THE INFLUENCE OF FOREIGN & DOMESTIC INSTITUTIONAL OWNERSHIP, BOARD INDEPENDENCE, AUDIT QUALITY, AUDIT COMMITTEE, AND STOCK LIQUIDITY ON COST OF DEBT IN INDONESIAN COMPANIES

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THE INFLUENCE OF FOREIGN & DOMESTIC INSTITUTIONAL OWNERSHIP, BOARD INDEPENDENCE, AUDIT QUALITY, AUDIT COMMITTEE, AND STOCK LIQUIDITY ON COST OF DEBT IN INDONESIAN COMPANIES

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PENGARUH PEMILIKAN INSTITUSI ASING & DOMESTIK, LEMBAGA LUAR, KUALITI AUDIT, JAWATAN KUASA AUDIT DAN KECAIRAN SAHAM TERHADAP KOS HUTANG PADA SYARIKAT DI INDONESIA

ABSTRAK

Kajian ini memberi tumpuan untuk mengkaji hubungan antara tadbir urus korporat, kecairan saham dan kos hutang. Kajian kesusasteraan menunjukkan bahawa tadbir urus korporat akan mengurangi asimetri informasi yang mendorong kecairan saham dan menurunkan kos hutang. Indonesia yang diklasifikasikan sebagai negara membangun mempunyai kadar faedah yang lebih tinggi daripada negara-negara lain di ASEAN. Ini boleh disebabkan oleh adanya maklumat mengenai asimetri di pasaran modal Indonesia. Satu lagi faktor yang boleh mempengaruhi kos hutang adalah kecairan saham. Walaupun harga indeks komposit Indonesia menunjukkan trend menaik, kecairan cenderung menurun. Kecairan saham menunjukkan maklumat mengenai asimetri di pasaran modal. Akibatnya, peminjam akan menuntut kadar faedah yang lebih tinggi sebagai pampasan kerana mengambil risiko kerana kekurangan maklumat. Kajian ini menggunakan sampel 170 firma yang disenaraikan di Bursa Saham Indonesia dalam tempoh 2007-2016. Kaedah Generalized Method of Moment (GMM), kesan common, kesan fixed dan kesan random akan digunakan untuk mengatasi masalah endogeniti dan kesan kausalitas. Kejutan luar juga akan menentukan dalam kajian ini. Pemeriksaan kekukuhan tambahan mempertimbangkan sama ada keputusan sensitif terhadap krisis kewangan global 2007-2009 untuk memeriksa kejutan luar. Kajian ini menemui bukti bahawa kehadiran pemilikan institusi domestik dapat mengurangkan kos hutang dan meningkatkan kecairan stok. Berbeza dengan itu, hasilnya mendapati bahawa pemilikan institusi asing tidak mempunyai pengaruh yang signifikan dalam mengurangkan kos hutang tetapi mempunyai pengaruh yang signifikan dalam meningkatkan kecairan stok. Lembaga luar yang diukur dengan peratusan jumlah lembaga luar menunjukkan bahawa kehadiran lembaga luar boleh meningkatkan kecairan stok pada masa krisis dan bukan krisis. Kajian ini juga menemui bukti bahawa kualiti audit dapat menurunkan kos hutang dan kecairan stok. Hasilnya juga menunjukkan bahawa tadbir urus korporat lain yang merupakan jawatankuasa audit, mempunyai pengaruh yang signifikan dalam meningkatkan kos hutang. Hasil yang berkaitan dengan pemboleh ubah kontrol menunjukkan bahawa semua pemboleh ubah kontrol mempunyai pengaruh yang signifikan terhadap kos hutang. Saiz firma, pulangan aset dan nisbah liputan faedah menunjukkan pengaruh negatif yang signifikan terhadap kos hutang. Dari segi kecairan stok, pemboleh ubah kontrol yaitu saiz firma, nisbah pasaran ke buku, pulangan aset, nisbah liputan faedah dan nisbah kecekapan mempunyai pengaruh yang signifikan terhadap kecairan saham.

THE INFLUENCE OF FOREIGN & DOMESTIC INSTITUTIONAL OWNERSHIP, BOARD INDEPENDENCE, AUDIT QUALITY, AUDIT COMMITTEE, AND STOCK LIQUIDITY ON COST OF DEBT IN INDONESIAN COMPANIES

ABSTRACT

This study focuses on examining the relationships between corporate governance, stock liquidity, and cost of debt. An extensive literature review indicated that the implementation of corporate governance will reduce the information asymmetry that encourages stock liquidity and lowers the cost of debt. Indonesia, which is classified as an emerging market, has higher interest rates than other ASEAN countries. This can be caused by information asymmetry in the Indonesian capital market. Another factor that can affect the cost of debt is the stock liquidity. Although the price of the Indonesian composite index showed an upward trend, the stock liquidity tended to decrease. The illiquidity of a stock indicates information asymmetry in the capital market. As a result, lenders will demand higher interest rates as a compensation to bear the risk of insufficient information. This study used a sample of 170 firms listed on the Indonesia Stock Exchange over the period of 2007-2016. The Generalized Method Of Moments (GMM) was used to overcome problems with endogeneity. Exogenous shock was also determined in this research. Additional robustness checks considered whether the results were sensitive about the global financial crisis of 2007–2009 in order to examine the exogenous shock. This study found evidence that the presence of domestic institutional ownership could decrease cost of debt and increase stock liquidity. Additionally, this results showed that foreign institutional ownership has no significant effect on reducing cost of debt but has a significant effect on increasing stock liquidity. Variable independent boards, which were measured by the percentage of independent boards, indicated that the presence of an independent board could increase stock liquidity in times of crisis and non-crisis. This study also found evidence that audit quality could decrease the cost of debt and stock liquidity. The results also showed that an audit committee has significant effect on increasing cost of debt. The results related to the control variables showed that all of control variables had a significant effect on cost of debt. Firm size, return on assets, and interest coverage ratio showed negative significant influence on cost of debt. In terms of stock liquidity, control variables, which were size, market-to-book ratio, return on asset, interest coverage ratio, and efficiency ratio, had significant effects on stock liquidity.

