

Corporate governance mechanisms and the cost of debt: evidence from Tunisian context

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Audit quality, governance, board, Monitoring, Debt cost, Tunisian listed companies.

Abstract

This paper investigates the effect of corporate governance and audit quality on the debt cost financing of Tunisian listed companies. When, banks and other financial institutions don't participate in corporate governance structures (such as boards of directors for example), they might pay attention to overall quality of monitoring tool set up within companies and to financial reporting's quality. So, we may expect an inverse relation between the debt cost and the quality of governance and auditing structure. Using a pooled sample of large, nonfinancial listed Tunisian companies over the years 2000 to 2011, the empirical findings reveal that corporate governance quality has a significant reducing effect on the cost of debt, whereas audit quality does not. Specifically, multivariate analyzes document an inverse relation between the ex post cost of debt and (1) the Board size, (2) the presence of shareholder block, (3) the presence of institutional shareholders, and (4) the international auditor network membership.

1. Introduction

Within a debt economy, companies turn to debt financing. Yet, such a debt is not without cost. Indeed, agency conflicts existence support to the lenders a double risk. The first one is the shareholders expropriation behavior. The second is the misappropriation by the company of a part of the investment earnings. For these reasons, lenders are demanding a higher cost debt. Reinforcing the corporate governance quality could reduce these costs. Morellec and Schürhoff (2011) show that information disclosure and corporate governance mechanisms have an effect on the cost of equity capital.

In this paper, we try to examine the effect of corporate governance and the quality of audit on the debt cost of Tunisian listed companies. The question is very important in Tunisia because external debt holders were for a longtime the major financing source of company's development. Contrary to the German system, banks and other financial institutions are not engaged in corporate governance structures such as director's boards. So they are supposed to pay a particular attention to audit quality and control as well as to financial reporting quality of these companies.

In such context, empirical investigation has shown that the leverage proxies may, in certain circumstances, influence the choice of high profile auditors (Piot, 2004) or creating effective audit committees (Schöndube, 2011). So, according to the cost-benefit reasoning and assuming that investment in governance and audit quality are costly, there should be exist an inverse relation between debt cost capital, government quality and audit quality public companies.

This paper is organized as follow. Section 2 develops the theoretical framework and the hypotheses of the study. Section 3 explains methodological issues to select the sample and variables description. Section 4 presents the empirical results and a final fifth section summarizes our main finding and conclusions.

2. Theoretical Framework and Hypotheses

a) The relation risk-debt capital

The major difference between debt and equity capital is the control effectiveness by lenders. In fact, debtholders have no effective control on the use of the funds they provide. These funds can then be used opportunistically by corporate managers to achieve their own interest or these of shareholders. The use of debts contracts (especially in Anglo-Saxon contexts) may reduce such behavior. The use of these contracts in Tunisia remains minor. Debtholder's protection is largely guaranteed by securities and warranties

mechanisms taken on the firm's assets in place. As a result, one can consider that debtholder's risk stems from two origins:

- (1) The importance of agency conflicts with the managers or the shareholders, that can be mitigated by corporate governance system quality;
- (2) The quality of financial reporting, as long as the nature and the value of assets is taken in to consideration to appreciate the warranties of debt contract.

So, one could argue that the quality of corporate governance on one hand, and the quality of audit process on the other hand, are likely to mitigate debtholder's risk and therefore the cost of debt capital.

b) Quality of the corporate governance and prevention of agency risk

Agency theory shows that the monitoring effectiveness of manager's actions stems from the board of directors on the one hand (Lorca, 2011), and from active institutional investors on the other hand (Jia, 2010). They may increase monitoring mechanisms in controlling the discretionary power and the opportunism of managers (Bhojraj and Sengupta, 2003).

According to Lajmi and Gana (2011), the director board's characteristics and the ownership structure may affect the power control and monitoring effectiveness of manager's action. Therefore, a powerful board can regulate the significant investment and financing decisions of the managers, such as, fixing a threshold above which some investment and financing decision need its approval. The board's approval can prevent non-optimal investment decisions or the asset's substitution which often brings to a wealth transfer from debtholders to shareholders (Myers, 1977; Galai and Masulis, 1976). The effective monitoring of the board depends on:

- (1) The size: it may influence the effective functioning of the board as well as its composition and characteristics (number of internal and external directors, number of mandates, duration and role of the directors).
- (2) The director's independence: the board director's effectiveness finds its origin in skill and in independence of its members. Nominating an independent director could positively affect the credit note.

