

Does better corporate governance result in higher valuations in emerging markets? Another examination using a new data set

Matthew Morey^{a,*}, Aron Gottesman^b, Edward Baker^c, Ben Godridge^d

^a Lubin School of Business, Pace University, New York, NY, USA

^b Lubin School of Business, Pace University, New York, NY, USA

^c The Cambridge Strategy, London, UK

^d AllianceBernstein, London, UK

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Abstract

This paper utilizes a new data set from AllianceBernstein that, unlike other corporate governance data, has monthly-updated firm-level governance ratings for 21 emerging markets countries for almost a five year period. With these unique data, we examine how changes in corporate governance ratings impact firm valuation. Using this test we find evidence that improvements in corporate governance result in significantly higher valuations.

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*Corresponding Author. Tel.: (212) 618-6471; fax: (212) 618-6410

E-mail addresses: mmorey@pace.edu (F. author), agottesman@pace.edu (S. author), edward.baker@thecambridgestrategy.com (third author), benjamin.godridge@alliancebernstein.com (4th author).

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1. Introduction

The economic literature on corporate governance has exploded in the wake of the recent corporate scandals such as Enron, World.com and Parmalat. Indeed, in a search of economic literature with the phrase “corporate governance” in the title, we found that approximately 53 percent of the listings were published since the Enron crisis first came to light in the fall of 2001, while only 47 percent of the listings were published between 1969 through the Fall of 2001.¹ In terms of policy, corporate governance has also risen greatly in importance in last several years. From the U.S. to Brazil, to South Korea, governments have enacted laws and institutions in an effort to improve corporate governance. In fact, in 1999 the World Bank formed a corporate governance forum in order to improve governance practices around the globe.

Given the recent importance of corporate governance in academic research and policy, we ask a very straightforward question: Do companies in emerging markets that practice better corporate governance receive higher valuations in the market? That is, do investors care, via valuations, if a firm practices better governance?

We are far from being the first to examine this question. Indeed, there is a large literature that has examined this question in emerging markets. For example, Black (2001), Klapper and Love (2004), Durnev and Kim (2005), Black, Jang and Kim (2006a, 2006b) Black, Love and Rachinsky (2006) and Chua, Eun and Lai (2007) among others, have examined this question in various emerging markets. This literature has generally found that better governance is indeed linked with higher market valuations. However, due to data limitations it has been difficult to determine if better governance causes higher market valuations or if higher valued firms endogenously choose better corporate governance.

¹ The search was conducted on October 6, 2007 using the database Econlit.

Two of the above papers (Durnev and Kim (2005) and Black, Jang and Kim (2006a)) directly attempt to deal with the endogeneity issue by using an instrumental variables approach. However there are problems with each paper's approach. In the case of Durnev and Kim, the instruments used are somewhat suspect² and in the case of Black, Jang and Kim the instruments are only applicable to South Korea.

In this paper we utilize a unique and new data set from AllianceBernstein that allows us to investigate whether better governance does indeed cause higher valuations. The data we have consist of monthly firm-level corporate governance ratings for 21 emerging market countries for almost five years. These monthly firm-level corporate governance ratings allow us to conduct a study to examine the effects of changes in corporate governance ratings at the firm level. In other words, we can examine firms on a time-series basis and see what happens to market valuations before and after corporate governance improves or declines. Because we are directly examining specific firms that show a change in governance over a specific time our results are not as subject (but not immune (see below)) to the endogeneity issues that plague so much of the previous literature.

Of course we need to state up front that we cannot eliminate all endogeneity from our approach, as it could be that during the window of time when corporate governance ratings change other factors change as well, which then influenced valuation. That being said, because the period that we measure the change in valuation is so short (at most seven months) and

² Durnev and Kim (2005) use industry instruments. Hence, they make the assumption that industry does not influence governance. However, separate research by Black, Jang and Kim, (2006a) and Gillan, Hartzell, and Starks (2003) finds that industry does affect governance.

because we control for other possible changes, the likelihood of such endogeneity is low in our opinion.

Finally, besides examining the changes in corporate governance ratings, this paper also investigates two other issues. First, using our data we investigate if better governance implies higher valuations by investigating the levels of governance and valuation rather than the changes. This approach is similar to Klapper and Love (2004) and to a lesser extent, Durnev and Kim (2005). Our results using this scheme are subject to endogeneity (as was Klapper and Love's results) so we cannot definitively conclude that governance leads to valuations or vice versa. Nonetheless these results supplement this previous research which, like ours, uses corporate governance ratings from an investment bank (both Klapper and Love (2004) and Durnev and Kim (2005) use Credit Lyonnais Security Analysis (CLSA)).

Second, since we have monthly time-series data on firm-level governance, we examine the link between firm-level governance and country-level laws and policies via time-series regressions. Specifically we conduct country-specific, time series regressions to see if changes in a country's International Country Risk Guide (ICRG) ratings influence the average level of firm level governance in the country.

The rest of the paper is organized as follows. Section 2 presents the data. Section 3 presents the methodology. Section 4 provides the results. In Section 5 provides a summary of our main results and concludes the paper.