Chapter 1

INTRODUCTION

1.1. Background

The use of external funding can provide advantages for companies. Investors and lenders, considered outside parties, monitor management activities (Binsbergen, Graham & Yang, 2010; Darmadi & Gunawan, 2013; Jensen & Meckling, 1976; Mustapha & Ahmad, 2011). This monitoring of activities will encourage transparency and disclosure, and the level of information asymmetry will be reduced, indicating a low level of risk (Chava, Livdan & Purnanandam, 2009; Francis, Khurana & Pereira, 2005; Roberts & Yuan, 2006). Issuing debt has much advantage for a firm. Debt enables managers to effectively guarantee their promise to pay out future cash flows. Managers have an obligation to pay out the debt in the future, this condition will ensure that the managers spend free cash flow. Issuing debt rather than stock will reduce agency costs of free cash flow available for spending at the discretion of managers. The control effects of debt is a form of policy in capital structures. The threat caused by failure to make debt service payments serves as an effective motivating force to make such organizations more efficient (Harris & Raviv, 1991; Jensen, 1986; Stulz 1990; Yun, 2009). Ahn and Choi (2009) implied that for a firm with a bank loan, bank monitoring plays an important role in constraining a firm manager’s opportunistic financial reporting behavior. Ghouma, Ben-Nasr & Yan (2018) stated that debt financing has three major advantages over equity financing. First, the calculation of corporate tax after the interest provides benefits from tax shield for a company. Second, lenders play a monitoring role since highly leveraged firms tend to pay more attention to the reactions of the debt markets. Third, related to the signaling theory, debt would enhance the disclosure and transparency of the company. Moreover, debt provides an assessment on the firm’s overall quality and reduces asymmetric information between companies and investors.

Easley and O’Hara (2004) showed that differences in the composition of information between public and private information affect the cost of capital, with investors demanding a higher return to hold stocks with greater private information. Derrien, Kecskés & Mansi (2016) found that an increase in information asymmetry causes an increase in both expected and actual losses to debtholders. Wang and Zhang (2008) confirmed that companies with more asymmetric information have wider yield spreads. To analyze a company's ability to pay debts, lenders need better information regarding the company's financial and non-financial information. If information about a company exhibits a lack of transparency, lenders will have difficulty analyzing companies. Consequently, lenders will demand higher interest rates because of the risk factors related to the missing information. Akerlof (1970) described the asymmetric information between managers and lenders as a "lemons problem." This arises when lenders can not analyze the quality of borrowers and thus demand high interest rates to bear the risk of information. This problem can be mitigated through both financial and non-financial disclosure so that outside parties can make a proper assessment about the condition of a company. Francis et al. (2005) found that firms that use external financing should provide higher information disclosure, and the greater transparency of a company leads to lower costs of debt and equity.

Corporate governance impacts companies in lowering cost and capital and is associated with higher firm value. This makes firms more attractive to investors, leading to growth and increased employment. Better corporate governance will make companies more efficient and affect not only the access to and the amount of external financing, but also the cost of capital (Claessens & Yurtoglu, 2013). Ali, Liu & Su (2018) concluded that corporate governance quality has a negative and statistically significant relationship with default risk, suggesting that better governed firms experience a lower level of default risk.

Corporate governance is a concept that emphasizes that disclosure and transparency provide great benefit for companies (Fung, 2014). Acharya, Myers & Rajan (2011) stated that internal and external governance helps to mitigate agency problems and improve efficiency. Darmadi and Gunawan (2013), in their study of all firms that conducted IPOs in the Indonesia Stock Exchange, found that institutional ownership and board size play important roles in mitigating information asymmetry. Implementing corporate governance has a critical impact on companies' policies, such as capital structure policy (Jiraporn, 2012). Corporate governance also results in lower cost of capital. Implementation of corporate governance, especially in information disclosure, will result in lower risk. Disclosure of information shows a low risk, so this will affect cost of capital. Chung, Elder & Kim (2010); Barth, Konchitchki & Landsman (2013); Diamond and Verrecchia (1991); and Habib, Johnsen & Naik (1997) stated that companies with good corporate governance have a lower cost of capital and higher stock liquidity.

Indonesia is an emerging country in South East Asia with a relatively stable Gross Domestic Product (GDP) and level of consumption (Figure 1.1). The figure also shows that in terms of investment, Indonesia's investment fluctuates over time. This implies that investors are not sure about investing in Indonesia. The fluctuating trends of investment in Indonesia can be caused by an unsupported business environment. The data from Economic Surveys Indonesia 2018 by The Organization for Economic

Cooperation and Development (OECD), stated that Indonesia is ranked below 100 in ease of doing business, and corruption is still the biggest problem that investors have to face (Figure 1.2).

