

## Corporate Governance And Cost Of Capital From A Value Creation Perspective: Critical Literature Review

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**ABSTRACT** | *Corporate governance encompasses a range of endeavors aimed at mitigating agency risk. The strategies encompassed in this framework are implementing stricter controls on managers' opportunistic conduct, enhancing the integrity of information dissemination inside organizations, and intensifying oversight of management activities. Numerous academic studies elucidate the potential of corporate governance policies to enhance the value of a firm. Accounting performance indicators or market metrics are commonly employed to assess the worth of a company. Conversely, as a company's cost of capital decreases, it results in the generation of value. Theoretically, organizations that possess effective safeguards for stakeholder rights and implement rigorous monitoring procedures should be capable of mitigating instances of managerial power abuse and ensuring proper resource allocation. This particular type of firm is expected to have a lower level of risk compared to other industries, hence granting it access to more cost-effective sources of finance. The primary objective of this study is to conduct a comprehensive evaluation of the existing body of literature about the impact of corporate governance on the cost of capital. The analysis will specifically focus on the value generation component of corporate governance.*

**KEYWORDS** | *Corporate governance, cost of equity capital, cost of debt*

### **How to Cite**

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## **INTRODUCTION**

In contemporary public businesses, the effect exerted by financing sources on decision-making processes is relatively limited, resulting in a reduced level of control over the allocation of financial resources. In the realm of corporate governance, professional controllers or managers

assume control and exert significant influence over the various resources of a firm, so superseding the authority of the owners. In public organizations, it is important to note that control and ownership are distinct concepts. Conflicts of interest arise between managers and owners due to the

separation of ownership and control (Berle and Means, 1932). Conflicts of interest manifest when managers engage in actions that are contradictory to the objective of enhancing shareholder value. However, it is important to note that ongoing conflicts of interest ultimately diminish the overall worth of the organization. These notions serve as the foundation for scholarly investigations in the field of corporate governance.

In their seminal study on business theory, Jensen and Meckling (1976) extended the scope of agency theory to encompass the contemporary corporation. They presented a comprehensive model that formally addresses the agency costs associated with external ownership. The researchers provided evidence to support the notion that the implementation of corporate governance is necessary in order to minimize the negative effects resulting from incomplete contracts and agency costs, which are often generated by opportunistic behavior exhibited by managers. Corporate governance (CG) encompasses a diverse range of internal and external mechanisms designed to mitigate agency risk within the context of a separation between ownership and control. The approaches encompassed in this framework are enhancing restrictions on managers' opportunistic behavior, enhancing the quality of information dissemination inside businesses, and intensifying oversight of management activities. Although the significance of corporate governance in publicly listed entities is widely acknowledged, its impact on shareholder value creation remains uncertain. Market and accounting data are frequently employed to estimate the value of a firm. Nevertheless, an expanding body of scholarly literature indicates that the valuation of a company may also be assessed based on its capacity to leverage reduced cost of capital (COC) stemming from effective implementation of corporate governance principles (Donker and Zahir, 2008). The primary objective of this study is to conduct a comprehensive examination of the limited yet expanding collection of research on the impact of corporate governance on capital costs. The study will specifically focus on the value creation aspect of corporate governance.

## **Theoretical foundations**

### **Agency Theory**

Agency theory serves as the fundamental basis for any discussion related to corporate governance (CG) in a general sense. According to Jensen and Meckling (1976), an agency relationship can be characterized as a legally enforceable agreement in which one party, known as the principle, engages the services of another party, referred to as the agent, to carry out certain duties on behalf of the principal. The principal will transfer a certain level of decision-making responsibility to the agent.