2. Data

2.1. AllianceBernstein corporate governance ratings

Our study utilizes corporate governance ratings compiled by AllianceBernstein. These ratings have never been used before in the academic literature and have never before been available to

the general public. They are constructed internally by AllianceBernstein to help them make better investment decisions in emerging markets. The ratings are calculated every month for all firms within the AllianceBernstein Capital Emerging Market Universe during the period November 2001 through September 2006 (59 total months). The AllianceBernstein Capital Emerging Markets Universe consists of approximately 200 firms from many emerging market countries. The inclusion of firms in the AllianceBernstein universe is determined by their inclusion in indexes generated by index providers, particularly the Morgan Stanley Capital International Emerging Markets Index (MSCI EM). While the AllianceBernstein data do not include a number of non-growth oriented firms in the MSCI EM, it does consistently include about 75 percent of the total market capitalization of MSCI EM.³

As stated above, the corporate governance ratings are calculated on a monthly basis for each firm within the AllianceBernstein universe. The ratings are based on an AllianceBernstein analyst's answers to a questionnaire that consists of 58 questions. The questions primarily require answers of yes or no, with scores provided for each yes or no answer. For example, one question asks "Is senior management accessible to investors?" If the analyst answers yes then the firm receives five points; if the analyst answers no then the firm receives zero points. The highest possible score, representing the highest firm-level corporate governance rating that a firm can

³ AllianceBernstein does not run a quantitative screen to determine the firms to include in their universe. Instead, this is determined on a case-by-case basis.

receive, is 111 while the lowest is a zero. We provide more information about the questionnaire in Appendix A.⁴

To calculate the firm-level corporate governance ratings, AllianceBernstein gives firms an A rating if their total score is above 84 out of a total of 111 points; a B rating if their score is between 56 and 83; a C rating if their score is between 28 and 55; and a D if their rating is 27 or below. Finally, at the completion of the questionnaire, the analyst is asked to provide a directional indicator as to whether he or she thinks the firm's corporate governance is improving or deteriorating. If improving, the analyst gives a plus sign, if deteriorating the analyst gives a minus sign, and if no change is perceived then the analyst provides no sign. This plus or minus sign is then added to the above-mentioned grade to arrive at the final grade. Hence, a firm that scored a 77 on the questionnaire and was seen by the analyst as having improving corporate governance would receive a final grade of B+.

Note finally that the analysts that answer the questionnaire all live in the same region as the firms they survey. Most are locals that grew up in the local culture and speak the local language. Also, most of the analysts have advanced graduate degrees from top U.S. and foreign business and economics programs and have extensive experience as analysts.⁵

In Table 1, panels A-B, we present some descriptive statistics on the entire sample of AllianceBernstein corporate governance ratings we use in the study. The table uses the variable $firmrating1 - 9_{i,t}$, which quantifies the AllianceBernstein firm governance rating of firm i at

⁴ We note here that according to AllianceBernstein, the corporate governance ratings are not based on stock price movements but rather the criteria described in Appendix A.

⁵ Note that Boubaker and Labégorre (2008) have recently examined the type of firms that analysts tend to follow.

time t (e.g., a firm that has an A+ rating receives a value of nine, a firm that has an A rating receives a value of eight and values decrease incrementally until our lowest firm rating of C-, which receives a value of one). The table presents the number of ratings, and the mean and standard deviations for the variable $firmrating1 - 9_{i,t}$ for each country (panel A) and year (panel B). Note that the sample contains approximately 14600 total ratings provided over the period November 2001 to September 2006. The mean rating for the entire sample is slightly below a 6 (a B+ rating) and the standard deviation is approximately 1.75. Panel A shows that most of the ratings come from six countries: Brazil, China, India, Korea, South Africa and Taiwan.

2.2. *International country risk guide country governance ratings*

To control for the impact of country-wide policies and laws related to governance, we use the International Country Risk Guide ratings (ICRG) provided by Political Risk Services (PRS). These ratings range from zero through 100, with country risk increasing as the rating declines. They have been used in previous literature, notably Bekaert, Harvey and Lundblad (2005, 2006). ICRG calculates four types of country risk ratings: a political risk rating (*ICRGP*), an economic risk rating (*ICRGE*), a financial risk rating (*ICRGF*) and a composite country rating (*ICRGC*) which is composed of a 50 percent weighting of the *ICRGP* and a 25 percent weighting each from *ICRGE* and *ICRGF*. The ratings are updated monthly for 140 countries for a period beginning in the mid-1980's for most countries.

The *ICRGP* rating is composed of twelve variables. These include government stability, socioeconomic conditions, corruption, law and order and other variables related to the political climate of the country. The *ICRGE* rating is composed of five variables including GDP per capita, real GDP growth, the annual inflation rate, the budget balance as percentage of GDP, and

the current account balance as a percentage of GDP. The *ICRGF* rating is also composed of five variables, which include foreign debt as percentage of GDP, foreign debt as a percentage of exports of goods and services, current account as a percentage of exports of goods and services, a measure of international currency reserves, and a measure of exchange rate stability. In Appendix B we explain in detail the various variables used in the ratings.

2.3. Other data

The other data used in this study are from Worldscope. For market valuation purposes we use monthly price-to-book (*PB*) and *Tobin's Q*. For *PB*, the price is a month-end price in the local currency. The book values per share are determined on an annual basis. They are extracted at the fiscal year end. For *Tobin's Q* we use the definition used by Klapper and Love (2004) which is market value of equity plus total liabilities divided by total assets. The market value of equity is determined using the month-end price in local currency and the total liabilities and total assets are determined on an annual basis in local currency from the end of the last fiscal year. As control variables we use sales (in U.S. dollars), the debt to equity ratio, and the capital expenditure to sales ratio, which are all provided on an annual basis. We discuss the rationale for using these control variables in the next section.

Note finally that throughout this paper we do not exclude any outliers. In previous works by Klapper and Love (2004) and Durnev and Kim (2005) and others, typically the top and bottom one percent of the observations are excluded. We felt that to do this would bias our results and hence we do not exclude any outliers from our sample.

3. Methodology

Using the AllianceBernstein governance ratings we identified several hundred cases where a firm's corporate governance rating changed during the sample period of November 2001-September 2006. These changes in firm-level corporate governance allow us to examine the effects of corporate governance change on a micro level, something that has rarely been examined in the previous emerging markets literature due to a lack of panel data. Since we can examine what actually happens to market valuation before and after the change in governance rating, we can overcome the issue of whether better governance causes better valuations, or whether firms with better valuations endogenously choose better governance.

