

Corporate Governance Strength and Leverage: Empirical Evidence from Jordan

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Abstract

This paper examines the impact of corporate governance strength on capital structure in an emerging country, namely, Jordan, by constructing a corporate governance score that captures both internal monitoring mechanisms (foreign ownership and institutional ownership) and external monitoring mechanism (audit fees). In addition, this study uses profitability as control variable. This paper uses data of non-financial companies (industrial and services) of 87 listed firms on Amman Stock Exchange (ASE) from 2011 to 2019. Using the random-effects generalized least square (GLS) regression model, the findings reveal that foreign ownership significantly and negatively influences the level leverage, while institutional ownership has a positive and insignificant association with level leverage. Further, audit fees have a positive and strong significant association with level leverage in Jordan. In addition, profitability has a positive and significant association with leverage. These outcomes suggest that foreign ownership should be encouraged in listed companies as it can replace the weakness of other corporate governance mechanisms in Jordan. The outcomes of the current study should be of great interest to regulators and policy-makers. The results, which are robust to a range of alternative proxies and to additional tests, provide new insights into the determinants of level leverage.

Keywords: Ownership Structure, Audit Fees, Leverage

JEL Classification Code: G3, G32, G11

1. Introduction

The fundamental objective of a firm is the maximization of the wealth of shareholders. Corporate governance and firm leverage play a major role in maximizing the wealth of shareholders. Strong corporate governance leads to the enhancement of firm value (Black, 2000; Gompers et al., 2003; Rouf, 2014), whereas high leverage leads to a decline in the firm value due to increased risk of bankruptcy (Obradovich & Gill, 2012). It is therefore necessary for a firm to establish a strong governance and an optimal capital structure. Salehi, Arianpoor, and Dalwai (2020) found that companies are able to reduce the cost of equity by establishing

strong corporate governance. However, Jantadej and Wattanatorn (2020) argue that corporate governance plays a crucial role in protecting shareholder wealth and reduces asymmetric information between corporate and external investor including debt holder leading to a decreasing in cost of debt financing.

Corporate governance has been defined as the control systems and practices through which investors or lenders get assurance of receiving returns on the money they invested (Shleifer & Vishny, 1997). A solid and well established corporate governance system is important for the rapid advancement of an economy. The countries with strong corporate governance systems have been able to rapidly expand their corporate sector by bringing more capital into their economies at lower costs, thereby increasing the value of the firm and maximizing the wealth of the shareholders (Ahmed Sheikh & Wang, 2012). Integration of China's economy into the global economy along with the speedy development of capital markets enabling higher investment from different countries have caught the attention of researchers to investigate the governance structure of the firms in China (Huang & Wang, 2015; Liu & Fong, 2010; Wei, 2007; Xu & Wang, 1997).

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The outside auditor performs a vital role in monitoring the interest of protecting and management shareholders in the capital markets via the financial statements the public companies. In view of the benefits derived from the auditor, they provided standardized reports to regulators, investors, and other important personalities involved in the business. The pass and fail model are adopted by many nations, including Jordan in presenting the audit report to show the difference in companies audit process with little insight.

Ownership structure has become a subject for organizations, accounting profession's regulators, several researchers and existing authorities around the world (Filatotchev, Jackson, & Nakajima, 2013). The monitoring strength acquired from the ownership structure results in a type of control applied to the firm, specifically the high management team (González & García-Meca, 2014). As a result, the ownership structure is a core determinant of the agency cost (Habbash, Xiao, Salama, & Dixon, 2014). Many empirical studies have confirmed the effective role of ownership structure in monitoring the firm's action, for instance, Siregar and Utama (2008) argue that ownership structure influences the monitoring mechanisms used by the firm. Further, Alshetwi (2016) and Ramadan (2015) find that top stockholders have less influence on earnings management, and can decrease the level of management opportunism.

Ownership and control separations are associated with agency problems among shareholders and management, which generate the requirement for external auditors. External auditors are in charge of confirming that the statements of a financial report are impartially specified according to generally accepted accounting principles and revealing the firm's operating outcomes and accurate economic condition. Therefore, the confirmation of the external auditors enhances the integrity of the financial statements (Al-Zoubi, 2017).

