model (2), where a regression of the COE capital is performed on the BETA, SIZE and MB indices, respectively. The results show a moderately positive correlation between BETA and capital COE, while SIZE and MB are negatively correlated with capital COE, which is consistent with previous literature (Fama and French, 1993). Therefore, according to the evaluation criteria of Botosan and Plumlee (2005), the COE capital estimate can be a good representative of the company's COE capital.

The results of Table 2 of Fama and French (1993) for proxy risk capital COE show an R2 of 17.5%, in agreement with Mazzotta and Veltri (2014). In general, the COE estimate is a good indicator of the COE capital of companies in both markets. Before analysis, the Hausman test was used in this study, and the results showed that the fixed effects model was more suitable than the random effects model. The results for the entire sample are shown in table 2. The SIZE risk proxy has an inverse relationship with COE capital, similar to Fraz and Hassan (2016), and the results do not fit the relationship between market risk proxy and COE capital proposed by Fama and French (1993) in the earlier literature. Therefore, according to the Botosan and

Plumlee (2005) rating criteria, the COE capital estimate does not represent a company's COE capital.

Thus, Model (3), a measure of corporate governance (GOVSCORE), is added to Model (2), which is estimated to verify that companies with high-quality governance benefit themselves by reducing the cost of capital after adjusting for risk indicators considered in the study.

$$\dots COE_{it} = \alpha + \beta_1 Beta_{it} + \beta_2 MB_{it} + \beta_3 Size_{it} + \beta_4 GDGOVScore_{it} + \varepsilon_{it} \dots (3)$$

In Model (3), the coefficient  $\beta_4$ , which tests the effect of the independent variable on the dependent variable, is considered the most important. If  $\beta_4$  is significant and less than 0, the value indicates that a higher quality of government is associated with a lower capital COE (CC). Therefore,  $\beta_4$  is expected to be negative and negatively related to corporate governance and COE.

**Table 3. Results for Pakistani and Indian Markets**

| constructs | Pakistan |              | India  |              |
|------------|----------|--------------|--------|--------------|
|            | OLS      | Fixed Effect | OLS    | Fixed Effect |
| Intercept  | 0.265    | 0.469        | 0.694  | 0.353        |
| Beta       | 0.008    | 0.008        | 0.024  | 0.029        |
| Size       | -0.16    | -0.149       | -0.181 | -0.174       |
| MB         | -0.005   | 0.013        | -0.144 | 0.189        |
| DGOVSCORE  | -0.007   | -0.063       | -0.013 | -0.099       |
| R-squared  | 0.419    | 0.395        | 0.469  | 0.428        |

The results in Table 3 illustrate a negative relationship between corporate governance and COE, similar to the proposed hypothesis and Faysal et al. (2021) findings. These results suggest that high-quality governance with low COE capital compares with low-quality governance. In addition, other MB of risk agents were also significantly associated. These results are similar to those of Mazzotta and Veltri (2014). Based on the above discussion, it is not enough that a strong government company listed on the Pakistani market benefits from a low capital COE compared to India. A Hausman test was performed, and the results of the Hausman test were

found to be zero for  $\text{Prob} > \chi^2$ . Based on the results of the fixed effects panel regression above, it can be concluded that in Pakistan and India, firms with stronger governance enjoy lower capital COE than firms with weaker governance. Incoherent with Defond et al. (2005), a dichotomous variable, Distributed Governance Score (DGOVSCORE), is formed to measure the strength of COE level for the firms with higher governance. The DGOVSCORE considers a value of 1 if GOVSCORE for the firm is higher than the sampled median and 0 otherwise.