The methodology we use is as follows. First, we begin with an examination of two windows of time surrounding the ratings change: one and three months *before and after* the month of the ratings change.⁶ Then we examine the effect of the ratings change on the firm's valuation.⁷

In our approach, we attempt to control for other factors that may have caused the firm's valuation to change over the window. For example we control for changes in overall market conditions and internal firm changes that might have occurred within window period. We also

⁶ The windows always include the month of the ratings change. Hence, the one-month pre-post window is a total of three months: one month before the change, the month of the change, and one month after the change. The three month pre-post window is a total of seven months: three months before the change, the month of the change, and three months after the change.

⁷ Although the information used by AllianceBernstein to change a firm's rating is generally known to the public and other analysts, the actual firm governance rating that AllianceBernstein gives to each firm is not public information. It is only know by AllianceBernstein.

control for the firm's market risk and the level of country risk within which the firm operates.⁸

More specifically, we estimate Equation (1) using ordinary least squares:

$$\begin{aligned} \Delta V_i = & \alpha + \beta_1 \Delta Rating_i + \beta_2 Beta_i \times Countryreturn_i + \beta_3 \Delta Debt_i \\ & + \beta_4 \Delta Sales_i + \beta_5 \Delta Capexsales_i + \beta_6 ICRGC_i + \varepsilon_i \end{aligned} \quad (1)$$

where,

ΔV_i is the change in valuation (either *PB* or *Tobin's Q*) of firm *i* over the window of time surrounding the governance rating change. We estimate the change by subtracting the valuation at the end of the window from that at the beginning of the window. Hence, positive values indicate that firm valuation increased after the ratings change.

$\Delta Rating_i$ is a variable which proxies the magnitude and direction of the firm rating change for firm *i*. This variable is defined as follows: For each quarter grade rating increase (decrease), $\Delta Rating_i$ increases (decreases) by one. For example, a firm that sees its corporate governance rating increase from a B to B+ receives a value of one. A firm that sees its corporate governance rating decrease from B to C receives a value of negative three. The largest increase (decrease) in the firm rating grade change increment variable experienced by any one firm at one time was 6 (-6).

$Beta_i \times countryreturn_i$ is an estimate of the expected return of firm *i* over the sample window. The estimation of *Beta* is performed through Ordinary Least Squares regressing of the firm's returns against the country index returns (using country indices from MSCI). Both returns

⁸ Note that Hagendorff, Collins and Keasey (2008) examine the impact of corporate governance in a somewhat similar fashion by investigating the valuation effects of bank mergers.

series are in local currency terms.⁹ *Beta* is estimated for each firm over the 24 month period that ends the month before the first month of the pre/post window period. *Countryreturn_i* is the mean monthly return of the country stock market index of firm *i* over the window.¹⁰ Hence, for the three month window *Countryreturn_i* is the mean monthly return of the country index for seven months (three months before the ratings change, the month of the ratings change, and three months after the ratings change). We use the variable *Beta* × *countryreturn* to control for expected changes that would take place to the firm over the time window due to general market conditions and hence isolate the effect of the change in corporate governance.

$\Delta Debt_i$ is the change in the debt to equity ratio of firm *i* over the window. Hence for the three month window this is the change in the debt to equity ratio over a seven month period of time. A positive value would indicate that the debt to equity increased over the window. We use this as a control since changes in a firm's leverage may influence the firm valuation.

$\Delta Sales_i$ is the change in the log sales (measured in U.S. Dollars) of firm *i* over the window. We use this as a control since changes in firm sales give an indication of the change in firm size and growth. For example if the firm were to grow larger, the valuation of firm would change independently of improvements in governance.

$\Delta Capexsales_i$ is the change in capital expenditure to sales of firm *i* over the window. We use this as a control since changes in capital intensity may also affect valuation. By examining

⁹ So as to avoid the issue of which risk-free rate to use, we use unadjusted, i.e., not excess returns, returns in the calculation of beta.

¹⁰ We use the local Morgan Stanley Capital International country indexes in local currency to calculate this variable. We obtain the same results using U.S. dollars returns.

the change in capital intensity we can control for structural changes within the firm over the window period.

$ICRGC_i$ is the International Country Risk Guide Composite Index rating for the country of firm i during the month when the ratings change takes place. In another specification we use the International Country Risk Guide Political ($ICRGP_i$), Financial ($ICRGF_i$), and Economic ($ICRGE_i$) index ratings. These variables are used to control for country differences at the time of the ratings change. For example, it may be that improvements in firm governance have a different impact in countries with greater country risk.¹¹ Again, the country risk increases as the ICRG measure declines, so improvements in ICRG are associated with lower country risk.

The rationale for equation (1) is as follows. Obviously we are interested in the relationship between changes in corporate governance ratings and the resulting change in firm valuation. The problem of course is that many other factors could influence the change in valuation besides that of an improvement in corporate governance. To control for general market conditions influencing firm valuation we use the variable $Beta \times countryreturn$, where the $Beta$ is constructed before the window period begins and the $countryreturn$ is for the window period itself. The idea is that this variable will proxy how much the firm's value increases during the window period due to overall market conditions. The use of this variable assumes that Beta is constant throughout the window period (3 months for the 1-month window (1-month before, the month of the ratings change, and 1 month after) and 7 months for the 3-month window). The

¹¹ Both Klapper and Love (2004) and Durnev and Kim (2005) show that corporate governance matters more to valuation in countries with poor legal standards and weak investor protection.

other firm control variables, $\Delta Debt_i$, $\Delta Sales_i$, $\Delta Capexsales_i$ are used to control for other firm changes that might have occurred during the window periods that would have caused valuation to increase. Since the Debt, Sales and Capexsales are only available on an annual basis and because our windows of time are short (again three months for the 1-month window and seven months for the 3-month window), the change in these variables is sometimes zero. Note that when we exclude these variables we find similar results to those reported in Section 4. Finally we use $ICRGC_i$ to control for country differences at the time of the ratings change. As stated above, it may be that improvements in firm governance have a different impact in countries with greater country risk.