2. Literature Review

In the context of business, the financial leverage term is seen as a loan, or refers to borrowing (getting debt) to finance various purchases (Gill & Mathur, 2011). If a firm acquiring a lot of debts (leverage), it seems to raise its chance of insolvency (Asif et al., 2011). When debt (external financing) is employed rather than equity (internal financing), the firm capital is not deducted by the issuing more ownership securities. Investors are aware that getting debt is a good thing for companies seeking to grow. Nevertheless, when leverage reaches a critical position, investors become worried regarding the firm's financial position (Bhatti et al., 2010). Although, academic research has been done on the subject of leverage and earning power, it has found contradictory results (Asif et al., 2011; Ayub, 2015; Enqvist et al., 2014; Lartey et al., 2013). Some studies have stated that companies with a high level of financial leverage are profitable (Lartey

et al., 2013; Memon et al., 2012). That is to say, there is a positive association between the leverage and the firm's earning power when a company depends greatly on debt (external finance), which will lead to maximize the wealth of shareholders (Memon et al., 2012). Moreover, when equity holders control the business operations, then the level of debt and financial leverage become positively correlated to each other, and vice versa (Kraus & Litzenberger, 1973). However, Nguyen and Nguyen (2020) show that capital structure has a negative effect on the firm performance.

Hingorani, Lehn, and Makhija (1997) argued that foreign ownership could use their control to mitigate agency problems by aligning the interests of managers and other shareholders. According to Guedhami, Pittman, and Saffar (2009) reported that foreigners prefer transparent companies, as it could reduce information asymmetry and the impulse for expropriation. Moreover, foreign investors are more experienced and efficient in evaluating companies (Grinblatt & Keloharju, 2000; Seasholes, 2000). Ferreira and Matos (2008) reported that foreign ownership plays a more efficient role on corporate governance level than domestic intuition, leading to enhanced firm performance, which may influence corporate investment policy.

Furthermore, foreign investors face more agency costs than domestic institutional investors due to various legal environments (Patibandla, 2006). Merton (1987) argues that investors have various amounts of information related to a company and they invest in a company that is already well-known to them. According to Zou and Xiao (2006), foreign owners are able to discipline the local managers via debt financing as foreign ownership focuses on corporate valuations and transparency. However, Suto (2003) found that foreign ownership reduces the agency cost of equity financing. These could appear as reasons for the negative relationship between foreign investors and leverage.

Phung and Le (2013); Sivathaasan (2013); Mishra (2013) reported significant positive influence of foreign ownership on leverage. The result indicates that foreign investors are motivated to force firms to employ more debt to mitigate the agency problem because of the issue of high level of information asymmetry in Vietnam. From the information asymmetric argument for foreign investors, it is expected that there is a negative relationship between foreign ownership and leverage. According to Kang and Stulz (1997), foreign investors tend to invest in large and low leverage firms suggesting that large firm have lower information asymmetries than small firms.

However, Li et al. (2009) point out that foreign investment is negatively related to all measures of leverage. This result is clarified by two explanations. First, firms with high foreign ownership would have more diversified financing channels to access capital than others because of their reputation and relationship. In the same

result Huang et al. (2011) argue that foreign owners are mainly institutional investors with considerable experience in monitoring managers. Le and Tannous (2016) found a negative relationship between foreign ownership and capital structure. This negative relation in the Vietnamese market can be clarified. First, firms having foreign ownership usually are reputable and have strong financial circumstances. Therefore, they can easily finance for their firms from multiple channels. Second, foreign owners can reduce the agency cost of equity as they can help firms to control overinvestment problems. Similarly, Gupta, Yadav, and Jain (2020), investigating Indian firms in the period from 2008 to 2018 by using the generalized method of moments (GMM) technique for empirical analysis, observe that there is a statistically significant negative relationship between foreign ownership and leverage. In addition, Chen and Yu (2011); Anwar and Sun (2015) provide that foreign ownership affect leverage significantly and negatively. However, Zou and Xiao (2006) reported a non-monotonic relationship between foreign ownership and leverage.

Institutional ownership structure can advance the corporate governance effectiveness since institutional investors monitor the progress of firms where ownership is denoted by shares holding. According to Al-Najjar and Clark (2017), institutional ownership is the percentage of shares held by institutions. Institutional investors exert a greater influence on corporate governance and are important performers in most financial markets due to their influence and the policy of privatization being pursued by several countries (Al-Najjar, 2010). Institutional investors consist of pension funds, trust institutions, insurance companies, financial and investment companies (Lang & McNichols, 1997). Chung and Wang (2014) find that changes in leverage decrease when changes in institutional ownership increase, suggesting that a firm reduces its debt level as institutional investors substitute for external debt monitoring.

