

Institutional Monitoring, Foreign Directors and the Cost of Debt: Evidence from Listed Companies in Nigeria

Armaya'u Alhaji Sani

*Centre for Entrepreneurship Development, Federal University Dutse Jigawa State
armadisina@gmail.com , armadisina@fud.edu.ng*

Ishaq Alhaji Samaila

*Department of Accounting, Bayero University Kano.
ishaqismail005@yahoo.com iaismaila.acc@buk.edu.ng*

Abstract

This paper examines the relationship between institutional investors and the cost of debt of listed companies in Nigeria. The paper also explores the moderating effect of foreign directors on the relationship between institutional shareholders and the associated cost of debt. Based on the data of 220 firm-year observations of manufacturing companies, the study finds that institutional shareholders are associated with higher cost of debt. The study also finds that foreign directors are more likely to reduce the cost associated with debt financing. Interestingly, the interaction of foreign directors with institutional shareholders weakens the positive association of institutional investors on the associated cost of debt. This implies that foreign directors are more interesting in getting a higher return while lowering the associated risk of the firms.

Keywords: Institutional Investors, Foreign Directors, Cost of Debt, Nigerian Securities and Exchange Commission

Introduction

Debt financing is among the financial and strategic decision of corporate managers. It plays a significant role in the emerging market finance (Shailer & Wang, 2014). Corporate managers are faced with selecting the appropriate financing mix. The choice of higher or lower debt is largely the discretion of corporate managers. Thus, access to

finance has been the difficult task in emerging countries. Raising funds through public offer involves stringent requirement on the listed firms. It is also time consuming and costlier than debt financing. Therefore, trade-off between debt financing and equity finance is still a going concerned in the finance literature.

Agency theory of free cash flow suggests that debt may reduce the managers opportunities to invest the surplus cash flow in an unprofitable investment (Jensen, 1986). It is also urged that higher debt may force firms to signal quality information to the market, reduce information asymmetric and improve the firms overall quality (Ghouma, Ben-nasr, & Yan, 2018). High debt may subject firms to be monitored by debt holders. Similarly, Valipour and Moradbeygi (2010) argue that debt forces managers to act in the shareholders' best interest and to elude going to bankruptcy. A number of studies have examined many aspect of corporate governance and debt financing. Shailer and Wang (2014) suggest that government controlled firms are associated with less cost of capital. Feltham, Robb and Zhang (2007) document that higher debt drive firms to disclose quality information and to signal a better performance to the users. However, the effect of institutional monitoring on cost of debt is still been researched. In Malaysia, Tee (2018) has suggested the role of institutional ownership on cost of debt in Malaysia.

In Nigeria, institutional investors are recognized as the largest owners of listed companies with an average ownership exceeding 56% in 2015 (Miko & Kamardin, 2015b). Despite the role of institutional investors in ensuring effective monitoring and decision in the upper echelon of the firms, their effort depends on the

nature of institutional shareholding. Generally, institutional shareholders are categories in to active and transient shareholders; active shareholders are expected to play a significant role in reducing the cost associated with debt financing. The transient on the other hand are more likely to demand immediate benefit without regard to associated risk profile of the firms. (Chung, Kim, Kim, Lee, & Lee, 2019; Miko & Kamardin, 2015a)

Recent studies have also suggested the need for foreign directors to fill the missing competence and weak monitoring associated with board (Masulis, Wang, & Xie, 2012; Snday & Godwin, 2017). The benefits of foreign directors are attributed to the cognitive skills and information diversity offered into the upper echelon of the firms (Kim & Rasheed, 2014). Thus, foreign directors are expected to use their cross countries experience to lower the cost of financing. Our study makes several contributions to the literature. First, we show that institutional shareholders in Nigeria do not follow the active monitoring hypothesis but rather transient and positively related to cost of debt. We further show that foreign directors institutionalized control and weakened the positive association between the institutional shareholders. This study shed more light on how institutional shareholders influence the cost of debt and the moderating effect of foreign investors on institutional shareholding cost of debt relationship.

