Discussion of

Which Aspects of Corporate Governance Matter in Emerging Markets:

Evidence from Brazil, India, Korea, and Turkey

(Black, de Carvalho, Khanna, Kim, Yurtoglu)

by

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Summary

- Develop country-specific governance indices
  - "**Country specific**" = different elements are used in each country index
  - Emerging markets: Brazil, India, Korea, Turkey
- Six broad indices
  - Disclosure, board structure
  - Ownership structure, shareholder rights, board procedure, control of related party transactions

- **Disclosure (financial)** and board structure (independence) seem to matter for firm value
  - Other indices have low correlation with firm value

- Multi-country index does not predict firm value
  - Does not cover disclosure

Interesting study

- Ambitious data collection
- Allowing for cross-sectional and time series attributions
- Ambitious goal

Why not contrast with developed markets, e.g., US?

- Emerging markets: "significant variation in corporate governance practices both across firms and within firm over time" (p. 3)
- Should be similar even in developed market?

Comments

1. Causal link
2. Digging into (financial) disclosure
3. Attribution analysis
4. Building a better multi-country index

Research question is (too?) ambitious

"We are interested in the **causal** question:

Will a within-country *change* in governance change Tobin's *q*, or another outcome variable?"

(p. 6; emphasis added)

- Admirable aim
- The paper focuses on panel analysis
  - Difficult to make causal inference
  - "Our panel data design is not a true causal design, and is vulnerable to omitted variable bias (OVB) and reverse causation" (p. 4)

(1) Omitted variables

Omitted variables are likely to be correlated with governance index

- "Lower bound" tests (e.g., HHH)
  - *Lower bound 4*: "the omitted covariates have predictive power as strong as all observed covariates"
    - Assumption: $\rho(q,\mathbf{u})_{\mathbf{x},CGI}$ = largest value of $\rho(q,x_2)_{(\text{rest of } \mathbf{x}),CGI}$ for any included covariate x_2
  - Is this reasonable?
  - Depends on whether the covariates are orthogonal to the omitted variables

- Useful exercise!
  - Should be applied throughout the paper, rather than as an isolated robustness test
  - E.g., in Table 11 (whose results are used in the abstract)

(2) Reverse causality

High value firms can afford better governance

- "Better" firms disclose more
- "Better" firms have more independent board
- Firm managers are not worried about being fired (or being target of M&A)
  - Due to the higher valuation

(2) Reverse causality

Determinants of CGI?

"In separate work for India, Korea, and Turkey (we have not studied Brazil), we find that non-time varying firm characteristics (e.g., firm, industry, business group) strongly predict governance, but time-varying firm characteristics only *weakly* predict governance."

- Is this true for **disclosure** as well?
- Re-run for the sample in the paper

Offered solution: Firm FE

- But only few snapshots, e.g., 3 for Korea
- Can also try "change" regression?

Disclosure is important

The accounting profession will be happy

- Statutory boards
- Accounting academics

It would be useful to understand the "disclosure" choice

- Many variables to choose from
- Extensive accounting literature
- Asset volatility
- Investor location (Bernile, Kogan, Sulaeman)

Is disclosure a feature of corporate governance?

Choice variable ~ demand vs. supply

- "Firm has regular meetings with analysts"
- "English language financial statements exist"

Disclosure policies are likely to be related to competition and regulatory requirements

- Firms may do other things at the same time
- Which may be correlated with valuation

Digging deeper into disclosure

"Improved disclosure should reduce information asymmetry (e.g., Diamond and Verrecchia, 1991)"

- **Lower stock volatility?**

"Better disclosure could improve liquidity, which should in turn increase share prices – a channel proposed by Amihud and Mendelson (1988)"

- **Higher stock liquidity?**

Would it be possible to evaluate these channels?

Attribution analysis

Decomposing R^2

- Looks large ~ 0.4
- Marginal R^2 of governance indices?
- R^2 between: cross-sectional
- R^2 within: time-series

Time-series effects:

- How much comes from:
  - Country-level variations, vs.
  - Industry-level variations, vs.
  - Firm-level variations?
- How important is (country*)year FE?

Multi-country Index

Can the authors build their own "common indices" using the data in this paper?

- Excellent data
- Potentially superior to "data providers"

At least a multi-country Disclosure Index

- Need to make some decisions regarding "NM" items (no within-country variation)

Disclosure index ***Financial disclosure elements***				
RPTs are disclosed to shareholders	**b_dis_1 (NP)**	**i_dis_1**	NA	NM
Firm has regular meetings with analysts	**b_dis_2 (NP)**	**i_dis_2**	**k_dis_2 (NP)**	NA
Firm puts annual financial statements on firm website	**b_dis_3**	**i_dis_3**	NA	**t_dis_3**
Quarterly financial statements are consolidated	**b_dis_4**	NA	NA	NM
Firm puts quarterly financial statements on firm website	**b_dis_5**	**i_dis_5**	NA	**t_dis_5**
Firm puts annual report on firm website	NA	**i_dis_6**	NA	**t_dis_6**
English language financial statements exist	**b_dis_7**	NM	**k_dis_7 (NP for past data)**	**t_dis_7**
Financial statements include statement of cash flows	**b_dis_8**	NM	NM	NM
Financial statements in IFRS or US GAAP	**b_dis_9**	NA	NM	NM
MD&A discussion in financial statements	**b_dis_10**	NM	NM	NA

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Similar to credit rating analysis:

- Sovereign risk vs. firm-level risk
- Country index vs. within-country index

Country-level Index

- NA = poor governance?

Audit committee procedure elements				
Firm has internal audit/control function	NA	NA	NM	**t_bpa_1**
Audit comm. members & chair are disclosed	NA	NA	NM	**t_bpa_2**
Firm has bylaws governing audit comm.	NA	**i_bpa_3**	**k_bpa_3 (NP)**	NA
Company discloses audit comm. bylaws	NA	NA	NA	**t_bpa_4**
Audit comm. recommends external auditor	NA	**i_bpa_5**	NA	NA
Outside directors on audit comm. meet separately	NA	**i_bpa_6**	NA	NA
Audit comm. includes accounting or finance expert	NA	NM	**k_bpa_7 (NP)**	NA
Audit comm. (Korea: or internal auditor) approves head of internal audit team	NM	NA	**k_bpa_8 (NP)**	NA
Audit comm. meets at least 4 times per year	NA	NA	**k_bpa_9**	NA

- Percent survey responder?

Korea

Survey year	**Capitalization of responding firms (% of KSE firms)**
2002	134.76 (88%)
2003	208.55 (95%)
2004	237.68 (75%)

India

Survey year	**Capitalization of responding firms (% of public firms)**
2006	21 (18%)
2007	47 (5%)
2012	38 (8%)

Conclusion

Very nice dataset

- Would be useful to disseminate …

Paper does many things well:

- Introduce governance data
- Connecting governance indices with valuation, particularly in the time series
- Lower bound analysis
- Decomposing the indices
- Examining profitability

But has not (yet) convincingly achieved its even more ambitious aim