

Corporate Governance Compliance and Firm Value: A Cultural Perspective

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Paper in brief

- Question* Do voluntary codes of corporate governance affect firm value?
- Finding* The reforms have been counterproductive
- Why* We suspect there is a cultural explanation
- Importance* An aspect overlooked in the mainstream (US-based) corporate governance literature
-

*Finance literature has finally woken up
to the importance of culture...*



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Editorial

The “cultural revolution” in finance

Luigi Zingales

Early-life experiences

American CEOs who grew up during the Great Depression are:

- Averse to debt leading to suboptimal capital structure
- Lean excessively on internal finance

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Overconfidence and Early-Life Experiences: The Effect of Managerial Traits on Corporate Financial Policies

ULRIKE MALMENDIER, GEOFFREY TATE, and JON YAN*

ABSTRACT

We show that measurable managerial characteristics have significant explanatory power for corporate financing decisions. First, managers who believe that their firm is undervalued view external financing as overpriced, especially equity financing. Such overconfident managers use less external finance and, conditional on accessing external capital, issue less equity than their peers. **Second, CEOs who grew up during the Great Depression are averse to debt and lean excessively on internal finance.** Third, **CEOs with military experience pursue more aggressive policies, including heightened leverage.** Complementary measures of CEO traits based on press portrayals confirm the results.



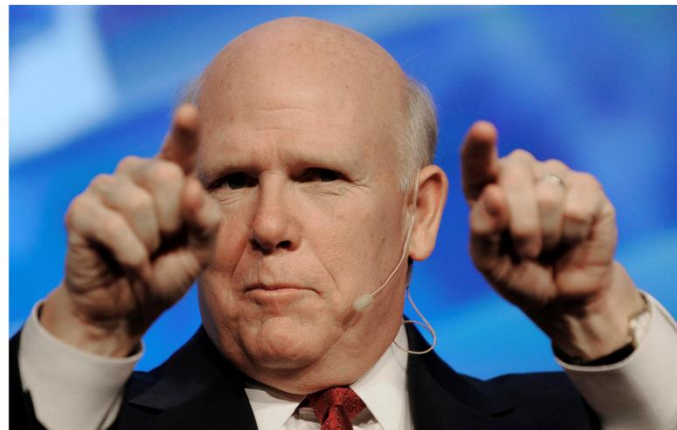
Military culture

CEOs with military culture are less likely to be involved in corporate fraud (Benmelech and Frydman, 2015, JFE)

- They are also less tax avoidant, and leave on average \$1-2m more tax on the table (Law and Mills, 2017, RAS)

15 Fortune 500 CEOs who got their start in the military

Alex Lockie Aug. 26, 2015, 2:02 PM



Military veteran and former CEO of General Motors, Daniel Akerson. AP Photo/Pat

Culture and perceptions of luck

In Chinese culture, the numbers 6, 8, and 9 are considered lucky because they sound similar to words meanings ‘prosperity’ and ‘longevity’

While 4 is unlucky: sounds similar to ‘death’.



Hirshleifer et al. (2016, MS) find that Chinese investors significantly overreact to IPOs with a registration code containing lucky numbers, e.g., 601988 (Bank of China)

These IPOs underperform by more than 10% after three years.

*What is special about the
Japanese culture?*

Japanese culture

- Historically, Japan has been isolated geographically and politically for several centuries during the Shogunate period.

- This, among other reasons, has led to:
 - Very distinct and strong cultural identity
 - High levels of cultural (and racial) homogeneity
 - Rather lukewarm approach to inward and outward immigration

