THE EFFECT OF CORPORATE GOVERNANCE ON THE COST OF DEBT CAPITAL

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DEDICATION

This work is dedicated to my wife, Farahnaz and my son Aidin for their support and unconditional love.

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ABSTRACT

Agency theory predicts that corporate governance (CG) and audit quality (AQ) enhance the convergence of interests between shareholders and managers and enable investors and lenders to have better perception on the optimum level of cost of debt capital. However, there is a lack of studies that investigate this issue in the emerging markets, particularly in Malaysia. Therefore, this research is conducted to investigate the relationship between internal monitoring characteristics of board of director and audit committee relating to the size, independence, financial expertise, frequency of meeting, ethnicity and education of directors and ethnicity of chairperson, and AQ as proxies by audit fees, non-audit service fees and industry specialist auditor, as external monitoring on the cost of debt capital. This study reports the results of multivariate analysis on dataset that were obtained from the Bursa Malaysia, DataStream, Bloomberg and annual reports of firms between 2003 and 2012. The empirical results of this study indicate that larger size and independent non-executive directors with less frequent directors' meeting, ethnicity of Malay directors on the board, larger size and more frequent meeting of audit committee have significant effects on reducing the agency problem with internal monitoring function. These lead to a reduction in the cost of raising fund from lenders in capital market. The results also indicate that hiring industry specialist auditors and using non-audit services of external auditors have remarkable influence on reducing the information asymmetry with external monitoring function, which help to lower the cost of debt capital in the capital market. Findings are consistent with the agency theory, signaling theory and cultural theory, whereby internal and external CG mechanisms are associated with effective monitoring, which in turn helps to lower information asymmetry and agency problem in capital markets and consequently increases potential investors and lenders. The findings are of potential interest to policy makers, board members, audit committee members and external auditors.

ABSTRAK

Teori agensi meramalkan tadbir urus korporat (CG) dan kualiti audit (AQ) mempertingkatkan penyatuan antara kepentingan pemegang saham dengan kepentingan pengurus serta memperbaiki persepsi pelabur dan pemberi pinjaman tentang aras kos modal hutang yang optimum. Namun, tidak banyak kajian dilakukan untuk mengkaji isu ini dalam pasaran yang semakin berkembang, khususnya di Malaysia. Oleh sebab itu, kajian ini dijalankan untuk meneliti hubungan antara ciri-ciri pemantauan dalaman lembaga pengarah dan jawatankuasa audit dalam hal yang berkaitan dengan saiz, ketakbersandaran, kepakaran kewangan, kekerapan mesyuarat, etnik dan pendidikan pengarah dan etnik pengerusi, dan AQ yang diproksi oleh fi audit, fi perkhidmatan bukan audit dan juruaudit pakar industri, sebagai pemantauan luaran bagi kos modal hutang. Penyelidikan ini melaporkan keputusan analisis multivariat bagi set data yang diperoleh daripada Bursa Malaysia, DataStream, Bloomberg dan laporan tahunan syarikat dari tahun 2003 hingga tahun 2012. Keputusan empirikal daripada kajian ini menunjukkan pengarah bukan eksekutif dengan bilangan ahli yang lebih besar dan bebas serta menjalankan mesyuarat pengarah dengan kurang kerap, lembaga pengarah beretnik Melayu, jawatankuasa audit dengan bilangan ahli yang lebih besar dan menjalankan mesyuarat dengan lebih kerap mempunyai kesan ketara dalam mengurangkan masalah agensi dengan fungsi pemantauan dalaman. Hal ini membawa kepada pengurangan kos bagi mendapatkan pembiayaan daripada pemberi pinjaman dalam pasaran modal. Keputusan ini juga menunjukkan bahawa pengambilan juruaudit pakar industri dan penggunaan perkhidmatan bukan audit daripada juruaudit luar mempunyai kesan yang ketara dalam mengurangkan maklumat yang tidak bersimetri dengan fungsi pemantauan luaran, yang seterusnya membantu mengurangkan kos modal hutang dalam pasaran modal. Dapatan ini konsisten dengan teori agensi, teori isyarat dan teori budaya, iaitu mekanisme CG dalaman dan luaran berkait rapat dengan pemantauan berkesan yang seterusnya membantu mengurangkan keasimetrian maklumat dan masalah agensi dalam pasaran modal lalu menambahkan bilangan bakal pelabur dan peminjam. Dapatan ini mungkin penting kepada penggubal dasar, ahli lembaga pengarah, ahli jawatankuasa audit dan juruaudit luar.

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LIST OF ABBREVIATIONS

ACCA	-	Association of Chartered Certified Accountants
ASEM	-	Alternative Securities Market
BMSE	-	Bursa Malaysia Stock Exchange
CA	-	Companies Act
CMP	-	Capital Market Master Plan
CIMA	-	Chartered Institute of Management Accountants
CFA	-	Chartered Financial Analyst
CPA	-	Certified Public Accountant
CAPM	-	Capital Asset Pricing Model
CG	-	Corporate Governance
CODC	-	Cost of Debt Capital
FSMP	-	Financial Sector Master Plan
KLSE	-	Kuala Lumpur Stock Exchange
KCGS	-	Korean Corporate Governance Service
MCCG	-	Malaysian Code on Corporate Governance
MICG	-	Malaysian Institute of Corporate Governance
MSWG	-	Minority Shareholders Watchdog Group
OLS	-	Ordinary Least Squares
NEP	-	New Economic Policy
NEDs	-	Non-Executive Directors
NASD	-	National Association of Security Dealers
NYSE	-	New York Stock Exchange
NASD	-	National Association of Corporate Directors
SEC	-	Securities and Exchange Commission
SC	-	Securities Commission
SMEs	-	Small and Medium Sized Enterprises
TSE	-	Toronto Stock Exchange

VP	-	Vice President
VIF	-	Variance Inflation Factor

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CHAPTER 1

INTRODUCTION

1.1 Overview

This chapter provides study outline, which is comprised of eleven sections: Section 1.2 provides the research background. Section 1.3 discusses the problem statements, while sections 1.4, 1.5, and 1.6 focus on the research questions, the research objectives, and the significance and contributions of the study. Section 1.7 highlights the scope of the study. Sections 1.8, 1.9, 1.0 and 1.11 methodologies, limitation of study, thesis outline, and the terminology used.

