



Political connection and cost of debt: Some Malaysian evidence

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ABSTRACT

This paper investigates the association between Malaysian politically connected (PCON) firms and the cost of debt. We extend previous research that finds Malaysian PCON firms are perceived as being of higher risk by the market, and by audit firms, by providing evidence that lenders also perceive these firms as being of higher risk. We also find that PCON firms have a significantly (1) higher extent of leverage, (2) higher likelihood of reporting a loss, (3) higher likelihood of having negative equity, and (4) higher likelihood of being audited by a big audit firm. We suggest that PCON firms are charged higher interest rates by lenders as a result of efficient contracting given their higher inherent risks. Additionally, we find that CEO duality present in PCON firms is perceived by lenders as being more risky, and that a higher proportion of independent directors on the audit committee mitigate this perceived risk.

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1. Introduction

The understanding of “relationship-based” non-Western economies has been the focus of a number of studies in recent years spurred on by the growth and subsequent importance of these economies over the last decade. One country that has received such attention is Malaysia. This may be attributed to it having the phenomenon of politically connected (PCON) firms (Gomez and Jomo, 1997; Faccio et al., 2001; Gomez, 2002; Johnson and Mitton, 2003; Faccio, 2006; Gul, 2006; Fraser et al., 2006) well documented. As Johnson and Mitton (2003) found, in the early stages of the 1997 Asian financial crisis, the stock prices of PCON¹ firms fell lower than those of non-favored firms. They explain this by suggesting that the market saw PCON firms as being inefficient and perceived the government as being unable to support these favored firms. The Malaysian government then introduced capital controls that resulted in the stock prices of PCON firms recovering. It was also reported that PCON firms carried comparatively more debt than non-PCON firms. In a related study, Gul (2006) found that during this period the audit firms assessed PCON firms as being more risky and,

as such, devoted greater audit effort in auditing them. Of course, the greater audit effort led to the auditors charging the PCON firms higher audit fees. Subsequent to the Malaysian government's introduction of capital controls, the costs of auditing PCON firms fell. The two papers just discussed provide evidence that both the market and auditors respectively assessed PCON firms as being riskier than non-PCON firms and both papers suggest the reason for this is that these firms are perceived as being inefficient. Fraser et al. (2006) find that Malaysian PCON firms are significantly associated with higher leverage. These papers indicate that PCON firms are more risky. The objective of this study is to extend our understanding of these firms by investigating (1) whether these firms have a higher cost of debt capital given their association with higher leverage, and (2) whether major corporate governance reforms instituted by the Malaysian government have had any effect on the cost of debt to these firms.

Since the market and audit firms have perceived Malaysian PCON firms to be associated with higher risk higher leverage compared to non-PCON firms, it would be reasonable to expect that the cost of debt capital would be higher relative to non-PCON firms. This study investigates whether PCON firms are associated with a higher cost of debt. The study further investigates whether two corporate governance attributes impact on the cost of debt of PCON firms. The two corporate governance attributes that we investigate are (1) CEO duality (where the chief executive officer and the chairman of the board are the same person), and (2) the proportion of independent directors on the audit committee. The data used in

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¹ Malaysian politically connected firms for the purpose of this study are defined as firms that have been identified as being politically connected in Johnson and Mitton (2003) and Faccio (2006).

this study was hand-collected from the annual reports published by firms listed on the Kuala Lumpur Stock Exchange (KLSE) from 2001 to 2004.²

The Malaysian Code on Corporate Governance (MCCG) became effective from the financial year ending 30 June 2001 and mandated that firms comply with a number of prescriptions aimed at enhancing corporate governance practices.³ The MCCG advocated that CEO duality on boards be avoided stating that no one individual should have such “unfettered” powers.⁴ CEO duality was thus regarded as a sub-optimal corporate governance attribute by the MCCG, the market at large and by audit firms. Coupled with the previous findings about the riskiness incidental to PCON firms, it is posited that lenders will perceive PCON firms with CEO duality to be more risky. This would, in turn, enhance the cost of debt. The MCCG also prescribed the establishment of an audit committee with the majority of the members being independent directors⁵ implying that this will result in higher quality financial reporting. As may be expected, the audit committee’s duties include liaising with the external auditors concerning the nature and scope of their work, reviewing financial statements, and discussing problems and reservations that they may have in relation to the financial reporting (MCCG, BB, II, (ii) and (iii)). [Carcello et al. \(2002, p. 381\)](#) provide evidence that independent directors (on boards) are prepared to pay more for a higher quality audit “to protect their reputation capital, to avoid legal liability, and to promote shareholder interests”. Given that PCON firms may be considered by lenders as clients posing a higher risk, it is considered reasonable to conjecture that a stronger, or more independent audit committee may reduce that risk. That is, it is posited that a more independent audit committee on PCON firms will be associated with lower costs of debt.⁶

The results from this study provide evidence that the interest rates charged by lenders to PCON firms are significantly higher than those charged to non-PCON firms. This is in line with our expectation that lenders perceive PCON firms to be more risky. This finding is in line with the previous findings by [Johnson and Mitton \(2003\)](#) and [Gul \(2006\)](#) who found PCON firms to be perceived riskier by the market and by audit firms, and by [Fraser et al. \(2006\)](#) who provided evidence that PCON firms are more highly leveraged. This study also finds that CEO duality in PCON firms is associated with higher interest rates being charged, and that a higher proportion of independent directors on the audit committee are associated with lower interest rates. These results indicate that that sound corporate governance practices in relation to the boards of PCON firms impact on the risk assessment of these firms by lenders.