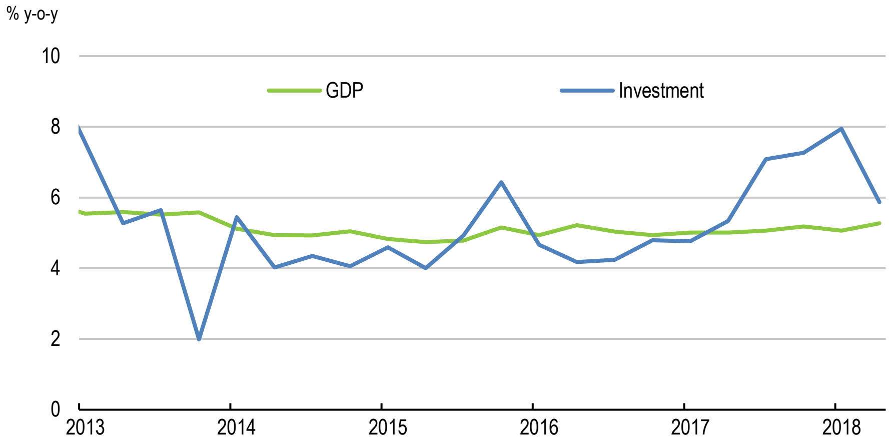


Figure 1.1 Indonesia real GDP and Investment Growth
Source : OECD (Surveys, 2018)

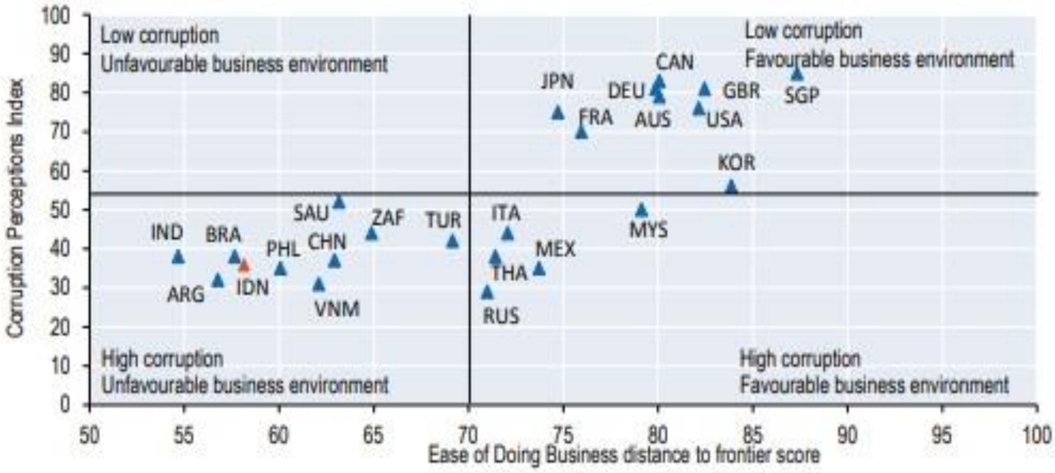


Figure 1.2 Corruption Perception Index and ease of doing business indices
Source: OECD (Surveys, 2016)

A survery by the World Economic Forum in 2016 reported that corruption is the single most problematic factor in doing business in Indonesia. With 70% of entrepreneurs believing that corruption has increased recently in Indonesia, low trust in the Indonesian private sector is a major obstacle to foreign investment. Figure 1.2 shows that investment in Indonesia is facing tough challenges, such as corruption and the long bureaucracy that must be passed by investors. Data from the Indonesia Corruption Watch (ICW) showed that almost one-third of Indonesia's education budget is not used as it should be, mostly caused by mismatching in the procurement of goods and services. Consultant firm A.T. Kearney estimated that Indonesia loses USD $4 billion every year (0.5% of GDP) due to poor public procurement practices. Around 30% of the cases handled by the Corruption Eradication Commission (KPK) over the past decade were related to poor procurement practices (OECD Survey, 2018).

The volatile investment growth shows that investors assume Indonesia to be a risky country. This will affect the cost of capital that must be paid in order to raise funds. Table 1.1 presents data from The Global Economy, which stated that Indonesia has a high lending interest rate. This means that investors ask for more return as compentation to bear the risk. Table 1.1 also presents a comparison of lending interest rates among countries of the Association for South East Asian Nations (ASEAN), and Indonesia has the highest interest rate similar with Vietnam. This high interest rate is complicated for companies because the cost of debt that must be paid is higher. According to data from Pricewaterhouse Coopers (2018), the most non-performing loan concern in Indonesia is concentrated on corporate loans and large small and medium-sized enterprises (SMEs), with a reach above 50%. This condition indicates that Indonesian firms use debt to finance most of the operations of the company. A high cost of debt means that companies are obligated to pay high interest rates. In order to fulfill this obligation, companies must obtain higher profits (Easley & O'hara, 2004).