According to Sun, Ding, Guo, and Li (2016) found a positive relation between institutional ownership and leverage. This study provides two explanations: First, high institutional ownership firms have an incentive to issue more bonds and less equity. Second, such firms are more likely to turn to other types of debt as financing channels. However, past studies have reached inconclusive results between institutional ownership and leverage. Tong and Ning (2004) argue that as domestic institutional investors have better access to different information resources, they prefer firms with low leverage ratio, since firms with high leverage could face future financial difficulties. Furthermore, institutional investors could use their monitoring ability to minimize the conflict between managers and other shareholders (Pushner, 1995). Several authors such as Ciceksever, Kale, and Ryan (2006); Ezeoha and Okafor (2010); Michaely and Vincent (2012) found a negative relation between institutional

ownership and leverage. Ashrafi and Muhammad (2014), investigating Malaysian firms in the period from 2002 to 2011 by using the generalized method of moments (GMM) technique for empirical analysis, observe that there is a statistically significant negative relationship between institutional ownership and leverage. In contrast, Crutchley, Jensen, Jahera, and Raymond (1999) found a positive relation between institutional ownership and leverage.

According to Al-Ajmi and Saudagaran (2011), economic reliance of external auditors on their clients is one of the factors that threaten independence. Unpaid audit fee is one of the factors that were found to negatively affect the perceived auditor independence (Alleyne, Devonish, & Alleyne, 2006). Stanley (2011) demonstrated that unexpected contemporaneous audit fees are higher when the client has lower future return on assets, suggesting that auditors charge a premium in the presence of increased likelihood of future client losses and future auditor litigation. Forms of auditor business risk with respect to cash holdings and its potential consequences include shareholder class action lawsuits for lost wealth, which typically name both the client and the auditor as defendants, lost audit fees resulting from declining client performance, and reputational damages due to the auditor's association with the client. These arguments suggest that audit fees are associated with leverage.

Essentially, higher audit risk requires greater audit effort, which translates into higher audit fees (Ettredge, Fuerherm, & Li, 2014). In Jordan, Vanstraelen (2000) asserted that audit fees have a big effect on the audit quality; and the decrease in the audit fees is considered one of the problems by the Jordanian audit firms. Siam (2003) found that among other factors, audit fees significantly influence the independence of external auditors in Jordan. Overall, the higher the audit fees, the better the audit quality (Gist, 1994; Clarkson & Simunic, 1994).

Using a sample of 150 Indonesia firm-year observations between 2014 and 2016, Harahap and Prasetyo (2018) examined the relationship between audit fees and leverage. The study found that the relationship between audit fee and leverage is not significant. In another study, Nehme and Jizi (2018) conducted a study on London firms for the period of 2011 until 2015. The panel data fixed-effects method resulted in negative and significant association between audit fees and leverage. This implies that low leverage firms are subject to less audit testing and consequently require less chargeable hours, as they are considered less risky (Fan & Wong, 2005). Firms with larger asset size incur relatively higher audit fees as they are likely to have more diversified and complex business transactions (Demsetz & Strahan, 1997), which require more audit hours and hence higher audit fees (Haskins & Williams, 1990). Similarly, Benjamin et al. (2015) found the same results in US S&P firms for the period from 2000 to 2012. Recently, Barua, Hossain, and Rama

(2019) also found a negative and significant relationship between audit fees and leverage for manufacturing firms listed in USA firms.

On the other hand, Hossain and Sobhan (2019), investigating Bangladesh firms in the period from 2015 to 2018 by using a robust ordinary least square (OLS) method for empirical analysis, observe that there is a statistically significant positive relationship between audit fees and leverage. In addition, Gul and Tsui (1997); Shakhathreh, Alsmadi, and Alkhataybeh (2020) found a positive relation between audit fees and leverage.

3. Hypothesis Development

Foreign shareholders play a key part in the ownership structure of firms particularly in developing countries (Randoy & Goel, 2003; Douma, George, & Kabir, 2006). Furthermore, previous empirical evidence indicates that the presence of foreign ownership leads to lessening agency cost (Abor & Biekpe, 2007; Guo & Zhou, 2015). The foreign owners are able to discipline the local managers via debt financing as foreign ownership focuses on corporate valuations and transparency (Zou & Xiao, 2006). Suto (2003) states that foreign ownership reduces the agency cost of equity financing. This would lead to negative relationship between foreign ownership and leverage. However, in Jordanian setting, Zeitun (2009) and Al-Thuneibat (2018) conclude that foreign ownership negatively influences on firm's performance. Several empirical studies for example, Chen and Yu (2011); Anwar and Sun (2015); Le and Tannous (2016) found that foreign ownership affects leverage significantly and negatively. However, Zou and Xiao (2006) reported a non-monotonic relationship between foreign ownership and leverage. Therefore, the first hypothesis is developed as follows:

