

Political Connections, Corporate Governance, and the Cost of Equity in Malaysia

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The purpose of this study was to examine the relationship between political patronage and cost of equity, and whether corporate governance variables (board size, level of independent director, chief-executive-officer duality, institutional investors and auditor size) affect this relationship. Analyses are conducted on 2,223 firm-year observations listed on Bursa Malaysia from 1999 to 2009. We find a negative and significant relationship between political patronage and cost of equity suggesting that connected firms are less risky than non-connected firms. We find minimal evidence that corporate governance could minimise cost of equity. Our findings are robust when we test for other institutional settings and event in Malaysia.

Key words: *Political connections, corporate governance, Malaysian Code on Corporate Governance, cost of equity.*

Introduction

Malaysia is always an interesting case when it comes to political patronage. Studies in the past have tapped on this uniqueness in Malaysia and produced numerous studies that investigate on capital control (Johnson and Mitton, 2003), audit fees (Gul, 2006; Abdul Wahab et al. 2009), institutional investors (Abdul Wahab et al. 2009) and the role of ethnicity (Gul et al. 2016). Malaysia presents an interesting case as highlighted by Faccio et al. (2006), that it is ranked at number 2, for the number of connected firms in the capital market.

This study, which investigates the relationship between political connections and cost of equity, is an extension of the current literature of political patronage, and we further investigate whether corporate governance variables moderate this relationship. Our interest in equity financing costs is motivated by two main considerations. First, the cost of equity is the discount rate applied to a firm's expected future cash flows to determine its current stock price. It is thus the required rate of return given equity investors' perception of a firm's riskiness. If the perceived riskiness of political connected firms differs with respect to non-connected firms, then we should find that equity pricing varies systematically with political connectivity. Second, the cost of equity is a direct measure of external equity financing costs, and as such, it affects both investment decisions and financing decisions (Shleifer and Vishny, 2003).

Chaney et al. (2011) also suggested that political connections should increase earnings quality due to a heightened media scrutiny which could increase monitoring. One would expect that, with increased scrutiny, better access to resources, enhanced monitoring due to public or state interest, these connected firms should have higher level of earnings quality, relative to non-connected firms.

Some studies on political connections find a positive relationship between political connections and earnings quality. However, these studies suggest that the results are contingent upon some institutional settings of a particular country. An example is that of Batta, Sucre Heredia, and Weidenmier (2014) which puts forward that that the degree of expropriation risk in a country could amount to a positive relationship between political connections and earnings quality, since firms with high earnings could be subjected to asset appropriation by the government. Harymawan and Nowland (2016) argue that earnings quality of politically connected firms increase as the government effectiveness improves. Guedhami et al. (2014) investigate the relationship between political connections and auditor choice. They argue that insiders in these connected firms will be likely to appoint Big 4 auditors to enhance financial transparency, and at the same time to attract outside investors.

Chaney et al. (2011) offer three reasons that could contribute to a negative relationship between political connections and earnings quality. First, insiders of connected firms could hide, obscure or delay reporting the benefits received with the intention of misleading investors. Second, Chaney et al. (2011) argue that the connected firms simply care less with the quality of accounting information as they are being shielded by politicians, and the third argument is that firms with poor earnings quality are more likely to establish political

connections. The arguments above suggest that the relationship between political connections and earnings quality is ambiguous. As such, for our first research objective, we predict an association between political connections and cost of equity in Malaysia.

The second objective of our paper is to investigate the area in which corporate governance attributes are intended to reduce agency problems that affect a firm's cost of equity capital. This study seeks to investigate the extent to which the board size, level of independent director, CEO duality, and institutional investor attribute influence the cost of equity capital in the context of Malaysian public-listed companies. The main goal of corporate governance is to supervise the activities of management and to execute decision making to guarantee that the decisions agree with share- and debt-holder goals. The quality of corporate governance can reduce problems from conflicts of interest to a certain degree (Gursoy and Aydogan, 2002). However, a brand new idea proposes that the firm can also be perceived from its capabilities. A reduction in cost of capital (the cost of equity and debt) from an outcome of strong corporate governance mechanisms would be beneficial (Donker and Zahir, 2008).