The higher risk of PCON firms is further evidenced in this study through analysis using tests of differences of means [using *t*-tests

and *Chi-square* (for indicator variables)] on a selection of variables taken from the sample collected. The analysis reveals that in addition to PCON firms being charged significantly higher interest rates, they also have a significantly (1) higher extent of leverage, (2) higher likelihood of reporting a loss, (3) higher likelihood of having negative equity, and (4) higher likelihood of being audited by a big audit firm.⁷ These findings further support the view that PCON firms are risky. This evidence suggests that the higher interest rates charged by lenders reflect efficient contracting by them following their consideration of the higher risks inherent in these firms.

Whilst a number of studies have investigated political connections and cronyism, and a small number of studies have investigated the cost of debt (see e.g. [Pittman and Fortin, 2004](#)), there appears to have been no study of political connections and the effect thereof on debt pricing for the PCON firms. The major contribution of this study is that it provides evidence that lenders perceive PCON firms to be higher risk borrowers than non-PCON firms and accordingly, charge them a higher interest rate. The evidence presented in this study is in line with and builds on previous papers that investigated Malaysian PCON firms. The results also lend support for prescriptions made by the MCCG towards achieving an “optimal governance framework”. Evidence is presented that supports MCCG prescriptions made against firms having CEO duality, and the importance placed on audit committee independence. Our findings indicate that lenders take these board characteristics into account when assessing the risk and subsequent interest rate pricing of PCON firms. A further contribution of this study is the documentation that 14.5% of PCON firms (and 4.5% of non-PCON firms) in this sample have negative equity. Whilst these firms continue to be listed and trade on the KLSE, they are technically bankrupt as the value of the liabilities of these firms exceeds the value of their assets by the extent of their negative equity. It is surprising that this has not been reported in previous investigations of Malaysian PCON firms.

The remainder of this study is organized as follows. Section 2 contains the literature review from which the hypotheses are developed. Section 3 discusses the research methodology, followed by a discussion of the results. Section 5 contains the conclusions that summarize the main findings of the paper and includes a discussion on identified limitations and the implications of our findings.

2. Literature review and hypotheses development

2.1. Cost of debt

Only small number of studies has investigated the cost of debt and the determinants of debt pricing. [Pittman and Fortin \(2004\)](#) in a study of IPOs considered the effects of auditor type on the cost of debt. These authors find that big audit firms enhance the credibility of financial statements and, as such, are associated with lower borrowing costs. These authors find, however, that the choice of auditor becomes less important over time as a determinant of interest rates charged on debt over time. In fact, this association diminishes quickly as a young firm establishes a history with its lenders. [Francis et al. \(2005\)](#) investigate the association between both the cost of debt and equity capital and the level of voluntary disclosures made in financial statement reporting. These authors find that firms in industries with greater external financing needs have higher levels of voluntary disclosure levels which, in turn, are associated with lower costs of debt and equity.

² The Kuala Lumpur Stock Exchange changed its name to Bursa Malaysia on April 14, 2004.

³ The aim of the MCCG was to ‘set out principles and best practices...towards achieving the optimal governance framework’ (para. 1.3).

⁴ MCCG (para. AA,II) concerning CEO duality prescribes that there ‘should be a clearly accepted division of responsibilities... (to) ensure a balance of power and authority, such that no one individual has unfettered powers of decision’ and that when CEO duality is present ‘there should be a strong independent element on the board’, and that such a practice should be publicly explained. The Code adopts best practice prescriptions of the Cadbury Committee Report and the [Greenbury Report \(1995\)](#).

⁵ The MCCG prescribes that at least two thirds of those that sit on the audit committee be independent. An investigation of the emerging market in Malaysia provides an excellent opportunity to ascertain the effectiveness of the audit committee in view of the fact that the MCCG mandated that only the majority of directors on the audit committee are independent, and not that they all be independent.

⁶ It should be noted that whilst our study focuses on the MCCG prescriptions concerning increased audit committee effectiveness, and CEO duality, the Code covers other prescriptions concerning the Board of Directors and its responsibilities, remuneration, and other areas that are not within the scope of this study.

⁷ PCON firms having a likelihood of being audited by a big audit firm may suggest that the management of these firms contract with larger audit firms to signal higher credibility in the reported financial statements, and as a means of reducing agency costs ([Watts and Zimmerman, 1986](#)).