Table 1.1. Lending Interest Rate

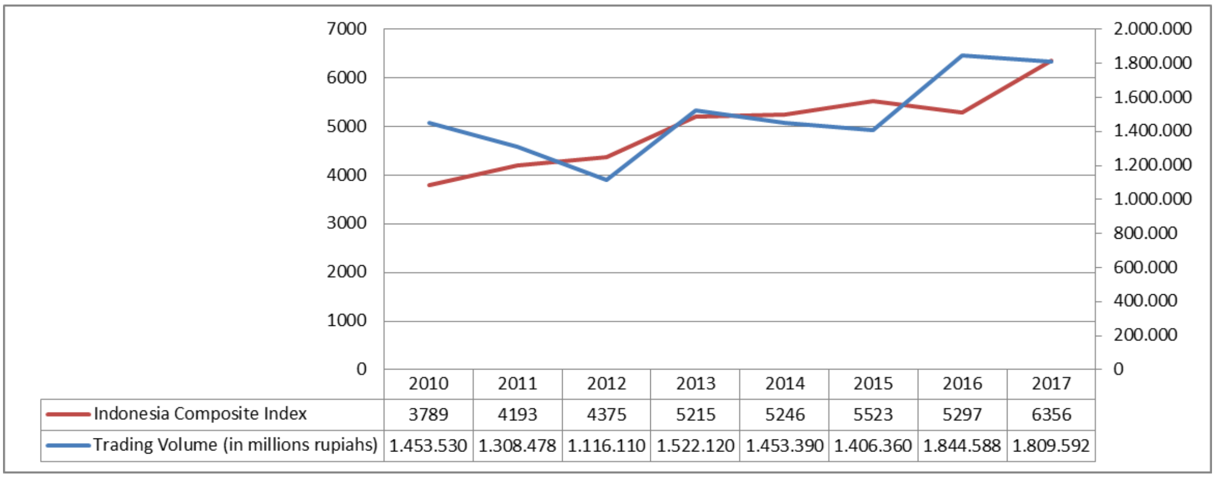
Country	2010	2011	2012	2013	2014	2015	2016	2017	Average
Indonesia	13.3	12.4	11.8	11.7	12.6	12.66	11.89	10.25	12.07
Vietnam	13.1	17	13.5	10.4	8.7	6.96	6.96	6.49	10.39
Thailand	5.9	6.9	7.1	7	6.8	4.63	4.34	12	6.83
Philippines	7.7	6.7	5.7	5.8	5.5	5.58	5.64	5.5	6.01
Brunei	5.5	5.5	5.5	5.5	5.5	5.5	5.5	7.5	5.75
Malaysia	5	4.9	4.8	4.6	4.6	4.59	4.54	4.75	4.72

Source : The global economy, 2018

The high level of lending interest rates in Indonesia could be caused by a lack of information available to lenders who are conducting an analysis of a company. If lenders have little information about the condition of a company, that will affect lending decisions and lenders will charge high interest rates (Akerlof, 1970). This condition is referred to as information asymmetry, that is the condition in which there is an imbalance of information acquired by management (as the agent) and information acquired by the shareholders and other stakeholders. In this condition, management tends to be more informed about the company rather than outsiders, including shareholders. Accordingly, management has the opportunity to deviate, which might benefit themselves individually or collectively. The existence of information asymmetry causes the cost of debt to increase, due to the probability of expected losses to debt holders. This implies that more information asymetry and higher cost of debt causes the bond to spread wider.

Another factor that can affect the cost of debt is the stock liquidity. Amihud, Mendelson & Pedersen (2005) stated that liquidity has a negative correlation with the expected return of the stock. If stock is illiquid, the investor will demand a higher level of return, which will cause a company's cost of capital to increase. Companies that have high liquidity are often associated with transparent information disclosure. A measurement of information asymmetry using the bid-ask spread indicates that there is a relationship between information asymmetry and the level of liquidity, where a lower spread indicates high liquidity. Butler and Wan (2010) as well as Odders-White and Ready (2006) concluded that firms with liquid stock have more ability to meet their obligations than firms with illiquid stock. Additionally, stock liquidity has a significant effect on cost of debt.

Figure 1.3 shows data from the Indonesia Stock Exchange. Although the price of the Indonesian composite index (*Indeks Harga Saham Gabungan*) trends increased, the total trade in the Indonesia Stock Echange tends to fluctuate. Stock liquidity, as shown by trading volume, indicates that Indonesia has an illiquid stock, and this may affect the cost of debt.



	2010	2011	2012	2013	2014	2015	2016	2017
Indonesia Composite Index	3789	4193	4375	5215	5246	5523	5297	6356
Trading Volume (in millions rupiahs)	1.453.530	1.308.478	1.116.110	1.522.120	1.453.390	1.406.360	1.844.588	1.809.592

Figure 1.3. Indonesia Composite Index and Trading Volume
Source : Weekly Statistic The Financial Services Authority (OJK)

The decreasing trading activities reflect the illiquidity of the stock. This causes investor to ask for more return as a compensation to bear the cost of holding illiquid assets. Numerous studies conducted by Barth et al. (2013); Chung et al. (2010); Diamond and Verrecchia (1991); and Habib et al. (1997) stated that companies that implement good corporate governance will have higher stock liquidity because the information asymmetry will be reduced by the disclosure and tranparency of financial oprations.

Stock liquidity tends to fluctuate over time. The more volatile the stock liquidity indicates the existence of uncertainty, and this one of the risks that must be borne by investors trading in a stock exchange. In modern investment theory, investors rely on two factors to predict expected return—risk and liquidity. Both of these factors relate each other in opposite ways. Stocks that have high risk tend to be less liquid because they are difficult to trade in the stock exchange. In other word,s one way to increase stock liquidity is by controlling the risk. According to Amihud and Mendelson (2000), firm value can be defined as the future cash flow that investors expect, which is discounted at the level of a firm's cost of capital. The cost of capital indicates the sum of the risk-free rate and the risk premium as a compensation for investors to bear the risk. The function of risk-free interest rates and the risk of a firm's stock could be assumed as the cost of capital.

One of the factors that may affect the level of stock liquidity is ownership structure. Indonesia, as an emerging market, is dominated by foreign institutional investors in the capital market. Data from the Indonesia Stock Exchange showed that the largest holdings in Indonesian companies controlled by institutional ownership accounted for nearly 73% of the total ownership. Figure 1.4 shows data from the Indonesian Central Securities Depository (KSEI - *Kustodian Sentral Efek Indonesia*) that demonstrates that in 2018 domestic institutional ownership increased to 48% and foreign institutional investors increased to 52%. This data indicates that foreign investors, especially foreign institutions have a great influence in Indonesian stock exchanges. Foreign institutional investors, as a controlling ownership, monitor to ensure appropriate management of a company's main objectives. Compared with domestic institutional investors, the existence of foreign institutional investors will provide a positive influence in emerging market. Research by Dang et al. (2019) showed that institutional ownership plays a major role in maintaining stock liquidity during crisis. Their results showed that the relationship between institutional ownership and stock liquidity had a greater effect on stock performance during the crisis.