Previous literature finds consistent global evidence that good corporate governance is associated with a higher firm valuation (Gompers et al. 2003 and Aggarwal et al. 2007). However, it is not clear why firms have an interest in assessing good governance practices. The interest may arise from a firm with better governance practice generating higher cash flows to shareholders or they have contacts to external financing at lower costs that discount future cash flow less heavily. Hail and Leuz (2006) find that firms from countries with greater disclosure requirements, regulations and a high safety of law enforcement have a much lower cost of equity capital. Yavuz (2008) finds that investor protection prevents wealth redistribution by the management and a reduction of costs that are related to the systematic risk of equity.

Research by Chen et al. (2009) finds that the level of corporate governance firms has a negative impact on the cost of equity capital, especially in countries where the provision of legal protection for investors is relatively weak. They conclude that a strong complementarity between firm-level governance practices and the protection and disclosure laws at state level reduce the cost of equity.

Chen et al. (2009) explore the impact of disclosure, corporate governance (non-disclosure variables) and country-level shareholder-protection variables on the cost of equity, and they find that corporate governance variables are correlated negatively with cost of equity. Hail and Leuz (2006) and Regalli and Soana (2010) provide strong evidence that better corporate

governance can reduce the cost of equity¹. Regalli and Soana (2010) find that the cost of equity increases with a higher proportion of institutional investments.

We find a negative and significant relationship between political connections and cost of equity. Consistent with prediction, we find a positive relationship between institutional investors and cost of equity, which supports the argument that firms with good institutional investors reduce the cost of equity. However, this study fails to support the level of independent director and board size, as governance roles are significant influences on the cost of equity. Our third objective is to investigate whether these governance roles mitigate the effect on political connections on cost of equity. We find that board size mitigates the cost of equity.

The remainder of the paper is organised as follows. Section 2 presents the institutional background that covers the political economy and corporate governance in Malaysia. Section 3 delineates the rationale behind the hypotheses developed for the study. Section 4 and 5 describes the sample selection and research methods respectively. Section 6 presents the results and Section 7 conclusion.

Literature Review

Hypothesis Development

Political Connections and Cost of Equity

The managerial view suggests that politically connected firms suffer from both the traditional manager-shareholder agency problem and agency problems stemming from the conflict of interest between politicians and shareholders (Shleifer and Vishny, 1997). Conventional wisdom suggest that political connections should increase a firm's value as it is earning tremendous amount of political rents, due to the resources they need to devote in rent seeking activities (Fisman, 2001). In fact, there are many ways for political connections can accumulate benefit to a firm. Such connections can increase the preferential treatment to finance (Dinc, 2005) political bailout in the event of financial distress (Faccio et al., 2006),

¹ Regalli and Soana (2010) examine the relationship between corporate governance quality and cost of equity. They use the one-stage Dividend Discount Model to estimate the cost of equity, and the quality of corporate governance is measured using an index of protection takeover, the GIM Index, whereas the quality of internal governance is measured from a percentage of institutional investors among the shareholders. From 122 American financial companies that were listed on the US stock exchange in 1990, 1993, 1995, 1998, 2000, 2002, 2004 and 2006, a better quality of governance was found to be associated with a lower cost of equity.

and greater allocation of government investment during financial crisis (Johnson and Mitton, 2003). Firms can benefit from government officials' support, especially when it comes to imposing tariffs on competitors, reducing regulatory requirements or awarding valuable government contracts (Goldman et al., 2009). As a consequence, the overall exposure to market-wide risk is lower for political connected firms during economic downturns, thus driving the cost of capital down for these firms that observe a lower covariance between their cash flows and the rest of the market. The cost of equity financing should thus be lower for political connected firms compared to their non-connected peers.

Numerous studies argue rent seeking and extraction to be key objectives of government intervention (Shleifer and Vishny, 1997) and these have negative repercussions on firm value. These conflicting goals between the government and the firm worsen the agency problem and this situation is especially severe when institutional monitoring is weak (Shleifer and Vishny, 2003). Moreover, political connections increase the perceived financial risk of the firm. Gul (2006) argues that auditors perceive politically connected firms to be riskier and present evidence that show that audit fees increased substantially more for these firms than their counterparts post Asian financial crisis. Gul (2006) suggests that politically connected firms have a higher risk of business failure and would more likely engage in earnings management to avoid debt covenant violations. Contrastingly, some studies find that politically connected firms exhibit an overall better performance (Chen et al., 2009). This may be the result of the special privileges given to politically-connected firms, such as government contracts and bailouts when in financial distress (Faccio et al., 2006). Moreover, Boubakri, Cosset, and Saffar (2008) presents evidence that investors require a lower cost of capital from politically-connected firms, indicating that politically-connected firms are deemed less risky than non-politically connected firms.