H1: *There is a negative relationship between foreign ownership and leverage.*

In order to monitor the activities of firm's management, institutional ownership serves as internal mechanism which further safeguard the enactment of firm's value maximization. Under information asymmetry theory, Myers and Majluf (1984) state that company could reduce information asymmetric problem by first using internal funds, followed by debt and finally equity. Institutional investors mitigate the adverse selection costs of equity by reducing information asymmetry through information-gathering activities and their trading patterns (Sias, 2004; Bushee & Goodman, 2007). Chang, Kang, and Li, (2016) argued that by strengthening the corporate governance, institutional investors play a strong role in monitoring and mitigating agency costs.

Several empirical studies, for example, Michaely and Vincent (2012); Ashrafi and Muhammad (2014); Gupta, Yadav, and Jain (2020) found that institutional ownership affect leverage significantly and negatively. In contrast, Crutchley, Jensen, Jahera, and Raymond (1999); Abobakr and Elgiziry (2016) and Sun, Ding, Guo, and Li (2016) reported significant and positive relationship between Institutional ownership and leverage. However, In Jordan, there is lack of evidence for institutional ownership and leverage. Therefore, the second hypothesis is developed as follows:

H2: *There is a positive relationship between institutional ownership and leverage.*

In the modern business world, diversified capital structure is very common meaning that companies have both equity and debt capital in their capital structure. Equity providers get dividend whereas debt providers earn interest as a benefit on their investment. It is likely that debt providers impose a great number of conditions in order to secure their invested money. It implies that the company with high debt capital faces a large number of debt covenants (increase pressure on management), which lead management to earnings manipulation in order to convince the capital providers. Thus, external audit fees are expected to have a positive association with leverage. The literature provided exception to Hossain and Sobhan (2019) and Shakhathreh, Alsmadi, and Alkhataybeh (2020) who found that external audit fees are significantly and positively associated with leverage. In contrast, Md Noor and Raihan Sobhan (2019) reported that there is no significant relationship between audit fees and leverage. The previous studies (Sun & Liu, (2011), Hay et al., (2006), Simunic, (1980) and Firth (1993) have identified a positive association between client risk and the external audit fees. However, the consideration of risk factors was different such as equity to total assets, low level of return on assets. Therefore, based on the finding of the previous studies, the following hypothesis is developed:

H3: *There is a positive relationship between audit fees and leverage.*

4. Methodology

4.1. Population and Sampling

This study examines the relationship between internal monitoring mechanisms corporate governance (foreign ownership and institutional ownership) and external monitoring mechanism (audit fees) on leverage of the public-listed firms on Amman Stock Exchange (ASE) from 2011 to 2019. This period is selected due to the fact

that the implementation of corporate governance in Jordan started after the year 2009.

4.2. Model Specification

To investigate the influence of corporate governance on leverage, the following regression model is employed (see Table 1).

$$\text{Leverge}_{it} = \beta_0 + \beta_1 \text{Fown}_{it} + \beta_2 \text{Iown}_{it} + \beta_4 \text{Afee}_{it} + \text{Pro}_{it} + \varepsilon_{it}$$

5. Empirical Results

Table 2 shows the descriptive statistics. Table 3 displays the results of correlation analysis. This study assumes a negative relationship between foreign ownership and leverage. Table 4 shows that the relationship between

foreign ownership and leverage is negative and significant ($\beta = -0.5363$, $p = 0.004$). This result is consistent with the result of Kang and Stulz (1997); Kim and Piman (1998); Li, Yue, and Zhao (2009); Le and Tannous (2016) who find a negative relationship between foreign ownership and leverage. This result foreign investors tend to invest in large and low leverage firms suggesting that large firm have lower information asymmetries than small firms, and therefore, hypothesis one (H1) is accepted.

Institutional ownership is expected to be positively associated with leverage. Table 4 shows that there is an insignificant positive relationship between institutional ownership and leverage ($\beta = 0.0192$, $p = 0.182$). A plausible explanation for insignificant result is that, since domestic private institutional investors have low ownership, they do not have enough incentive to involve in management actions as they bear the costs of monitoring but the benefits accrue

Table 1: Measurement of Variables

Variables	Variable Name	Measurement
LEV	Leverage	Ratio of total debt to total assets
FOWN	Foreign ownership	The proportion of shares possessed by foreigners (non-Jordanian) to gross company's shares numbers
IOWN	Institutional ownership	The percentage of shares owned by institutions
AFEE	Audit fees	Natural log of fees paid for the services of audit
PRO	Profitability	EBIT/Total assets

