



Corporate governance and firm value: International evidence [☆]

Manuel Ammann ^a, David Oesch ^b, Markus M. Schmid ^{c,*}

^a Swiss Institute of Banking and Finance, University of St. Gallen, CH-9000 St. Gallen, Switzerland

^b Department of Finance, Stern School of Business, New York University, New York, NY 10012, USA

^c University of Mannheim, Finance Area, D-68131 Mannheim, Germany

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ABSTRACT

In this paper, we investigate the relation between firm-level corporate governance and firm value based on a large and previously unused dataset from Governance Metrics International (GMI) comprising 6663 firm-year observations from 22 developed countries over the period from 2003 to 2007. Based on a set of 64 individual governance attributes we construct two alternative additive corporate governance indices with equal weights attributed to the governance attributes and one index derived from a principal component analysis. For all three indices we find a strong and positive relation between firm-level corporate governance and firm valuation. In addition, we investigate the value relevance of governance attributes that document the companies' social behavior. Regardless of whether these attributes are considered individually or aggregated into indices, and even when "standard" corporate governance attributes are controlled for, they exhibit a positive and significant effect on firm value. Our findings are robust to alternative calculation procedures for the corporate governance indices and to alternative estimation techniques.

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1. Introduction

Agency problems, and therefore good corporate governance helping to overcome them, may affect firm value in two different ways. First, good corporate governance may lead to high stock price multiples as investors anticipate that less cash flows will be diverted and a higher fraction of the firm's profits will come back to them as interest or dividends (Jensen and Meckling, 1976; La Porta et al., 2002). Second, good corporate governance may reduce the expected return on equity to the extent that it reduces shareholders' monitoring and auditing costs, leading to lower costs of capital (Shleifer and Vishny, 1997). However, it is not unequivocally clear that better governance is in fact related to higher company valuations as the costs associated with the implementation of stronger governance mechanisms may outweigh the benefits (e.g., Bruno and Claessens, 2010; Chhaochharia and Grinstein, 2007; Gillan et al., 2003).

The majority of the prior literature on the relation between corporate governance and firm value, documents that a stronger corporate governance is associated with a higher firm valuation (e.g., Bebchuk et al., 2009; Cremers and Nair, 2005; Core et al., 2006;

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* Corresponding author. University of Mannheim, Finance Area, Chair for Corporate Governance, D-68131 Mannheim, Germany. Tel.: +49 621 181 37 54.
E-mail address: schmid@bwl.uni-mannheim.de (M.M. Schmid).

Gompers et al., 2003; Yermack, 1996). While much of this literature deals with specific aspects of corporate governance, such as ownership or board structure, part of the literature aggregates individual corporate governance attributes to corporate governance indices. For the U.S., a number of studies (e.g., Bebchuk and Cohen, 2005; Bebchuk et al., 2009; Gompers et al., 2003) demonstrate the value-relevance of such governance indices aggregating a number of firm-level governance attributes. Relatively few studies investigate the valuation impact of firm-level corporate governance practices in an international context, notable exceptions being Durnev and Kim (2005), Francis et al. (2005), Klapper and Love (2004), and La Porta et al. (2002). However, these studies use data compiled by La Porta et al. (1998) on minority shareholder rights protection, CLSA (Credit Lyonnais Securities Asia) scores, whose usefulness has been questioned by Khanna et al. (2006) for example, or governance attributes related to disclosure only as measured by Standard & Poor's rankings. To overcome the problem of data availability, some studies use hand-collected and survey-based datasets on the firms' corporate governance structure within one specific country. For example, Balasubramaniam et al. (2009), Beiner et al. (2006), Black et al. (2006), and Drobetz et al. (2004) document a positive relationship between governance practices and firm valuation for Indian, Swiss, Korean, and German public firms, respectively.