Public order



Conformity



Conformity even in distress



Public apologies



*Recent corporate governance
reforms in Japan*

Three Arrows of Abenomics

1. Aggressive monetary policy
2. Flexible fiscal policy
3. New **growth strategy**

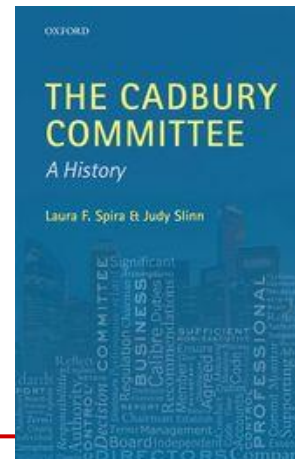


Comply or Explain

- The principle originated in the field of financial markets regulation.
 - Aims to ensure **transparency**
 - Mandates a listed company either to **sign up** to a corporate governance code, or to **explain** why it does not apply such a code, or why it derogates from the provisions of this code.
-

Origins

- 1992 Cadbury Report in UK was drafted to be applied according to the “comply or explain” principle
- In 2000, UK imposed the application of this principle through the Financial Services Authority’s listing rules.
- In Europe, the “comply or explain” principle was established by the directive of 14 June 2006.



Advantages for companies

- Improves **competitiveness**, because the cost of compliance with a corporate governance code is typically lower than the cost of compliance with regulation, such as the Sarbanes-Oxley Act.

 - Advocates a more **flexible** approach that allows companies to adapt faster in a competitive environment.
-

Canadian adoption

Canadian companies fully comply with **only 55%** of the code

UK adoption

Companies	No of provisions with which all companies comply	% of code provisions with which all companies comply
FTSE 1-30	36	75.00 %
FTSE 31-80	31	64.58 %
FTSE 81-130	27	56.25 %
All	20	41.67 %

British companies fully comply with **only 42%** of the code

German adoption

Number of code provisions all companies are in compliance with

Companies	No of provisions all companies are compliant with	% of code provisions all companies are compliant with
Dax 30	51	62.20%
MDax	35	42.68%
SDax	36	43.90 %
All	18	21.95 %

German companies fully comply with **only 22%** of the code

Japanese adoption

Average Compliance Rate by the layer of the Code Principles

Layers	Average Compliance Rate	Change from Jul. 2016
GP (General Principles)	99.90%	+0.0pt
P (Principles)	96.86%	+0.1pt
SP (Supplementary Principles)	92.36%	-0.2pt

Average Compliance Rate by the layer of the Code Principles

Layers	Average Compliance Rate	Change from Dec. 2017
GP (General Principles)	99.93%	+0.0pt
P (Principles)	97.68%	+0.8pt
SP (Supplementary Principles)	93.41%	+1.0pt