Note that we also tested estimation specifications that included other variables, such as the change in estimate of the firm's growth in earnings and the change in the ICRG measures. However, these variables were rarely significant and did not change our overall results.

4. Results

Table 2 presents descriptive statistics related to the changes in corporate governance ratings. Panel A presents the distribution of the changes in rating. A one point increase (decrease) would indicate that the rating increased (decreased) by a quarter letter grade. As can be seen, the changes are relatively evenly distributed between increases in ratings and decreases in ratings. Panel B presents the distribution of the change in ratings by country. The panel indicates that the largest number of changes were from South Africa, Taiwan, Brazil, Korea and India. Nine countries (Argentina, the Czech Republic, Egypt, Indonesia, Israel, the Philippines, Poland, Thailand and Venezuela) were represented by five or less changes each. Indeed, as a percentage of the entire sample (which we presented in Table 1) the changes only represent about three

percent of the entire sample (390 total changes out of entire sample approximately 14600 observations). The small number of changes is due to the fact that the analyst may only change the governance rating once during the November 2001-September 2006 sample. Since there are monthly observations this would mean that this one company could have 59 monthly observations of which there would be only one change in the governance rating over this period.

The results of the estimation of Equation (1) are presented in Table 3. As stated in the methodology we use two specifications of Equation (1). The first uses *ICRGC* solely as the control for country issues while the second uses *ICRGP*, *ICRGF* and *ICRGE* (the individual components of *ICRGC*). Again, we use two windows of time surrounding the time of the ratings change, one-month and three-months, and we examine the change in valuation by examining the change in *PB* and the change in *Tobin's Q* during these windows. The results indicate that in every case there is a positive and significant (although sometimes at the 10 percent level) relationship between $\Delta Rating$ and valuation (both *PB* and *Tobin's Q*). That is, improvements in corporate governance are associated with significant increases in valuation over the one-month and three-month windows before and after the rating change. Hence, our results indicate that investors value such improvements in governance.

To complement our results above, we also examine the relationship between valuation and governance by examining the *levels* of governance and valuation rather than the *changes*. This approach closely follows Klapper and Love (2004), and as such suffers from the above-mentioned endogeneity issue.

Since we have monthly governance ratings data over the period November 2001-September 2006 we choose a simple approach for examining the levels. Specifically, we take the month of the year when there are the most total observations over a five year period (this is

September for our data). We then examine Equation (2) on each of the individual five September samples, i.e., September 2002, September 2003, September 2004, September 2005 and September 2006.

We of course could have pooled together all our of monthly data (not just Septembers) but since some our control variables have only an annual frequency, i.e., Debt, Sales, CapexSales, and Growth, it would mean that we are using the same observations for these control variables for 12 observations. For example, the observations for Debt for the Brazilian firm Petrobras are the same from January 2002 to December 2002 and hence the same observation would be included 12 times in the pooled regression.

Alternatively we could have pooled all the Septembers together in one regression. This would have alleviated the problem described above with the annual data. We decided not to report such results as the pooling method, i.e. fixed effects, random effects, can influence the results and because the individual September OLS results are clearer for a reader to understand. Moreover, each individual September sample had more than enough data to conduct the regression.

Equation (2) is:

$$\begin{aligned}
 V_{i,t} = & \alpha + \beta_1 \text{firmrating}1 - 9_{i,t} + \beta_2 \text{Debt}_{i,t} + \beta_3 \text{Sales}_{i,t} \\
 & + \beta_4 \text{Capexsales}_{i,t} + \beta_5 \text{Growth}_{i,t} + \beta_6 \text{NoGrowthDummy}_{i,t} \\
 & + \beta_7 \text{ICRGC}_{j,t} + \text{AnnualDummies} + \varepsilon_i
 \end{aligned} \tag{2}$$

where,

$V_{i,t}$ is valuation (either measured by *PB* or *Tobin's Q*) for firm i at time t ; $firmrating1-9_{i,t}$ is a variable that quantifies the AllianceBernstein firm governance rating of firm i at time t (e.g., a firm that has an A+ rating receives a value of nine, a firm that has an A rating receives a value of eight and values decrease incrementally until our lowest firm rating of C-, which receives a value of one); $Sales_{i,t}$ is the log sales of firm i at time t (in U.S. dollars); $Debt_{i,t}$ is the debt-to-equity ratio of firm i at time t (divided by 100 to get more meaningful coefficients); $Capexsales_{i,t}$ is the capital expenditure-to-sales ratio of firm i at time t (divided by 10 to get more meaningful coefficients); $Growth_{i,t}$ is the earnings per share growth estimate for firm i at time t .¹² $NoGrowthDummy_{i,t}$ is a dummy variable which receives a value of 1 if firm i at time t does not have a growth estimate and 0 otherwise. We use this variable because a significant percentage of observations did not have a growth estimate. $ICRGC_{i,t}$ is the International Country Risk Guide Composite Index rating for firm i 's country for month t . In another specification we use the International Country Risk Guide Political ($ICRGP_{i,t}$), Financial ($ICRGF_{i,t}$), and Economic ($ICRGE_{i,t}$) index ratings.

¹² This represents a forecasted expected annual increase in operating earnings over the company's next full business cycle. The forecasts are received directly from contributing IBES analyst (IBES is a company owned by Thomson Financial). Because a significant proportion of the *Growth* observations are missing, we set missing values of *Growth* equal to zero and include a corresponding dummy variable that is equal to 1 if the *Growth* variable data is missing and 0 otherwise (*NoGrowthDummy*).