1.2 Background of Research

Cost of debt is one of the burdens a company can be exposed to as it raises debt ; this cost is reflected in the interest charged on the money borrowed, which is the amount of money the company pays for the privilege of using borrowed money to run or expand its business. It represent the interest that is paid on bank loans, bond options, and similar types of financial transactions (Ertugrul and Hegde, 2008). According to Abdulhafedh (2006), firms finance their activities using funds from debt and equity; however, most successful companies depend on debt more than equity fund. It is documented that the value of borrowing is much greater than equity funding only from its owners and companies with mixed financing (internally and externally) as having more weight in the marketplace than companies funded by owners. So, it has been argued that a healthy financial structure must consist of mix debt and equity leading to a lower weighted average cost of capital (Keown *et al.*, 2001). However, the importance of debt as a source of funding for companies needs to be approached carefully because excessive debt could affect companies' riskiness which would eventually negatively affect the shareholders wealth (Ertugrul and Hegde, 2008).

It is well recognized that cost of debts is considered an important issue for all companies due to several reasons. Firstly, companies can manage their finance effectively when they obtain the best interest rate. Secondly, calculating the cost of debt capital as it applies to incurring more debt can assist companies to weigh the benefits of the potential action with the liabilities. Finally, evaluating properly the cost of debt will assist companies to determine effectively on whether to issue a bond to finance upcoming projects or not (Warga and Welch, 1993). Bhojraj and Sengupta (2003) indicate that companies can get low cost debts through a reduction in default risk due to reduced agency problems and improved monitoring of managerial actions when companies have stronger corporate governance.

The number of accounting scandals in North America and Europe has increased between 1990 and the start of the 21st century. This period of time saw accounting fraud committed by organizations such as Enron, HealthSouth, Xerox, Parmalat, WorldCom, and Tyco (Njuguna and Moronge, 2013). These scandals have brought to light the importance of monitoring systems such as corporate governance (CG). CG does not directly impact the performance of a corporation nor does it directly influence the organization's cost of raising funds. Instead, CG suggests solutions for agency problems that combines the interests of management and that of shareholders (Demsetz and Lehn, 1985). The effectiveness of using CG as a monitoring system was confirmed by Gul and Tsui (2001). Jensen and Meckling (1976) and Shleifer and Vishny (1997) pointed out that there may be conflicts between the interests of management and shareholders when management roles are separated from that of shareholders. Therefore, different internal and external mechanisms have been considered via CG to prevent agency conflicts as well as to reduce costs associated with such agency.

CG mechanisms are classified into internal and external mechanism. The internal mechanisms include board of directors, audit committee, institutional shareholders, insider ownership, and dividend policy. Meanwhile, external mechanisms include takeover, product market competition, external auditors, managing labour market, mutual monitoring by managers, and the legal environment (Farinha, 2003). Regulators around the world are increasingly looking to set standards or codes of best practice for CG to attract more capital or foreign investment to the country (Agrawal and Chadha, 2005). For example, following the Sarbanes-Oxley Act (SOX, 2002), the New York Stock Exchange (NYSE) and National Association of Corporate Directors (NASD) proposed a new corporate governance listing-standard, which was approved by Securities and Exchange Commission (SEC) on November 4, 2003. The new listing standards include provisions regarding board structure, audit committee composition and responsibilities, and other CG matters.

Consistent with other countries, Malaysia encourages listed firms to follow the best practices of CG. Two important governance internal mechanisms discussed in the Malaysian Code on Corporate Governance (MCCG) are board of directors and audit committee, consistent with their significant role in overseeing the financial reporting process (Yatim *et al.*, 2006). One of the important elements of internal CG mechanisms is the board of directors (Fama and Jensen, 1983b). As capital structure decisions are influenced by managers who prefer to have debt rather than equity financing (Myers, 2001), the board of directors serves as an important mechanism for monitoring management decisions (Shamsher and Zulkarnain, 2011).

The board's primary function is to protect the shareholders' interests. According to Limpaphayom and Connelly (2006), the role of board of directors in overseeing management is needed to check on management and to make sure that the management has complied with all rules. Of special relevance to this research is that board of directors' characteristics such as board size, board independence, board meetings, financial expertise board and others are argued to play a role in influencing cost of debts (Anderson *et al.*, 2004; El Dahrawy *et al.*, 2015; Ertugrul and Hegde, 2008; Pham *et al.*, 2012).

The audit committee is a sub-committee of the board of directors, which assumes some of the board's responsibilities (Menon and Deahl Williams, 1994). The main functions of an audit committee are to assume the responsibility of appointing the external auditor, meet regularly with the external and internal auditors to review the financial statements, audit process and internal controls of the firm (Al-Mamun *et al.*, 2014; Yassin and Nelson, 2012). This helps to lessen agency problems by the timely release of unbiased accounting information by managers to shareholders and others who rely on (Al-Mamun *et al.*, 2014). Existence of audit committee is considered while making investment in company. Hence, with the wide adoption of the audit committee scholars suggests that the audit committee is an important element of the system of CG (Anderson *et al.*, 2004; Karamanou and Vafeas, 2005; Mangena and Pike, 2005; Yassin and Nelson, 2012). As widely recognized, the duties of the audit committees have been related to internal audit see for example (Raghunandan *et al.*, 2001; Yassin and Nelson, 2012), financial reporting (Song and Windram, 2004), and external auditor (Archambeault and DeZoort, 2001; Carcello and Neal, 2003). These three interrelated duties are discharged to audit committees to ensure that financial statements and external filings fairly represent the financial results of the company and to enable independent verification of the efficiency of systems and controls.