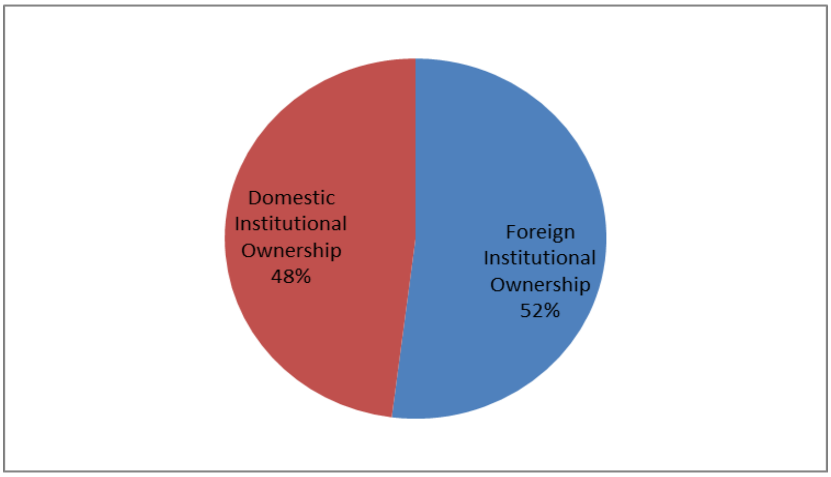


Figure 1.4. Indonesia Shareholding in 2018

Source: Indonesia Stock Exchange and Indonesian Central Securities Depository

According to Rhee and Wang (2009), stock is more illiquid in emerging markets than those in advanced economies. Stock illiquidity is the major concern that causes high volatility in the capital market and becomes an obstacle in the development of a financial market, especially in emerging markets. Foreign institutions, with their large ownership in the Indonesian Stock Exchange should have positive impacts in the financial market. Foreign institutional ownership could increase stock liquidity through disclosure, transparent information, and more active trading. Deng, Li & Li. (2018) concluded that foreign investors have greater influence in stock liquidity through their role in monitoring corporate transparency. Bekaert, Harvey & Lundblad (2002); Bekaert, Harvey & Lundblad (2007); Levine and Zervos (1998); and Moshirian (2017) concluded that foreign investors will increase the stock liquidity in emerging markets. Another study by Bekaert and Harvey (2000) showed that foreign investors and high stock liquidity has an effect in lowering cost of capital.

Other factors that could enhance the monitoring process is monitoring by boards, audit committees, and other external parties, such as external auditors. Board independence and audit committees play major roles in monitoring and help to mitigate agency problems and improve efficiency. The presence of external auditors ensures that monitoring process are completed effectively in order to achieve a company's ideal performance.

Board independence can be defined as an outside board with no material relationship to the company that is in a position to act without undue influence from management. Independent boards contribute to an organization by advising management on strategy and operations drawing from their professional experience. They also monitor the company to ensure that executives act in the interest of shareholders. Alves (2015) stated that the independence of a board will reduce the information asymmetry between managers and outside investors, thus the cost of debt will decrease. Anderson, Mansi & Reeb (2004) suggested that debtors are potentially concerned with board independence characteristics that influence the integrity of financial accounting reports. These conditions will also have an impact on the company's financial statements. Through an independent monitoring process, the quality of a company's financial statements will be proper, as evidenced by the results of financial statements prepared by the external auditor.

The primary purpose of a company’s audit committee is to provide oversight of the financial reporting process, the audit process, the company’s system of internal controls, and compliance with laws and regulations. The audit committee has an important role in order to maintain corporate accountability. An audit committee is in charge of overseeing and monitoring a company's financial reporting system and internal and external audit processes. Sukmono (2016) concluded that the role of an audit committee, as a corporate governance structure, is very important and strategic in realizing and maintaining corporate control systems. Aldamen, Duncan, Kelly & McNamara & Nagel (2011) found that during the recent global financial crisis, financial expertise and external directorships of audit committees were positively associated with firm performance.

Audit quality broadly refers to the services performed by auditors hired by client firms. Firms demand higher quality audits because of the standard and experience they have acquired. Hiring accounting firms for audit quality would attract more investors and provide insight into the performance of the organization. Hence, stakeholders and investors would have confidence and trust in the company engaged in higher audit quality because of the reputation and the experiences that accounting firms with audit quality have gained (Khudhaira, Al-Zubaidi & Raji, 2018). Causholli and Knechel (2012) stated that auditor quality plays a significant role in lowering the cost of debt financing. Spiceland, Yang & Zhang (2015) concluded that although debt covenant designs help mitigate adverse information risks, financial reporting quality is more important than strict debt covenants in lowering the cost of debt, a matter of concern for firm managers and lenders.

1.2 Problem Statement

The Indonesian capital market has a tendency of decreasing stock liquidity. Data from the Indonesia Stock Exchange shows that from 2010 until 2017, the level of liquidity fluctuated over time. The movement of stock prices has not always been followed by an increase in stock liquidity. Although the price of the Indonesian composite index tended to increase, the stock liquidity showed the opposite trend at same period of time. This shows that an increase in stock price is not always followed by trading volume in the stock market. The fluctuation of trading volume shows that there is possibility of information asymmetry in the stock market (Ali et al., 2018). In other words, illiquid stocks indicate the existence of information asymmetry. According to Derrien et al. (2016), investors require relevant information before making investment decisions; therefore, there is a relationship between information asymmetry and investor return. The increase in information asymmetry increases the risk of trade between market makers and informed traders and will reflect a higher bid-ask spread for security (Callahan, Lee & Yohn, 1997). This can be caused by a lack of disclosure in the stock exchange. Stocks with lower liquidity will increase the risk of investment, as lenders will ask for a greater profit for compensation for the higher risk (Amihud et al., 2005). This results in Indonesian companies' lending rates being higher than other countries in ASEAN. Data from The Global Economy (2018) show that on average the lending interest rate in Indonesia from 2010-2017 was 12.07%. This rate is much higher than other ASEAN countries, which on average is six to seven percent. According to data from Pricewaterhouse Coopers (2018), the most non performing loan concern in Indonesia is concentrated on corporate loans and large SMEs, with a reach above 50%. This situation can affect the level of corporate profits because they have to bear the higher cost of debt.