The control variables used in Equation (2) are very similar to those in the literature (specifically those used by Klapper and Love (2004) who also examine the relationship of governance ratings to firm valuation). The rationale for the control variables is that the valuation of firm may be influenced by factors besides that of governance. Consequently, these factors need to be controlled for in order to isolate the effect of governance on valuation. More specifically, we use *Capexsales* since Klapper and Love (2004) argue that firms with more intangible assets, i.e. lower levels of capital intensity, may have higher valuations as the market values intangible assets more than fixed assets. Similarly, we use *Growth* to control for the fact that firms with higher growth firms may endogenously be valued higher in the market. Likewise we use *Sales* to capture any effects from the size of a firm influencing valuation. For example, smaller firms may have greater growth opportunities and hence may be valued differently than larger firms. Finally, we use *Debt* because more leveraged firms may again be valued differently in the market.

Table 4 presents the descriptive statistics for the five individual September samples. We show the number of observations for each sample, by country, rating, and industry.¹³ Note that the number of observations changes each year because AllianceBernstein continually adds and drops firms from its universe.¹⁴ Table 4 also shows that there are relatively few firms that have C+, C or C- ratings. Indeed, most of the firms have ratings between A+ and B-. The table further

¹³ As with the results reported using Equation (1) we include financial firms. Note that the results obtained when firms are excluded are similar to those reported in Table 5.

¹⁴ When an AllianceBernstein analyst is replaced the firms that are covered by the analyst changes slightly as each analyst may focus on slightly different firms. This is part of the reason why the number of firms in our sample varies from year to year.

shows that the countries with the most observations are Taiwan, South Africa, Brazil, Korea, China and India.

Table 5 presents the results of estimating Equation (2) for the five individual September samples. Again, we use both PB and Tobin's Q to measure valuation. We find that in seven of the ten regressions the *firmrating1-9* variable is positive and significant, indicating that firms with better governance have significantly higher valuations. Also noteworthy is the fact that the variable *ICRGC*, the measure of country risk, is generally insignificant or at best weakly significant, indicating that after controlling for firm level governance and our other controls, overall country risk is not significantly related to valuations.

As our final test, we examine whether improvements in country risk are associated with improvements in firm-level governance to evaluate if government initiatives to lessen country risk encourage firms to pursue better firm-level governance.

To do this we estimate country-specific, time series regressions in which the monthly country risk is regressed against the monthly average firm-level governance rating of firms in our sample. For country risk we use two specifications, one with *ICRGC*, and the other using the three components of *ICRGC* (*ICRGP*, *ICRGF*, and *ICRGE*). For the average firm-level governance rating we take, for each country, all the firms that were continuously rated in our sample over the period January 2003-September 2006. We choose this sample to avoid the resulting bias from including and then excluding firms that were rated by AllianceBernstein in one month but not in another month. We choose the January 2003 start time rather than the beginning of our sample (November 2001) as it increases the number of firms that were continuously rated. We then only examine countries that had four or more firms continuously

rated by AllianceBernstein over the January 2003-September 2006 period. These inclusion criteria left six countries, Argentina, Brazil, Mexico, Russia, South Africa and Taiwan.¹⁵

The results of the time series regressions are in Table 6. They show two specifications for each country: one with *ICRGC* and one with the three components of *ICRGC*. The results for *ICRGC* are somewhat mixed. We find that in four of the six countries (Argentina, Brazil, Mexico and Russia), there is a positive and significant relationship between *ICRGC* and the average level of firm governance rating. In other words, as country risk falls (*ICRGC* increases), firms improve their governance. However, in the cases of South Africa and Taiwan we do not find such a positive and significant relationship. Indeed, in the case of South Africa the relationship between *ICRGC* and the average firm governance rating is actually negative and significant, indicating that lower country risk (increases in *ICRGC*) are associated with lower average firm governance. The results using the three components for *ICRGC* are also mixed as there is no obvious, consistent relationship that seems to hold between the components of the *ICRGC* and firm governance.

Hence, our results show only limited support for the idea that improvements in country risk are related to improvements in firm governance (four of six countries using the *ICRGC*

¹⁵ Note that the samples reported in Table 6 include all emerging firms rated by AllianceBernstein. For Table 4, and the results used in Table 5, we required that firms have valuation and internal firm performance data. This is the reason the number of observations for Argentina was four in Table 6 despite only having two or three observations in the September samples reported in Table 4.

measure). These results are certainly not conclusive given that they did not hold in all countries. Since there may be a lag between improvements in country risk and firm governance, using a somewhat different specification may be advisable.

5. Conclusion

In this paper we utilize a unique and new data set from AllianceBernstein that consists of monthly firm-level corporate governance ratings for 21 emerging market countries for almost five years. These monthly firm-level corporate governance ratings enable us to conduct a study that examines the valuation effects of changes in corporate governance ratings at the firm level. Using this approach and controlling for other changes that may have occurred during the window and for country risk, we find evidence that improvements in corporate governance are significantly linked with higher valuations. Hence, even when a very short window is examined around the time governance changes, we can observe significant valuation effects from such changes. Thus, it appears that investors do care about governance and not that better valued firms simply have better governance.

To complement the results above we also examine relationship between the *levels* (as opposed to changes) of governance and valuation. In this approach we follow the methodology of Klapper and Love (2004). We find, as they do, that there is generally a positive and significant relationship between governance and valuation. Moreover, in an analysis of country risk, we find some evidence that firms located in countries with relatively high political risk and yet low financial risk have higher valuations than firms in other countries. Hence, these results suggest that investors do positively value a country with a strong ability to pay back its debt and to maintain steady foreign exchange reserves.

Finally, we examine whether improvements in country risk are associated with improvements in firm-level governance. This is an interesting question because it may be that government initiatives to improve the country also encourage firms to pursue better firm-level governance. We find some support for this idea, as the majority of the countries in our sample (four of six) show that lower country risk is linked to improvements in firm-level governance.

In sum, our results, consistent with much of the previous literature, show that corporate governance is important to investors. Indeed, corporate governance is sufficiently important that major firms such as AllianceBernstein, who today manage over nine billion dollars in emerging market equity assets, are willing to spend significant resources to devise their own internal firm governance rating system. Our results suggests that money spend on evaluating firm governance is worth the cost.

