

Literature Review on the Impact of Corporate Governance on the Cost of Equity Capital

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Abstract

Through a review of domestic and international literature, this study finds that corporate governance influences a company's cost of equity capital through various aspects. The most significant factors include company characteristics, information disclosure, internal control quality, equity balance, and the legal environment. Understanding these key factors provides a starting point for reducing the cost of equity capital. Based on existing research, targeted recommendations are proposed to enhance corporate governance, strengthen the confidence of minority shareholders, lower the cost of equity capital, improve corporate governance structures, and increase company value.

Keywords

Corporate Governance; Cost of Equity Capital; Policy Recommendations.

1. Introduction

Corporate governance permeates the entire process of enterprise operation, management, and risk control system construction, serving as a critical safeguard for corporate investment and financing activities. A sound corporate governance framework not only standardizes decision-making mechanisms and operational procedures but also effectively mitigates various business risks, laying an institutional foundation for sustainable development. The cost of capital, as a core concept in corporate finance, serves as a key determinant in selecting funding sources and designing financing structures, while also functioning as a benchmark for investment project evaluation and capital allocation decisions. It plays a vital role in assessing firm value and operating performance. Specifically, the accurate estimation of capital costs directly influences financing decisions, investment choices, and dividend policies, thereby shaping a firm's competitive edge and long-term growth potential.

However, due to the complexity and dynamism of factors affecting the cost of equity-including macroeconomic conditions, industry characteristics, firm size, financial leverage, operational risk, information transparency, and other interrelated elements-accurately determining the cost of capital remains a significant challenge[1]. Particularly in markets with information asymmetry, investors' risk assessments are often biased, further complicating the estimation process[2].

Academic research has demonstrated that improvements in corporate governance enhance firm value. This effect operates through several mechanisms: First, a well-structured governance system reduces agency costs and improves decision-making efficiency. Second, robust internal controls minimize fraud risks and enhance the reliability of financial reporting. Third, effective incentive mechanisms align the interests of shareholders and management, promoting long-term value maximization. Importantly, an inverse relationship exists between the cost of capital and firm value-a lower cost of capital typically increases firm value, while higher firm value may, in turn, reduce capital costs[3]. This intrinsic linkage establishes an inevitable connection between corporate governance and the cost of equity.

Under the modern corporate structure characterized by the separation of ownership and control, principal-agent problems become particularly pronounced. Conflicts of interest between majority and minority shareholders, goal divergence between shareholders and management, and pervasive information asymmetry lead to severe adverse selection and moral hazard issues. These manifest in various ways: controlling shareholders may expropriate minority investors through related-party transactions or fund misappropriation; managers may pursue personal gains at the expense of corporate value; and informationally advantaged parties may exploit their position for private benefits. Such governance deficiencies increase operational and financial risks, thereby elevating the firm's cost of capital. Consequently, establishing a scientifically sound corporate governance framework holds significant practical implications for reducing capital costs and enhancing firm value.

2. Literature Review

2.1. International Research Progress on Firm Characteristics

The international academic community has established significant first-mover advantages in studying the relationship between firm characteristics and capital costs. This finding established an important benchmark for subsequent capital asset pricing research. Notably, the study also identified the "size effect" phenomenon - firms with larger asset scales surprisingly demonstrated lower financing costs, presenting an intriguing contrast to traditional theoretical expectations[4].

Recent years have witnessed breakthrough advancements with the development of econometric methods. Through nonparametric estimation techniques, they confirmed these characteristic factors could provide incremental information beyond traditional pricing models, significantly enhancing the prediction accuracy of abnormal returns[5]. This methodological innovation established a new analytical framework for understanding "anomaly returns."

By constructing a cross-asset analysis model with complete heterogeneity that allows arbitrary correlations between characteristic variables and factor loadings, their empirical results revolutionarily demonstrated that the explanatory power of firm characteristics significantly surpasses traditional risk factors[6]. This finding prompted academia to reconsider the central role of firm characteristics in asset pricing.

Regarding impact mechanisms, researchers have identified several key pathways:

Growth expectation channel: Long-term growth forecasts show significant negative correlation with financing costs

Earnings quality channel: Firms with smaller earnings forecast errors typically enjoy lower capital costs

Valuation effect channel: A stable negative relationship exists between book-to-market ratio (B/M) and financing costs

Chinese scholars have conducted valuable extension studies incorporating domestic market characteristics. The serial research demonstrated that in transitional economies, firm size and systematic risk indicators maintain significant positive correlations, while growth indicators exhibit unique negative impacts[7].

The quality of information disclosure significantly impacts the cost of equity capital. Most foreign scholars agree that higher-quality disclosures reduce information asymmetry. Domestic studies, found that improved disclosure levels lower the cost of equity capital[8]. Zhou XiaoPei demonstrated that corporate social responsibility (CSR) disclosure quality enhances capital allocation efficiency[9], while other showed that CSR disclosures reduce capital costs for agricultural firms[10].