Nadarajah (2018) concluded that companies need both corporate governance quality and stock liquidity in order to lower costs of capital and leverage. According to Hermalin and Weisbach (2012) in order to increase the stock liquidity and lower cost of capital, companies should reduce information asymmetry among all parties involved with the company. The existence of information asymmetry could increase the risk of trading due to the possibility of insider information or insider trading, which could reduce the stock liquidity and increase the cost of capital. One way to realize the disclosure of information is through an internal mechanism or mechanisms of corporate governance within the company, one of which is monitoring. Through monitoring, management will have difficulty hiding information on deviant behaviors and negligence. This was confirmed by Lee, Han & Kim (2014) who stated that shareholders of companies with poor corporate governance could suffer losses due to dishonest disclosure that led to information asymmetry. According to Jacoby (2019), internal corporate governance mechanisms and external control are more likely to be complementary in emerging markets, whereas those in developed countries tend to be supplementary. In emerging markets, more control is needed; therefore, internal control should be supported by external control. In developed countries the internal corporate governance mechanism has been implemented well, thus external control tends to be supplementary. Both internal and external corporate governance mechanisms would encourage the transparency of companies and reduce information asymmetry.

The ownership structure of companies listed in the Indonesia Stock Exchange was dominated by institutional investors at 73% in 2018. This data indicates that institutional ownership plays a major role in monitoring companies. Darmadi and Sodikin (2013) concluded that institutional ownership has more of a role in increasing the disclosure of information in Indonesian companies' annual reports than independent commissioners, indicating that institutional investors play a relatively effective governance role. Additional data from the Indonesia Stock Exchange in 2018 showed that 52% of companies are owned by foreign investors. This shows that foreign institutional investors play a major role in the Indonesia Stock Exchange. The existence of institutional investors should have a positive influence in the development of the Indonesian capital market. Foreign investors are considered to have better knowledge, experience, and information than domestic investors. Foreign investors, especially institutional investors, monitor management and encourage companies to be transparent (Bekaert et al., 2007; Froot & Ramadorai, 2008; Grinblatt & Keloharju, 2000; Rhee & Wang, 2009). According to Deng et al. (2018) foreign institutional ownership can play a significant role in enhancing corporate information quality, thereby affecting stock liquidity. With disclosure, information asymmetry will be reduce, liquidity will increase, and the cost of debt will be low. If associated with capital market conditions in Indonesia which are dominated by foreign investors, this research will develop earlier research by using foreign and domestic institutional investors as a measure of ownership structure. So far limited research related to foreign and domestic institutional ownership with the cost of debt has been done.

According to Claessens and Yurtoglu (2013) in times of economic shocks, a firm's behaviour can be affected by the quality of corporate governance and contribute to the occurrence of financial distress, with economy-wide impacts. Corporate governance and investor protection encompass rules and practices at both the country and firm level, which help ensure that financial supporters get a return on their investment. The International Monetary Fund (2015) stated that improving corporate governance makes emerging markets more resilient in a financial crisis and encourages more efficient and more liquid capital markets, which enables them to absorb shocks better. Corporate governance also increases the efficiency of the capital market, making stock prices insensitive to external shocks and not vulnerable to crises. The global financial crisis that occured in 2007–2009 was an exogenous shock to the implementation of corporate governance.

The problem that can arise in research on corporate governance is the possibility of endogeneity. The relationship between variables can be unclear because the direction of influence can be different. Independent variables can be dependent and vice versa. This difference can lead to a bias in the results of the study. This problem must be overcome through the use of dynamic data panels, such as the Generalized Method of Moments (GMM), to acheive more accurate results (Chen et al., 2007; Hermalin & Weisbach, 2012; Harris & Raviv, 2008; Agrawal & Knoeber, 1996; Roberts & White, 2013; Wintoki, 2012; Schultz, Tan Walsh , 2010).

1.3 Research Objectives

The need for information on the relationship between governance, stock liquidity, and cost of debt in listed companies in Indonesia dictates the objectives of this investigation, which are as follows:

1. To investigate the relationship between corporate governance variables (foreign institutional ownership, domestic institutional ownership, board independence, audit quality, and audit committee) and cost of debt.
2. To investigate the relationship between stock liquidity and cost of debt.
3. To investigate the relationship between corporate governance variables (foreign institutional ownership, domestic institutional ownership, board independence, audit quality, and audit committee) and stock liquidity.

1.4. Research Questions

1. To what extent do corporate governance variables (foreign institutional ownership, domestic institutional ownership, board independence, audit quality, and audit committee) have an influence on cost of debt?
2. To what extent does stock liquidity have an influence on cost of debt?
3. To what extent does corporate governance variables (foreign institutional ownership, domestic institutional ownership, board independence, audit quality, and audit committee) have an influence on stock liquidity?

In addition, the effect of each variable will also be tested at the time of the financial crisis to find out if there are differences in results if exogenous shock occurs. The methodology used to solve these issues is using common effect, fixed effect, random effect and GMM to overcome edogeneity problems.