Studies have additionally analysed the effect of political associations on the nature of accounting information. Chaney et al. (2011) finds that because of less weight on politically-associated firms to react to advertise requests, nature of profit revealed by these organisations are fundamentally poorer than their partners. For instance, nature of detailed income has a negative relationship with expense of obligation in non-politically associated firms (Chaney et al., 2011). Interestingly, Batta, Sucre Heredia, and Weidenmier (2014) finds that as politically-associated Venezuelan industrial firms confront bring down danger of expropriation, they have higher bookkeeping quality than their non-politically associated partners. Subsequently, the lease looking for exercises of government officials, data asymmetry issues, and potential confiscation of investors may influence politically associated firms' efficient hazard, and consequently the expense of capital, as investors increment the

required profit for their interests in political associated firms. A ramification of this dialog is that political associated firms ought to have a higher expense of value financing contrasted with equivalent non-associated peers. We predict the following hypothesis, state in the alternative form:

H1: There is a relationship between political connections and cost of equity.

Corporate Governance and Cost of Equity

Board Size and Cost of Equity

The board size refers to the number of directors on the board. The current situation and many studies have shown that the board of directors is an important component of internal corporate governance. Several researchers verify that the effectiveness of the board of directors is influenced by the board size, but conflicting ideas exist on the appropriate size of the board. Jensen (1993) finds that smaller boards will be able to solve problems more effectively. The board should be sufficiently small to function effectively and sufficiently large to achieve diversity of experience and have appropriate background (Conger et al. 1998). Egbunike and Odum (2018) shows that board size has a positive and significant relation toward a firm's earning quality. An increase in board size appears to decrease the cost of equity. This is evidenced by studies by Lipton and Lorsch (1992), who conclude that a large board of directors is less likely to function effectively which makes decision-making and control more challenging.

Other studies have proven that the board should be sufficiently small to be more effective at problem solving (Jensen, 1993). Smaller boards are more consistent in their decision-making than larger boards, because the latter may form political coalitions and override the CEO's decisions. Yermack (1996) provides evidence that smaller boards have higher market values because a small board is associated with good corporate governance. Kole and Lehn (1997) state that a larger board yields slower decision making and a small board may be more effective in improving performance, may be easier to monitor, make faster decisions and produce more effective decisions more quickly.

According to Pearce and Zahra (1991), few differences exist between larger boards and smaller boards although the former are more powerful and effective. They also state that a larger board size will have better agreement between the firm and the environment, provide advice and counsel in the process of better management decision-making, and will accentuate the company's image. Singh (2003) supports with evidence that board size influences the

ratio of assets positively and significantly. Eisenberg et al. (1998) emphasize that a larger board reduces the efficiency of communication skills, coordination and decision-making compared with a small board.

Contradictory ideas exist on the suitable size of the board of directors in companies and non-financial institutions. The size of the board is said to increase before an increase in activism by institutional shareholders. Size may also increase following mergers or acquisitions to combine several target directors (Wulf, 2004). Adams and Mehran (2003) in their review of the bank holding company argue that active levels of consolidation in the banking industry yield a larger board in bank holding companies. A complex organisational structure of bank holding companies in which the bank holding company controls the subsidiary banks and has many different boards, including the board of directors of bank holding companies, also contributes to a larger board size. A larger board is created from a positive relationship with the size of the board and the size of the firm (Yermack, 1996; Hermalin and Weisbach, 1991). Based on the abovementioned arguments, as stated in an alternative form, the following hypothesis is predicted:

H2: There is a relationship between the board size and the cost of equity.

Independent Directors and Cost of Equity

The board of directors' role is to provide independent overview of the organisation, implement decisions and hold management accountable to shareholders for its actions. Based on the study by Fitch Ratings (2004), the monitoring of management is more efficient if a strong base of independent directors sits on the board. Zulkafli and Samad (2007) support that the role of independent directors in an organisation is important to ensure company efficiency. To achieve effective corporate governance, a certain number of independent directors in a firm must supervise and control the actions of opportunistic directors by resolving agency problems between managers and shareholders. Some researchers suggest that an increase in the number of independent directors on the board should increase the firm's performance (Fama, 1980; Fama and Jensen, 1983; Adams and Mehran, 2003; Reverte, 2009).