In addition, the nature of ownership structure plays a more significant role in corporate governance. First, concentrate capital's ownership within a restrict number of big shareholders could be a source of agency conflicts between shareholder and debtholder. Second, an institutional investor in a board could have a disciplinary role (Chen, 2010). According to Viénot and Button reports (2004), these investors often hold a significant block of the company's capital which confers them a strong power on monitoring manager's actions. So, the presence of significant institutional investors in the capital and the pressure of financial market should minimize the debtholder's risk due to manager's opportunism. Third, sharing capital by manager would reduce agency costs. Indeed, when the managerial ownership rose, the agency costs decrease and the need for more effective monitoring is low.

In hole, we can suppose that corporate governance quality reduce the cost of debt financing (proposal 1). From this proposition, two testable hypotheses can be allowed (H1a and H1b):

H1a: there is an inverse relation between the cost of debt financing and the board composition.

H1b: there is an inverse relation between the cost of debt financing and the capital structure of the company.

c) Audit Quality and disclosed information's reliability

In France, Piot (2007) documents that leverage affect positively the probability that firm has created an audit committee. Lajmi and Gana (2011) note a positive relation between the probability to have a financial statement audited by one of the big six and leverage.

From an external user's viewpoint, audit quality can be achieved by two ways: (1) by nominating competent and independent external auditors and (2) by setting up independent and vigilant audit committees. It is commonly accepted that high-profile auditing network provide a high quality audit services (DeAngelo, 1981). In addition, the presence of an audit committee - that is not required yet in Tunisia -, as well as its independence, are important factors in protecting external and internal auditor's position from managerial pressure.

So, it is expected that improving audit process quality will lead to higher quality financial statements. Such quality will appear in the form of more conservative, less aggressive accounting methods associated to high-profile auditors (Francis and Lennox 2008) or to audit committee (Piot and

Janin, 2008). This higher conservatism in the accounting is a part of an efficient contracting with debtholders (Watts, 2003). Naser and al. (2013) document that committee's independence ensures its efficiency. They specify that a firm audit committee composed by independent members was less sanctioned by Securities and Exchange Committee because of misleading financial statements. So, a quality approved by an audit would offer to the administrators a high insurance's that financial statements do not contain clerical errors, reducing then the information's asymmetry. The existence of external independent directors may increase the monitoring role effectiveness of audit committee and influence its decisions (Mussolino, 2013). Other academic researchers such as Fraser and al. (2006) show that a higher ratio of independent directors within the audit committee may give lower interest rates.

Thus, an investment in audit quality by listed companies - by appointing qualified auditors and/or setting up independent audit committees - should limit the informative risk of debtholder and so the debt cost financing. This leads to our second research proposition, which also allow two testable hypotheses (H2a and H2b):

Proposition 2: Audit process quality reduces the debt cost financing.

H2a: there is an inverse relation between the debt cost financing and external auditor profile.

H2b: there is an inverse relation between debt cost financing and audit committee independence.

3. Sample and Methodology

a) Data collection

Our study concerns the listed not financial industrial companies having an ownership structure and board composition published in annual reports. We then concentrated on companies listed at least once during period going from 2000 to 2011. After several eliminations¹, a short list of 23 companies is selected. Financial and accounting data are collected from the database of financial market council and the valuable index published by the Tunisian stock exchange. Ownership, governance and auditing information were manually collected in annual reports. Final sample includes about 289 observations. Some companies did not exist or not publish financial statements for all the eleven financial years and dependent variable (the average cost of the debt) is not calculated with enough reliability in 13 cases.