2.2. Political connections in Malaysia

The Malaysian government in 1969 instigated a new economic policy (NEP) as a means of increasing participation by indigenous Malays (Bumiputeras) so as to address what was then a situation where the local Chinese predominantly controlled the economy (Gul, 2006). The government was selective in favoring certain firms by providing them with easy access to bank credit. Predominantly, these firms were Bumiputera-owned and were financed through the United Malay National Organization (UMNO) to acquire equity stakes in firms previously owned by the Chinese. The government also selectively chose favored firms to receive investment resources, again at favorable prices. As an example, the Heavy Industries Corporation of Malaysia (HICOM) was established in 1980. HICOM progressed successfully to the point that by the 1990s it either directly or indirectly controlled many companies (see Gomez (2002) for a discussion on how Bumiputera control over these firms is affected). Additionally, political favoritism results through “informal ties among firms run by Malay, Chinese, and Indian businessmen” with leading politicians (predominantly the then long-term Prime Minister, Dr. Mahathir, and his then deputy Anwar Ibrahim). These relationships developed through active solicitation by Chinese businessmen and resulted in several Chinese political parties becoming part of the ruling coalition that made up the government (Gul, 2006, p. 936).

Petroleum Nasional Bhd (Petronas) provides an example of how political connection with favored firms may cause inefficiency. Petronas, the national oil company, was established in 1974. During the Mahathir leadership, Petronas through cash injections kept afloat the debt-ridden and politically connected Bank Bumiputra that was to become Bumiputra Commerce. Petronas funds were also used to bail out Malaysian Airlines (MAS) and the inefficient national auto maker, Proton. Other notable bailouts of inefficient PCON firms include the 1998 rescue with Petronas funds of shipping company, Konsortium Perkapalan Bhd (KPB), a company controlled by Mahathir's son, Mirzan.⁸ Petronas, in March 2000, purchased 27.2% of Proton for US\$264 million making it the controlling shareholder. Proton reported a net loss of RM 19 million for the nine months to December 31, 1999. Following twenty-two years in power, in 2003 when Dr. Mahathir retired as Prime Minister, he took up the appointment as advisor to Petronas.

The theories of North (1990) and Olson (1993) explain why political (synonymous with “government”) connections with firms come into existence. Politicians, or government figures, seek relationships with firms as a means of controlling them so that they act to achieve goals that are conducive to the government's agenda to reward its supporters. For their political contributions and votes, the PCON firms receive benefits such as profitable contracts or subsidies. The benefits flowing from political connections make the PCON firms inefficient and possibly even foster a culture of inefficiency given the firms' ‘protected’ status.

Political connection in Malaysia has been well documented (Gomez and Jomo, 1997; Faccio et al., 2001; Gomez, 2002; Johnson and Mitton, 2003; Gul, 2006; Fraser et al., 2006) and, as such, provides an excellent opportunity in which to study the association between political connection and the cost of debt. Johnson and Mitton (2003) provide evidence that politically favored firms were expected by the market to, and did in fact, lose subsidies at the onset of the Asian financial crisis owing to the government inability to support them. This caused their stock prices to fall more than non-PCON firms. Conversely, the market anticipated that the government introduced capital controls to subsidize PCON firms, and

consequently those firms recovered faster than the non-PCON firms when the capital controls were implemented. Gul (2006) provides evidence that during this financial crisis period audit firms assessed politically favored firms as being of higher risk than non-PCON firm resulting in their being charged higher audit fees. Subsequently, the costs of auditing politically favored firms fell when the Malaysian government introduced the capital controls. Each of these two studies provides evidence that the market and audit firms viewed Malaysian PCON firms as risky. Further, Fraser et al. (2006) find that Malaysian PCON firms are significantly associated with higher leverage which suggests that these firms are inherently more risky than non-PCON firms. Hence, lenders will have reason to consider PCON firms to be of higher risk and we posit a positive association between cost of debt interest rate pricing and firms with political connections. To test this relationship, our first hypothesis is formally stated as follows:

H1. There is a positive association between the interest rate charged on debt and politically connected firms, *ceteris paribus*.

Additionally, this paper seeks to investigate whether two board attributes within PCON firms impact on their cost of debt. First, it investigates whether CEO duality (CEO) in PCON firms increases the perceived risk by lenders and leads to a higher cost of debt. The Cadbury Committee Report (1992) was of the opinion that CEO duality was to be discouraged. The rationale for this was the reduction in the conflict of interests stemming from an individual occupying both the offices of Board Chairman and Chief Executive. Proponents of CEO duality argue that having a board chairman well versed in the firm is in a better position to inform board members. Opponents of CEO duality argue that the board's duty of overseeing management is compromised when the CEO chairs the board. CEO duality has been found to be associated with lower levels of mandatory disclosure (Bassett et al. 2007), higher levels of unrelated diversification (Kim et al., 2009), higher levels of remuneration for the CEO (Lee, 2009), and the CEO being less likely to be removed following poor performance (Goyal and Park, 2002). This evidence suggests that CEO duality is associated with higher risk, and coupled with the Cadbury Committee discouraging it, this study investigates whether CEO duality in PCON firms impacts on the perceived risk by lenders. It is expected that CEO duality in PCON firms will increase the perceived risk by lenders leading to such firms experiencing higher costs of debt. To test this, the second hypothesis is formally stated as follows:

H2. There is a positive association between the interest rate charged on debt and politically connected firms with CEO duality, *ceteris paribus*.