Appendix A: Further information on the questionnaire that analysts answer to arrive at the firm-level governance rating

The questionnaire is divided into seven sections. We detail these below.

1. Information Disclosure

This section determines whether the company produces financial reports in a timely fashion, maintains an English language webpage, has an American Depositary Receipt (ADR), and other disclosure issues. There are eight questions with the highest possible score being an eight. Hence only eight out of 111 points, or about seven percent of the final firm-level corporate governance score, come from this section.

2. Management Access and Fair Disclosure

This section deals with the accessibility of management, the usefulness of investor relations, the dissemination of information and issues surrounding possible insider trading. There are five questions with the highest possible score being a 12. Hence, about 11 percent of the score is formed from this section.

3. Representation of Data (Accounting)

The questions in this section examine the rigor and consistency of accounting methods, treatments of items such as goodwill, deferred taxation, research and development, and auditor independence. The questionnaire also evaluates transactions such as related-party loans and takes into account the company's accounting track record, deducting points for a change in auditors or qualification to the financial statements in the past five years. There are ten questions in this section worth a total of 13 points (about 12 percent of the overall score).

4. Value Creation

This section examines whether management understands the concept of value creation and has a track history of creating value. Issues include stability of management and compensation packages that are linked to suitably challenging performance criteria. The analyst has to determine whether the company is clearly articulating a business direction. There are nine questions in this section worth a total of 24 points (about 22 percent of the overall score).

5. Board and Shareholder Structure

The questionnaire also examines board and ownership structure. The questionnaire contains questions on whether the board of directors is suitably qualified, including whether they have been convicted of bribery or fraud in the last three years. The questionnaire also examines the degree of board independence and uses the best practices of the Institute of International

Finance's Code of Corporate Governance as the role model for board independence. There are 12 questions in this section worth a total of 24 points (about 22 percent of the overall score).

6. Capital Management

This section examines the degree of the firm's capital efficiency, and whether the capital is used for the benefit of minority shareholders. For example, the questionnaire asks whether the company is making satisfactory use of its cash flow in the form of dividends or share buybacks, hedging its risks adequately and using appropriate sources of financing for projects and acquisitions. There are seven questions in this section worth 14 points (about 13 percent of the overall score).

7. Ethics, Social Responsibility and Other

In this section the questionnaire asks if the company has a code of ethics, whether it has an equal opportunity policy and whether it explicitly avoids employing under-age labor. It also asks whether the company does business in countries that support terrorism or deals with parties suspected of terrorist activity. In addition, analysts are required to answer the most subjective question of the questionnaire, "Do you trust management?" This question is asked because experience has shown that management's statements may be accurate, but they may still behave in a way that hurts minority shareholders. There are nine questions in this section worth 16 points (about 14 percent of the overall score), with the "Do you trust management" question receiving five points (about 4.5 percent of the total score) for a yes answer.

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Table 1: Descriptive Statistics of Governance Ratings. Descriptive statistics are presented for the November 2001 through September 2006 sample of monthly observations of AllianceBernstein firm corporate governance ratings. The table uses the variable $firmrating\ 1-9_{i,t}$ which quantifies the AllianceBernstein firm governance rating of firm i at time t (e.g., a firm that has an A+ rating receives a value of nine, a firm that has an A rating receives a value of eight and values decrease incrementally until our lowest firm rating of C-, which receives a value of one). Panel A presents, separately for each country, the number of monthly rating observations, the mean of the rating observations, and the standard deviation of the rating observations. Panel B presents these descriptive statistics for each year.

Panel A: Descriptive statistics of governance ratings per country

Country	Number of ratings	Mean	Std. Dev.
Argentina	250	7.54	1.14
Brazil	1,576	5.38	1.31
Chile	464	6.06	1.72
China	1,240	5.03	1.32
Czech Republic	106	6.25	1.38
Egypt	129	4.95	1.64
Hungry	240	6.65	1.54
India	1,441	6.42	1.67
Indonesia	179	4.91	1.12
Israel	341	6.43	1.55
Korea	1,249	5.92	1.82
Malaysia	490	6.19	2.32
Mexico	809	6.10	1.67
Philippines	73	3.86	1.37
Poland	211	5.82	1.43
Russia	539	5.38	2.05
South Africa	2,154	6.71	1.52
Taiwan	2,216	5.86	1.56
Thailand	304	6.92	1.60
Turkey	598	4.80	2.29
Venezuela	55	8.15	0.36

Panel B: Descriptive statistics of governance ratings per year

Year	Number of ratings	Mean	Std. Dev.
2001 (Nov. - Dec.)	334	5.71	1.73
2002	2,796	5.77	1.80
2003	3,063	5.79	1.88
2004	2,924	6.15	1.70
2005	3,349	5.97	1.67
2006 (Jan. - Sept.)	2,204	6.15	1.65

Table 2: Descriptive Statistics of Governance Rating Changes. Descriptive statistics are presented for the sample of observations of $\Delta Rating$, changes in firm corporate governance rating. $\Delta Rating$ proxies the magnitude and direction of the firm rating change. For each quarter grade increase (decrease) the $\Delta Rating$ increases (decreases) by 1. For example, a firm that sees its corporate governance rating increase from a B to B+ receives a value of 1. A firm that sees its corporate governance rating decrease from B to C receives a value of -3. Panel A presents the number of observations for each type of firm rating change. Panel B presents the number of observations for each country, and the number of positive and negative firm rating changes.