External auditors are one of the important external CG mechanisms. External audits focus on aligning the interests of both managers and shareholders while reducing the possibility of information asymmetry in the capital markets. According to Cohen et al (2007), an auditor is responsible for the reliability of financial reports in situations where the audit committee is symbolic but may retain the power to question management. The effectiveness of an external auditor lies in their ability to produce pertinent and dependable financial information that can be used to create accurate financial reports (Raedy and Helms, 2002). DeFond et al. (2005) claim that the importance of role played by independent external auditors has been highlighted by the accounting scandals of the last twenty years and their association to the monitoring role of CG.

Companies with quality information and lower information asymmetry attract more investors, which encourages the market to further discount the company's future earnings thus improving its current value and gains for current investors. The most common proxies for a company's value are its market and accounting performance. However, a new concept is emerging that assesses an organization's value based on its capacity to profit from lower cost of raising fund provided by the dynamic mechanisms of CG (Donker and Zahir, 2008).

Several researchers have documented that poor internal monitoring (board of directors and audit committees) and external monitoring (the quality of the audits conducted by external auditors) lead to increased information asymmetry, agency problems, and a higher cost of debt capital (Bliss and Gul, 2012; El Dahrawy *et al.*, 2015; Kim *et al.*, 2011; Koerniadi and Tourani-Rad, 2011; Pham *et al.*, 2012; Soha, 2011). On the other hand, reductions in information asymmetry and agency problems result in decreased cost of debt capital in the capital market. Sound CG monitors managerial practice in dealing with debt financing. In its absence the cost of debt goes up and firms with high cost of raising fund decrease the rate of return to lenders and investors, which in turn unfavorably affect public confidence in the reliability of corporate reporting in capital market (El Dahrawy *et al.*, 2015; Koerniadi and Tourani-Rad, 2011; Pham *et al.*, 2012).

These claims show the significant role played by internal and external monitoring in investment decisions made by investors and lenders in the capital market. This study claims that companies with strong internal monitoring mechanisms consisting of boards of directors, audit committees, and external monitoring in the form of high quality external auditors will lower the cost of raising fund from lenders (debt) in capital market. In contrast, firms with poor internal and external CG monitoring are likely to engage in more cost of raising fund from lenders that often disregarding the interests of both the owners and the debt holders. This requires the participation of key players in CG systems, especially local CG systems such as the Bursa Malaysia, Securities Commission (SC), corporate boards, corporate advisors, auditors, and management to prevent further accounting scandals and restore the confidence of investors and lenders.

Board of directors characteristics, audit committee characteristics and quality of the audits conducted by external auditors are CG tools. They act as control mechanism to lower of agency problem and information asymmetry in capital market. Research on cost of debt and CG has been dominated by studies on developed countries. There is an increasing awareness that theories validated by research on developed countries such as the USA and the UK may have limited applicability to emerging markets. Emerging markets have different characteristics such as different political, economic and institutional conditions, which may limit the application of theoretical models used to explain behavior in developed markets. Malaysia as an emerging market provides an excellent setting for the study of the impact of CG. It differs from developed countries in respect of various institutional characteristics such as stronger political connections (Gul, 2006), significant government, family ownership of firms (Lemmon and Lins, 2003) and concentrated ownership (Claessens et al., 2000). In more general terms, Malaysia provides a setting for robust examination of the role of internal and external CG on lower of cost of debt in capital market. The next section discusses the problem statements presented in this thesis.

1.3 Problem Statements

Firms finance their activities using a combination of debt and equity capital. However, most successful companies depend on debt more than equity fund (Abdulhafedh, 2006; Ertugrul and Hegde, 2008). It has also been argued that a healthy financial structure must consist of a mix of debt and equity that may lead to a lower weighted average cost of capital (Keown *et al.*, 2001). However, the importance of debt as a source of funding for companies should be approached carefully, because excessive debt could affect companies' results, which would eventually affect the shareholders wealth (Ertugrul and Hegde, 2008).

CG mechanisms are a way to protect the shareholders and lenders interest. Firms with stronger CG are expected to get external fund. The theoretical foundation for the relationship between CG and cost of debt capital in this study is provided by the agency theory. The core of the agency theory is to resolve conflicts resulting from the separation of ownership and management control of corporate resources (Fama and Jensen, 1983b; Jensen, 1986). The existence of such conflicts of interest between owners and managers may affect the monitoring over company activity and information, which may consequently, increase the cost of raising fund in capital markets. Therefore, to control the conflict of interests and reduce agency costs, various internal and external tools, known as CG, have been suggested.

A review of literature indicated that the quality and implementation of CG influences the cost of debt capital because high quality audits conducted by external auditors and the best practices of CG boost the confidence of managers, investors and lenders when making investment decisions. By contrast, as agency problems and information asymmetry increases, investors claim higher cost of debt capital because of the associated risks. On the other hand, the literature shows that poor quality external audit and weak CG leads to increased information asymmetry and agency problems, which ultimately leads to a higher cost of debt capital (Aldamen *et al.*, 2010; Ashbaugh-Skaife and LaFond, 2006; Bhojraj and Sengupta, 2003; Bin-Sariman *et al.*, 2015; Cornaggia *et al.*, 2015; Huguet and Gandía, 2014; Kholbadalov, 2012; Lou and Vasvari, 2009).

