

Leverage, Firm Value and Corporate Governance

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The level of debt acts as a disciplinary financial tool. Moreover, more leverage raises firm value (FV) until a specific point, and then the FV starts to decline.

Keywords: firm value ; corporate governance ; leverage ; agency costs of debt ; financial position

1. Leverage and Firm Value

Leverage can improve the firm value (FV) because it compels managers to make value-maximizing decisions. The agency cost of free cash flow is also reduced using leverage because managers might not exercise discretion over the corporate resources; thus, debt provides efficiency to the firm and shows a positive influence on internal capital markets ([Wruck 1990](#)). Some prior studies showed that lucrative firms increase their performance quality by rising their debt indicators, meaning a positive relationship between debt and FV ([Abor 2005](#); [Jensen 1986](#); [Modigliani and Miller 1958](#); [Ruland and Zhou 2005](#)).

On the other hand, there are two views to study the negative relationship between leverage and FV. The traditional view of the pecking-order theory involves higher profitability and retained earnings, which declines the level of firm debt ([González 2013](#)). For instance, American highly leveraged firms have a tendency to experience lower operating profits than their competitors and lose market shares ([Opler and Titman 1994](#)). The management-entrenchment hypothesis implies that the entrenched managers have incentive enough to increase leverage beyond the optimal level. According to ([Aggarwal et al. 2007](#); [Harris and Raviv 1991](#)), the entrenchment hypothesis stimulates managers to increase debt to inflate the elective influence of their equity securities and decrease the appropriation attempts by outside parties who may enlarge FV. Entrenched managers might also adopt excess leverage to use a signaling device to reveal an allegiance to sell assets or otherwise restructure, thereby displacing takeover attempts by third parties who might replace the firm assets to increase FV. The agency costs of debt may also motivate entrenched managers to enlarge leverage over and above the optimal point by taking large risks, hiring under investment, or milking properties. The higher the level of debt is, the more possibility there is for stockholders to engage in selfish strategies and the lower the FV will be, respectively. Previous studies in developing countries have shown a significant negative relationship between leverage and FV ([Chen 2004](#); [Ibhagui and Olokoyo 2018](#); [Simon-Oke and Afolabi 2011](#)).

2. Corporate Governance and Firm Value

Corporate governance (CG) is an arrangement of direction and supervision that influences the firm's goals. CG might act as a contract that governs the relationships between shareholders and managers. CG comprises the effective assessment of the firm's risk. Good- and strong-CG mechanisms allow firms to (i) generate the firms' value through operations, research, and innovation, which also includes financial wealth; (ii) offer accountability and satisfactory control systems; and (iii) introduce a status of consciousness and transparency ([Detthamrong et al. 2017](#); [Tulcanaza-Prieto and Lee 2022b](#)). Moreover, CG can be considered a strategic tool in countries with weak legal atmospheres. The literature ([Durnev and Kim 2005](#)) mentioned that CG provides instruments to decrease the inadequacies and complications of the legal organization of nations.

Previous studies developed CG metrics according to the country's environment, showing that CG might positively influence FV ([Tulcanaza-Prieto et al. 2020b](#)). The authors found that CG policies and practices positively influence FV in developed and emerging markets ([Black et al. 2006](#); [Brown and Caylor 2006](#); [Gompers et al. 2003](#); [Klapper and Love 2004](#); [Tulcanaza-Prieto and Lee 2022b](#); [Tulcanaza-Prieto et al. 2020b](#)). The positive relationship between CG and FV is grounded in the agency model of divided payout because of the higher investor confidence, and, also, it generates a low cost of capital ([La Porta et al. 2002](#)). Moreover, the agency-cost problems and the opportunistic behavior of managers are reduced in firms with a high level of CG because these firms increase their transparency, disclose their public information, increase the reliability of their firms, and raise confidence in their decision-making process. Specifically, in the Korean

market, most companies have controlling shareholders or families as an efficient tool of CG. It promotes efficient operations, increases the FV, and controls the actions of managers ([Black et al. 2006](#); [Lee et al. 2015](#); [Yoon et al. 2006](#)).

3. Leverage, Corporate Governance and Firm Value

The traditional view of management entrenchment states the relationship between leverage and FV, showing a negative relationship between both variables, which also is grounded in the agency cost of debt and the different interests between parties (shareholders and debtholders) based on the decisions made by management. Moreover, agency costs of debt might rise when the interests of shareholders and managers diverge, given an increase in the cost of debt. However, strong-CG mechanisms attempt to reduce this conflict of interest ([Chan-Lau 2001](#); [Jensen 1986](#)).

If the entrenchment hypothesis is a dominant explanation, then CG practices may play a moderating role in loosening and breaking down the negative relationship between leverage and FV. The entrenched managers have access to firms' information and have discretion over the leverage decisions of their firm. Information asymmetry generates monitoring and controlling difficulties with their actions. Specifically, entrenched managers fail to undergo discipline from the full range of corporate governance, which includes monitoring by the board committee, the takeover threat, and stock-based performance incentives. CG practices might act as effective corporate-control tools to reduce the probability of entrenched managers using discretion to decide to leverage above the optimal level, which may not necessarily reduce FV as a result.

CG structure has a vital influence on the degree of agency of costs of debt since it helps to mitigate the inefficiencies of capital allocations between business units, given the decrease in information asymmetries between parties ([Altieri 2022](#)). Moreover, the authors ([Abdullah and Tursoy 2021](#)) mentioned that CG significantly positively affects FV, while there is a negative relationship between a CG measurement (board size) and FV. However, these findings were weakened after the IFRS implementation in German firms, suggesting that both capital and CG structures cause better firm performance. The authors ([Ngatno et al. 2021](#)) showed that CG mechanisms in Indonesian firms act as a control and monitor the capital-structure decisions and decrease the agency costs of debt, given the presence of a commissioner and its optimal role in reducing the opportunistic behavior of managers, showing that effective CG decreases agency costs of debt, and, thus, the negative relationship between debt and FV is loosened.

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