The period selected (2000-2011) is relevant to test our research proposition in the Tunisian context for two main reasons. First, this time frame agrees to a growing attention paid to board monitoring activities in corporate governance reports. Indeed, Tunisia began a reform program aiming to improve governance mechanism as solution to the transparency problems of information published by companies and to the debtholder's loss reliability. This is essentially materialized through the various reports of good behavior and the successive rule's amendments. The board structure, its functioning, the presence of independent members, the setting up of an audit committees were widely discussed in the first guide of good behaviors and corporate governance in 2007. Two years later, the second version of the guide underlined more the independence of the directors. It notably recommended (p. 13-14) that board has to be composed from 7 to 9 members and that has to include at least one third of independent directors. Second, this period covers a series of events having a major incidence on corporate governance and on financial information published by companies. To begin with the BATAM scandal (2002) that revealed the bankruptcy of monitoring structures and procedures. Three years later, a financial transaction security law has strengthened the credibility of the financial information published by companies. Widely inspired by the law Sarbanes-Oxley, it tries to increase the manager's responsibility, to reinforce the internal control and to reduce the sources of interest conflicts. In 2007, another law presents several measures to protect shareholders. So, shareholders who detain less than 10 % of equity capital could cancel any decision judged against the statutes and who would strike company interests. Finally, a new law (law n°2009-16) has changed the trading company's code. It aims to avoid interest conflicts by indicating in the

¹ Elimination criteria are: Companies recently listed, Companies of which one single annual report at least was not able to be consulted during the last three years of the study and Companies which do not publish strengthened states.

board report any direct or indirect interest that managers have in contracts settled with company. This law has also mentioned the methods to approve decision by the board and to inform external auditor.

b) Variable measurement and presentation of the model

Dependent Variable

The dependent variable is defined as the average interest rate on the firm's debt. It is calculated by dividing its interest expense for the year by its average financial debt.

Variables of interest

Variable of interest are used to test our hypotheses. They relate to the concept of corporate governance quality on the one hand and audit quality on the other hand.

Corporate governance quality

In a disciplinary agency framework, corporate governance quality refers to the monitoring effectiveness of the firm's governance structures. Following the research framework, we consider two aspects of an effective corporate governance system: (1) The composition and the size of the board (H1a) and (2) the nature of the capital structure (H1b).

The board of directors is, generally, the ultimate monitor of manager's discretionary power, and bears the legal responsibility for the quality of financial statements disclosed to outside stakeholders. We consider the following variables to proxy for board effectiveness (or ineffectiveness):

- The size of director board (BrdSize), which is often be argued to be inversely correlated to the board effectiveness (Jensen, 1993)².
- The independence of board directors (BrdInd). Charreaux (1997) consider as external or independent the directors who are neither managers nor shareholders within the company. He notes that presence of independent directors may improve the quality of monitoring and internal control.

Farther, we consider three other proxy variables for the monitoring effectiveness stemming from the nature of capital structure.

- The presence of an institutional shareholder (InstSh). The monitoring effectiveness is associated with the significant presence of institutional investors in firm's equity (Klein and Zur, 2009).
- The presence of a shareholder blocks (ShlderBlock), which means the presence of a majority shareholder who detains more than 50 % of the firm's capital equity. Such a situation is captured by a dummy variable coded 1. It confers to the shareholder widely attributions that may weak the board role.
- The presence of managerial shareholders, such as managers or company's employees who detain shares in the capital equity while taking part in strategy elaboration, in decision-making and who are almost present or represented in the management board.

Audit process quality

The quality of audit process is study in several ways. The first one focuses on the characteristics of external auditors (H2a). The second emphasizes on the existence of an effective audit committee (H2b):

- The size and the reputation of external auditor. The quality of external audit depends essentially on two variables linked to auditor's skills and independence (DeAngelo, 1981). We consider the presence of an international network auditor with a dummy coded 1 if an auditor belonging to an international network has been nominated as external auditors. Lennox and Pittman (2009) document that the presence of international network auditor guarantees these two qualities. Indeed, human, material and financial resource's availability allows these auditing firms to support more pressure exerted by unsatisfied customer (certification refusal of not reliable financial statements) and increases their independence degree.

² Opposite arguments also exist in the literature. Having said that, Lipton and Lorsch (1992) and Yermack (1996) suggest that a larger board provide less individual assignments, and thus more extensive monitoring possibilities.

- The existence of an audit committee (AudCom), which is not compulsory in Tunisia but recommended by the financial transactions safety (2005) and by the corporate governance guide (2007). The existence of an audit committee is denoted by a dummy variable.
- According to Klein (2002), the part of not executive independent members within the committee measure the independence of audit committee (ACInd).