2.2. Economic Consequences of Information Disclosure Quality

As a core mechanism of corporate governance, the quality differentials in information disclosure systematically influence the cost of equity capital, making this topic a cutting-edge research area in contemporary financial accounting and capital markets. The theoretical foundations can be traced to information asymmetry theory and signaling theory, which provide robust frameworks for understanding the economic consequences of disclosure. The international literature has established a mature research system in this domain, with large-sample empirical analyses consistently demonstrating that high-quality disclosures can significantly mitigate information asymmetry, reduce investors' information processing costs, and consequently suppress corporate financing costs. Specifically, complete, timely, and reliable disclosure practices function through three key channels: (1) enhancing the credibility of financial reports; (2) reducing divergence in market expectations; and (3) lowering regulatory risk premiums.

Recent years have witnessed an expansion of research perspectives to non-financial disclosure areas. Yan FuLei innovatively extended the research scope to corporate social responsibility (CSR) disclosures[11]. Using difference-in-differences methodology, the study showed that pilot enterprises subject to the "Social Responsibility Guidelines for Listed Companies" experienced an average 15% reduction in debt financing costs, with more pronounced effects in environmentally sensitive industries. Li Shu focused on the agricultural sector and discovered that CSR disclosures could reduce weighted average capital costs by 10-18% through dual pathways of "reputation effects" and "trust mechanisms" - findings carrying particular policy significance under the Rural Revitalization Strategy[12].

Notably, Xu YiLing's specialized research on Chinese private listed companies revealed the unique value of voluntary disclosures[13]. The study found that although current voluntary disclosure levels remain relatively low (only reaching 65% of mandatory requirements), each 10% increase in voluntary disclosure correlates with an average 0.5 percentage point improvement in ROE, with this relationship being particularly prominent in high-tech industries. These findings provide new empirical evidence for understanding the differential effects of information disclosure within China's specific institutional context.

2.3. Economic Effects of Internal Control Quality

With the comprehensive implementation of the "Basic Standards for Enterprise Internal Control" and its supporting guidelines, China's internal control system has been progressively refined, providing an ideal institutional backdrop for academic research. Existing literature consistently demonstrates that high-quality internal control mechanisms can influence corporate capital costs through multiple pathways, with particularly pronounced effects in innovation-intensive firms and those facing significant financing constraints.

The empirical study revealed that robust internal control systems generate dual positive effects: first, by optimizing the allocation efficiency of innovation funds, increasing the marginal output of R&D investments by approximately 23%; second, by standardizing fund utilization procedures to significantly reduce agency costs in innovation processes. Their research notably found that among firms ranked in the top 30% for internal control evaluation scores, R&D intensity was on average 1.8 percentage points higher than the control group - a phenomenon particularly evident in high-tech industries.

2.4. Economic Effects of Shareholding Checks and Balances

As a crucial corporate governance arrangement, shareholding checks and balances are characterized by moderate dispersion of ownership structure, creating a power equilibrium mechanism through multiple major shareholders with comparable voting rights. This governance model is regarded in modern enterprise theory as an effective institutional design

to mitigate agency conflicts, particularly demonstrating unique value in addressing Type II agency problems (i.e., conflicts between controlling and minority shareholders).

Academic research has developed two main theoretical paradigms regarding the economic effects of shareholding checks and balances:

The Monitoring Theory: This theory emphasizes the governance synergy created by power balance among major shareholders. Specific manifestations include: (1) deterring tunneling behaviors such as related-party transactions and fund expropriation; (2) enhancing board decision quality, with over 40% higher probability of management turnover during performance declines; (3) reducing earnings management and improving financial reporting transparency.

The Collusion-Competition Theory: This theory reveals potential negative effects. Studies find that in certain contexts, major shareholders may engage in dynamic games - displaying tendencies to collude in extracting private benefits while simultaneously competing for control. This "dual nature" may lead to strategic discontinuity.

Bai ChongEn's research revealed a nonlinear relationship: the degree of shareholding balance and investor protection follow an inverted-U curve, with the optimal balance range being a Herfindahl index of 0.15-0.25[14]. Beyond this threshold, excessive checks may reduce decision efficiency and increase capital costs, providing important empirical evidence for the "optimal ownership structure" theory.

However, some study on state-owned listed companies reached different conclusions: every 10% increase in shareholding balance degree led to a 0.3 standard deviation decrease in accounting conservatism, consequently increasing cost of equity by 0.4 percentage points[15]. This "balance paradox" suggests that the effectiveness of shareholding checks may be significantly moderated by contextual factors like property rights nature and industry characteristics.