1.5. Significance of the study

1.5.1 Theoretical Contribution

This study contributes to fill the gap of research on the relationship between corporate governance, stock liquidity, and cost of debt in the Indonesia Stock Exchange. OECD Surveys (2016); The global economy (2018); The Financial Services Authority (OJK) indicated that Indonesian corporate governance practice is weak, lending interest rates are high, and liquidity is decreasing. A deeper study on this topic can assist to find out if it has any influence of corporate governance and liquidity on cost of debt. This will benefit the future of Indonesia in implementing corporate governance since Indonesia currently has weak corporate governance practices, decreased liquidity, and a high cost of debt. Studies that examine the relationship between corporate governance with liquidity and the cost of debt have been done before. In general, previous studies have been done using blockholders and insider ownership as a measure of ownership structure (Aldamen et al., 2012; Bhagat, Bolton, Subramanian, 2012; Bruslerie & Latrous, 2012; Skaife, Collins & LaFond, 2006) and institutional ownership (Adam, 2015; Bhojraj & Sengupta, 2003; Bradley & Chen, 2011; Cremers et al., 2007; Elyasiani, 2010).

The ownership structure of companies in Indonesia, which are dominated by foreign institutions, opens up opportunities for further research to examine the relationship between stock liquidity and the cost of debt. The ownership structure, as measured by domestic and foreign institutional ownership, form the difference of this study with previous research. Deng et al. (2018) emphasized the monitoring roles of foreign institutional investors in increasing stock liquidity and found that company transparency is the most important factor for foreign institutional investors to increase stock liquidity. Other research by Rhee and Wang (2009), related foreign institutional ownership with stock liquidity in the Indonesia Stock Exchange but limited the study to the relationship between foreign and domestic institutional ownership and the cost of debt. This research seeks to fill the gap of ownership measurement, using foreign and domestic institutional ownership to examine the relationship with stock liquidity and cost of debt.

Previous studies concerning corporate governance have been developed through various methods. Mostly, past studies use OLS pooled regression to test the hypotheses (Ali et al., 2018; Arping & Sautner, 2010; Bhojraj & Sengupta, 2003; Byun, 2007; Dasilas & Papasyriopoulos, 2015; Dang et al., 2019; Deng et al., 2018; Elyasiani, Jia & Mao, 2010). However, previous studies also showed that there is a possiblity of an endogeneity problem related to corporate governance research

(Agrawal & Knoeber, 1996; Chen et al., 2007; Hermalin & Weisbach, 2012; Harris & Raviv, 2008; Roberts & White, 2013; Schultz, et al., 2010; Wintoki, 2012). These researchers believe that well-developed panel GMM is an appropriate estimator to control for dynamic endogeneity, unobserved heterogeneity, and simultaneity, which may alleviate potential biases in this context. This study also contributes to methodology by using panel data regression (common efffect, fixed effect and random effect) and GMM to overcome the endogeneity problem. According to Wintoki et al. (2012) the GMM estimator incorporates the dynamic nature of governance to provide valid and powerful instruments that address unobserved heterogeneity and simultaneity. The causality effect and exogenous shock were also determined in this research. The dynamic nature of the relation between corporate governance, stock liquidity, and cost of debt actually sets up a powerful methodology for identifying the causal effect of governance on stock liquidity and cost of debt. Additional robustness checks consider whether the results are sensitive to the global financial crisis of 2007–2009 in order to examine the exogenous shock.

1.5.2 Practical Contribution

This study could also help firms in their strategic decisions by being aware of corporate governance practices and stock liquidity, which have significant effect on cost of debt. For an investor, this study can be used as an additional reference for information and consideration when they make an investment. Investors could use this study to become more aware of their role in corporate governance, stock liquidity, and cost of debt. This study also can be used by banks as a references related to the firm’s implementation of corporate governance in order to make decisions regarding to lending and interest rates.

1.6 Scope of the Study

This study focused on the relationship of corporate governance variables, stock liquidity, and cost of debt. The corporate governance variables consisted of foreign institutional ownership, domestic institutional ownership, board independence, audit quality, and audit committee. This study also used control variables, with the aim that the relationship between a dependent and independent is not influenced by other factors not examined. This was done to ensure that the relationship between variables was not biased. In this study, the control variables were those most commonly used in previous studies—firm size, market-to-book ratio, return on asset, interest coverage ratio, and efficiency ratio.

This study used data from company annual reports and daily stock prices for each company. Companies that were used as samples in this research were companies listed on the Indonesia Stock Exchange period from 2007-2016. This 10-year study period was used so that the results could represent actual long-term conditions and cover the fluctuating stock price movements.

This study used the panel data techniques common, fixed, and random effect. The selection of the best technique was determined by the Chow test, Hausman test and Langrange Multiplier test. Also, this study used the generalized dynamic data panel with generalized method of moments to test the proposed hypotheses. The GMM estimator was used to correct for biases caused by endogenous explanatory variables. This research used a well-developed dynamic panel GMM estimator to alleviate endogeneity concerns.

The exogenous shock was also determined in this research. The relation between corporate governance, stock liquidity, and cost of debt tested whether the results were sensitive to the global financial crisis of 2007–2009, in order to examine exogenous shock.

1.7. Definition of Key Terms

For ease of reference and understanding, this section provides definitions of key terms used in this research.

Corporate governance: The relationship, system, and process used by a company's organs to provide added value to shareholders on a sustainable basis in the long term, while still taking into account the interests of other stakeholders (Organization for Economic Cooperation and Development).

Institutional Ownership: Shares held by funds, brokers, social security firms, and financial firms (Xue & Hong, 2015).

Foreign Institutional Ownership: The fraction of a firm's shares that are held by foreign institutional investors (Chung & Zhang, 2011).