MacAvoy and Millstein (1999) and Hermalin and Weisbach (1991) argue that independent directors are connected with better decisions especially regarding acquisition, executive compensation and CEO turnover. The board structure in the organisation can affect agency costs that arise from low-quality financial reporting. Firms with a more independent board

exhibit less evidence of CEO over-composition (Core et al. 1999). Based on the abovementioned arguments, stated in an alternative form, the third hypothesis is:

H3: There is a relationship between independent directors and cost of equity.

Political Connections, Corporate Governance, and Cost of Equity

We posit that despite the negative relationship between political connections and cost of equity, the relationship is weaker in firms with more favourable governance mechanisms. Based on this argument, we predict the following hypothesis:

H4: The relationship between political connections and cost of equity is mitigated for firms with more favourable corporate governance mechanisms.

Research Methodology

Sample and Source of Data

This study is based on a sample of 2,223 firm-year observations that represent 978 firms on the Bursa Malaysia from 1999 to 2009. Data on corporate governance and institutional ownership variables are collected from annual reports available on the Bursa Malaysia website (www.bursamalaysia.com). The remaining data are collected from Compustat Global. After filtration of data, the final sample consists of 2,223 firm-year observations for the period from 2000 to 2009. These details are presented in Table 1.

Table 1: Industry Classifications

Industries	Obs	%
<i>AGRI</i>	112	5.04
<i>CONSTRUCT</i>	243	10.93
<i>MANU</i>	627	28.21
<i>CONSUMER</i>	644	28.97
<i>TRANSPORT</i>	188	8.46
<i>WHOLESALE</i>	181	8.14
<i>HOTEL</i>	82	3.69
<i>HEALTH</i>	54	2.43
<i>GOVT</i>	44	1.98
<i>OTHERS</i>	30	1.35
<i>MINING</i>	18	0.81
	2,223	100

Analysis Techniques and Research Models

We use the following regressions to validate our research objectives. For the first and second research objectives, regression (1) is used to examine the relationship between (1) political connection and (2) corporate governance and cost of equity. For the third research objective, regression (2) is used to examine whether corporate governance mitigates the relationship between political connections and cost of equity.

$$COE_{it} = \alpha - \beta_1 POLCON_{it} + \beta_2 CGOV_{it} + \beta_3 X_{it} + e_{it} \quad (1)$$

$$COE_{it} = \alpha - \beta_1 POLCON_{it} + \beta_2 CGOV_{it} + \beta_3 POLCON * CGOV_{it} + \beta_4 X_{it} + e_{it} \quad (2)$$

Where CGOV_{it} is corporate governance variables (board size, independent directors, duality, institutional investors and auditor size), while X_{it} is a list of control variables to capture the variations in the cost of equity.

Dependent Variable

The dependent variable is the cost of equity, which is the firm's return for investors and is normally used by firms as a discount rate to evaluate the project or investment. This study uses Regalli and Soana (2010)² method by relying on the Gordon model to obtain estimates of the cost of equity capital. In this model, the cost of equity (COE_{it}) is estimated using the one-stage Dividend Discount Model. It provides the price of a share at time (t) as the product of the ratio between the dividend at time $t+1$ and the difference between the cost of equity and growth rate of the share, or:

$$P_o = D_o \times \frac{(1+g)}{(k_e - g)} = \frac{D_1}{(k_e - g)} \quad (3)$$

Where P_o is the share price at time t , D_o is the dividend of the share at time t , g is the rate of growth of the dividends, k_e is the cost of the equity and D_1 is the dividend of the share at time $t+1$. By inverting (1), we can estimate the cost of equity as:

² Regalli and Soana (2010) have used a one-stage Dividend Discount Model (also termed the Gordon model) to estimate the cost of equity capital. The Gordon growth model is a variant of the [discounted cash flow](#) model, which is a method for valuing a [stock](#) or business. It is often used to provide difficult-to-resolve valuation issues for litigation, tax planning and business transactions that do not have a specific market value. It is termed after [Myron J. Gordon](#), who published it in 1959, and it assumes that the company issues a [dividend](#) that has a current value that grows at a constant rate. It also assumes that the required rate of return for the stock remains constant and equal to the cost of equity for that company. It involves summing the [infinite series](#) that gives the value of the current price.

$$K_e = \frac{D_1}{P_0} + G \quad (4)$$

The growth rate g is estimated as:

$$g = \text{ROE} \times (1 - \text{Payout Ratio})$$

This is an estimated solution of cost of equity that takes into account company performance but also the market-share appreciation. It is possible to demonstrate that the calculated cost of equity is given by the return on equity (ROE) multiplied by the ratio between net equity and capitalization. The value of goodwill therefore achieves a multiplicative and a de-multiplicative role in the cost of equity. For values that are relative to the variables used to calculate the cost of equity (share price at time t , dividends distributed at time $t+1$, ROE and Payout Ratio), refer to the data extracted by the Value Line database.

