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

Johan Sulaeman
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: \( \rho(q, u)_{x, CGI} = \text{largest value of } \rho(q, x_2)_{(\text{rest of } x), CGI} \) 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 $\sim 0.4$
- 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)
<table>
<thead>
<tr>
<th>Disclosure index</th>
<th>Financial disclosure elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>RPTs are disclosed to shareholders</td>
<td>b_dis_1 (NP)</td>
</tr>
<tr>
<td>Firm has regular meetings with analysts</td>
<td>b_dis_2 (NP)</td>
</tr>
<tr>
<td>Firm puts annual financial statements on firm website</td>
<td>b_dis_3</td>
</tr>
<tr>
<td>Quarterly financial statements are consolidated</td>
<td>b_dis_4</td>
</tr>
<tr>
<td>Firm puts quarterly financial statements on firm website</td>
<td>b_dis_5</td>
</tr>
<tr>
<td>Firm puts annual report on firm website</td>
<td>NA</td>
</tr>
<tr>
<td>English language financial statements exist</td>
<td>b_dis_7</td>
</tr>
<tr>
<td>Financial statements include statement of cash flows</td>
<td>b_dis_8</td>
</tr>
<tr>
<td>Financial statements in IFRS or US GAAP</td>
<td>b_dis_9</td>
</tr>
<tr>
<td>MD&amp;A discussion in financial statements</td>
<td>b_dis_10</td>
</tr>
</tbody>
</table>
Multi-country Index

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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?**

<table>
<thead>
<tr>
<th>Audit committee procedure elements</th>
<th>Korea</th>
<th>India</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm has internal audit/control function</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Audit comm. members &amp; chair are disclosed</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Firm has bylaws governing audit comm.</td>
<td>NA</td>
<td>i_bpa_3 k_bpa_3 (NP)</td>
</tr>
<tr>
<td>Company discloses audit comm. bylaws</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Audit comm. recommends external auditor</td>
<td>NA</td>
<td>i_bpa_5</td>
</tr>
<tr>
<td>Outside directors on audit comm. meet separately</td>
<td>NA</td>
<td>i_bpa_6</td>
</tr>
<tr>
<td>Audit comm. includes accounting or finance expert</td>
<td>NA</td>
<td>NM k_bpa_7 (NP)</td>
</tr>
<tr>
<td>Audit comm. (Korea: or internal auditor) approves</td>
<td>NM</td>
<td>NA</td>
</tr>
<tr>
<td>head of internal audit team</td>
<td></td>
<td>k_bpa_8 (NP)</td>
</tr>
<tr>
<td>Audit comm. meets at least 4 times per year</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>

• **Percent survey responder?**

<table>
<thead>
<tr>
<th>Survey year</th>
<th>Capitalization of responding firms (% of KSE firms)</th>
<th>Survey year</th>
<th>Capitalization of responding firms (% of public firms)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>134.76 (88%)</td>
<td>2006</td>
<td>21 (18%)</td>
</tr>
<tr>
<td>2003</td>
<td>208.55 (95%)</td>
<td>2007</td>
<td>47 (5%)</td>
</tr>
<tr>
<td>2004</td>
<td>237.68 (75%)</td>
<td>2012</td>
<td>38 (8%)</td>
</tr>
</tbody>
</table>
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