Panel A: Number of observations per firm rating change increment

$\Delta Rating$ increment	Number of Observations
6	2
5	1
4	6
3	59
2	36
1	82
-1	121
-2	30
-3	43
-4	8
-6	2

Panel B: Number of observations per country

Country	Number of positive firm rating changes	Number of negative firm rating changes	Total number of observations
Argentina	3	2	5
Brazil	23	22	45
Chile	6	5	11
China	8	14	22
Czech Republic	1	2	3
Egypt	2	3	5
Hungry	5	1	6
India	12	25	37
Indonesia	2	0	2
Israel	0	3	3
Korea	16	23	39
Malaysia	7	5	12
Mexico	14	9	23
Philippines	1	1	2
Poland	2	2	4
Russia	9	10	19
South Africa	34	39	73
Taiwan	33	31	64
Thailand	2	1	3
Turkey	5	5	10
Venezuela	1	1	2

Table 3: Tests of the impact of a firm corporate governance rating change on PB and Tobin's Q. OLS regression estimation is performed that uses as the dependent variable either the change in PB (ΔPB) or the change in Tobin's Q ($\Delta Tobin's Q$) over a period before and after a firm's rating changed. The before/after windows range from 1 month to 3 months pre and post the ratings change. For example, the 3 month ΔPB is the firm's price to book 3 months *after* the month of the ratings change minus the firm's price to book 3 months *before* the month of the ratings change. The t-statistics are reported below each coefficient. ***, **, * indicate one, five and ten percent levels of significance, respectively.

Dependent Variable	Independent Variables										N	Adj-R2
	Constant	$\Delta Rating$	Beta x country return	$\Delta Debt/100$	$\Delta Sales$	$\Delta Capexsales /10$	ICRGC	ICRGP	ICRGF	ICRGE		
1-month ΔPB	-1.53** (-2.32)	0.05** (2.06)	-0.03 (-0.26)	0.23*** (4.92)	-1.97** (-2.30)	-0.20** (-2.14)	0.02*** (2.65)				335	0.08
3-month ΔPB	-2.05 (-1.52)	0.10* (1.88)	-0.51** (-2.20)	0.21** (2.41)	-3.58*** (-2.92)	-0.28* (-1.90)	0.04** (2.14)				299	0.06
1-month ΔPB	-1.59** (-2.31)	0.05** (2.02)	-0.03 (-0.26)	0.23*** (4.91)	-1.94** (-2.25)	-0.20** (-2.13)		0.01 (0.90)	0.01 (0.38)	0.02 (0.68)	335	0.08
3-month ΔPB	-2.60* (-1.87)	0.09* (1.78)	-0.56** (-2.42)	0.21** (2.43)	-3.60*** (-2.88)	-0.26* (-1.77)		0.07*** (2.94)	0.00 (0.15)	-0.05 (-0.85)	299	0.07
1-month $\Delta Tobin's Q$	-0.57 (-1.45)	0.03* (1.80)	0.11 (1.54)	-0.00 (-0.14)	-0.93* (-1.81)	0.04 (0.76)	0.01 (1.43)				331	0.02
3-month $\Delta Tobin's Q$	-1.00* (-1.72)	0.05** (1.97)	-0.04 (-0.38)	-0.00 (-0.05)	-2.17*** (-4.05)	-0.06 (-0.95)	0.02** (2.15)				296	0.05
1-month $\Delta Tobin's Q$	-0.58 (-1.44)	0.03* (1.76)	0.11 (1.59)	-0.00 (-0.12)	-0.88* (-1.70)	0.04 (0.74)		-0.00 (-0.01)	-0.00 (-0.06)	0.02 (0.92)	331	0.01
3-month $\Delta Tobin's Q$	-1.15* (-1.90)	0.04* (1.90)	-0.05 (-0.51)	-0.00 (-0.04)	-2.18*** (-3.95)	-0.06 (-0.88)		0.02** (2.01)	0.00 (0.31)	-0.01 (-0.34)	296	0.05

Table 4: Number of observations during September. The numbers of observations are presented for each September of the years 2002 through 2006. All observations associated with each month are presented, as well as the observations each month for each country, firm corporate governance rating, and for each industry.

	<i>Sept 2002</i>	<i>Sept 2003</i>	<i>Sept 2004</i>	<i>Sept 2005</i>	<i>Sept 2006</i>
Total Observations	201	176	220	242	198
<i>By country:</i>					
Argentina	3	3	3	2	2
Brazil	25	11	21	30	25
Chile	6	5	8	5	3
China	15	18	20	29	17
Czech Republic	1	1	1	2	2
Egypt	2	1	1	2	2
Hungary	3	2	3	4	2
India	17	16	29	15	15
Indonesia	2	0	3	5	1
Israel	3	4	5	5	4
Korea	14	16	20	22	12
Malaysia	9	11	8	8	2
Mexico	14	6	12	15	15
Peru	0	0	0	0	1
Philippines	2	1	1	1	0
Poland	3	2	2	2	2
Russia	6	8	8	12	14
South Africa	39	25	27	31	28
Taiwan	22	35	36	38	40
Thailand	7	6	4	3	1
Turkey	7	4	7	10	10
Venezuela	1	1	1	1	0
<i>By Firm Rating:</i>					
A+	11	12	11	10	9
A	32	41	63	65	65
A-	3	3	3	1	2
B+	57	42	53	18	18
B	69	48	68	125	91
B-	12	12	11	15	11
C+	4	4	3	0	1
C	10	12	8	8	1
C-	3	2	0	0	0
<i>By Industry:</i>					
Consumer Discretionary	23	22	28	30	24
Consumer Staples	25	4	19	22	20
Energy	15	14	17	21	20
Financials	4	6	4	4	3
Health Care	6	1	7	3	4
Industrials	16	20	18	24	22
Information Technology	30	34	41	39	45
Materials	28	27	37	44	30
Telecommunications Services	39	38	41	44	28
Utilities	15	10	8	11	2

Table 5: The relation between firm corporate governance ratings and valuation. Regression estimation is performed on data from each September in our sample. *PB* is the price to book ratio. In each regression we use *firmrating1-9*, a variable that quantifies the firm corporate governance rating, where a firm with an A+ rating receives a 9, a firm with an A rating receives an 8, etc. *Debt/100* is the debt-to-equity ratio. *Sales* is the log(sales). *Capexsales/10* is the capital expenditure-to-sales ratio. *Growth* is the estimate of growth in earnings per share. *NoGrowthDummy* is a dummy variable that is equal to 1 if the EPS growth data is missing. We also include the International Country Risk Guide's Composite Index (*ICRGC*) to measure country risk. The ***, **, * indicate that this difference is significant at the one, five and ten percent levels, respectively. The t-statistics are reported below each coefficient.