Remarkably, most of the recently published research regarding CG and cost debt capital has focused primarily on U.S. and UK companies and other developed countries, with less attention being devoted to companies in emerging markets. Furthermore, most of the prior studies relating to internal CG and cost of debt capital have concentrated on ownership structures, voting rights, shareholder rights, and anti-takeover factors (Ashbaugh *et al.*, 2004; Cheng *et al.*, 2006; Farooq and Derrabi, 2012; Klock *et al.*, 2005; Regalli and Soana, 2012). Additionally, a review of the CG literature revealed that other important attributes can impact the perception of monitoring mechanisms held by shareholders and lenders because these attributes played a role in reducing information asymmetry and agency problems in the capital markets and consequently reduced cost of raising fund form lenders (debt) (Anderson *et al.*, 2004; Cornaggia *et al.*, 2015; El Dahrawy *et al.*, 2015; Paige Fields *et al.*, 2012; Upadhyay and Sriram, 2011). These attributes are classified as the effectiveness of the board of director and the effectiveness of audit committee. This includes internal monitoring by a boards of directors (Fama, 1980; Fama and Jensen, 1983b) and audit committees (Pincus *et al.*, 1990). However, little attention has been devoted to investigate the association between board of directors and audit committee characteristics (as a governance mechanism) and cost of debt capital particularly in emerging market such as Malaysia.

The Malaysia Code of Corporate Governance (MCCG) (2007 and 2012) for listed companies consider the role of board of directors to be an important mechanism for governance which protects investors from defaults and agency costs that company face when involve in financial transactions such as loans and others. Fama and Jensen (1983b) indicated that board of directors is one of the important mechanisms in internal CG mechanisms. Therefore, Klapper and Love (2004) argue that board of directors' effectiveness lead to the protection of investors and lenders from the risks exposed as a result of borrowing from financial institutions, examples include defaults and increasing the cost of debt. Furthermore, Paige Fields et al. (2012) argue that board effectiveness may cause banks to have greater faith in internal governance mechanisms and thus reduce borrowing costs. More generally, the quality of the board may have a substantial impact on the cost of debt capital. Rajan (1992) argues that high quality boards, by better governance, may complement the monitoring role of banks and thus reduce the costs.

The widespread use of audit committees and a quick glance at CG guidelines (MCCG, 2007 and 2012) highlights the importance placed on the role of appropriately constituted audit committee in monitoring the financial reporting process. Various regulatory committees reports (BRC, 1999; Committee, 1992) have recommended that a number of characteristics are important for an audit committee to perform its role competently and effectively. The combination of mechanisms can be considered better to reduce the agency problem and information asymmetry because a particular mechanism's effectiveness depends on the effectiveness of others (Rediker and Seth, 1995). Audit committee characteristics, such as independence, financial expertise, size and meetings are a measurement of its effectiveness (Karamanou and Vafeas, 2005; Mangena and Pike, 2005). However, DeZoort et al. (2002) argue that the audit committee effectiveness framework could increase considerably if audit committee characteristics are studied together.

This study suggests that an increase of the characteristics that enhance the board and audit committee effectiveness leads to a decrease of the level of information asymmetry and agency problem in capital market. Few studies have investigated the relationship between board of directors, audit committee characteristics and cost of debt by focusing on the impact of board independence, size, board ownership, audit committee size and independence (Adam *et al.*, 2015; Anderson *et al.*, 2004; Ashbaugh-Skaife *et al.*, 2006; Ertugrul and Hegde, 2008; Paige Fields *et al.*, 2012; Rahaman and Zaman, 2013; Tanaka, 2014).

Most prior studies provided inconclusive or mixed results regarding the impact of CG and the cost of debt capital. Leaving the question of the impact of board and audit committee on cost of debt capital unanswered. Furthermore MCCG (2007 and 2012) consider the role of board of directors and audit committee to be a significant mechanism for governance which protects investors in capital market. Hence, this study aims to address this theoretical gap in the accounting literature and attempted to explore the relationship between board of directors characteristics namely size, independence, meeting, financial expertise and audit committee characteristics namely size, independence, meeting, financial expertise with the cost of debt by using sample of companies listed on the Malaysia capital markets.

Prior studies on the cost of debt capital used governance indices to measure the effectiveness of the CG of company (Adam *et al.*, 2015; Ashbaugh-Skaife *et al.*, 2006; Bin-Sariman *et al.*, 2015; Chu *et al.*, 2009; Paligorova and Yang, 2011; Zhu, 2012). Bhagat et al. (2008) and Jiraporn and Chintrakarn (2009) claimed the governance indices have a serious weakness because some indices assign equal weights to all governance provisions included in the construction of the index. Some governance provisions may exacerbate managerial entrenchment, there is strong empirical evidence that staggered boards have more influence than any other governance provision (Jiraporn and Chintrakarn, 2009). Hence, this study aims to address this gap in the accounting literature as it concentrates on the single CG characteristic, in order to capture the association between the board of directors and audit committees characteristic and cost of debt capital.

The Malaysian capital market contains a unique corporate environment as its economy offers clearly identifiable capital segments divided along ethnic lines (Jesudason, 1989). After independence from the British in 1957, the government introduced the New Economic Policy (NEP) that gradually added Bumiputras to the Malaysian capital market (Jow *et al.*, 2007). The presence of clearly recognizable ethnic domination of board membership and ownership of Malaysian listed companies provides evidence of monitoring differences that exist in these companies (Jow *et al.*, 2007). Similarly, Chuah (1995) claimed that the minds of Malaysian managers are influenced by ethnicity, education, and the type of organizations they work for.

In a study conducted by Archambault and Archambault (2003) companies in countries with a higher number of Muslim people had more transparent annual reports that reduced information asymmetry between companies and investors. According to Mohd Ghazali (2004) and Haniffa and Cooke (2002), there is a significant relationship between the number of directors in a board who are Malay and voluntary disclosure in annual reports. They found that Malaysian companies dominated by Malay directors have higher levels of voluntary disclosure, which is consistent with Islamic business ethics that encourage business transparency. Using the best practices of CG reduces information asymmetry and agency problems in capital market by encouraging high levels of transparency. A reduction of information asymmetry in capital market indirectly decreases the cost of raising fund from lenders. Prior studies have revealed that cultural characteristics such as ethnicity and education influences business processes, including disclosure, transparency, corporate social reporting, accounting conservatism, financial reporting quality, and earnings management, (Haniffa and Cooke, 2005; Haniffa and Cooke, 2002; Hashim, 2012; Rahman and Ali, 2006; Stulz and Williamson, 2003; Tosi and Greckhamer, 2004; Yunos *et al.*, 2012). Currently, there is lack of empirical evidence regarding the influence of the ethnicity and education of corporate board members on the cost of debt capital. This is the first study that used ethnicity and education of corporate board for lowering agency problem in line of raising fund from lenders (debt). This study proposes that ethnicity and education of directors on the board enhance the transparency of company information, consequently leads to decrease of the level of information asymmetry and agency problem in capital market. Hence, this study addressed this theoretical gap by examining the effect of ethnicity and education of board and cost of debt capital as a bundle of board of director's characteristic in protecting lenders' interests in capital market.