Table 2: Summary Statistics

Variable	Obs.	Min	Max	Mean	Std. Dev.	Prob.	Skewness	Kurtos
LEV	783	0.0009	1.0423	0.3307	0.2110	0.2927	0.9072	3.4324
FOWN	783	0.0000	0.9872	0.1111	0.2238	0.0000	2.2132	7.1019
IOWN	783	0.0000	0.9991	0.3658	0.3166	0.3326	0.4285	1.9103
AFEE	783	7.6543	11.438	9.0711	0.6224	9.0710	1.1181	5.6185
PRO	783	-0.476	0.6834	0.0261	0.1075	0.0340	-0.475	9.3409

Table 3: Correlation Matrix Results

Variables	LEV	FOWN	IOWN	AFEE	PRO
LEV	1				
FOWN	- 0.0238	1			
IOWN	0.0805	0.3818	1		
AFEE	0.2560	0.3072	0.4840	1	
PRO	- 0.2837	0.0321	0.0767	0.1366	1

Note: ***, ** and * Indicates significant at 1%, 5% and 10% level of significance based on t-statistics.

Table 4: GLS Regression Results of LEVERAGE Model

Variables	Fixed-Effect		Round-Effect		Gls	
	Coefficient	Prob.	Coefficient	Prob.	Coefficient	Prob.
FOWN	-0.1083783	0.101	-0.0924241	0.081	-0.0536324	0.004
IOWN	0.0295498	0.475	0.0368544	0.294	0.0192192	0.182
AFEE	0.0149601	0.399	0.0369182	0.0019	0.1072227	0.000
PRO	-0.3380515	0.000	-0.3611371	0.972	-0.6958964	0.000
VIF	1.25					
F-stat	Prob-f	0.0000				
Hausman	$\chi^2 =$	0.0090				
Homo	No Hetero					

to other shareholders. This result is not consistent with Crutchley, Jensen, Jahera, and Raymond (1999) who found that institutional ownership positively influences leverage. Thus, hypothesis two (H2) is not accepted.

This study expected a positive relationship between audit fee and leverage. As shown in Table 4, audit fee has a positive and significant relationship with leverage ($\beta = 0.1072$, $p = 0.000$). This result suggests that audit fee contributes positively to the leverage. This result is consistent with Hossain and Sobhan (2019) and Shakhathreh, Alsmadi, and Alkhataybeh (2020) who found that leverage positively influences audit fees, which is in line with agency costs explanations under corporate governance whereby leverage exert a stronger effect on audit fees in firms with low growth opportunities. These relationships were expected because of the high level of debt capital indicates a large number of debt covenants that lead management to manipulate performance in order to make debt providers happy.

In Jordan, audit fees have a significant influence on audit quality and independence of external auditors (Siam, 2003; Vanstraelen, 2000). This study contributes to the existing literature by finding that audit fee has significant influence on leverage, and thus, hypothesis three (H3) is accepted.

6. Conclusion

Optimal leverage and strong corporate governance structures are vital for increasing the value of the firm and maximizing the wealth of shareholders. However, prior literature suggests that the governance characteristics and leverage structures change at various life-cycles of the firm. Therefore, this study has examined 87 companies in the industrial and service sector on Amman stock exchange, using the random-effects generalized least square (GLS) regression model to study the effects of both internal monitoring mechanisms (foreign ownership and institutional ownership) and external monitoring mechanism (audit fees) on the leverage of a firm.

The results of this study point to several factors affecting leverage. The results show a significant negative relationship between foreign ownership and profitability, while audit fees has a positive and significant association with leverage in Jordan. The results also indicate a non-significant relationship between institutional ownership and firm complexity as well as leverage.

These outcomes suggest foreign ownership should be encouraged in listed companies as it can replace the weakness of other (CG) mechanisms. The outcomes of the current study should be of great interest to regulators and policy-makers. The results, which are robust to a range of alternative proxies and to additional tests, provide new insights into the determinants of leverage. Consequently, such results perhaps alert the firms' audit committees and the Jordanian securities commission (JSC), to verify the reasons that make institutional ownership engage in leverage. In addition, the result of this study could encourage JSC to develop the Jordanian corporate governance code and tighten the penalties of companies that do not comply with the requirements of such code.

However, this research is limited to the region of Jordan with a small sample size. Future research should test the arguments and conclusions of this study in different contexts as knowledge of the interactions of the effects of different ownership structure and audit quality remain limited. Better research along with improved literature is much needed for the effects of various metrics about ownership on leverage, especially in emerging markets.

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