Sample Time Period	Dependent Variable	Independent Variables								N	Adj-R2
		Constant	Firmrating 1-9	Debt/100	Sales	Capexsales /10	Growth	NoGrowth Dummy	ICRGC		
Sept. 2002	PB	-0.09 (-0.04)	0.17 (1.37)	0.25*** (5.27)	-0.76** (-2.02)	-0.31*** (-2.67)	0.81*** (3.08)	0.79 (1.26)	0.04 (1.55)	201	0.19
Sept. 2002	Tobin's Q	1.38 (1.21)	0.10* (1.72)	-0.01 (-0.45)	-0.62*** (-3.56)	-0.14** (-2.57)	0.44*** (3.60)	0.19 (0.63)	0.02 (1.51)	197	0.17
Sept. 2003	PB	2.53 (0.68)	0.20 (1.45)	1.02*** (13.63)	-1.57*** (-3.44)	-0.22 (-1.27)	0.19 (1.03)	-0.42 (-0.49)	0.04 (0.99)	176	0.52
Sept. 2003	Tobin's Q	4.66** (2.24)	-0.02 (-0.29)	-0.01 (-0.25)	-1.15*** (-4.57)	-0.13 (-1.35)	0.18* (1.76)	-0.31 (-0.69)	0.01 (0.60)	174	0.12
Sept. 2004	PB	8.54*** (2.78)	0.41*** (3.44)	0.12 (0.52)	-1.11*** (-2.98)	-0.12 (-0.86)	0.03 (0.27)	0.56 (0.96)	-0.06* (-1.68)	220	0.09
Sept. 2004	Tobin's Q	5.70*** (3.60)	0.17*** (2.86)	-0.29** (-2.60)	-0.72*** (-3.83)	-0.05 (-0.70)	0.02 (0.30)	0.24 (0.84)	-0.03* (-1.67)	216	0.13
Sept. 2005	PB	12.63*** (3.43)	0.30** (2.24)	0.64*** (4.37)	-1.77*** (-4.42)	-0.15* (-1.83)	0.22** (2.12)	-1.02 (-1.60)	-0.07 (-1.62)	242	0.18
Sept. 2005	Tobin's Q	4.37*** (2.71)	0.18*** (3.08)	-0.07 (-1.07)	-0.87*** (-4.97)	-0.06* (-1.69)	0.10** (2.27)	-0.54** (-2.03)	-0.00 (-0.21)	238	0.17
Sept. 2006	PB	13.42** (2.51)	0.47*** (2.66)	0.37 (1.20)	-1.20** (-2.51)	-0.15 (-0.76)	1.19*** (5.47)	-0.13 (-0.17)	-0.12** (-2.04)	198	0.25
Sept. 2006	Tobin's Q	5.47* (1.85)	0.23** (2.41)	-0.43*** (-2.61)	-0.98*** (-3.78)	-0.01 (-0.13)	0.79*** (6.66)	0.20 (0.46)	-0.02 (-0.65)	194	0.37

Table 6: The relation between average firm corporate governance ratings and the International Country Risk Guide Indexes, by country.

We identify six countries with four or more firms for which the firm corporate governance rating is reported for all 45 months during the period January 2003 through September 2006. For each country, we calculate the average firm corporate governance rating for each month, and regress these monthly averages against the monthly value of either the International Country Risk Guide's Composite Index (*ICRGC*) or the International Country Risk Guide's Political Risk Index (*ICRGP*), Financial Risk Index (*ICRGF*), and Economic Risk Index (*ICRGE*).

Country	Dependent Variable	Independent Variables					N	Adj-R2
		Constant	<i>ICRGC</i>	<i>ICRGP</i>	<i>ICRGF</i>	<i>ICRGE</i>		
Argentina	Avg. Firm Rating 1-9	4.77*** (9.22)	0.04*** (5.74)				45	0.42
Argentina	Avg. Firm Rating 1-9	2.36* (1.70)		-0.01 (-0.61)	-0.02 (-0.63)	0.10*** (3.01)	45	0.48
Brazil	Avg. Firm Rating 1-9	-3.66*** (-4.41)	0.14*** (11.27)				45	0.74
Brazil	Avg. Firm Rating 1-9	0.11 (0.03)		0.01 (0.30)	0.09*** (5.99)	0.03 (0.89)	45	0.75
Mexico	Avg. Firm Rating 1-9	-26.47*** (-15.29)	0.44*** (19.03)				45	0.89
Mexico	Avg. Firm Rating 1-9	-23.23*** (-10.81)		-0.04 (-0.83)	0.16*** (5.59)	0.35*** (9.14)	45	0.93
Russia	Avg. Firm Rating 1-9	-7.52*** (-7.47)	0.17*** (13.16)				45	0.80
Russia	Avg. Firm Rating 1-9	-7.76*** (-4.33)		0.07*** (2.94)	0.12*** (3.16)	0.08*** (3.31)	45	0.79
South Africa	Avg. Firm Rating 1-9	10.97*** (5.91)	-0.06** (-2.35)				45	0.09
South Africa	Avg. Firm Rating 1-9	17.23*** (8.52)		-0.25*** (-4.82)	-0.05 (-0.93)	0.01 (0.30)	45	0.39
Taiwan	Avg. Firm Rating 1-9	9.61 (1.17)	-0.04 (-0.39)				45	-0.02
Taiwan	Avg. Firm Rating 1-9	2.00 (0.27)		0.73*** (3.55)	-0.35** (-2.12)	-0.14*** (-2.71)	45	0.31