Independent Test Variables

The main independent variable is political connections ($POLCON_{it}$). We operationalised this variable by assigning it a value of 1 if the firms are politically connected based on the same premise of Johnson and Mitton (2003), and 0 otherwise.³ In addition, we identify government link firms under the Khazanah Berhad as politically connected firms.⁴ Our next main independent variable is a corporate governance variable ($CGOV_{it}$). This variable could be sub-categorized into internal and external governance mechanisms.⁵

For governance mechanisms, board independence ($BIND_{it}$) is measured based on the proportion of independent, non-executive directors to the total number of directors on the board. Moreover, the board size ($BFSIZE_{it}$) is measured from a natural-logarithmic transformation of the total number of directors on the board.

Table 2 summarises the descriptive statistics of the variables used in the analysis of the sample. Panel A shows the descriptive statistics of the cost of equity. The cost of equity

³ Johnson and Mitton (2003) rely on the analysis of Gomez and Jomo (1999) by identifying officers or major shareholders with close relationships with key government officials, primarily Tun Mahathir, Tun Daim, and Dato' Seri Anwar Ibrahim.

⁴ Founded in 1993, Khazanah Berhad is owned by the Malaysian government to manage selected commercial assets of the government and undertakes strategic investments on behalf of the nation.

(COE_{it}) has a mean value of 0.088, a median value of 0.084, a maximum value of 4.889, and a minimum value of -6.037 and a standard deviation of 0.367. Panels B of Table 2 reports that 14.5 percent of sample firms are politically connected. This is similar to Gul (2006) and Abdul Wahab et al. (2015).

Table 2: Descriptive Statistics (1999-2009, n=2,223)

	Mean	Median	Maximum	Minimum	Std. Dev.
Panel A: Dependent Variable					
COE_{it}	0.088	0.084	4.889	-6.137	0.367
Panel B: Political Connection					
$POLCON_{it}$	0.145	0.000	1.000	0.000	0.352
Panel C: Corporate Governance					
$BSIZE_{it}$	1.829	1.792	2.708	0.693	0.263
$BIND_{it}$	33.805	33.333	83.333	0.000	18.784
Panel D: Control Variables					
$DUALITY_{it}$	0.650	1.000	1.000	0.000	0.477
$INSTOWN_{it}$	10.418	5.192	78.918	0.000	14.345
$BIGN_{it}$	0.646	1.000	1.000	0.000	0.478
$MANOWN_{it}$	5.964	0.277	95.726	0.000	12.967
$BUMI_{it}$	27.288	20.000	100.000	0.000	27.984
$ASSETS_{it}$	19.958	19.759	24.991	17.010	1.307
$DEBT_{it}$	1.869	0.877	65.002	0.001	4.044
$MTBV_{it}$	2.202	1.320	20.000	0.000	2.524
$STROA_{it}$	4.671	3.576	19.943	0.000	3.762
$XLIST_{it}$	0.033	0.000	1.000	0.000	0.178

Results

We perform univariate analysis to examine differences between the mean and median of the variables between politically and non-politically connected firms tabulated in Table 4. We find the COE_{it} for $POLCON_{it}$ is significantly lower than non-connected firms, and this lends support that political connections provide benefits to the firms. This initial support is similar to Boubakri et al. (2012).

As for the governance variables presented in Panel B of Table 3, we find political connected firms have bigger board size, more separation of power between CEO and chairperson,

higher institutional investors' ownership and more percentage of firms being audited by a Big 4 auditing firm.

Panel C tabulates the mean and median differences for control variables. Politically connected firms have significantly lower $MANOWN_{it}$, but higher percentage of Bumiputra directors ($BUMI_{it}$), larger in size ($ASSETS_{it}$), $DEBT_{it}$, $MTBV_{it}$ and risk ($STROA_{it}$).