Second, this paper investigates whether PCON firms with a higher proportion of independent directors on the audit committee (IN-DAC) reduce the perceived risk by lenders leading to a lower cost of debt for these firms. Carcello et al. (2002, p. 381) provide evidence that independent directors (on boards) are prepared to pay more for a higher quality audit “to protect their reputation capital, to avoid legal liability, and to promote shareholder interests”. Beasley (1996) finds that more independent boards are associated with lower levels of financial statement fraud. Tsui et al. (2001) in a study of Hong Kong firms find that firms with more independent corporate boards are associated with significantly lower audit fees which they attribute to perceived lower control risk by audit firms. Thus, a more independent audit committee in PCON firms may mitigate the perceived risk by lenders resulting in lenders charging a lower interest to these firms. To test this, the third hypothesis is formally stated as follows:

⁸ Malaysian International Shipping Corp Bhd which is controlled by Petronas acquired debt-laden KPB assets.

H3. There is a negative association between the interest rate charged on debt to PCON that have a higher proportion of independent directors on their audit committee, *ceteris paribus*.

3. Research methodology

3.1. Sample

The sample consists of the Malaysian top 500 non-finance public listed companies in terms of market capitalization for years 2001–2004. Finance companies are excluded as, under the Banking and Financial Institution Act 1989 (BAFIA), they are governed under this different regulatory body. A summary of the selection process is provided in Table 1. The sample size is 1667 firms after further excluding firms with missing data.

3.2. Measurement of the dependent and independent variables

3.2.1. Dependent variable

The dependent variable, Interest Expense (*IR*), is measured as the interest expense of the firm divided by its average short-term and long-term debt during the year. The interest expense for the year is disclosed in the income statement and the short-term and long-term debt is disclosed in the balance sheet of the financial statements incorporated in the annual reports.

3.2.2. Experimental variables

The major experimental variable of interest in this study is politically connected firms (*PCON*). Firms are identified as being *PCON* firms if they are identified as such by either Johnson and Mitton (2003) or Faccio (2006), and is operationalized as an indicator variable with '1' if the firm is identified as being politically connected in either of these papers, and '0' otherwise. Data on the composition of the independence of the audit committees, and on CEO duality were manually collected from the 2001 to 2004 Malaysian annual reports. The variable *INDAC* is measured as the proportion of (independent) non-executive directors on the audit committee. The first hypothesis posits that *PCON* firms will be associated with higher costs of interest rates on debt. To control for the effects that CEO duality may have on interest rates charged to a firm an indicator variable *CEO* is used. It is coded '1' if the same person occupies both positions of chairman of the board and CEO, and '0' if the positions are held by different individuals. To test the second hypothesis as to whether there is a positive association between interest rates and *PCON* firms with CEO duality, an interaction term *PCON * CEO* is used. To test the third hypothesis as to whether there is a negative association between interest rates and *PCON* firms with a higher proportion of independent directors on the audit committee, an interaction term *PCON * INDAC* is used.

3.2.3. Control variables

Based on prior research on cost of debt capital studies (Petersen and Rajan, 1994; Pittman and Fortin, 2004; Francis et al. 2005; Qiu and Yu, 2009), the following variables are included in the regression as control variables: the number of years since incorporation (*AGE*), whether audited by a big audit firm (*AUDITOR*), leverage (*LEV*), cash-flow (*CF*), total assets (*SIZE*), property, plant and equipment

(*PPE*), sales growth (*GROWTH*), whether the firm has negative equity (*NEGEQ*), current ratio (*CR*) and (*LOSS*). A firm's age is expected to be negatively associated with the cost of debt in line with the reputation effect posited by Diamond (1989) that firms over time are able to create good credit histories that reduce the perceived risk to lenders. It is expected that the financial statements of firms audited by big audit firms would be more credible to lenders hence the expectation that big audit firms would be negatively associated with cost of debt. More highly geared firms are more likely to be considered risky by lenders so it is expected that leverage and cost of debt will be positively associated. A higher cash-flow is expected to reduce a lenders' perceived risk as these firms are more likely to be able to service their debts. Larger firms are expected to be associated with lower costs of debt as they are perceived as less risky by virtue of their having more assets in place and greater opportunities for economies of scale (Carey et al., 1993). The association between cost of debt and property plant and equipment is expected to be negative as borrowers with *PPE* are in a better position to provide security on their loans. Secured loans enjoy lower interest. Sales growth (*GROWTH*) is measured as the change in sales revenue from the previous year scaled by sales revenue in the previous year. Firms experiencing sales growth would be considered less likely to default on their loans. The coefficient on the variable *GROWTH* is expected to be negative. Firms with negative equity are considered to be higher risk to a lender and would be levied a higher interest rate. A firm's current ratio (*CR*) is measured by its current assets divided by its current liabilities. Firms with higher current ratios are more likely to be able to meet their current obligations and are expected to be associated with lower costs of debt. Lenders are likely to consider firms reporting a loss in the financial year as more risky borrowers. Such firms are expected to be associated with higher interest rates. Data are winsorized to the 1 and 99 percentiles to control for extreme values. All of the *t*-tests reported in this study are White's (1980) corrected *t*-tests. All tests performed in this study control for industry and year (not reported in tables).

