



Corporate governance and cost of debt financing: Empirical evidence from Canada



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ABSTRACT

We explore the impact of the Globe and Mail corporate governance index on bond spreads in a sample of Canadian listed companies. The index is composed of four sub-indices—board composition/structure, board compensation, shareholder rights, and disclosure—assessing the quality of the firm's governance. Our empirical findings point to a decrease in the bond spreads for an improvement of the overall quality of the corporate governance index. When we analyze the impact of each of the sub-indices, only the quality of the board composition/structure as well as the disclosure quality seems to matter to bondholders. We interpret our finding within the Canadian “comply or disclose” approach to governance where more responsibility is put on investors to assess and judge the quality of the governance practices. In such context, bondholders value stronger boards (in terms of composition as well structured board can mitigate agency problems), and are also particularly concerned with the quality of the firms' disclosure policies (to reduce information asymmetry). In addition to the Board Composition and the Disclosure sub-indices, we also find a significant negative relationship between shareholder rights sub-index and the cost of debt for issuers headquartered in Quebec. Only in Quebec, features that protect shareholders from the managers (and major shareholders)' potential misbehavior seem to reduce the cost of debt. This might be due to the lower confidence that bondholders have in the Quebec French-Common-Law-based jurisdiction even after the adoption of the new Quebec Business Corporations Act in 2011.

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1. Introduction

When companies need external funds to finance their investment opportunities, a trade-off between the two traditional financing vehicles, debt vs. equity, arises (Myers & Majluf, 1984). In the Finance literature, it is largely argued that debt financing has many advantages over equity. First, firms would benefit from tax shield when they choose to issue debt since corporate tax is calculated after interests being paid to debt holders (Ross, Westerfield, & Jordan, 2008). Second, debts might play a monitoring role within corporations since highly leveraged firms tend to pay more attention to the reactions of the debt markets. Third, debt might signal positive signs to the markets (signaling theory) which would potentially reduce the asymmetric information between the companies and the investors leading to a lower future financing costs. As such, debt provides an assessment on the firm's overall quality.

Recently, empirical researches have tried to address the relationship between the debt financing and some firm's corporate

governance mechanisms. Sengupta (1998) provides evidence that corporate governance mechanisms could mitigate information asymmetry problems and hence lower the cost of debt financing. Moreover, Ashbaugh-Skaife, Collins, and LaFond (2006) find that firms that exhibit quality corporate governance enjoy lower cost of debt financing. Ertugrul and Hegde (2008) show that higher CEOs compensation, supposedly used to align the interests of the managers with those of the owners, could reduce the cost of debt. Schauten and van Dijk (2010) show that better financial disclosure would reduce firms' cost of debt only if shareholder right is at a low level. Finally, Boubakri and Ghouma (2010) document that the voting/cash-flow rights wedge (as a proxy of major shareholders expropriation) and the family control have a positive and significant effect on bond costs. Their results suggest that a higher protection of debtholders' rights generally reduces the cost of debt financing. More importantly, the authors report that what really matters to bondholders and rating agencies is the level of enforcement of the debt laws rather than their mere existence on books.

Although this handful of studies bridges the literature on debt markets and corporate governance, it is noticeable that the majority of them was conducted in the USA (Ashbaugh-Skaife et al., 2006; Bhojraj & Sengupta, 2003; Sengupta, 1998). There is no

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clear evidence on how the quality of firm's corporate governance affect the cost of debt financing in other large developed countries. In the Canadian context for instance, only handful studies have investigated the impact of corporate governance on the firm's performance. Using Globe & Mail governance scores, Gupta, Kennedy, and Weaver (2009) examine possible associations between the corporate governance scores and various measures of firm value in the Canadian context. Their results do not support any association between the governance index (or its subcategories) and various measures of firm value. The authors conclude that the Globe and Mail governance rankings have no impact on firm value and hence does not appear to have any information content. Bozec and Bozec (2010) further investigate the relationship between corporate governance and the cost of capital, as a proxy for the firm's value. Their analysis finds strong evidence that the cost of capital decreases as the quality of corporate governance practices increase. However, the study has not examined the association between the direct cost of debt (as a component of the cost of capital) and the corporate governance scores. This leaves the question on the role of the Canadian debt markets in shaping corporate governance unanswered.

This paper aims to fill this gap in the literature. It seeks to empirically highlight the potential impact of the quality of corporate governance in a sample of Canadian firms listed on the Toronto Stock Exchange (TSX). The choice of Canada is motivated by two unique features of the Canadian context. First, while the corporate governance systems in Canada and the U.S. appear to be similar in certain aspects, they are fundamentally different with respect to corporate governance regulation (Broshko & Li, 2006). Corporate governance regime in Canada can be characterized as a "principles-based" approach (Adjaoud & Ben-Amar, 2010; Broshko & Li, 2006 among others) which relies on the "comply or disclose" principle. Canadian listed companies are required to comply with some suggested "best practices" (by the stock exchange authorities), and in case they depart from such guidelines, they will have to disclose and clarify to investors the procedures they implemented to achieve the same "suggested" governance objective. This transfers the monitoring role to the investors (markets) who will judge the effectiveness of the firms' corporate governance practices. In contrast, in the United States, where most of the related studies have been carried on, the governance system is mostly a "rules-based" approach where compliance with the stock exchange requirements is mandatory rather than voluntary. Given this distinguished feature of the higher responsibility of the Canadian markets, it is crucial to assess to which extent investors fulfill their monitoring responsibilities and discipline not well governed firms.