COE_{it} is cost of equity based on Dividend Discount Model, based on Regally and Soana, (2010). $POLCON_{it}$ takes the value of 1 if the firm is politically connected. $BSIZE_{it}$ is the natural log transformation of board size. $BIND_{it}$ is the percentage of independent directors on board. $DUALITY_{it}$ takes the value of 1 if the firm splits the CEO and chairperson. $INSTOWN_{it}$ is top 5 institutional investor shareholdings. $BIGN_{it}$ is an indicator variable that takes the value of 1 if the firm is audited by a Big N firm. $MANOWN_{it}$ is the percentage of managerial ownership. $BUMI_{it}$ is the percentage of Bumiputras directors on the board. $LASSETS_{it}$ is natural log transformation of total assets. $DEBT_{it}$ is total liability to total equity. $MTBV_{it}$ is market to book value. $STROA_{it}$ is standard deviation of return on assets computed over a rolling five years period. $XLIST_{it}$ takes the value of 1 if the firm is cross-listed at an external stock exchange. Significant p-values are in boldface. χ^2 results are in parenthesis.

Table 3: Differences of Mean and Median between Politically and non-politically connected firms (1999-2009, n=2,223)

	POLCON=1 (N=323)		POLCON=0 (n=1,900)		T-test p-value	Mann-Whitney p-value
	Mean	Median	Mean	Median		
Panel A: Dependent Variable						
COE_{it}	0.059	0.083	0.093	0.085	0.000	0.000
Panel B: Corporate Governance Variables						
$BSIZE_{it}$	1.935	1.946	1.811	1.792	0.000	0.000
$BIND_{it}$	34.607	33.333	33.669	33.333	0.531	0.530

Multivariate Analysis

Table 4 presents the test of the panel least-squares regression. The regression result between the dependent variable (COE_{it}) and a set of independent variables is shown in Column 1 with the main independent variable, $POLCON_{it}$. We find a negative and significant relationship

between $POLCON_{it}$ and COE_{it} and this suggests that political connected firms do enjoy lower cost of equity as relative to non-connected firms. The control variables are significant with the exception of $BUMI_{it}$ and $XLIST_{it}$. The result also shows that $MTBV_{it}$ is positively (0.020 , $t = 6.474$, $p < 0.01$) and significantly related to COE . This finding supports our prediction, where there is a positive relationship between market-to-book ratios with cost of equity. This finding is consistent with a previous study (Botosan and Plumlee, 2005; Hail and Leuz, 2006), which suggests a positive relationship between the implied cost of equity and market-to-book ratio.

Column 2 of Table 5 present the regression for the corporate governance variables and COE_{it} , without $POLCON_{it}$. We find positively and significantly relationship for two variables, $BSIZE_{it}$ and $BIND_{it}$ and COE_{it} . The results remain statistically similar as presented in column 3 of Table 5.

Table 4: Main Regressions (1999-2009, n=2,223)

Variable	Expected Direction	COE 1		COE 2		COE 3	
$INTERCEPT_{it}$?	-0.773		-0.742		-1.012	
		-4.244	***	-3.893	***	-5.074	***
$POLCON_{it}$		-0.091				-0.117	
		-3.458	***			-4.384	***
$BSIZE_{it}$				0.110		0.122	
				2.728	***	3.053	***
$BIND_{it}$				0.001		0.001	
				1.835	*	1.860	*
Control		Included		Included		Included	
Industry fixed		Yes		Yes		Yes	
Period fixed		Yes		Yes		Yes	
Adj R ²		0.081		0.099		0.108	
F-stats		8.919	***	8.835	***	9.374	***

COE_{it} is cost of equity based on Dividend Discount Model, based on Regally and Soana, (2010). $POLCON_{it}$ takes the value of 1 if the firm is politically connected. $BSIZE_{it}$ is the natural log transformation of board size. $BIND_{it}$ is the percentage of independent directors on board. $DUALITY_{it}$ takes the value of 1 if the firm splits the CEO and chairperson.

INSTOWN_{it} is top 5 institutional investor shareholdings. BIGN_{it} is an indicator variable that takes the value of 1 if the firm is audited by a Big N firm. MANOWN_{it} is the percentage of managerial ownership. BUMI_{it} is the percentage of Bumiputras directors on the board. LASSETS_{it} is natural log transformation of total assets. DEBT_{it} is total liability to total equity. MTBV_{it} is market to book value. STROA_{it} is standard deviation of return on assets computed over a rolling five years period. XLIST_{it} takes the value of 1 if the firm is cross listed at an external stock exchange. . *, **, and *** denote significant levels of 10%, 5%, and 1%, respectively.