3.2.4. Regression model

The regression models used to test the hypotheses are:

$$IR = \beta_0 + \beta_1 PCON + \beta_2 AGE + \beta_3 AUDITOR + \beta_4 LEV + \beta_5 CF + \beta_6 SIZE + \beta_7 PPE + \beta_8 GROWTH + \beta_9 NEGEQ + \beta_{10} CR + \beta_{11} LOSS + \beta_{12-14} YR + \beta_{15-24} INDUST + \varepsilon \quad (1)$$

$$IR = \beta_0 + \beta_1 PCON + \beta_2 CEO + \beta_3 INDAC + \beta_4 PCON * CEO + \beta_5 PCON * INDAC + \beta_6 AGE + \beta_7 AUDITOR + \beta_8 LEV + \beta_9 CF + \beta_{10} SIZE + \beta_{11} PPE + \beta_{12} GROWTH + \beta_{13} NEGEQ + \beta_{14} CR + \beta_{15} LOSS + \beta_{16-18} YR + \beta_{19-28} INDUST + \varepsilon \quad (2)$$

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

<i>IR</i>	interest expense for the year divided by its average short-term and long-term debt
<i>PCON</i>	indicator variable, 1 if the firm is politically connected
<i>CEO</i>	indicator variable, 1 if chief executive officer is also chairman of the board
<i>INDAC</i>	proportion of non-executive (independent) directors on the audit committee
<i>AGE</i>	Number of years since the firm was incorporated
<i>AUDITOR</i>	indicator variable, 1 if audited by a big auditor firm
<i>LEV</i>	sum of total short-term and long-term debt divided by total assets

Table 1
Sample description of Malaysian firms (2001–2004).

Original sample size (excluding financial institutions)	1788
Less: observations with missing information including the sample firm having no interest expense or debt	(121)
Final sample size used for doing analysis	1667

CF	cash flow from operations divided by total assets
SIZE	natural logarithm of total assets
PPE	gross property, plant and equipment divided by total assets
GROWTH	sales revenues in year t minus sales revenues in year $t - 1$ divided by sales revenue in year $t - 1$.
NEGEQ	indicator variable, 1 if firm reported negative equity
CR	current assets divided by current liabilities

4. Results and discussion

4.1. Descriptive statistics

The breakdown of sample firms by industry type is provided in Table 2. The descriptive statistics for both the dependent and independent variables are provided in Table 3 for both PCON and non-PCON firms.⁹ The mean interest rate charged is 0.0556. CEO duality occurs in 16.13% of the total sample firms. The mean of the proportion of independent directors on the audit committee is 67.83%. Seventy-five percent of firms are audited by big audit firms. The total size of the sample firms in terms of total assets range between RM 22.065 million and RM 15,535 million. The number of firms reporting a loss was 28.3%. It is interesting that 14.5% of the PCON firms have negative equity compared to non-PCON firms where only 4.6% have negative equity. PCON firms are found to be significantly older and larger firms. PCON firms are also considered to be riskier in that they have significantly higher leverage and are more likely to have negative equity or have reported a loss compared to non-PCON firms. PCON firms are also more likely to have been audited by a big audit firm possibly because they are more risky and auditing by big auditors may signal greater credibility to the users of the financial statements.

4.2. Correlations

Table 4 reports on the bivariate statistical correlations for both PCON and non-PCON firms. Interest rates are found to be significantly and positively correlated with leverage, negative equity and loss, and found to be negatively correlated with firm size and current ratio (for non-PCON firms only). Non-PCON firms only are found to be negatively correlated with firms' age. CEO duality is negatively correlated with age for PCON firms indicating that CEO duality for these firms is less likely as the firm advances in years.

4.3. Regression results

Column A of Table 5 reports the multiple regression results from testing the association between interest rates charged on debt and firms with political connection (PCON) to enable the testing of the first hypothesis. The coefficient of PCON is positive and significant (0.005, $p < 0.05$, 1-tailed) supporting the first hypothesis that politically connected firms are associated with higher interest rates on debt. This result indicates that lenders perceive PCON firms to be riskier and, as such, compensate themselves by charging these firms higher rates of interest on their borrowings. Column B of Table 5 reports the association between interest rates charged on debt and PCON firms and includes corporate governance board of director variables of interest CEO and INDAC. Again, the coefficient of PCON is positive and significant (0.005, $p < 0.05$, 1-tailed) supporting the first hypothesis. The coefficients of CEO

Table 2
Number of observations by industry.