With the emergence of more detailed information on firm-level corporate governance for large samples of firms from multiple countries, a new stream of research has emerged. Aggarwal et al. (2009), for example, use data from RiskMetrics (formerly Institutional Shareholder Services (ISS)) and compare the governance of non-U.S. firms with a matched set of U.S. firms and find that the valuation of non-U.S. firms falls as their governance index value decreases as compared to the governance index of matching U.S. firms. Bruno and Claessens (2010) also use ISS data and find that firm value depends on both country-level shareholder protection laws and firm-level corporate governance attributes. In addition, these relations are more pronounced in companies that depend on external financing. Chhaochharia and Laeven (2009), also using the ISS database, distinguish between governance attributes that are legally required and attributes that are adopted voluntarily. They show that firms that voluntarily adopt a more rigorous corporate governance structure are rewarded with a higher firm value.¹

In this paper, we provide new evidence on the relationship between firm-level corporate governance and company valuation in an international setting. We contribute to the literature by using a new and previously unexplored dataset from Governance Metrics International (GMI). Using a new dataset is important as the quality of corporate governance data has been questioned (e.g., Khanna et al., 2006) and a check of prior results based on a new dataset provides an important "out-of-sample" test. Our GMI dataset covers 22 developed countries (excluding the U.S.) around the world over the time period from 2003 to 2007. The governance data we use is much richer than the datasets used in prior studies. It covers 64 different governance attributes classified by GMI in six categories, namely board accountability, financial disclosure and internal control, shareholder rights, remuneration, market for control, and corporate behavior. One benefit emerging from the breadth of our database is that we are able to investigate the valuation effect of specific governance attributes that document a company's social behavior, also termed "corporate social responsibility" (CSR). To our knowledge, there are only three previous studies that investigate whether a company's CSR has an impact on firm value when standard corporate governance attributes are accounted for (Barnea and Rubin, 2010; Fisman et al., 2006; Harjoto and Jo, 2009).² Another advantage of our GMI dataset is that it contains the longest panel used in international studies on the valuation effect of firm-level corporate governance so far. Aggarwal et al. (2009) and Bruno and Claessens (2010) use purely cross-sectional datasets and Chhaochharia and Laeven (2009) a three-year panel dataset. Our five-year panel covering the time period from 2003 to 2007 has two major advantages. First, our sample size is substantially larger than that of Aggarwal et al. (2009) and Bruno and Claessens (2010) and similar to that of Chhaochharia and Laeven (2009) even though our dataset does not include any U.S. firms which account for approximately 1500 observations (20%) of Chhaochharia and Laeven's (2009) sample. Second, the longer time-series enables us to better investigate the dynamics of the relation between corporate governance and firm value and thereby accounting for the endogeneity of corporate governance in a dynamic panel GMM approach.

Even though there is an extensive literature investigating the relationship between corporate governance and firm value, there is still no consensus on how to measure corporate governance (e.g., Ertugrul and Hegde, 2009; Larcker et al., 2007). Besides using a new dataset, we contribute to the literature by testing alternative and distinct approaches on how to condense the large number of governance variables contained in our database into one measure of corporate governance. Prior literature almost exclusively uses additive indices giving mostly equal weights to each considered governance attribute. In addition to using two alternative additive approaches to construct a governance index, we rely on principal component analysis (PCA) to condense the information content of a large number of variables into a small and tractable number of governance indices as recently proposed by Larcker et al. (2007). The first of the two additive approaches we use is based on Aggarwal et al. (2009) and Chhaochharia and Laeven (2009). To construct this index, we first determine the number of governance attributes with data available for each firm-year observation and then define the governance index as the percentage of attributes a particular company has in place. The second additive approach employs a similar procedure but treats a governance attribute for which there is no information as if this attribute was not in place, instead of omitting such missing observations from the index construction. If firms are more likely to disclose information on governance attributes that are adopted, we would expect a stronger valuation effect of this second index as compared to the first one. The third alternative index, which uses PCA and is based on Larcker et al. (2007), condenses the

¹ Aggarwal and Williamson (2006) and Brown and Caylor (2006) use the ISS database to construct governance indices for U.S. firms only and both find a positive relation between corporate governance and firm value.

² A common problem in all these studies is that the measure of CSR, obtained from the Kinder, Lydenberg, and Domini's (KLD) Socrates database, is binary and only indicates whether a firm invests in CSR or not. Moreover, only Harjoto and Jo (2009) account for the endogeneity of CSR and none of the studies attempt to simultaneously account for the endogeneity of corporate governance.

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