Audit quality of external auditors is another way to protect the lenders interest in capital market. The theoretical foundation of the relationship between audit quality and cost of debt capital in this study was provided by the signaling theory. Fundamental concern of signaling theory is the reduction information in capital market (Spence, 2002). Signaling theory highlights the problems related to the information asymmetry in the markets. This theory presents how this information asymmetry can be lowered by the side with more information signaling to the other side (signaler and receiver). Hence, to decrease of information asymmetry in capital market, such external tools, known as audit quality of external auditors have been suggested. Recently, regulatory emphasis has been placed on the requirements for independent external auditors, the extent of the consultancy services, the non-audit services provided to audit customers, and use of the industry specialist auditors. The strong industry-specific knowledge offered by industry specialist auditor is expected to contribute to higher quality audits, more accurate financial information, and reduce information asymmetry in capital markets (Amir *et al.,* 2010; Dhaliwal *et al.*, 2008; Li *et al.*, 2010). Similarly, prior studies found that higher expensive audit fees were related to better monitoring (Elitzur and Falk, 1996; Hoitash *et al.*, 2007).

Most of the prior studies relating to audit quality and the cost of debt capital have concentrated on the size of the audit company, audit opinions, audit tenure, and Big 4 and non-Big 4 auditors (Hwang *et al.*, 2008; Karjalainen, 2011; Lai, 2011; Lou and Vasvari, 2009). Despite all the work done, substantial empirical evidence is still lacking and the many inconclusive and varying results leave the question of the association between audit quality proxies by (non-audit services, audit fees, and industry specialist auditors) and the cost of debt capital still unanswered. Therefore, in terms of audit quality, the current literature only offers a partial concern of audit quality conducted by external auditors. Moreover, there is a lack in the studies of the potential effect of audit quality on the cost of debt capital. Hence, this study aims to address this theoretical gap in the accounting literature as it concentrated on the association between non-audit services, audit fees, and industry specialist auditors as proxies of audit quality and the cost of debt capital.

1.4 Research Questions

Based on the problem statements discussed above, the objective of this study was to answers to the research questions listed below:

RQ1: Do board of directors characteristics (including: size, independence, financial expertise, meetings, ethnicity of directors and chairperson and education) affect the cost debt capital in Malaysian companies?

RQ2: Do audit committees characteristics (including: size, independence, financial expertise and meetings) influence the cost debt capital in Malaysian companies?

RQ3: Does audit quality proxies (including: audit fees, non-audit fees and industry specialist auditors) conducted by external auditors have significant effect on the cost of debt capital Malaysian companies?

1.5 Research Objectives

The objectives of this study were classified into three main objectives, which were derived from the research questions mentioned in the previous section:

RO1: To assess whether board of directors characteristics (including: size, independence, financial expertise, meetings, ethnicity of directors and chairperson and education) have a significant effect on the cost of debt capital.

RO2: To investigate the effect of audit committee characteristics (including: size, independence, financial expertise and meetings) on the cost of debt capital.

RO3: To examine whether audit quality proxies (including: audit fees, non-audit fees and industry specialist auditors) conducted by external auditors have a significant influence on cost of debt capital.

1.6 Significance and Contributions of the Study

This study suggested that the cost of raising funds from lenders (debt) in capital market depends on CG monitoring mechanisms. CG monitoring mechanisms are related to internal CG mechanisms including board of directors, audit committees, and the quality of the audits conducted by external auditors as external mechanism. This study contributed to the existing body of knowledge by filling in gaps in the financial and accounting literature by evaluating the association between internal CG characteristics and audit quality proxies on the cost of debt capital. The empirical findings revealed that large boards with independent non-executive directors that met infrequently, the ethnicity of the directors on the board, and larger audit committees that met frequently, significantly reduced agency problems related to internal monitoring functions. These effective monitoring reduce the cost of raising fund from lenders (debt) in the capital market. The results also indicates that hiring industry specialist auditors and using the non-audit services of external auditors significantly reduced information asymmetry connected to external monitoring functions, which helped to lower the cost of debt capital in the capital market.

This study contributes to knowledge in several ways:

First, this study contributed to the existing body of knowledge by responding to the lack of finance and accounting literature by assessing the association between audit quality using external auditor proxies such as audit fees, non-audit services, and industry specialist auditors, and the cost of debt capital. No previous studies have examined the relationship between audit quality using these external auditor's proxies and the cost of debt capital in Malaysia context. Currently, more regulatory emphasis has been placed on the requirement for independent external auditors, the extent of the consultancy services they offer, the non-audit services provided to audit customers, and the use of the industry specialist auditors. The strong industry specific knowledge of the industry audit specialists contributes to a better quality audits, more accurate financial information, and better monitoring, all of which reduce information asymmetry (Amir *et al.*, 2010; de Fuentes and Sierra, 2015; Dhaliwal *et al.*, 2008; Fernando *et al.*, 2010; Hajiha and Sobhani, 2012; Hope *et al.*, 2009; Li *et al.*, 2010). Better monitoring by auditors allows investors to forgo their own costly monitoring actions used to reduce the risk of expropriation by managers. The investigation of Malaysia companies expanded existing knowledge by providing evidence from external CG practices, different institutional settings, and litigation each of which encourage quality in the audit market. This study's findings contributed to signaling theory by providing evidence that higher audit quality is associated with lower cost of debt capital.