Industry	With political connection	Without political connection	Total
Consumer products	29	174	203
Industrial products	50	328	378
Properties	49	263	312
Construction	26	110	136
Hotels	8	12	20
Trading/services	98	292	390
Plantations	12	132	144
Mining	0	4	4
Infrastructure	6	18	24
Technology	4	52	56
Total	282	1385	1667

and INDAC are not significant indicating that whether CEO duality being present or the proportion of independent directors do not impact on interest rates charged. Column C of Table 5 reports the association between interest rates charged on debt and PCON firms and includes the interaction terms between PCON firms and the presence of CEO duality (PCON * CEO), and PCON firms and the proportion of independent directors on the audit committee (PCON * INDAC) to test the second and third hypotheses, respectively. The coefficient of PCON is positive and significant (0.024, $p < 0.05$, 1-tailed). Whilst the coefficient of CEO is negative and significant (-0.005 , $p < 0.05$, 1-tailed), the coefficient of PCON * CEO is positive and significant (0.013, $p < 0.05$, 1-tailed). This result supports the second hypothesis that CEO duality present in PCON firms would be perceived by lenders to be of higher risk and be associated with higher interest rates being charged. Whilst the coefficient of INDAC is positive and significant (0.015, $p < 0.05$, 1-tailed), the coefficient of PCON * INDAC is negative and significant (-0.031 , $p < 0.05$, 1-tailed). This result supports the third hypothesis that a higher proportion of independent directors on the audit committee would be perceived by lenders to be of lower risk and be associated with lower interest rates being charged. Of the control variables, as expected, interest rates are positively and significantly associated with the coefficients of LEV, NEGEQ and LOSS, and are negatively and significantly associated with the coefficients of AGE, PPE, GROWTH, and CR. The adjusted R^2 of the regression analyses range from between 11.97% and 12.27%.

4.4. Further analysis

The previously reported results are based on PCON firms identified as such by either Johnson and Mitton (2003) or Faccio (2006). It should be noted that the former Prime Minister of Malaysia, Dr. Mahathir Mohamad, held this post from July, 1981 to September, 2003. His long tenure in office provides us some degree of confidence that major changes in the identified PCON firms are unlikely to have been confounded by contests for political allegiances that may have resulted following his departure. Johnson and Mitton (2003, p. 358), whose identified PCON firms were based on the analysis of Gomez and Jomo (1997), express a similar confidence "given the stability of the government over this period." Faccio (2006, p. 373) identified PCON firms based on the "percentage of firms connected to a (government) minister or MP, or close relationship" as of 2001. To alleviate concerns that political connections may have changed between the two studies, we conducted further analyses using PCON firms identified as such by (1) Johnson and Mitton (2003), and (2) Faccio (2006), separately. In our sample, there are 282 PCON firms identified as being in either one or the other of the two studies. Of these, 221 firms are only identified

⁹ As previously discussed, descriptive statistics described here reflect data that has been winsorized to the 1 and 99 percentiles.

Table 3
Descriptive statistics of PCON and non-PCON Malaysian firms 2001–2004.

Variable	PCON firms (N = 282)			Non-PCON firms (N = 1385)			t-test/chi-square
	Mean	Std Dev	Median	Mean	Std Dev	Median	
IR	0.064	0.042	0.059	0.054	0.041	0.050	3.77***
CEO	0.198	0.400		0.154	0.361		3.47*
INDAC	0.680	0.160	0.667	0.678	0.132	0.667	0.22
AGE	34.094	18.748	32.714	26.839	17.789	25.848	6.18***
AUDITOR	0.805	0.397		0.739	0.439		5.39**
LEV	0.471	0.493	0.348	0.257	0.311	0.197	9.42***
CF	0.039	0.080	0.034	0.043	0.070	0.037	1.00
TA (in RM'000)	2319,680	3411,039	1025,844	1172,887	2149,756	471,220	7.49***
PPE	0.351	0.277	0.317	0.350	0.263	0.323	0.05
GROWTH	0.182	0.961	0.048	0.178	0.837	0.066	0.07
NEGEQ	0.145	0.353		0.046	0.210		39.04***
CR	2.761	13.821	1.196	3.546	9.790	1.675	1.14
LOSS	0.393	0.489		0.260	0.439		20.41***

Variable definitions: IR is the interest expense for the year divided by its average short-term and long-term debt; PCON is the indicator variable that equals one if the firm is politically connected; CEO is the indicator variable that equals one if the chief executive officer is also the chairman of the board; INDAC is the proportion of independent directors on the audit committee; AGE is the number of years since the firm was incorporated; AUDITOR is the indicator variable that equals one if the firm is audited by a big auditor firm; LEV is the sum of total short-term and long-term debt divided by total assets; CF is cash flow from operations divided by total assets; TA is total assets expressed in thousand Malaysian ringgit; SIZE is the natural logarithm of total assets; PPE is the gross property, plant and equipment divided by total assets; GROWTH is sales revenues in year t minus sales revenues in year $t - 1$ divided by sales revenue; NEGEQ is the indicator variable that equals one if the firm reported negative equity; CR is current assets divided by current liabilities; and LOSS is the indicator variable that equals one if the firm reported a loss in the last financial year.

* Significance at 0.10.

** Significance at 0.05.

*** Significance at 0.01.

Table 4
Correlations among interest rates, CEO duality, the proportion of independent directors on the audit committee, and control variables.