In line with the established agency relationship, shareholders, who possess the ownership rights, appoint directors as their representatives in publicly listed corporations. The shareholders bestow authority upon the directors to oversee the company's activities. Agency theory posits that issues related to corporate governance stem from the ownership and control framework within corporations, as well as the limited ability of inactive debt holders and dispersed shareholders to adequately monitor the actions and conduct of corporate executives. According to Jensen and Meckling (1976), agents frequently participate in the expropriation of external investors and pursue self-serving ulterior motivations or personal agendas, in addition to operating in the best interests of shareholders. The agents exercise complete control over the business operations, resource allocation on behalf of shareholders, and the dissemination of information to capital suppliers. Managers are driven by self-interest to allocate corporate resources into efforts that are in conflict with the goal of generating shareholder value.

The presence of agency costs poses a significant challenge to the interests of capital providers, thereby emphasizing the crucial importance of good governance structures. The primary aim of corporate governance is to ensure that the actions and choices made by management align with the objectives of shareholders and debt holders. The implementation of robust corporate governance mechanisms has the capacity to somewhat alleviate conflicts of interest, as it facilitates the alignment of objectives among stakeholders (Gursoy and

Aydogan, 2002; Conyon and Schwalbach, 2000). Furthermore, the presence of corporate governance (CG) systems has the potential to mitigate information asymmetry by creating incentives for firms to disclose information in a timely and correct manner (Ajinkya et al., 1999; Bhojraj and Sengupta, 2003).

The value creation objectives of corporate governance pertain to the goals and aims that are pursued by corporate entities in order to generate and enhance value for their stakeholders.

Numerous scholars in the fields of accounting and finance have a strong inclination towards comprehending the intricate relationship between corporate governance (CG) and the valuation of a firm. Firms that successfully adopt effective governance structures are seen as financially lucrative and efficiently managed. According to Shleifer and Vishny (1997), the implementation of robust corporate governance practices is anticipated to have a positive impact on the whole value creation process. A considerable body of literature has examined the impact of various corporate governance mechanisms, including ownership structure, audit committee, independent directors, and information quality, on a firm's performance. This topic has been extensively explored in scholarly works by Foerster and Huen (2004), Drobetz et al. (2004), Brown and Caylor (2006), Rubach and Picou (2005), Bauer et al. (2008), Abdullah (2004), and Black et al. (2006).

Although the cost of capital (COC) is usually used as a risk indicator, it is also associated with corporate value and may be considered a significant factor influencing a firm's worth, along with accounting and market performance measurements. The reduction of capital costs is a well acknowledged benefit of effective corporate governance (Donker and Zahir, 2008). Robust corporate governance measures frequently mitigate business risk, so reducing the cost of capital and subsequently enhancing the market valuation of a firm. Value is generated when a firm is able to utilize a more cost-effective means of obtaining financial resources. Moreover, for the purpose of evaluating current investments and projecting future investment opportunities, it is imperative for a firm to comprehend its cost of

capital.

In the realm of debt capital, the cost of debt (COD) is intricately linked to the likelihood of default and the presence of reliable data for accurately assessing the risk of default. The implementation of corporate governance practices has the potential to mitigate the likelihood of default by diminishing agency costs, overseeing managerial performance, and alleviating information asymmetry between the company and its lenders.

Prior studies investigating the relationship between corporate governance and company debt expenses have established an adverse correlation between these two factors. Moreover, while assessing the likelihood of default, creditors take into account the effectiveness of a company's corporate governance processes. Debt holders may exhibit a willingness to accept a decrease in their risk premium if they perceive that the implementation of sound corporate governance practices will mitigate the probability of default. The acquiescence of the debt holders to this reduction engenders value for the company.

Business management systems refer to the comprehensive frameworks and processes implemented inside an organization to effectively manage and oversee many aspects of its operations. These systems encompass a wide range of activities, Internal governance mechanisms refer to the structures and processes within an organization that are designed to provide effective oversight, control, and decision-making. These mechanisms are put in place to align.