Table 5 presents the results for the seventh hypothesis. Interestingly, we find the coefficients for $POLCON*BSIZE_{it}$ is positive and significant (0.155, $t=2.115$, $p<0.05$) while a negative and significant coefficient for $POLCON*BIGN_{it}$ (-0.098, $t=-2.030$, $p<0.05$). These findings provide a useful insight on the role of corporate governance; both internal and external in determining the cost of equity. As such, we find that the auditor's role as suggested by Fan and Wong (2002), do play a certification role in the Asian capital market, and this is supported by our finding.

Table 5: Regressions for Interaction between Corporate Governance and Political Connections (1999-2009, n=2,223)

Variable	COE		COE		COE		COE		COE		COE	
	1		2		3		4		5		6	
<i>INTERCEPT_{it}</i>	-1.012		-0.948		-1.012		-1.013		-1.023		-1.021	
	-5.074	***	-4.694	***	-5.073	***	-5.073	***	-5.087	***	-5.117	***
<i>POLCON_{it}</i>	-0.117		-0.411		-0.115		-0.109		-0.106		-0.047	
	-4.384	***	-2.813	***	-2.628	***	-2.303	***	-3.284	***	-1.085	
<i>BSIZE_{it}</i>	0.122		0.089		0.122		0.122		0.123		0.124	
	3.053	***	2.062	**	3.048	***	3.054	***	3.073	***	3.106	***
<i>BIND_{it}</i>	0.001		0.001		0.001		0.001		0.001		0.001	
	1.860	*	1.927	*	1.733	*	1.854	*	1.862	*	1.920	*
<i>POLCON*BSIZE_{it}</i>			0.155									
			2.115	**								
<i>POLCON*BIND_{it}</i>					0.000							
					-0.058							
Control	Yes		Yes		Yes		Yes		Yes		Yes	
Industry Fixed	Yes		Yes		Yes		Yes		Yes		Yes	
Period fixed	Yes		Yes		Yes		Yes		Yes		Yes	
Adj R ²	0.108		0.109		0.107		0.107		0.107		0.109	
F-stats	9.374	***	9.253	***	9.086	***	9.088	***	9.099	***	9.233	***

COE_{it} is cost of equity based on Dividend Discount Model, based on Regally and Soana, (2010). $POLCON_{it}$ takes the value of 1 if the firm is politically connected. $BSIZE_{it}$ is the natural log transformation of board size. $BIND_{it}$ is the percentage of independent directors on board. $DUALITY_{it}$ takes the value of 1 if the firm splits the CEO and chairperson. $INSTOWN_{it}$ is top 5 institutional investor shareholdings. $BIGN_{it}$ is an indicator variable that takes the value of 1 if the firm is audited by a Big N firm. $MANOWN_{it}$ is the percentage of managerial ownership. $BUMI_{it}$ is the percentage of Bumiputras directors on the board. $LASSETS_{it}$ is natural log transformation of total assets. $DEBT_{it}$ is total liability to total equity. $MTBV_{it}$ is market to book value. $STROA_{it}$ is standard deviation of return on assets computed over a rolling five years period. $XLIST_{it}$ takes the value of 1 if the firm is cross listed at an external stock exchange. *, **, and *** denote significant levels of 10%, 5%, and 1%, respectively.

Further Analyses

The role of Bumiputras Directors

We extend the test by focusing on the role of Bumiputras directors. Since Malaysia's capital market is being developed and deeply rooted to the establishment of the NEP, it is imperative to examine the role of Bumiputras directors. Studies have indicated that Bumiputra directors could be a proxy for political connections. Papers such as Gul (2006) and Abdul Wahab et al. (2017) used Bumiputras as a proxy for political connections. Their premise is simple as the main political party is dominated by UMNO, which is a Malay political party. However, another strand of research that utilise this Bumiputra proxy, focus on the role of culture and its impact of financial reporting. Studies such as Haniffa and Cooke (2002) and Abdul Wahab et al. (2015) proxied the cultural values mooted by the Hofstede-Gray framework by focusing on Bumiputras directors.