Second, this study was a pioneer study, as there are no studies that examined the effect of the cultural characteristics, specifically the ethnicity and education, of board members in a multicultural country such as Malaysia on the cost of debt capital. Previous studies have emphasized the effect of ethnicity and business processes, including disclosure, transparency, corporate social reporting, accounting conservatism, financial reporting quality and earnings management (Haniffa and Cooke, 2005; Haniffa and Cooke, 2002; Hashim, 2012; Rahman and Ali, 2006; Stulz and Williamson, 2003; Tosi and Greckhamer, 2004; Yunos *et al.*, 2012). The results of this study contribute to cultural theory by revealing the increase of transparency and disclosure of information directly in Malaysian companies. Consequently, the results of this study can be used to decrease the cost of debt indirectly in the capital markets. The results of this study can also be used to improve information asymmetry in capital market, increase investment, and lower the cost of raising fund from lenders (debt) in capital market by increasing transparency and disclosure.

Third, this study also contributed to the growing body of literature related to internal CG characteristics and cost of debt. As stated earlier, prior research in these areas has focused on developed countries that have different legal and institutional environments and governance structures (Bradley and Chen, 2011; Gul *et al.*, 2010; Hann *et al.*, 2013; Huang and Wu, 2010; Paige Fields *et al.*, 2012; Rahaman and Zaman, 2013; Upadhyay and Sriram, 2011). For example, some of these studies were conducted in the United States (Attig *et al.*, 2012; Paligorova and Yang, 2011; Pham *et al.*, 2012) and Australia. The results of these studies are limited and cannot be generalized to other countries. The results of this study contributed to agency theory by showing how increased internal monitoring by a board of directors and audit committees enhances shareholder confidence in the capital market by reducing agency problems.

Fourth, many past studies related to CG and the cost of debt capital have concentrated on ownership structure, voting rights, shareholder rights, anti-takeover strategies, and institutional block holders (Farooq and Derrabi, 2012; Klock *et al.*, 2005; Pham *et al.*, 2012; Piot and Missonier-Piera, 2007). Additionally, a review of the CG literature reveals that there are other important attributes that can affect the perception held by lenders of monitoring mechanisms and their role in reducing information asymmetry and agency problems in the capital markets. These attributes are representing in CG by the effectiveness of the board of directors and the audit committee. CG attributes that have an effect on reducing of the cost of raising funds from lenders (debt) include internal monitoring by a board of directors (Fama, 1980; Fama and Jensen, 1983b), and audit committees (Pincus *et al.*, 1990).

Fifth, Malaysian CG codes have undergone a long process of amendments and enhancements to reach the current set of codes. The revisions made to the MCCG in 2007 and 2012 emphasized the responsibilities, functions, and role of the board of directors, audit committee, and internal audit processes. Nevertheless, the effect of CG characteristics such as the board of directors and audit committee characteristics on the cost of debt capital has not been tested empirically in Malaysia. This study is a pioneer study that assessed the effect of internal CG mechanisms such as characteristic of an effective board of directors (size, independent, meeting, financial expertise) and audit committee (size, independent, meeting, financial expertise) on the debt in emerging capital market such as Malaysia. The findings from this study contribute to agency theory by supporting the growth of internal monitoring mechanisms that improve confidence in the capital markets.

Sixth, this study also contributed to the practice as the findings of this study have implications for managers of companies and individuals as well as institutional investors, regulators, and corporate directors. This study demonstrated to managers who are in charge of investor relations and other parties the advantages and costs of the best practices of CG.

Seventh, this present study contributed to methodology literature by considering and using synthetic rating estimation methods as a proxy of cost debt capital as an alternative to playing the role of a ratings agency and assigning a rating to a company based on its financial ratios (synthetic ratings). To overcome the lack of rating information for Malaysia agencies, this study used the synthetic rating estimation method proposed by Damodaran (2002) as a proxy of cost debt capital. Table 1.1 provides a summary of this study.

Table 1.1: Summary of this Research

Research Gap	RQ 1	Findings	Conclusion	Contribution	Implication
-A lack of studies related to the relationship between board of director's characteristics and the cost of debt capital due to the mixed and inconclusive results of previous studies. -No previous studies examined the effect of board of director's characteristics on the cost of debt capital in Malaysian. -No previous studies examined the impact ethnicity and education of the directors on the board on cost of debt capital.	Do board of directors characteristics (including: size, independence, financial expertise, meetings, ethnicity of directors and chairperson and education) affect the cost debt capital in Malaysian companies?	-Board size, independent non-executive directors, and the ethnicity of Malay directors have a significant negative effect on the cost of debt capital. -Board meetings had a positive and significant effect on the cost of debt capital.	The results indicate that characteristics of the board of directors have a significant ability to decrease agency problems, which helps lower the cost of raising fund from lenders in the capital market.	**Theoretical** -This study contributed to agency theory by concentrating on monitoring the role of the best practices of internal CG (such as board of director's effectiveness) within companies to reduce the components of cost for raising fund in capital market. -This study contributed to cultural theory by concentrating on linking the ethnicity of the Malay directors who sit on the board of directors with line a decrease in the cost of raising fund from lenders (debt) in capital market. **Practical** The findings of this study have implications for managers of companies, individuals, institutional investors, regulators, and corporate directors. **Methodological** A methodological approach for measuring the cost of debt based on the synthetic rating estimation method was developed in this study.	-Implications for corporations that need to satisfy lenders and attract potential investors include the ability of measure the impact of monitoring systems such as CG so that decision makers can evaluate the role of these monitoring systems in enhancing lenders perception of the quality of financial information. -This study added to the understanding of agency theory in a developing country where companies are monitored by internal CG mechanisms (board of directors effectiveness), in which the agency relationships are complex.