### **The governing body of directors**

The board of directors serves as the primary safeguard for owners against potential misappropriation of money by professional management, as per theoretical perspectives. The appointment of board members is carried out by the owners. In practice, however, assessing the worth of the board's contributions is a challenging and disputed task. The two main topics pertaining to boards that have been extensively examined in the field of corporate governance research are board size and board composition. The aggregate number of directors comprising the board is commonly denoted as the board's size. The

composition of the board encompasses various aspects, including the involvement of independent directors, the leadership structure, specifically the roles of chairman and CEO, and the presence and responsibilities of board committees that support decision-making and oversight of the management team.

The topic of interest is to the remuneration received by Chief Executive Officers (CEOs) of corporations. The primary focus of the executive compensation analysis is around the degree to which the financial rewards received by managers align with the goals and interests of the shareholders or owners of their respective organizations. In their seminal work, Jensen and Meckling (1976) emphasize the significance of incentive alignment as a potential remedy for agency issues. They propose that executive remuneration should be designed in a manner that minimizes the conflict of interest between shareholders and management. A successful compensation scheme incentivizes managers to refrain from engaging in opportunistic behavior and instead directs their attention towards activities that enhance value.

### **The sequence of ownership**

Jensen (2000) posits that the ownership structure has a substantial impact on several aspects of a corporation, including its objectives, shareholder wealth, and the extent of management opportunism. While the separation of ownership and control is commonly observed in publicly traded organizations, this phenomenon is seldom encountered inside a singular firm. It is a common practice for managers to possess a certain level of equity in the organization, so assuming the role of owner-managers. The presence of firm shares in the possession of directors and managers facilitates the adoption of an owner-manager mindset, as opposed to a purely managerial perspective. The presence of an owner-manager mindset serves as a driving force for managers, compelling them to actively pursue activities that generate value. This is mostly due to the realization that neglecting such endeavors might potentially diminish the overall worth of their ownership stake.

Shareholders with significant ownership stakes, sometimes referred to as block holders, have the ability to exert their influence in order to compel management to prioritize the maximization of value. The presence of block holders who possess the ability to use their voting rights in order to remove ineffective management would likely incentivize managers to reduce their tendency towards opportunistic behavior. Moreover, due to the substantial ownership stakes held by institutional shareholders, they possess greater influence on the board of directors in order to align management aims with the interests of the shareholder collective. As a result of this, institutional shareholders are perceived as a potent mechanism for governance. Prominent institutional shareholders, due to their substantial ownership stakes, are less inclined to abruptly divest from a company without exerting an impact on the stock price. Consequently, individuals in these positions often depend on verbal communication, necessitating them to undertake monitoring duties in order to verify that organizational leadership conforms to strategies aimed at maximizing value. Family-owned firms exhibit a reduced degree of separation between ownership and control, resulting in a diminished presence of asymmetric information and a heightened alignment of interests. Consequently, this mitigates the traditional agency conflict that typically arises between owners and managers. Moreover, given the positive correlation between the company's prosperity and the affluence of the family, family members with greater ownership stakes exhibit a heightened motivation to closely monitor the management. In addition, it is observed that family-owned firms often adopt longer-term investment perspectives, perhaps mitigating managers' inclination towards making myopic investment decisions. In many nations, it is possible for the government to own a substantial ownership stake in public businesses. The prevalence of businesses holding a majority share in the government is especially pronounced in emerging nations, as public monies are channeled into public enterprises through government investment entities. The prioritization of value generating activities may carry greater significance



for the government, since it often exhibits a heightened level of interest in public enterprises compared to private investors. Moreover, when compared to non-government shareholders, the government exhibits a greater financial motivation to oversee the company's performance and may allocate funds to engage professionals, such as investment analysts, for this purpose.

### **Mechanisms of external governance**

#### **The corporate control markets**

When internal governance systems are ineffective in controlling opportunistic managers and generating value for shareholders, the market for corporate control is regarded as an alternative discipline mechanism. The takeover market is seen to be a way to address agency issues. It may be an effective discipline tool because managers who are afraid of losing control and authority are more inclined to concentrate on behavior that maximizes values. Managers are therefore motivated to make sure the company is valuable enough to withstand any potential competitor takeover effort.