### Conclusion

As the corporate governance in a firm is intended to minimize and mitigate agency risk and solve problems relevant to the agency, it is hence posited to have a considerable impact on the Cost of Equity for firm. The relationship between COE and GC has been discussed in the previous study (Albuquerque and Wang, 2008). Hence, the quality of corporate governance and its impact on lowering the cost of equity for firm is examined in the current study based on the literature on corporate governance, five prime dimensions of corporate governance, including size of boards, independence of board, dual role of CEO, co-existence of both nomination and audit committees as well as remuneration committee and board committees' individuality (Reverte, 2009). The current study has determined the role of board characteristics in mitigating tensions in the agency and the conflicts among strong insider and minority outsider shareholders that exist due to asymmetric information availability (Allegrini and Greco, 2013; Faysal et al., 2021). These problems arise due to the high use of debt in Asian markets, weak equity, minimal legal protection to minority shareholders, and concentration of ownership in firms in this region. The research has controlled factors known for obvious risk (Fama and French, 1993) and cannot provide strong support for the impact of certain governance dimensions on the cost of equity capital when studied in a synthetic corporate governance index.

The study by Reverte (2009) has described the significant dimensions of corporate governance, and the current study is conducted in companies in India and Pakistan where control of firms is within the family and have a bureaucratic corporate structure with disregard for minority shareholder's interest, these dimensions of CG are implied in the research. Moreover, the results deducted from the effectiveness of independent directors are questionable as it is highly dependent upon the behaviors of directors that cannot be tolerated in the corporate culture of India and Pakistan, which suffused in Confucian values and hence highly focused on humility, respecting other, conformity and tolerance (Miles, 2007) instead of "rock the boat". In addition to these two prominent deductions from the sample of firms selected for evaluation, most of the firms in the samples were found to have weak corporate governance. Firstly, implementing and building strong corporate governance in a firm requires a change in culture along with economic investment, and that culture should be contrasted with the economic benefits of equity capital cost at lower levels.



At the same time, the second prominent reason for weak corporate governance in firms is the unawareness of directors regarding the impact of CG on capital cost when equity is used as a source of capital. This is evident from previous research (Mazzotta and Veltri, 2014; Faysal et al., 202; Fraz and Hassan, 2016).

Comprehensively, current research has indicated the lower cost of equity capital in the presence of higher quality corporate governance in companies, as hypothesized from the literature. Moreover, the findings suggested that conflicts in an agency relationship and asymmetric information among inside shareholders with majority and outsider minority shareholders can be mitigated successfully by the company's board characteristics.

Subsequently, based on the results, various recommendations are presented, including the duality role of CEO in listed companies in India and Pakistan stock markets, where the variable CEO duality is considered to have insufficient capacity regarding the measurement of its impact on COE capital. In contrast, the first, with circular or proportional ownership, provides an opportunity for complete control of the majority groups that do not have a major share. Hence, some of the most appropriate independent determinants in establishing studied relationships include the protection of shareholders' rights and ownership structure. The literature review suggests using one estimated model using PEG ratio, as indicated by Easton (2004), instead of using the residual income valuation model to derive COE capital which is implied by Ahn et al. (2008). While doing further research on corporate governance, additional features and dimensions of CG should be considered to observe their impact on cost of equity capital. A survey should be conducted to find significant additional dimensions of CG, including structure of ownership, role of debt financing using debt to equity ratio and quality of financial information. In addition to this, in rights of shareholders relevant to firms operating in India and Pakistan should also be included. The intervention of control variables, such as risk proxies, should be considered while establishing a relationship between COE capital and corporate governance in future research. Another suggestion for future research is using the weighted average cost of capital as a measure of COE capital, which is much more comprehensive or using different ex-ante models to evaluate COE. Additional research can be conducted to investigate the correlation among debt cost, corporate governance and cost of equity capital (Alali et al. 2012). Suggestions regarding the theoretical implications, including the development of quantitative model to study corporate governance and COE, are presented for future research (Elsayed, 2011).

The conclusion drawn from the current research is of significant importance for boards of corporations, including board members of the company and legislative bodies that can use these findings to enhance company performance due to its positive link to corporate governance. Security exchange commissions in emerging markets of India and Pakistan should be the final authority for providing mandatory direction for companies, despite researchers providing important and mandatory corporate governance regulations practices through various research. The current study has suggested various measures for improving corporate governance,

including enhancement of committees and board independence in the company along with the increased composition of non-executive directors. Hence, both India and Pakistan's markets should focus on establishing a corporate governance model. These models should also reflect corporate governance policies in lieu of both regions' political and economic frameworks and social and cultural elements.