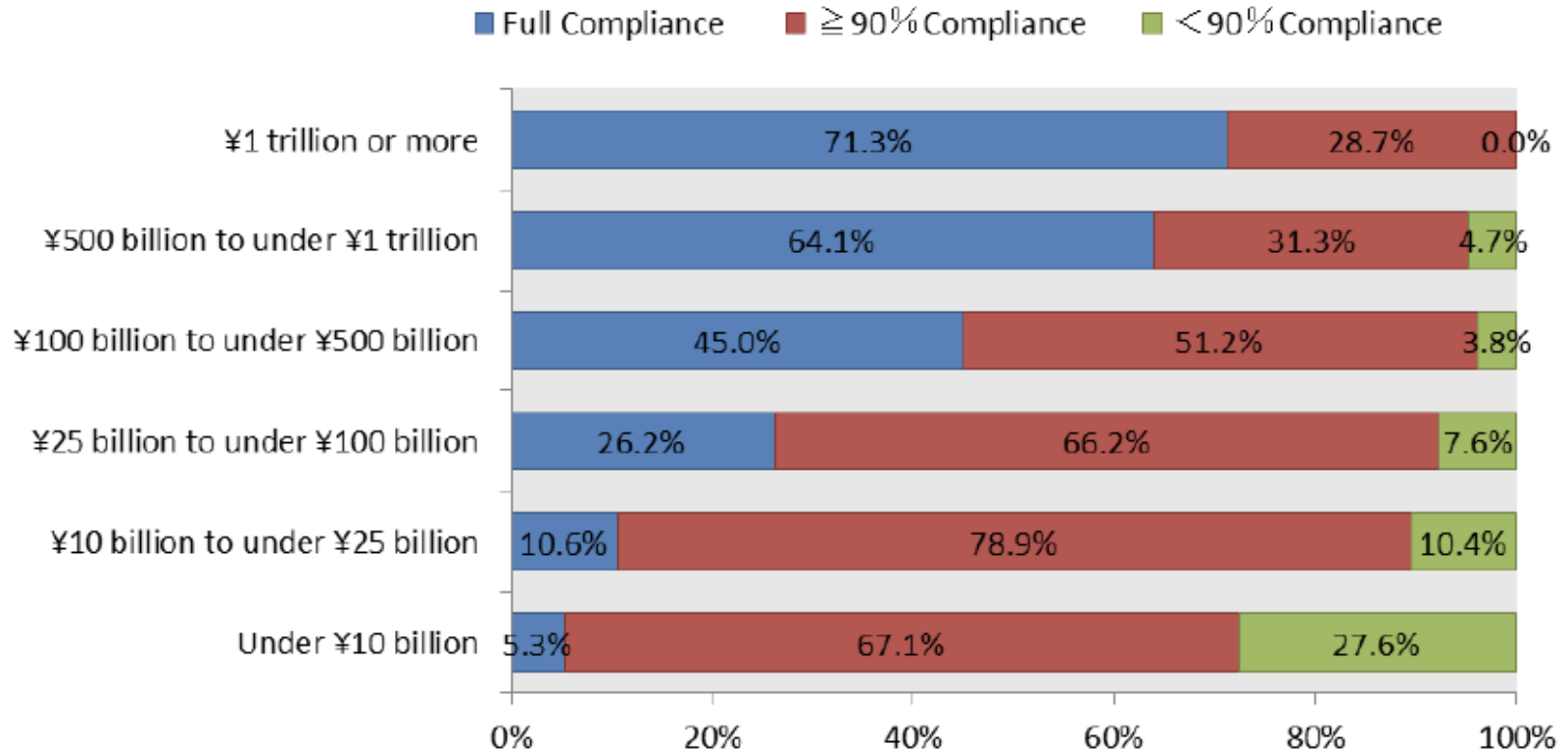
Japanese compliance rate is **96%** and increasing!

When do Japanese companies choose to explain?

As of July 2017

#	CGC Principles	Content	Explanation rate
1	1.2.4	Infrastructure allowing for electronic proxy voting and the provision of English translation of the convening notices for general shareholder meetings	55.8%
2	3.1.2	Information disclosure and provision in English	29.4%

Code compliance by company size



Even 72% of companies under ¥10bn (around \$90m) are above 90% compliant!

Hypotheses

Some possible explanations for the overcompliance behavior:

1. Signalling
 2. Reluctance to explain
 3. Culture of conformity
-

Signalling

Original models of signaling in economics include Akerlof (1970), Spence (1973), Myers and Majluf (1984)

However, there is no reason for signaling incentives to be stronger in **Japan** than other countries...

Reluctance to explain

Lazy Prices*

Lauren Cohen

Harvard Business School and NBER

Christopher Malloy

Harvard Business School and NBER

Quoc Nguyen

University of Illinois at Chicago

“When firms make an active change in their reporting practices, this conveys an important signal about the firm.”

Role of Culture

Japanese companies overcomply and therefore do **not use the full discretion** of the code.

The **cultural differences** seem to play an important role in the way Japanese, British and other European countries approach “Comply or Explain”

Herding is closely related

Role of Culture

- World Values Survey (1999-2004) – **Authoritarianism** measure is the largest among all countries.
 - “Should follow instructions at work?” – Only 9% answered they must be convinced first.
 - Hofstede’s Index – **Individualism** is weak.
 - Japan 46, US 91, UK 89, Germany 67
-

Role of Culture

- Chattopadhyay et al. (2019) – Managers **seek to avoid shame** for not being included in the Nikkei 400 index.
- Ahern et al. (2015) – **Cultural distance** prevents foreign firms from acquiring Japanese firms.