#### **The judicial system**

The legal environment, which is defined by laws and their implementation, shields creditors and shareholders from being taken advantage of by a company's management and controlling stockholders. The efficiency of a nation's corporate governance framework for businesses is influenced by the degree to which the legal system can offer this protection. La Porta et al. (2000) emphasizes the need of investor protection by pointing out that powerful stockholders have been known to extensively expropriate the wealth of minority shareholders and creditors in several jurisdictions.

Therefore, a nation's legal framework that offers robust investor protection enhances the security of shareholders' property rights. Furthermore, robust investor protection is linked to efficient corporate governance, which is demonstrated by thriving and wide financial markets, distributed share ownership, and effective capital allocation across businesses.

### **Business Governance and Capital Costs**

#### **Corporate governance and equity capital costs**

In the U.S. Setting the scene, Ashbaugh et al. (2004) use the firm's projected returns, beta, and realized returns to relate governance qualities to the impact of corporate governance on the cost of equity capital (COEC) of US enterprises. The ownership structure, board structure, shareholder rights, and the integrity of a company's financial information were the four governance qualities that were examined in this study. The purpose of these techniques is to mitigate the issues of moral hazard and adverse selection that arise in publicly traded corporations. They apply two methods to calculate COEC: (1) the target technique, which was used by Botosan and Plumlee (2002, 2005) and Francis et al. (2005) to calculate the average firm's projected return across its fiscal term; and (2) the price-earnings growth ratio, which was created by Easton (2004). Each firm's composite CG score is created to account for the overall governance risk of the company. Overall, they discover that as the majority of CG qualities are strongly correlated with, the governance attributes have a substantial direct impact on the firm's cost of equity capital (COEC), as well as an indirect one through systematic risk.

Huang (2004) examines the impact of firm-level change in shareholder rights on the ex-ante COEC using a sample of 8,836 firm-year data. In this research, the term "shareholder rights" refers only to the power that shareholders have to fire management. Weak shareholder rights allow underperforming management to become more ingrained, which raises the COC. A different theory contends that lax shareholder rights lead to job security for managers, which lowers management myopia and encourages them to save aside money for worthwhile long-term initiatives. This lowers the cost of capital. The amount of shareholder rights is represented by the Governance Score (G-score), which was adapted from Gompers et al. (2003) (later known as the GIM Index). The GIM Index has five aspects, namely: (1) strategies for thwarting hostile bids; (2) voting rights; (3) protection for directors and officers; (4) alternative takeover defenses; and (5) state legislation. Each GIM Index item that limits

shareholder rights and gives management more authority is worth one point. Therefore, a high G-score denotes a lower degree of shareholder rights inside a company. The anomalous earnings-based valuation model developed by Ohlson and Juettner-Nauroth (2005) serves as the foundation for the COEC estimation.

The findings show a strong correlation between greater COEC and weaker shareholder rights (higher G-score) using both pooled and cross-sectional regression approaches. The research also reveals a strong correlation between the variation in COEC and the variation in G-score. The findings provide credence to the idea that lower agency costs are caused by weaker shareholder rights, and that the efficient market accounts for this impact in the COEC.

Cheng et al. (2006) examine the impact of firm-level shareholder rights on the COEC of 8,281 US companies using the Gompers et al. (2003) data from 1992 through 2002. To estimate the COEC, they make use of the OJ Model.

A modified version of the GIM Index serves as a stand-in for the amount of shareholder rights. Their results show a substantial correlation between the COEC and the degree of shareholder rights. The GIM Index's voting rights and protection elements have a major impact on the outcomes.

The four clauses that make up the protection dimension are severance, contracts, golden parachutes, indemnity, liability, and blank checks. In essence, the protection clauses insulate directors and management from lawsuits and provide them severance benefits.