Control variables

Control variables refer to various surrogates of debtholder's risk and firm characteristics identified in the literature, which are likely to influence the interest rate of loan agreements needed by lenders.

- Firm performance: Bhojraj and Sengupta (2003) document that firm having a weak profitability support a high default risk. Thus, its leverage debt increase debt's agency costs and reduces firm's value. The profitability is measured by Return On Assets Ratio (ROA).
- Bankruptcy risk: Boubakri and Ghouma (2007) assert that large firms are more diversified and are less exposed to bankruptcy risk than small firms. According to them, large firms support a low debt costs. So, this risk depends on firm size (LnAssets).
- Debt leverage (Lev), which measures the independence's degree of the firm towards external lenders as well as its capacity to resist to hazards and exogenous shocks that cause losses. The debt is measured by the total debt to asset ratio.

Table 1 summarizes the variables, their detailed specification and their expected association with debt cost financing.

Name	Definition	Expected sign
Dependent variable		
DebtCost	Interest expenses divided by the average financial debt over the fiscal year.	
Variables of interest : Corporate Governance Quality		
BrdSize	Number of director on the board BrdInd	(-)
BrdInd	Board independence: the part of independent directors on the board	(-)
MgrialSh	Part of capital equity detained by employees or managers	(-)
Shlderblock	Dummy coded 1 if identified shareholders hold more than 50 % of common stocks	(+)
InstSh	Presence of institutional shareholders	(-)
Variable of interest : Audit quality process		
AudCom	Dummy coded 1 if an audit committee exists.	(-)
ACInd	Part of external director within audit committee member	(-)
INAudFirm	Dummy coded 1 if an international network audit firm has been nominated as external auditor	(-/+)
Control Variables		
LnAsset	Firm size is represented by the natural log of total assets.	(-)
ROA	Return of total assets: net income / total assets	(-)
Lev	Leverage ratio: total financial debt / total assets.	(+)

Table 1: List of variables and their specification

Descriptive statistics					
	Mean	SD	Min	Max	N
DebtCost	0.04	0.03	0.001	0.08	276
BrdSize	8.7	2.10	5	12	276
BrdInd	0.75	0.28	0	1	276
ACInd	0.59	0.42	0	1	276
MgrialSh	0.05	0.09	0	0.4	276
InstSh	0.11	0.18	0	0.88	276
LnAsset	17.7	1.02	13.09	19.67	276
ROA	0.06	0.07	-0.25	0.33	276
Lev	0.47	0.24	0.01	1	276
Variables dichotomous					
AudCom	1: an audit committee exists			19	82.61
	0: if not			4	17.39
Shlderblock	1: a major shareholder is identified			11	47.83
	0: if not			12	52.17
INAudFirm	1: an international network audit firm has been nominated as external auditor			9	39.13
	0: if not			14	60.87

Table 2: Exhibits descriptive statistics (pooled sample 2000-2011)

Table 2 presents corporate governance traits that are consistent with those reported in other investigations, and notably the report of good behavior and governance (2007). Specially, one can note that the part of independent director in the board is 75 %. Also, an audit committee has been formed in 82, 6 % of the cases, but that only more than half (59 %) of these committees include independent members, casting doubts about their effective monitoring power. Institutional shareholders are far less represented (only 11 % of the observations) compared with the presence of a majority shareholder concentrating all the powers (47, 8 %). Accordance to audit quality surrogates, the presence of international network audit firm among statutory auditor is found in 39, 13 % of the observations. Overall, this important variation in governance and auditing attributes offer potentially fruitful testing possibilities about the dependent variable under investigation.

4. Empirical Results

a) Bi variate Tests

Table 3 presents the correlation between independent variables as well as multi-collinearity³ measurement. The results show that there is no critical correlation between the independent variables and there is no serious problem of multicollinearity. As expected, there is a negative correlation between debt leverage (Lev) and the board independence (BrdInd) and the existence of an independent audit committee (ACInd). The control exercised by these two committees limit the manager's opportunist behavior. Interestingly, the existence of an institutional shareholder (Instsh) is negatively related (-0.139) to debt leverage and positively (0.367) to performances. This result confirms theoretical frameworks which document that institutional investors exercise a more effective control than individual shareholder. Finally, the Board independence and firm size are negatively correlated. This relation can be explained by the peculiarity of Tunisian firm (family firms). These companies are reluctant to the presence of independent directors.