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## **ZWIĄZEK MIĘDZY NADZOREM KORPORACYJNYM A KOSZTEM KAPITAŁU WŁASNEGO**

**Streszczenie:** Planowanie strategiczne firm jest w dużym stopniu uzależnione od inwestycji kapitałowych, a praktyki nadzoru korporacyjnego w firmach odgrywają kluczową rolę w dążeniu do inwestowania przy ograniczeniu ryzyka. Dwa wschodzące rynki giełdowe, Indie (NSE) i Pakistan (PSX), zostały wybrane do zbadania powiązań kosztów kapitału własnego z ładem korporacyjnym. Dlatego też głównym celem badania jest poznanie



związku między nadzorem korporacyjnym a kosztem kapitału własnego oraz sposobów, które mogą być pomocne firmom w ograniczaniu ryzyka. Dane zbierane są od 260 firm z branży chemicznej i farmaceutycznej w latach 2011-2020. Wymiary stosowane do pomiaru wskaźnika nadzoru korporacyjnego obejmują istnienie komitetów, wielkość i skład zarządu, strukturę własności oraz dualizm CEO. Do oszacowania współczynnika dotyczącego danych zebranych od firm zastosowano model regresji puli OLS (fixed effect). Wyniki badania pozwoliły na porównanie firm o silnym i słabym nadzorze korporacyjnym i wskazują na wyższy koszt kapitału własnego dla firm o słabym łańdże korporacyjnym w porównaniu z innymi. Wykorzystanie wskaźnika PEG do oszacowania kosztu kapitału własnego jest uważane za najbardziej odpowiednie dla krajów rozwiniętych i jest stosowana w niniejszym badaniu. Głównym wkładem badania jest wykorzystanie danych z różnych krajów do przeprowadzenia wstępnego badania relacji pomiędzy kosztami kapitału własnego a nadzorem korporacyjnym. Wyniki badań mają duże znaczenie dla rozwoju i wzmocnienia struktury ładu korporacyjnego w spółkach oraz zapewnienia ochrony interesów akcjonariuszy. W obecnym artykule przedstawiono implikacje zarządcze i sugestie dla decydentów i akcjonariuszy, które w zamian mogą zwiększyć pewność na rynku.

**Słowa kluczowe:** koszt kapitału własnego (COE), nadzór korporacyjny (CG), rynki wschodzące (EM), wskaźnik ceny do wartości księgowej (MB), wyniki organizacji (OP)

### 公司治理与股权资本成本的关系

**摘要:** 企业的战略规划高度依赖于资本投资，而企业的公司治理实践在寻求投资的过程中起到了至关重要的作用，并能降低风险。我们选择了两个新兴的股票市场，印度（NSE）和巴基斯坦（PSX），来研究股权资本成本与公司治理的联系。因此，本研究的主要目的是找出公司治理和股权资本成本之间的关系，以及有助于公司降低风险的方法。数据收集自 2011 年至 2020 年化工和制药行业的 260 家公司。用来衡量公司治理指数的维度包括委员会的存在、董事会的规模和组成、所有权结构和 CEO 的双重性。汇总的 OLS（固定效应）回归模型已被应用于估计有关从公司收集的数据的系数。研究结果对具有强势和弱势公司治理的公司进行了比较，并得出结论，与其他公司相比，具有弱势公司治理的公司的股权资本成本更高。使用 PEG 比率来估计股权资本成本的模式被认为是最适合发达国家的，并在目前的研究中得到了应用。本研究的主要贡献是利用跨国数据对股权资本成本与公司治理之间的关系进行了初步调查。研究结果对于发展和加强公司的公司治理结构以及为股东的利益提供保护有很大的意义。本文为政策制定者和股东提出了管理方面的影响和建议，而这些影响和建议反过来可能会促进市场的保证

**关键词：**股本成本（COE）、公司治理（CG）、新兴市场（EM）、市账率（MB）、组织绩效（OP