The second important feature of Canada is the coexistence of two different legal systems; the Common vs. Civil Law system. In spite of its common-law traditions, Canada has one of its largest province (Quebec) with a French civil-law heritage and jurisdiction. LaPorta, López-de-Silanes, Shleifer, and Vishny (1997, 1998, 2000, 2002) among other studies, report that investors enjoy the highest protection of their rights under Common Law systems, while they are the least protected under Civil Law systems, particularly those with French heritage as it is the case for Quebec. Hence, it is very informative to see whether the perception of the bondholders would be the same for bond issuers from Quebec (French Civil-Law) vs. the rest of Canada (Common-Law). Since the firms in our sample are all located in Canada (meaning that they are subject to the same accounting standards, political environment, as well as the same social, media, and public pressures), this reduces any cross country variations allowing us to directly test the impact of differences in investor protection on cost of debt. Finally, the Canadian context would allow us to assess, to some extent, the consequences of the attempts to align the Quebec Civil Law system with the Common Law one (in terms of investors protection). After being criticized for its poor investor protection, Quebec Govern-

ment undertook profound changes to its Corporation Act. In 2011, the province introduced the new Quebec Business Corporations Act (QBCA), replacing the old Quebec Companies Act (QCA). The new QBCA has many new features that make it similar to the Federal Act. Since our study happens 3 years after the adoption of the new Act, we would be able to assess to which extent the bond markets react similarly/differently to issuances from or outside Quebec.

We use a corporate governance index published by The Globe and Mail, a famous Canadian national newspaper, as a proxy for the governance quality. The index is composed of four blocks: board composition, compensation, shareholder rights, and disclosure. In line with previous studies (Bhojraj & Sengupta, 2003; Boubakri & Ghouma, 2010; Sengupta, 1998), we use corporate bond spreads as proxy for debt costs. Bond spreads are obtained by subtracting the yield to maturity on the Government of Canada bonds from the yield to maturity on the corporate bond issue with similar maturity. We find evidence that firms with higher governance quality enjoy lower corporate bond costs. More precisely, an increase of 1% in the overall governance score (which by construction ranges from 0 to 100), reduces the spread by around 0.612 basis point. We also investigate the impact of each governance dimension (board composition, board and CEO compensation, shareholder rights, and board governance disclosure) on the cost of debt and our results show that only a better board composition and a higher firm's disclosure reduce the cost of debt financing. The firm's compensation scheme and the level of shareholder's protection seem to be irrelevant to bondholders within the Canadian context. This finding highlights two main channels through which Canadian firms can enjoy lower cost of debt financing. The first channel is the reduction of the agency problems within the firm. This can be achieved through a better board composition and structure (independence of board overall and its sub-committees, whether the chairperson is also the CEO, how busy are the board members, etc). The second channel is the mitigation of the information asymmetry between the firm and the bondholders. Information asymmetry can be mitigated via a better disclosure policy. Our findings suggest that lower bond spreads are associated with higher Disclosure score, which assesses the firm in terms of the quality of information it discloses about its board (such as related vs. unrelated directors, disclosing detailed director biographies and qualifications, directors meeting attendance, etc.). It is clear that in the context of the Canadian governance "comply or disclose" approach (where more responsibility is put on investors to assess the quality of the governance), bondholders are particularly concerned with the quality of the firms' disclosure policies.

We further split our sample into two subsamples; firms headquartered in Quebec (French Civil Law Province known to have lower investor's protection) vs. firms headquartered in the rest of Canada (Common Law system known to have higher investor's protection). Our results show that in both sub-samples, board composition and disclosure sub-indexes both remain significantly and negatively associated with the bond spreads. Interestingly, only for the Quebec sub-sample we find a significant negative relationship between shareholders rights and the cost of debt. It seems that only in Quebec, governance features that protect shareholders from the managers' potential misbehavior reduce the cost of debt. This might be due to the lower confidence of bondholders in the Quebec jurisdiction compared to the rest of Canada. Interpreted within the context of the Quebec new Corporation Act of 2011, these results show that 3 years after such amendment, the bond market has not yet priced that change.

Our findings contribute to the existing literature in many ways. First, the results contribute to our understanding of the role of the debt markets, outside the U.S. framework, which seem to price the quality of corporate governance. We are unaware of any study that tried to directly assess the "monitoring role" of the Canadian

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