Variable	IR	CEO	INDAC	AGE	AUDITOR	LEV	CF	SIZE	PPE	GROWTH	NEGEQ	CR	LOSS
<i>PCON firms (N = 282)</i>													
IR	1.000	0.119**	-0.056	-0.073	0.085	0.162***	-0.023	-0.149**	-0.176***	0.043	0.247***	0.047	0.216***
CEO		1.000	-0.042	-0.179***	-0.024	-0.022	-0.074	-0.019	0.050	0.009	0.072	0.055	0.127**
INDAC			1.000	0.048	-0.013	0.037	-0.040	-0.001	0.065	-0.028	-0.039	-0.106*	0.066
AGE				1.000	-0.079	-0.089	0.036	-0.093	0.003	-0.018	-0.070	-0.102*	-0.055
AUDITOR					1.000	0.0700	0.064	-0.101*	-0.070	-0.072	0.076	0.040	-0.006
LEV						1.000	-0.230***	-0.409***	0.125**	-0.046	0.735***	-0.123**	0.450***
CF							1.000	0.236***	0.220***	0.021	-0.170***	-0.045	-0.389***
SIZE								1.000	-0.016	-0.005	-0.435***	-0.064	-0.292***
PPE									1.000	0.118**	0.080	-0.119**	-0.073
GROWTH										1.000	-0.056	-0.041	-0.148**
NEGEQ											1.000	-0.073	0.471***
CR												1.000	-0.108*
<i>Non-PCON firms (N = 1385)</i>													
IR	1.0000	-0.046*	0.042	-0.054**	-0.013	0.262***	-0.048*	-0.081***	0.008	-0.034	0.288***	-0.133***	0.228***
CEO		1.000	-0.005	0.005	-0.048*	-0.036	0.047*	-0.034	0.114***	0.031	-0.027	0.046*	0.030
INDAC			1.000	0.048	-0.013	0.037	-0.018	0.032	0.067**	0.007	-0.006	-0.083**	0.022
AGE				1.000	-0.079	-0.089	-0.115***	0.098***	-0.073***	0.038	0.069**	0.110***	0.078***
AUDITOR					1.000	0.070	0.127***	0.060**	0.075***	0.013	-0.049*	0.014	-0.056**
LEV						1.000	-0.238***	-0.062**	0.014	0.006	0.694***	-0.126**	0.401***
CF							1.000	0.075***	0.238***	-0.021	-0.128***	-0.060**	-0.307***
SIZE								1.000	0.025	0.020	-0.163***	-0.143***	-0.183***
PPE									1.000	-0.049*	0.009	-0.079***	-0.042
GROWTH										1.000	-0.081***	-0.040	-0.096***
NEGEQ											1.000	-0.003	0.347***
CR												1.000	-0.052*

*Please see Table 3 for variable definitions.

* Significance at 0.10.

** Significance at 0.05.

*** Significance at 0.01.

as such in Johnson and Mitton (2003), and 271 firms only identified from Faccio (2006). The results of these separate multiple regression analyses are reported in Table 6. The results are quantitatively the same as previously reported providing us confidence in the identified PCON firms, and the associations found. For the Johnson and Mitton (J&M) PCON firms, the coefficient of CEO is negative and moderately significant (-0.004 , $p < 0.10$, 1-tailed), and the coefficient of PCON * CEO is positive and significant (0.016 , $p < 0.05$, 1-

tailed). The coefficient of INDAC is positive and significant (0.015 , $p < 0.05$, 1-tailed), and the coefficient of PCON * INDAC is negative and significant (-0.032 , $p < 0.05$, 1-tailed). For the Faccio PCON firms, the coefficient of CEO is negative and moderately significant (-0.004 , $p < 0.10$, 1-tailed), and the coefficient of PCON * CEO is positive and significant (0.012 , $p < 0.05$, 1-tailed). The coefficient of INDAC is positive and significant (0.015 , $p < 0.05$, 1-tailed), and the coefficient of PCON * INDAC is negative and significant

Table 5
OLS regression analysis of Malaysian firms 2001–2004.^a Dependent variable: Interest rate ($N = 1667$).

	Predicted sign	Column A		Column B		Column C	
		Coefficient	t-Values	Coefficient	t-Values	Coefficient	t-Values
Intercept	+ or –	0.063	5.86***	0.057	4.73***	0.054	4.37***
<i>Control variables</i>							
AGE	–	–0.000	–1.96**	–0.000	–2.03**	–0.000	–1.84**
AUDITOR	–	0.000	0.01	–0.000	–0.03	–0.000	–0.11
LEV	+	0.001	3.78***	0.001	3.78***	0.001	3.78***
CF	–	0.021	1.12	0.022	1.14	0.023	1.22
SIZE	–	–0.001	–1.42*	–0.001	–1.44*	–0.001	–1.56*
PPE	–	–0.006	–1.70**	–0.006	–1.68**	–0.005	–1.65**
GROWTH	–	–0.000	–7.64***	–0.000	–7.52***	–0.000	–7.44***
NEGEQ	+	0.033	6.47***	0.033	6.51***	0.032	6.33***
CR	–	–0.000	–1.67**	–0.000	–1.59**	–0.000	–1.61**
LOSS	+	0.013	5.62***	0.013	5.55***	0.013	5.56***
<i>Experimental variables</i>							
PCON	+	0.005	1.89**	0.005	1.96**	0.024	2.13**
CEO				–0.002	–0.79	–0.005	–1.80**
INDAC				0.008	1.20	0.015	1.97**
PCON * CEO	+					0.013	1.65**
PCON * INDAC	–					–0.031	–1.95**
Adj. R^2		0.1197		0.1199			0.1227

^a Please see Table 3 for variable definitions.