Research Gap	RQ 2	Findings	Conclusion	Contribution	Implication
.-A lack of studies related to the relationship between audit committee characteristics and the cost of debt capital due to the inconclusive results of previous studies. -No previous studies examined the effect of audit committee characteristics on the cost of debt capital in Malaysian.	Do audit committee characteristics (including: size, independence, financial expertise and meetings) influence the cost debt capital in Malaysian companies?	-The size of the audit committee had a significant negative effect on the cost of debt capital. -Audit committee meetings had a significant negative effect on the cost of debt capital.	The results indicate that characteristics of the audit committee have a remarkable ability to reduce information asymmetry and agency problems, which helps lower the cost of raising fund from lenders in the capital market.	**Theoretical** -This study contributed to agency theory by concentrating on monitoring the role of the best practices of internal CG (such as audit committee effectiveness) within companies to reduce the agency problem. **Practical** The findings of this study have implications for internal auditor and audit committee of companies and regulators. **Methodological** A methodological approach for measuring the cost of debt based on the synthetic rating estimation method was developed in this study.	Creditors and shareholders benefit from the findings of this study because they will have a better understanding of how internal CG characteristics such as (audit committee effectiveness) affect the cost of debt capital. -The CG authorities, especially in Malaysia, can use this study as empirical support for developing their regulations and making further recommendations.

Research Gap	RQ 3	Findings	Conclusion	Contribution	Implication
-There is a need to investigate the effect of audit quality proxies (audit fees, non-audit fees and industry specialist auditors) on the cost of debt capital due to a lack of studies and the mixed results of the previous studies that do exist. -There are no prior studies conducted in Malaysia context.	Does audit quality proxies (including: audit fees, non-audit fees and industry specialist auditors) conducted by external auditors have significant effect on the cost of debt capital Malaysian companies?	Non-audit services fees have a significant and negative effect on the cost of debt capital. -Using auditors who specialize in an industry has a significant and negative effect on the cost of debt capital.	The results show that using the non-audit services provided by external auditors and hiring auditors who specialize in an industry has a remarkable influence on reducing information asymmetry, which lowers the cost of raising funds from lenders in the capital market.	**Theoretical** -This study contributed to signaling theory by focusing on the external monitoring role of audit quality as a way to reduce the cost of raising funds from lenders in the capital market. -The prevalent doubts expressed in the literature regarding how proxies for audit quality decrease the of cost debt was supported. **Practical** The findings from this study have implications for managers of companies, internal and external auditors, and regulators. **Methodological** -A methodological approach for measuring the cost of debt capital based on the synthetic rating estimation method was developed in this study.	-This study has added to the understanding of signaling theory in developing countries, where companies are monitored by external CG mechanisms such as the quality of the audits conducted by external auditors with complex information asymmetry in the capital market. -Stock market authorities can employ this study's results to evaluate the role of the quality of an audit conducted by an external auditor to improve the quality of information and accounting reports in capital markets.

1.7 Scope of the Study

In line with the research objectives, this study was carried out using companies listed on the Bursa Malaysia from various industries (construction, industrial products, plantations, properties, consumer products, hotels, REITS, infrastructure, tin, mining, technology, trade, and services) from 2003 to 2012. This study empirically assess the relationship between the internal CG mechanisms characteristics of an effective board of directors and audit committee, the quality of audits conducted by external auditors as external CG mechanisms proxies (non-audit services, audit fees and industry specialized auditor) on the cost of debt capital. Related objectives were examined using the three main research questions. Each of the research questions were deconstructed into testable hypotheses. The Table 1.2 present's summary of hypotheses developed and the underlying theories.

Table 1.2: Summary of Hypotheses and the Underlying Theories

Objectives	Hypothesis	Theory
1	H_1: Larger boards of directors are associated with lower cost of debt capital.	Agency theory
	H_2: Larger proportion of independent boards of directors is associated with lower cost of debt capital.	Agency theory
	H_3: Financial expertise director on the board is associated with lower cost of debt capital.	Agency theory
	H_4: There is a relationship between the board's meeting frequency and cost of debt capital.	Agency theory
	H_5: There is a relationship between ethnicity of director on the board and cost of debt capital.	Cultural Theory
	H_6: There is a relationship between ethnicity of chairperson on the board and cost of debt capital.	Cultural Theory
	H_7: There is a relationship between qualification of director on the board and cost of debt capital.	Cultural Theory
2	H_8: Larger audit committees are associated with lower cost of debt capital.	Agency theory
	H_9: Larger proportion of independent audit committees is associated with lower cost of debt capital.	Agency theory
	H_{10}: There is a negative relationship between the audit committee's financial expertise and cost of debt capital.	Agency theory
	H_{11}: There is a relationship between the audit committee's meeting frequency and cost of debt capital.	Agency theory
3	H_{12}: There is a positive relationship between audit fees and cost of debt capital.	Signaling Theory
	H_{13}: There is a negative relationship between Non- audit service fees and cost of debt capital.	Signaling Theory
	H_{14}: There is a negative relationship between industry specialist auditor and cost of debt capital.	Signaling Theory

1.8 Methodology

In addressing the concerns enumerated in the study objectives the researcher adopts a positivist epistemological construct and uses a deductive research approach and quantitative research strategy relying on secondary data. Specifically, the annual reports of companies, both in hard copy and on-line versions, as well as, information from DataStream, a Blomberg database were used extensively. The data collected were prepared (which involved classification, rearrangement, and transformation) to make them ready for statistical and econometric processing. The statistical software STATA version 13 is utilized for data analysis. The data analysis involves techniques such as the descriptive statistics, correlation analysis, multivariate regression (ordinary least square (OLS) regression model), assumption for multiple regressions analyses and robustness analysis.