In section two, we introduced literature review and development of hypotheses; section three presents the research methodology and variables measurement. Then section four outlined the empirical results, while conclusion of the study is in section five

Literature Review and Hypothesis Development

Institutional Monitoring and Cost of Debt

Recent studies have established that institutional shareholders are perceived to enhanced decision making of the firms. In view of the above, prior studies extend their efforts to find the relationship between the institutional shareholders and cost of debt (e.g. Ghouma et al., 2018; Tee, 2018). Agency theory established that institutional ownership serves as instrument of effective monitoring when there is separation of ownership and control (Jensen & Meckling, 1976). The presence of shareholders coalition play a significant role in mitigating the associated agency problems (Rossi, Barth, & Cebula, 2018). Accordingly, Edmans (2014) transcripts that block holders can either lessen or intensify the agency costs. On the other hand, they may serve to mitigate conflict between managers and investors. García-Meca, López-Iturriaga and Tejerina-Gaite (2017) argue that institutional investors with less pressure are more likely to provide strong support for the

firm's decision making through active monitoring.

Dong and Ozkan (2008) suggest that active (long-horizon) institutions shareholders are more involved in corporate governance and better monitoring and disciplining role than other short-term transient institutions.

H₁ Ceteris paribus, institutional investors are negatively related with cost of debt

The Moderating Role of Foreign Director on Institutional Monitoring and Cost of Debt

Despite the importance of institutional shareholders to monitor compliance with the provision of code of Corporate and improve the integrity of financial statement (Securities and Exchange Commission, 2011). Not all institutional investors are willing to monitor and perform their function effectively (García-Meca et al., 2017). The literature suggests that some institutional investors are more interesting on information superiority and short term trading profits (Elyasiani, Jia, & Mao, 2010). Furthermore, some institutional investors vary in terms of investment strategy and their desire to gather information for better decision (Bennett et al. 2003; Cox et al. 2004). Therefore, the role of institutional shareholders to monitor and ensure appropriate cost of debt or capital is expected to be stronger in the presence of foreign board members. foreign

directors are more likely to make corporate managers to respond to appropriate strategic decision for investment purpose (David, Yoshikawa, Chari, & Rasheed, 2006). According to Masulis et al. (2012) foreign directors with cross countries experience can deliver valuable international expertise to the upper echelon of the board, especially those with significant skills in foreign operations. Thus, foreign directors jointly with long horizon institutional investors could play a significant role in strengthening the board's monitoring and lessening the cost associated with corporate debt financing. Furthermore, scholars such as Kim and Rasheed (2014) and Schmid and Dauth (2014) find that investors are more concern on hiring foreign top executives because they signal firm's willingness to better corporate governance and are very crucial for financial reporting monitoring.

H₂ Ceteris paribus, the role of institutional investors is expected to be stronger in the presence of foreign directors.

Research Methodology

Research Sample and Data

For our data analysis, we used a sample of listed manufacturing companies in Nigeria over the period of 2012-2016. Data on cost of debt, leverage, profitability (ROA) and firm size were obtained from Thomson Reuters data stream. The data on

institutional ownership, foreign ownership, foreign directors, BIG 4 and firm's age were derived from the annual reports of the sampled firms.

Our sample consists of 220 firm-year observations of listed manufacturing firms whose nature of business involve manufacturing or production of goods and services. These firms are active on the floor of the Nigerian Stock Exchange during the period 2012-2016.

Variable Construction and Measurement

Dependent Variables

The dependent variable in this paper is cost of debt. Consistent with previous studies (Jung, Herbohn, & Clarkson, 2016), we measured cost of debt as firm's interest expense in year t divided by average debt (short term and long term debt). In addition, this study considers the relative nature of Nigerian capital market and construct a second measurement as interest expenses divided by the firm's total liabilities. This will provide a new way for researchers in Nigeria.