* Significance at 0.10.

** Significance at 0.05.

*** Significance at 0.01.

Table 6
OLS regression analysis with PCON firms as identified by (1) Johnson and Mitton (2003) [J&M], or (2) Faccio (2006).^a Dependent variable: Interest rate ($N = 1667$).

	Predicted sign	J&M		Faccio	
		Coefficient	t-Values	Coefficient	t-Values
Intercept	+ or –	0.055	4.40***	0.055	4.38***
<i>Control variables</i>					
AGE	–	–0.000	–1.79**	–0.000	–1.79**
AUDITOR	–	–0.000	–0.23	–0.000	–0.10
LEV	+	0.001	3.34***	0.001	3.24***
CF	–	0.023	1.58*	0.023	1.54*
SIZE	–	–0.001	–1.45*	–0.001	–1.45*
PPE	–	–0.005	–1.18	–0.006	–1.46*
GROWTH	–	–0.000	–1.76**	–0.000	–1.82**
NEGEQ	+	0.032	7.17***	0.033	7.23***
CR	–	–0.000	–2.96***	–0.000	–2.93***
LOSS	+	0.013	5.12***	0.013	5.16***
<i>Experimental variables</i>					
PCON	+	0.026	2.13**	0.023	1.95**
CEO		–0.004	–1.52*	–0.004	–1.48*
INDAC		0.015	1.87**	0.015	1.81**
PCON * CEO	+	0.016	2.15**	0.012	1.77**
PCON * INDAC	–	–0.032	–1.81**	–0.028	–1.66**
Adj. R^2		0.1244			0.1225

^a Please see Table 3 for variable definitions.

* Significance at 0.10.

** Significance at 0.05.

*** Significance at 0.01.

($-0.028, p < 0.05$, 1-tailed). These results both provide further support for our second hypothesis that CEO duality present in PCON firms is perceived by lenders to be of higher risk, and our third hypothesis that the perceived risk by lenders of PCON firms is reduced in the presence of a higher proportion of independent directors on the audit committee. In both samples, PCON is found to be positive and significant [(0.026, $p < 0.05$, 1-tailed), and (0.023, $p < 0.05$, 1-tailed) respectively] also providing support for our first hypothesis that lenders perceive PCON firms as being of higher risk. The adjusted R^2 of the regression analyses are 12.44% and 12.25%, respectively.

5. Conclusions

The objective of this study is to build on and extend the scope of previous papers on Malaysian PCON firms. Previous research found Malaysian PCON firms are perceived as being more risky than non-PCON firms by the market (Johnson and Mitton, 2003), and by audit firms (Gul, 2006) and that these firms are associated with higher leverage (Fraser et al., 2006). The study expands into a hitherto unexplored area: whether Malaysian PCON firms taking loans are likely to be charged a higher interest than non-PCON firms.

The results from this study find a positive association between interest rates charged by lenders and PCON firms. This result suggests that lenders perceive these firms as being riskier than non-PCON firms. This result is corroborated by evidence that that Malaysian PCON firms have a significantly (1) higher extent of leverage, (2) a higher likelihood of reporting a loss, (3) a higher likelihood of having negative equity, and (4) a higher likelihood of being audited by a big audit firm. This study also documents that a high proportion of Malaysian PCON firms (14.5% in this study) have negative equity. The evidence provided suggests that the higher interest rates charged is the result of efficient contracting by the lenders taking into consideration higher risks inherent in PCON firms. We also find that lenders perceive CEO duality in PCON firms as being associated with higher risk, and these firms are associated with higher interest rates, and that lenders perceive a higher proportion of independent directors on the audit committee of PCON firms mitigates the perceived risk resulting in lower interest rates being charged for these firms. That lenders take into account these board committee characteristics in the loan pricing of PCON firms suggests support by lenders of prescriptions made by the MCGG aimed at improving corporate governance.

There study has three main limitations. First, this study only covers four years of Malaysian data and hence an external validity problem exists in that the results may not be transportable over different time periods and locations. Second, PCON firms are identified only if they are identified as such in either [Johnson and Mitton \(2003\)](#) or [Faccio \(2006\)](#). Whilst this is an objective criterion, it is possible that other PCON firms are present in the sample and remain unidentified, and that some PCON firms may be more politically connected than others. Third, the impact of only two corporate governance characteristics, CEO duality and the proportion of independent directors on the audit committee, on the cost of debt to PCON firms are considered. Many other corporate governance variables could be considered. Future research could, for example, consider such issues as whether the extent of managerial ownership and block holders may impact on the effects of interest rates charged by lenders to these firms.

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