Six components make up the voting right dimension: the bylaws, the charter, cumulative voting, secret ballot, supermajority, and unequal voting. The voting rights sections outline the voting rights of shareholders with regard to selecting directors, approving mergers, and changing the charter and bylaws. The correlation between greater (lower) COEC and weaker (stronger) firm-level shareholder rights levels is actually evident.

The premise that robust shareholder rights may lower the discount rate is bolstered by the data, which shows that investors applied a larger

discount rate to the cash flows of companies with greater agency costs than to those with robust shareholder rights.

Battacharya and Daouk (2002) investigate the effects of insider trading regulations and their enforcement on the COEC in 103 nations using a multi-country approach research.

The cost of equity capital (COEC) is impacted by widespread insider trading in two ways. Initially, it leads to a liquidity issue where investors raise the sale price and decrease the buy price. This can raise transaction costs and eventually have an impact on the COEC. It is referred to as the price protect approach. Furthermore, controlling major owners can be persuaded to profit from insider knowledge instead of carrying out the sometimes challenging and fruitless monitoring. Four methods are used to quantify the impact of insider trading factors on cost of equity capital (COEC): the credit rating, the international asset pricing factor model, the dividend yield changes, and event studies. According to this research, the sheer existence of rules against insider trading has no effect on the COEC, but the stringent application of those regulations is strongly linked to a substantial decline in the COEC.

Chen et al. (2003) investigates the effects on the COEC of 545 firm observations in nine Asian nations from 2001 to 2002 of firm-level disclosures, corporate governance (non-disclosure factors), and country-level investor protection variables. The COEC estimate derives from the residual income valuation model (RIV), whilst the CG variables are derived from Credit Lyonnais Securities Asia's two survey findings.

All three of the CG factors had a negative relationship with COEC, according to this study. It is discovered that the firm-level governance factors have a more notable impact on the COEC in comparison to the transparency variables. Furthermore, a key predictor of enterprises' COEC is revealed to be investor protection at the national level.

More protection for security rights and against wealth expropriation by controlling owners and management is provided by robust investor protection.

Hail and Leuz (2002) investigate how a nation's

securities laws and legal framework affect COEC. They investigate the claim that lower cost of capital is enjoyed by companies based in nations with more stringent disclosure laws and securities rules. The final sample consists of 35,118 firm-year observations from 40 countries between 1992 and 2001. The residual income valuation model (Ohlson, 1995; Claus and Thomas, 2001; Gebhardt et al., 2001; Ohlson and Juettner-Nauroth, 2005; Gode and Mohanram, 2003) serves as the foundation for the COEC calculation. They discover some evidence in favor of the idea that companies from nations with robust securities laws, stringent disclosure laws, and efficient judicial systems appear to have less of an impact on COEC.

As it happens, not many research has been done to look at the connection between CG and COEC. A summary of these empirical results indicates that stronger CG mechanisms have favorable implications for shareholder value for the businesses. Furthermore, earlier research finds empirical evidence for the idea that companies with good corporate governance (CG) procedures are seen favorably by the market, which enables them to benefit from lower equity capital raising costs. These studies also show that CG ratings are a reliable indicator of a firm's CG practices' strengths and flaws. The topic of interest is to the concept of corporate accountability and its potential impact on the cost of debt.

In the French setting, Piot and Missonier-Piera (2007) assert that there exists a correlation between the quality of corporate governance (CG) and the public auditing system. Business enterprises wield a substantial impact on the reduction of living expenses.

The concept of debt refers to the financial obligation that arises when one party borrows money from the ratio in this study serves as an indicator of the quality of the CG. The inclusion of an independent director on the board. The compensation committee is composed of non-executive members.

In addition to the existence of institutional investors, possesses an ownership interest exceeding 5%. The majority of research is Driven by the aforementioned circumstance, banks and

financial organizations

Financial institutions serve as the primary providers of capital. They seldom exert a direct influence on the company's corporate governance. The term "frameworks" refers to conceptual structures or models that provide a systematic approach for Consequently, these alternative financing sources may evaluate the reliability of the monitoring process. The integration of business operations with quality measures.