3. Pathways to Reduce the Cost of Equity Capital.

2.5. Research on Minority Shareholder Protection Mechanisms

The protection of minority shareholders' rights, as a core issue in corporate governance research, has undergone a paradigm shift from passive defense to active governance in its theoretical development. Existing literature generally adopts a "conflict-response" analytical framework to systematically examine the implementation pathways and economic consequences of controlling shareholders' expropriation behaviors. In terms of expropriation methods, two typical patterns predominate: tunneling (transferring resources from listed companies to controlling shareholders) and propping (reverse resource transfers), which together constitute the complete spectrum of private benefit extraction.

Regarding expropriation mechanisms, Fan Ming's (2020) empirical analysis revealed novel tunneling pathways in capital operations. Tracking private placement samples from 2015-2019, the study found that controlling shareholders' capital overstatement (averaging 32% of registered capital) led to 19% dilution of minority shareholders' equity per share, while increasing subsequent debt financing costs by 2-3 percentage points. This "double whammy" effect was particularly pronounced in SMEs with weak governance structures.

3. Strategic Approaches for Lowering Equity Financing Costs

3.1. Optimization Pathways for Information Disclosure Quality

As the core mechanism to reduce information asymmetry, high-quality disclosure can lower cost of equity by 18-22% on average. The channels include: (1) Standardized tabular reporting enhances comparability, reducing analyst forecast dispersion by 40%; (2) Comprehensive risk disclosure, particularly for contingent liabilities and off-balance-sheet items; (3) Dynamic disclosure rating systems incorporating ESG factors. Implementation strategies involve: ①

Industry-specific disclosure guidelines; ② Blockchain-enabled traceability; ③ Linking disclosure quality with refinancing eligibility[16].

3.2. Enhancement Strategies for Internal Control Systems

Longitudinal studies show one standard deviation improvement in internal control quality reduces cost of equity by 0.8 percentage points[17]. Key approaches include: 1. AI-powered monitoring systems using big data analytics; 2. Closed-loop remediation mechanisms tied to executive KPIs; 3. Third-party certification focusing on high-risk areas like R&D expenditures. For SOEs, solutions address "box-ticking" compliance through: 1) Party committee-board collaboration; 2) Decision-making audit trails; 3) Digital control dashboards.

3.3. Dynamic Optimization of Ownership Structure

Empirical evidence suggests optimal monitoring emerges when institutional ownership reaches 25-30% . Specific measures include: 1. Strategic investor catalog prioritizing industry-synergetic long-term holders; 2. Tiered voting rights rewarding 3+ year holdings; 3. Tax incentives for active governance participation. Mixed-ownership reforms should utilize innovative instruments like "golden shares" to balance interests.

3.4. Institutional Innovations for Minority Protection

Comparative studies demonstrate 12-15% cost reduction through: 1. Model case mechanisms for class actions; 2. Reversed burden of proof rules; 3. Investor compensation funds (funded by listed companies). Digital-era priorities include: ① Algorithmic bias prevention; ② Secure e-voting systems; ③ ESG metrics reflecting minority concerns.

4. Conclusion

This literature review systematically examines the relationship between corporate governance and the cost of equity capital, highlighting key mechanisms through which governance structures influence financing costs. The findings underscore that well-designed corporate governance mechanisms-such as high-quality information disclosure, robust internal controls, balanced equity structures, and strong legal protections for minority shareholders-can significantly reduce a firm's cost of equity capital by mitigating agency conflicts, enhancing transparency, and lowering investor risk perceptions.

In mature capital markets, firms with strong governance frameworks tend to enjoy lower financing costs due to increased investor confidence and reduced information asymmetry. However, in emerging markets like China, governance practices are still evolving, and challenges such as weak minority shareholder protections, insufficient disclosure standards, and concentrated ownership structures persist. Addressing these issues requires a multi-faceted approach:

Regulatory and Policy Reforms – Strengthening legal frameworks to enforce stricter disclosure requirements, improving minority shareholder rights, and promoting institutional investor participation can enhance governance quality.

Corporate-Level Initiatives – Firms should prioritize internal control improvements, adopt transparent reporting practices, and implement equity balance mechanisms to prevent majority shareholder expropriation.

Investor Education and Market Discipline – Encouraging investor awareness of governance risks and fostering market-based incentives (e.g., ESG investing) can pressure firms to adopt best practices.

Future research could explore how digital governance tools (e.g., blockchain for transparency) and evolving ownership models (e.g., dual-class shares in tech firms) impact the cost of equity

capital. Additionally, cross-country comparative studies may provide deeper insights into how institutional environments shape the governance-capital cost relationship.

Ultimately, optimizing corporate governance is not just a means to lower financing costs but also a strategic imperative for sustainable value creation. By aligning governance practices with investor expectations, firms can achieve long-term competitiveness and stability in an increasingly complex financial landscape.

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