1.9 Limitation of the Study

The main objective of the thesis was to contribute to the debate on the relationship between; internal and external CG characteristics, especially the board of director and audit committee characteristics, audit quality of external auditors and their effect on cost of debt capital. Some of the study limitations are discussed below:

The sample companies cover most industries but financial institutions were not included in the sampling framework of this study because of their different capital structure, regulations, profits (Ali Shah and Butt, 2009; Pham et al., 2012; Ramly, 2012) and materially different types of operations (Mohd Ghazali and Weetman, 2006). The exclusion of financial institutions limited the generalizability of the results across all industrial sectors. This limitation should be researched in future studies as the sample companies used in this study do not reflective of all companies, especially companies in the financial sector.

Some external audit quality variables such as non-audit fees, audit fees and the use of an industry specialist auditor are subject to debate about whether they indicate auditor independence and audit quality. In this thesis, the audit quality measures were driven by the auditor's reputation and perceived auditor independence. Thus, the results were based on market perceptions (audit quality as perceived by market participants).The use of other audit quality measures such as restatements and auditor litigation may help to generalize the actual audit quality rather than the perceived audit quality.

This study estimated the cost of debt capital using two methods: the synthetic rating estimation and average interest rate method. Although there are other methods for estimating the cost of debt capital, such as the yield spread and yield to maturity method recommended by (Anderson *et al.*, 2004; Duffee, 1998; Ertugrul and Hegde, 2008; Klock *et al.*, 2005). This study did not use either of those two due to their lack of information regarding the capital market for companies listed on the Bursa Malaysia. The limitations of study should be researched in future studies as additional methods for estimating the cost of debt capital may help generalize better results.

1.10 Thesis Outline

This study is organized into five chapters. The first chapter presents the research background and problem statements. In addition to, the research questions, research objectives, significance and contributions made by the study along with a short description of the scope of the study, methodology, limitation of study and terminology used are also covered.

Chapter two provides a general understanding of the nature of CG in general, and overview of Malaysian CG, and the development of the CG code. It discusses the demand for auditing services and quality audits, the monitoring role of the board of directors, audit committees, and external auditors. It also provides a general understanding of the cost of debt capital. It highlights theoretical frameworks, such as agency theory, signaling theory, and cultural theory. It provides a review of past studies conducted regarding CG characteristics, audit quality, and the cost of debt capital. The chapter ends with the research framework and the development of the hypotheses based on previous studies.

Chapter three provides the methodological framework utilized in this study. It elaborates and justifies the selection process used to generate samples, the duration of the study, sources of data, and data collection methods. The methods used to measure the independent and dependent variables, control variables, and model specifications are provided. The analysis process, a summary of methods used for testing the hypotheses, and measurement of variables are revealed.

Chapter four reports the results of the empirical findings related to CG, audit quality, and the cost of debt capital based on the objectives of study. It begins with descriptive statistics and correlation analysis, which is then followed by presenting the results of the tested models and the inferences occurring from the hypothesis testing. The outcome of the empirical findings regarding the relationships between CG characteristics and audit quality proxies on the cost of debt capital is presented. The results of additional analyses are also given to confirm the robustness of the initial regression analyses.

Chapter five includes a summary and discussion of the findings of the study and how it relates to prior research findings and related theories. This is followed by a description of the limitations of the study and possible avenues for further research before a final conclusion is presented.

1.11 Terminology

Particular terms were used in this study and they are defined as follows:

- Corporate Governance (CG): The Cadbury Committee Report (1992) point out that CG is an arrangement through which organizations are controlled and directed. It identifies the functions of key people in a company who are represented by a board of directors, the auditors, and the shareholders.

- Board of directors: Fama and Jensen (1983b) defined the board of directors as those who ratify management decisions, monitor performance, manage decisions and decision control functions. The board of directors is statutorily appointed by the shareholders to represent and protect their interests and they represent the highest decision making body of a company.

- Audit committee: The audit committee is defined as a subcommittee of board of directors that is comprised mostly of non- executive or independent directors who are responsible for overseeing auditing activities (Abernathy *et al.*, 2011; Birkett, 1986; Collier, 1993).

- Audit Quality: The quality of audit services is defined as the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system and (b) report that breach (DeAngelo, 1981b).

- Information asymmetry: Information asymmetry is the information gap between mangers and investors. When information asymmetry between managers and investors increases, investors increase the cost of raising fund because of the associated risk (Diamond and Verrecchia, 1991).

- Cost of Debt: The minimum expected return that providers of debt financial require before they will lend to companies. The cost of obtaining and using interest-paying liabilities is known as the cost of debt. Generally, companies incur debt through the issuance of debentures and bonds. Thus, the cost of debt is the cost associated with interest payments and other costs connected to issuing debentures and bonds (Pratt and Grabowski, 2008).

fees and engaging industry specialist auditor incurred lower cost of debt capital. This suggested that that a higher quality audits reduced information asymmetries in capital markets and consequently lower debt financing. The results of using industry specialist auditors and the cost of debt capital demonstrated that there was a significant negative relationship between engaging industry specialist auditors and the cost of debt capital. Based on signaling theory, the research result provided empirical evidence that lenders and investors can use to evaluate the benefits of auditor specialization for reducing information asymmetry in capital markets and consequently increase the quality of an audit.

The findings of the study revealed that companies audited by auditor who specialize in an industry provide higher audit quality. This suggests that debt investors charge lower rates for debt capital because of the perceived lower risks for these companies. There was a significant relationship between the use of auditors who specialize in an industry and the cost of debt in Malaysia context. The results regarding the effect of non-audit services on the cost of debt capital suggested that there is a significant and negative relationship between the costs of debt capital when higher non-audit service fees were incurred. The results were robust under various tests of robustness and sensitivity. There was no evidence to suggest that there was a relationship between audit fees and the cost of debt capital in Malaysia.

Overall, the present study concludes that agency problems can be reduced by encouraging internal CG characteristics that are associated with effective boards of directors and audit committees that supports their internal monitoring functions. This study also concludes that lowering the cost of capital may increase the demand for higher audit quality, because higher audit quality is expected to reduce information asymmetry and consequently lowering the cost of debt capital.

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