Experimental Variables

The experimental variables in this study include institutional ownership, foreign ownership and foreign board members. Institutional ownership is defined as the proportion of shares held by institutions such as pension funds, insurance companies and banks (Yang, Chun, & Ramadili, 2009). Foreign ownership is measured

as the proportion of shares held by foreign shareholders to the total shares issued (Guo, Huang, Zhang, & Zhou, 2015). Foreign directors are measured as the proportion of foreign directors on the board members (Du, Jian, & Lai, 2017). Foreign directors are used in this research as direct and interaction variable on the relationship between institutional monitoring and corporate debt financing.

Control Variables

In line with prior studies on corporate debt financing (Borisova, Fotak, Holland, & Megginson, 2015; Jung et al., 2016; Ni & Yin, 2018), this study considers the following (BIG4, leverage, ROA, Firms size and firms' age) as control variables for the research. BIG 4 is a dummy variable taking 1 if the firm is audited by the BIG 4 auditors and 0 if otherwise (Bala, Amran, & Shaari, 2018). Firm size is measured as the natural logarithm of total assets (Kim, Lee & Yoo, 2018). While firm age is measured as the firm number of years after listing (Olowokure, Tanko & Nyor, 2016).

Empirical Model

The regression models used to test the hypothesis is:

$$\begin{aligned} IR1 &= \beta_0 + \beta_1 ISOWN_{it} + \beta_2 FROWN_{it} + \beta_3 FBDMB_{it} + \beta_4 BIG\ 4_{it} + \beta_5 ROA_{it} + \beta_6 FSIZE_{it} + \beta_7 FAGE_{it} + \epsilon_{it} \text{ ---- (1)} \\ IR2 &= \beta_0 + \beta_1 ISOWN_{it} + \beta_2 FROWN_{it} + \beta_3 FBDMB_{it} + \beta_4 ISOWN*FBDMB_{it} + \beta_5 FROWN* \beta_6 FBDMB + \beta_7 BIG \end{aligned}$$

$$4_{it} + \beta_8 ROA_{it} + \beta_9 FSIZE_{it} + \beta_{10} FAGE_{it} + \epsilon_{it} \text{ ----- (2)}$$

The definitions of all the variables including the experimental and control variables follow

IR1= interest expense for the year divided by its average short-term and long-term debt.

ISOWN = proportion of shares held by institutions such as pension fund, insurance companies and Banks.

FROWN = The proportion of foreign shareholding to total shareholding of the firms.

FBDMB= refers to proportion of foreign directors on the board

BIG 4 = is an indicator variable, 1 if audited by a big 4 audit firm 0 if otherwise.

LEV = sum of total short-term and long-term debt divided by total assets.

FAGE = Firms number of years after listing

Result and Discussion

Table 1 reports the descriptive statistics of the sampled companies. IR1 has a mean value of 0.21 with a standard deviation of 0.28. This indicates that the interest expense is 21% of the total debt. The mean value of 0.11 for IR2 signifies that interest expense account for 11% of total liabilities. Foreign ownership (FROWN) account for 33% of the total shareholding. Institutional shareholders

control 56% of the shares of manufacturing companies in Nigeria. The resulted mean of FRBMB is 0.23, this mean that foreign directors constitute 23% of the board room. Table 1 also indicates that BIG 4 has a mean value of 0.62, implying that 62% of listed manufacturing firms were audited by the BIG4 auditors. The

average value of ROA is 0.07, implying that return on assets is 7k. The resulted mean for LRVG is 0.52, this signifies that debt constitutes 52% of the total capital of the sampled companies. The mean value of FMSIZE and FAGE are 7.27 and 24.09 respectively. This means that companies stay 24 years after listing.