Nevertheless, both strands of research provide a distinctive consensus. They find companies that are dominated by Bumiputra directors will have lower level of governance, less transparent and inefficient. These factors will influence the quality of financial reporting and thus affect the information environment. In unreported table, Column 1 to 6 present the regressions for sample firms that are equal or above the median value of $BUMI_{it}$, while columns 7 to 12 present the regressions for sample firms below the median value. We find negative and significant relationship between $POLCON_{it}$ and COE_{it} for both sample, and the differences in coefficients ($POLCON_{it}$) is significant (F -stats = 3.456, $p < 0.01$). This finding lends support that firms with higher level of Bumiputra directors do enjoy lower cost of equity capital.

COEit is cost of equity based on Dividend Discount Model, based on Regally and Soana, (2010). POLCONit takes the value of 1 if the firm is politically connected. BSIZEit is the natural log transformation of board size. BINDit is the percentage of independent directors on board. DUALITYit takes the value of 1 if the firm splits the CEO and chairperson. INSTOWNit is top 5 institutional investor shareholdings. BIGNit is an indicator variable that takes the value of 1 if the firm is audited by a Big N firm. MANOWNit is the percentage of managerial ownership. BUMIit is the percentage of Bumiputras directors on the board. LASSETSit is natural log transformation of total assets. DEBTit is total liability to total equity. MTBVit is market to book value. STROAit is standard deviation of return on assets computed over a rolling five years period. XLISTit takes the value of 1 if the firm is cross listed at an external stock exchange. *, **, and *** denote significant levels of 10%, 5%, and 1%, respectively.

Conclusion

Empirical studies have proven a negative relationship between corporate governance and cost of equity. In this study, we aimed to investigate the relationship between internal and external corporate governance variables to the cost of equity for a Malaysian context. This study is conducted on 2,223 firm-year observations, which represent 978 firms listed on the Bursa Malaysia from 1999 to 2009. Firm size, leverage, market-to-book ratio and risk are used as control variables in this study, which represents the firms' characteristics between the test of dependent and independent variables. We find connected firms enjoy a lower cost of equity capital providing support that connections in Malaysia could be helpful and provide support to those firms. Results from an analysis of this study show that institutional investor and market-to-book ratio are positively and significantly related to the cost of equity. We could find no support for the relationship between the board independence to the cost of equity. However, this study also finds that the result for board size, firm size and risk is inconsistent with a previous study. This finding warrants further investigation.

This study has a number of limitations that should be noted and thus, provides opportunities for further research. First, this study chooses the Gordon Model calculation method. Therefore, some aspects may not have been taken into consideration. An extensive study on the relationship between corporate governance and cost of equity is being carried out in foreign countries, but is limited in Malaysia. Therefore, this study can be considered as a revelation to increase studies on the relationship between corporate governance and cost of



equity. Future research should try to examine other corporate governance variables that are not used in this study and their relationship to the cost of equity.

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Appendix A: Operational Definitions

	Definition	Source
Panel A: Dependent Variable		
COE_{it}	Dividend Discount Model (calculations based on the model Regalli and Soana, 2010)	Annual Report/Compustat Global
Panel B: Political Connection		
$POLCON_{it}$	Takes the value of 1 if the firm is politically connected as defined by Johnson and Mitton (2003)	Johnson and Mitton (2003)
Panel C: Corporate Governance		
$BSIZE_{it}$	Percentage of board size	Annual Report
$BIND_{it}$	Proportion of independent directors on the board	Annual Report
$DUALITY_{it}$	Takes the value of 1 if there is separation between CEO and the Chairman.	Annual Report
$INSTOWN_{it}$	Top 5 institutional investors ownership	Annual Report
$BIGN_{it}$	Takes the value of 1 if the firm is audited by a Big N auditing firm	Annual Report
Panel D: Control Variables		
$MANOWN_{it}$	The percentage of managerial ownership	Annual Report
$BUMI_{it}$	The percentage of Bumiputra directors on Board	Annual Report
$ASSETS_{it}$	Natural log of total assets	Annual Report/Compustat Global
$DEBT_{it}$	The ratio of total debt to total equity	Annual Report/Compustat Global
$MTBV_{it}$	Market value of equity divided by the book value of equity	Annual Report/Compustat Global
$STROA_{it}$	Standard deviation of return on assets computed over a rolling five years	Annual Report/Compustat Global
$XLIST_{it}$	An indicator variable if the firms are cross listed at an external stock exchange	

Data Description