Domestic Institutional Ownership: The fraction of a firm's shares that are held by domestic institutional investors (Chung & Zhang, 2011).

Board Independence: A board of directors with those who have not owned a share of the company and do not have any business relationships with the company (Siagian, 2013).

Audit Quality: The market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach (DeAngelo, 1981).

Audit Committee: A selected number of members of a company's independent board whose responsibilities include helping auditors remain independent of management. Most audit committees are made up of three to five, or sometimes as many as seven, directors who are not a part of company management (Arens, Elder & Beasley, 2010).

Stock liquidity : Capability to purchase or sell a large amount of stock quickly, with comparatively little price impact. (Campbell et al., 1998).

Cost of Debt : The rate of return required by a lender in providing funding to companies (Fabozzi, 2007).

1.8. Organization of Chapters

There are a total of five chapters in this research.

Chapter one consists of an introduction and the background of study, problem statement, research objectives and questions, significance of the study, and the organization of the remaining chapters. The second chapter presents a review of the literature, previous research, the theoretical framework, and the hypotheses that were used in this study. Chapter three describes the methodology of this research, including the research design, population, sample of the study, data selection, variables measurement, and statistical analysis. Chapter four presents the result of the analyses and discussions of the results. Finally, chapter five provides the summary, implications, limitatitons of the study, and suggestions for direction for future research.

CHAPTER 2

LITERATURE REVIEW

2.1. Introduction

This chapter discusses the underlying theory and previous research that formed the research framework and hypothesis for this study. The review includes the cost of capital, cost of debt, corporate governance, and stock liquidity. An extensive literature review was done to understand the conceptual shifts and factors influencing cost of debt. This chapter highlights agency theory, which forms the basis of the corporate governance concept. This chapter also describes the control variables in this study.

2.2. Cost of Capital

Capital structure decisions are reflected in cost of capital, and as cost of capital has a negative impact on rate of return, it becomes important in financial decisions (Easley & O'hara, 2004). One of the key factors of company policy is decision on capital structure. A firm's cost of capital, risk faced by shareholders, and compensation of firm's owners, managers, and other stakeholders are affected by capital structure (Douglas, 2006). According to Modigliani and Miller (1958), the cost of capital is considered equal to the bond interest rate, regardless of whether funds are obtained through debt instruments or through the issuance of new common stock. The cost of capital depends on the funding decisions used by the company, namely the cost of equity if the business is only financed by equity, or the cost of debt if financed only through debt. Theories of capital structure (i.e., the static trade-off and pecking-order theories) predict the relationship between stock liquidity and leverage. According to the static trade-off theory, a firm with more liquid stock has a lower flotation cost for equity issuance, which makes the equity financing more attractive than debt financing. Thus, firms with more liquid stocks are expected to have lower leverage (Nadarajah, Ali, Liu & Huang, 2018).

A firm's cost of capital reflects investors' required return based on the firm's systematic risk. Mitton (2002) suggested that during economic crises, a lack of governance practices should lead to firms' poor performance, increading the cost of capital. Liao, Tarun & Wei (2015) stated that improving the quality of corporate governance through boards that are more independent, such as the separation of CEO and chairman authority, the existence of outside directors, and larger institutional ownership has a relationship with a higher level of financial leverage and a faster speed of adjustment of leverage toward the shareholders' desired level.

Nadarajah et al. (2018) stated that managers are faced with a choice regarding the allocation of sources of funds for the company. Decision making regarding capital structure becomes very important because the optimal capital structure can maximize firm value through minimizing the cost of capital. Clayman, Fridson & Troughton (2012) argued that defining the level of debt financing to which a firm reaches its optimal capital structure is difficult because this depends mainly on the firm's stock liquidity (i.e., asymmetric information) and corporate governance. A numerous study has been conducted and found the relationship of governance to cost of capital. The implementation of corporate governance will reduce information asymmetry, thus reducing risk and lowering the cost of capital (Barth et al., 2013; Chung et al., 2010; Diamond & Verrecchia, 1991; Habib et al., 1997; Teplova & Sokolova, 2018).

2.2.1. Cost of Debt

The use of debt can give advantage for the company. Ghouma et al. (2018) stated that debt financing has three major advantages over equity financing. First, the calculation of corporate tax after the interest would benefit from a tax shield for the company. Second, lenders would play a monitoring role since highly leveraged firms tend to pay more attention to the reactions of the debt markets. Third, related to the signaling theory, debt would enhance the disclosure and transparency of the company. Debt provides an assessment on a firm’s overall quality and reduces asymmetric information between companies and investors. The tax benefits of debt can also be expressed in terms of the difference between the cost of debt before and after tax. Debt provides a tax benefit for interest expense to reduce tax. Fosberg, (2004); Graham, (2000); Jensen (1986); Harris and Raviv (1991); Stulz (1990); and Yun (2009) stated that debt may encourage managers to be more disciplined in their investment choices. Debt will reduce the agency cost due to monitoring activities by lenders. This monitoring of activities will encourage transparency and disclosure, and the level of information asymmetry will be reduced, indicating a low level of risk (Chava et al., 2009; Francis et al., 2005; Roberts & Yuan, 2006).

Most organisations use some debt in their capital structure. Fosberg (2004) stated that companies use debt as a source of funding because companies can benefit from a reduction in interest tax, reducing the cost of debt financing. This shows that the source of funds from debt is the cheapest type of capital from outside the company. However, debt financing will increase a company's risk because it will increase the likelihood of corporate bankruptcy (Mustapha & Ahmad, 2011). Agrawal and Knoeber (1996) and Ang et al.. (2000) stated that another advantage of debt financing is the monitoring activities by lenders to managerial equity and family ownership, which