	BrdSize	BrdInd	ACInd	Mgrialsh	InstSh	LnAsset	ROA	Lev	VIF
BrdSize	1								1.82
BrdInd	-0.066	1							1.69

³ Variance Inflation Factor allows to control multi-collinearity of interest's variables. Linear independence is measured by a VIF coefficient equal to 1 and collinearity by a coefficient superior to 10.

ACInd	0.269**	0.516**	1					1.65	
Mgrialsh	-0.037**	-0.023	-0.038	1				1.64	
InstSh	-0.170*	-0.094	0.080	-0.004	1			1.50	
LnAsset	-0.129	-0.196**	-0.086	0.167**	0.155*	1		1.43	
ROA	-0.067	0.019	0.248**	0.016	0.367**	0.359**	1	1.31	
Lev	0.085	-0.077	-0.230**	0.164**	-0.139*	-0.056	-0.455**	1	1.10

** , * significance respectively at 1% and 5% level.

Table 3: Correlations matrix of Pearson and Variance Inflation Factor (VIF)

b) Multivariate Analysis

This paper favors a multivariate analysis and, using linear regression, tests what are the factors likely to affect the cost of debt. In the purpose, the following model, which considers at the same time the individual dimension (i) representing the firm and the temporal dimension (t) marking the period of the considered study, is tested empirically:

$$DebtCost_{it} = \alpha_0 + \alpha_1 BrdSize_{it} + \alpha_2 BrdInd_{it} + \alpha_3 AudCom_{it} + \alpha_4 ACInd + \alpha_5 MgrialSh_{it} + \alpha_6 ShlderBlock_{it} + \alpha_7 InstSh_{it} + \alpha_8 InAudFirm_{it} + \alpha_9 LnAsset_{it} + \alpha_{10} ROA_{it} + \alpha_{11} Lev_{it} + \varepsilon_{it}$$

Because of the error's properties, we use the test of Breusch-Pagan to test heteroscedasticity. We obtain a significant statistic Fischer (prob> F=0,000) that allows us to reject the null hypothesis. As well as the error's auto correlation, the Wooldridge test of intra-individual's auto correlation (2002) allow accepting null hypothesis (prob> F superior to 0.05) and confirming thus the absence of auto correlation problem.

As expected, the model shows that the Board size has a negative and significant effect on the debt cost (- 1, 14). This result which is similar to that got by Anderson and al. (2004), argue the idea that a board composed by a significant number of directors may have the power to refuse or approve decisions taken by managers. Thus, managers could not easily make decisions diverging with investor's interests. Second, the Board composition or the percentage of independent directors has no significant effect on the debt cost. Contrary to expected results, table 4 relates that the presence of shareholder block has a negative and significant effect (statistically significant at the 5 % level) on the debt cost financing. So, Tunisian firms characterizing by a strongly concentrated ownership structure may support a lower debt cost.

Given the presence of institutional shareholder, we can note a significant positively relation with debt cost. The positive sign shows that when the institutional shareholder holds parts in capital equity, the debt cost increases. Charreaux and Pitol-Belin's academic researches (1990) show that institutional investors do not have enough information on firm's financial situation and use public information that carry them to make poor decision for the company. Thus, contrary to expected result, the presence of institutional shareholder does not reduce debt cost financing, even though the Tunisian firm financing is weakly depending on stock market and banks are their principle lenders.

About the managerial shareholders, we notice that this variable has no significant effect on the debt cost. Thus, we reject the hypothesis stipulating that presence of managers-shareholders should reduce the debt cost.

Further, the relation between the debt cost and the presence of an international network audit firm nominated as external audit is significantly negative. Indeed, contrary to the French Firm (Piot, 2007), the Tunisian firms audited by an international network audit firm support a heavy low cost debt. Also, the presence of audit committee has no effect on the debt cost financing. This result shows that creating audit committees is not still well included. Indeed, several Tunisian firms have not been creating such committee yet. This result was often confirmed when the committee contain an independent members. So, the proposition arguing that audit committee independence is negatively related to debt cost is rejected.

Among the control variables, we notice that the ROA has no effect on debt cost. The same result is done when using leverage debt. We assume then that these variables are not significant. However, surprisingly, firm size is positively correlated to debt cost financing (statistically significant at 1 % level).