Table 1 Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
IR1	220	0.21	0.28	0.00	2.39
IR2	220	0.11	0.17	0.00	0.98
FROWN	220	0.33	0.31	0.00	0.75
ISOWN	220	0.56	0.23	0.00	0.88
FBDMB	220	0.23	0.22	0.00	0.78
BIG4	220	0.62	0.49	0.00	1.00
ROA	220	0.07	0.08	-0.11	0.23
LVRG	220	0.52	0.21	0.05	0.98
FMSIZE	220	7.27	2.68	6.24	8.41
FAGE	220	24.09	13.96	4.00	41.00

Correlations

Table 2 provides the bivariate correlation coefficients of both the predictors and the outcomes variables. The results show that IR1 is significant positively correlated with ISOWN and FMSIZE. The coefficient further indicates significant and negative

correlation between IR1 and ROA. Furthermore, the result shows significant and positive correlation between IR2 and ISOWN and FBDMB. Likewise, IR2 is negative and significantly correlated ROA and FMSIZE.

Table 2 Correlations

	IR2	FROWN	ISOWN	FDBMB	BIG4	ROA	LVRG	FMSIZE	FAGE	VIF
		0.032	0.112*	0.524*	0.015	-0.149**	-0.1000	-0.187***	0.01	
IR1	1.000		0.524***	0.645***	-0.067	0.037	-0.0120	0.287***	0.250***	
FROWN	0.032	1		0.538***	0.045	0.165**	-0.0570	0.266***	-0.049	2.25
ISOWN	0.112*	0.524***	1		0.148**	0.168**	0.0610	0.370***	0.228***	1.66
FDBMB	-0.074	0.645***	0.538***	1		0.289***	-0.0440	0.457***	0.262***	2.11
BIG4	0.015	-0.067	0.045	0.148	1		-0.179***	0.307***	-0.063	1.64
ROA	-0.149**	0.037	0.163**	0.168**	0.289***	1		-0.083	0.284***	1.2
						-	0.179**			
LVRG	-0.1	-0.012	-0.057	0.061	-0.044	*	1		0.027	1.15
	-									
FMSIZE	0.187**	*	0.287***	0.266***	0.370***	0.457***	0.307***	-0.083	1	1.61
FAGE	0.01	0.250***	-0.049	0.228***	0.262***	-0.063	0.284***	0.027	1	1.47

Note: *** significant at 0.01, ** significant at 0.05 and * significant at 0.1 level.

Regression Results

Table 3 Regression Result

	IR1 Model 1		IR2 Model 1		IR1 Model 2		IR2 Model 2	
	Coef.	t-stat	Coef.	t-stat	Coef.	t-stat	Coef.	t-stat
Intercept	0.690	3.51***	0.482	4.24***	0.708	3.93***	0.496	4.8***
ISOWN	0.192	4.33***	0.130	4.62***	0.045	0.89	0.016	0.43
FROWN	0.071	1.49	0.051	0.87	0.314	4.35***	0.238	4.25***
FDBMB	-0.145	-1.95*	-0.080	-1.97**	-0.108	-0.38	-0.056	-0.31
FB*FROWN					-1.028	-4.91***	-0.788	-4.64***
FB*ISOWN					0.614	1.74*	0.476	1.78*
BIG4	0.079	2.42**	0.047	2.52**	0.050	1.86*	0.025	1.56
ROA	-0.405	-2.12**	-0.261	-2.26**	-0.183	-1.07	-0.090	-0.89
LVRG	-0.110	-1.26	-0.088	-1.70*	-0.103	-1.25	-0.083	-1.72*
FMSIZE	-0.077	-3.16***	-0.057	-4.15***	-0.077	-3.36***	-0.056	-4.36***
FAGE	0.000	0.14	0.000	-0.04	0.000	0.02	0.000	-0.14
Years	5		5		5		5	
R ²	13.06%		12.25%		19.07%		19.07%	
N.	220		220		220		220	
Prob>	0.000		0.000		0.000		0.000	
Hetro	0.000				0.000			
Pesaran's								
CSD	0.05				0.039			
AR1	0.019				0.026			
Wald Chi2	64.35		158.79		155.15		389.52	