When determining their risk premium via financial reporting. The writers employ the average loan interest rate of a corporation. This is achieved by the deduction of interest from the total amount. when divided by the average debt amount held at the conclusion of the fiscal year Within the same calendar year. It is important to acknowledge that this evaluation of the COD used by Francis et al. (2005) has similarities. Based on the outcomes of the investigation, three cognitive features were identified

This study displays a substantial decrease in chemical oxygen demand (COD). The term "board" refers to a flat, rigid surface often made of wood or other materials, which is used for many purposes Engagement in the monitoring of the corporate governance issue, (2)

The capacity of institutional investors to oversee, and (3) the governing body known as the Board of Directors. The concept of autonomy refers to the ability of individuals or groups to exercise independent decision-making and self-governance. It encompasses the capacity to question and evaluate the actions and policies of those in positions of power within an administrative structure. According to the empirical analysis conducted by Blom and Schauten (2006), it was determined that..

Based on the concept, the impact of corporate governance on the firm's cost of debt. When evaluating risk, debt holders do an analysis of the firm's gross margin. The characteristics of companies play a significant role in the assessment of default risk. The user's text is not sufficient to be rewritten in an academic manner.

The perspective is further strengthened by the claim that the danger

The necessary rate of return for loan holders is

determined by their individual characteristics and circumstances. This refers to the company's cash on delivery (COD) policy. 2016; Johnson, 2018) have examined the impact of technology on student learning outcomes. These studies have found that technology may enhance student engagement and motivation, as According to the studies conducted by Franz et al. (2005) and Franz et al. (1998), it has been observed that defaults have a significant role. Due of the significant level of danger involved, they are able to effectively duplicate as the cause of death (COD).

### **Conclusion**

Extensive empirical research has been conducted within the accounting and finance disciplines to examine the impact of corporate governance (CG) on the valuation of firms. Numerous academic studies elucidate the positive impact of corporate governance (CG) on a firm's performance, as observed from both accounting and market standpoints. In recent times, there has been a growing focus on examining the influence of corporate governance policies on the cost of capital, which is a significant determinant of a firm's overall worth. It might be said that shareholders derive value when firms are able to avail themselves of reduced costs associated with capital-raising activities. Based on the limited yet expanding body of research, it has been observed that the implementation of more robust internal and external conflict of interest protocols can effectively mitigate agency costs that arise due to conflicts of interest among managers, shareholders, and debt holders. The utilization of corporate governance (CG) has the capacity to mitigate company risk, hence leading to a decrease in the agency costs associated with debt and equity. It is important to highlight that a

significant portion of prior scholarly investigations were conducted within the United States. Moreover, many corporate governance procedures that were scrutinized, such as robust investor protection and measures against takeovers, were exclusive to the United States and did not extend to developing nations.

Further investigation may be warranted in some regions. It is advisable to prioritize doing empirical research on the impact of corporate governance (CG) on corporate outcomes and performance (COC) in emerging markets, namely in regions such as East Asia, Russia, and Eastern Europe. This approach would enable the extrapolation and generalization of study findings. Furthermore, in order to replace CG quality, it is important to provide a more thorough metric for evaluating CG mechanisms. A prior study has constructed a governance index that is equivalent to the one established by Gompers et al. (2003). Additional crucial components of corporate governance that might potentially be incorporated into the Global Index of Governance (GIM) encompass the structure and procedures of the board, payment of directors, accountability and audit practices, level of transparency, and dedication to social and environmental matters.

Moreover, similar to previous research, there exist apprehensions over the presence of incomplete data and the absence of inclusivity when employing specific characteristics of computer graphics. In practice, companies depend on a more comprehensive governance framework to supervise management behavior and guarantee the execution of value-creation endeavors. Furthermore, scholarly investigation may examine the correlation between the cost of capital and the practice of earning management.



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