So, large companies support higher costs than small firms. These results counter the theoretical proposition associating negatively the costs with firm's financial information. We can explain this result by two ways. First, the information reliability has been dropped.

Indeed, when firms grant less interest to internal audit committees, they hope to escape monitoring mechanism on their management method. In the same time, having no more trust in audit committee, investor and banks don't bring out this information when claiming interest rates. The second reason is much more fanciful. During the last 10 years, Tunisian economic was marked by investor rarity, by subjective criteria dominance in granting credit such as owner fame or his relational network and, finally, by the loss of stakeholder's credibility (State, external auditors, etc.).

So, in a weak competitive context based essentially on bank financing, it is difficult for companies to enforce the rate proportionality's rule to their financial situation. The interventionism and the member board passivity of many lenders (especially public one) allow not successful and heavily indebted firms to support a lower debt cost than healthy one. The intervention of an influential personality can decide on granted rates. At the same time, and because of competition's lack, a successful firm could accept high rates to finance their development programs.

Variables	Coefficients	Student probability
Constance	-4.497136	0.199
BrdSize	-1.145523	0.014*
BrdInd	-.0711923	0.416
AudCom	.0151796	0.811
ACInd	.1243759	0.485
ShlderBlock	-.1114762	0.042*
MgrialSh	.0442908	0.511
InstSh	.1722782	0.000**
INAudFirm	-.1770514	0.028*
LnAsset	3.264705	0.002**
ROA	.0423597	0.371
Lev	-.1348752	0.327
R ² ajusted	0.7567	
Fischer	3.12	
Prob de F	0.0006	
N	276	

** , * significance respectively at 1% and 5% level.

Table 4: Regression's results

4. Conclusion

This paper examines empirically the effect of corporate governance mechanisms on debt cost of Tunisian listed companies. Because they are not taking in corporate governance structures (such as boards of directors for example), banks and other financial institutions might pay attention to the overall quality of monitoring tools set up within companies, as well as to the quality of financial reporting. According to risk-aversion properties, when the risk of debtholders is higher, larger risk premium is demanded and in the same time the cost of debt financing. Specially, we posit that debtholder's risk has two main parts: (1) agency/expropriation risk and (2) informative risk. The first part is the possibilities of wealth transfers by the managers or shareholders at the expense of debtholders, while the second depends on the quality of financial reports disclosed by the firm. Therefore, we may expect an inverse relation between the cost of debt and the quality of corporate governance and auditing structures of public companies.

Using a pooled sample composed of non-financial listed companies over the years 2000 to 2011, we test whether the ex post cost of debt is correlated with surrogates of the corporate governance quality and the audit process quality. Empirical findings reveal that three individual have a significant reducing effect on the cost of debt: the characteristics and composition of the board, the structure of capital equity and the quality of external audit.

Besides, we note that four governance traits present a significant reducing effect on borrowing costs: (1) the Board size, (2) the presence of shareholder block, (3) the presence of institutional shareholders, and (4) the international auditor network membership. However, a single surrogate of audit process quality affects the cost: the existence of an international network audit firm appointed as an external auditor guarantees the independence of the auditors and increases the reliability of debtholders. However, the existence of an independent audit committee has no effect on the cost of debt. These results are robust to firm size effects and to the control for a large set of firm-specific characteristics. Contrary to prior studies, control variables proxying for debtholders's risk (ROA, the debt leverage, the firm size) are not correlated with the cost of debt.

In conclusion, our findings globally support reinforcing monitoring function as strongly recommended in Tunisia. They stress the important role of an effective board of directors when minimizing the cost of debt financing. They show internal audit committees importance in supervising the manager's opportunist behavior and in reducing risks. However, they also suggest that financial reporting and accounting number's quality are not of prime interest to debtholders in the Tunisian setting. This can be explained by the culturally less important use accounting-based monitoring devices such as debt contracts in the Tunisian debt contracts. Indeed, contractual guarantees taken on assets in place (mortgages or equivalents) have long been a sufficient mean to secure banker's investments in corporate financing.

However, as economic assets become more and more intangible and illiquid, and as the Tunisian setting became uncertain after the 2011's revolution, one can notice that audit quality considerations will gain importance soon.

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