Noted: ***sig at 0.01, ** sig at 0.05 and * sig at 0.1 level

In this study, Panel Corrected Standard Error (PCSE) regression techniques was employed. PCSE is chosen because our data shows presence of

heteroskedasticity, auto correlation and cross section dependency as presented in Table 3. Hence, this study employed the PCSE model to correct for the

violation. Finally, test for multicollinearity using the variance inflation factor (VIF) was done and results show the values are all within the required threshold of less than 10 (See Table 2). Hence, the outcome is used in testing our hypotheses. Table 4 shows that the coefficient of ISOWN is positive and significant with IR1 (0.192, $P < 0.05$) and IR2 (0.130, $P > 0.05$) rejecting the hypothesis that institutional shareholders are less associated with higher cost of debt. This result indicates that institutional ownership may not exercise the optimum financing decision and could allow for costly debt financing to avoid dispersing the ownership and control. Our findings contradict previous studies such as Elyasiani et al. (2010) and Tee (2018) who urge that institutional ownership affects the cost of debt to a greater extent.

Table 3 also reports that FROWN is positive but insignificant with IR1 (0.017, $P > 0.05$) and IR2 (0.051, $P > 0.05$) indicating that foreign ownership is not associated with interest expense of the firms. Furthermore, the coefficient of FBDMB shows a negative significant relationship with IR1 (-0.145, $P < 0.05$) and IR2 (-0.080, $P < 0.05$). This result provide that foreign board members are less associated with high interest expenses, thus; supporting our hypothesis that citrus paribus, foreign board members are perceived as being professional in their decision.

In Table 3 also, the interaction of foreign directors on foreign ownership and cost of debt has reversed and strengthen the positive relationship reported in the direct effect. This finding conform the prediction of agency theory that foreign could enhance and strengthen board monitoring and reduce the associated agency conflict (Jensen & Meckling, 1976). Hence, the results support our hypothesis that presence of foreign directors could strengthen the association between foreign ownership and cost of debt in the firm.

However, the interaction of foreign directors with institutional ownership indicates that presence of foreign board members could weaken the positive influence of ISOWN on IR1 and IR2. This suggest that foreign board members may weaken the ability of institutional shareholders from increasing the cost of capital of listed companies in Nigeria. Thus, we could establish that foreign directors could have a strong impact in reducing the associated cost of debt.

Regarding the control variables, the results from this study finds a positive association between BIG 4 and IR1 (0.079, $P < 0.05$) and IR2 (0.047, $P < 0.05$). This is an indication that BIG 4 auditors are associated with higher cost of debt. The result also shows that ROA is negative and significant with IR1 (-0.405, $P < 0.05$) and IR2 (-0.261, $P < 0.05$), an indication that profitable firms are link with lower interest

expenses. Likewise, LVRG is found to be negatively associated with IR1 (-0.110, $P > 0.05$) and IR2 (-0.088, $P < 0.05$). As reported in Table 3, the results show that FMSIZE is negative and significantly associated with IR1 (-0.077, $P < 0.05$) and IR2 (-0.057, $P < 0.05$).

Conclusion

Building on the agency theory, the study examined the relationship between institutional ownership and the cost of debt, and whether presence of foreign directors can moderate the relationship. The result from this study shows that institutional and foreign shareholders are positively associated with higher cost of debt.

In addition, the study finds that foreign directors can reduce the cost associated with cost of debt and that foreign directors can moderates the association between institutional shareholders and the cost of debt. Likewise, foreign directors were found to moderates the relationship between foreign shareholders and associated cost of debt. The findings of this study provide important implications on both regulators, investors and debt holders. First, the presence of high institutional and foreign shareholders may not reduce the cost associated with high interest expense but rather increase the cost to generate more return thereby ignoring the future value of the firms. The investors should know that foreign directors can reduce the cost associated with debt financing and that their

presence on the board could better the board monitoring and the likely agency conflict. Finally, the findings provide a useful insight to Securities and Exchange Commission on the importance of foreign shareholders and their role of ensuring the optimum cost of capital.

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