Role of Culture

Studies on Japanese social behaviour - for example Benedict (1946), Caudill and Scarr (1962) - have emphasized the importance of:

1. *Conformity*
2. *Group membership*
3. *Respect for authority*
4. *Long termism*

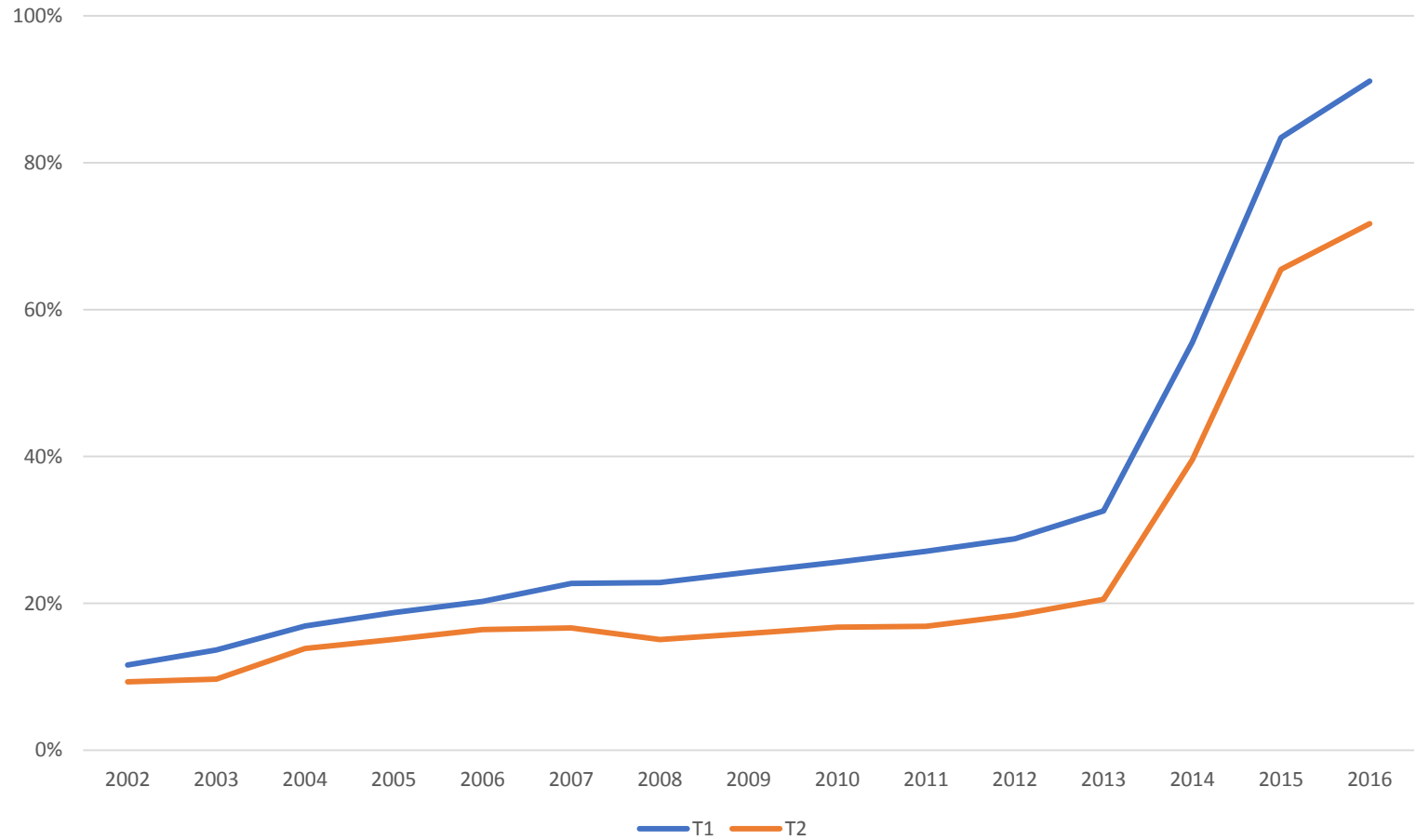


Descriptive stats

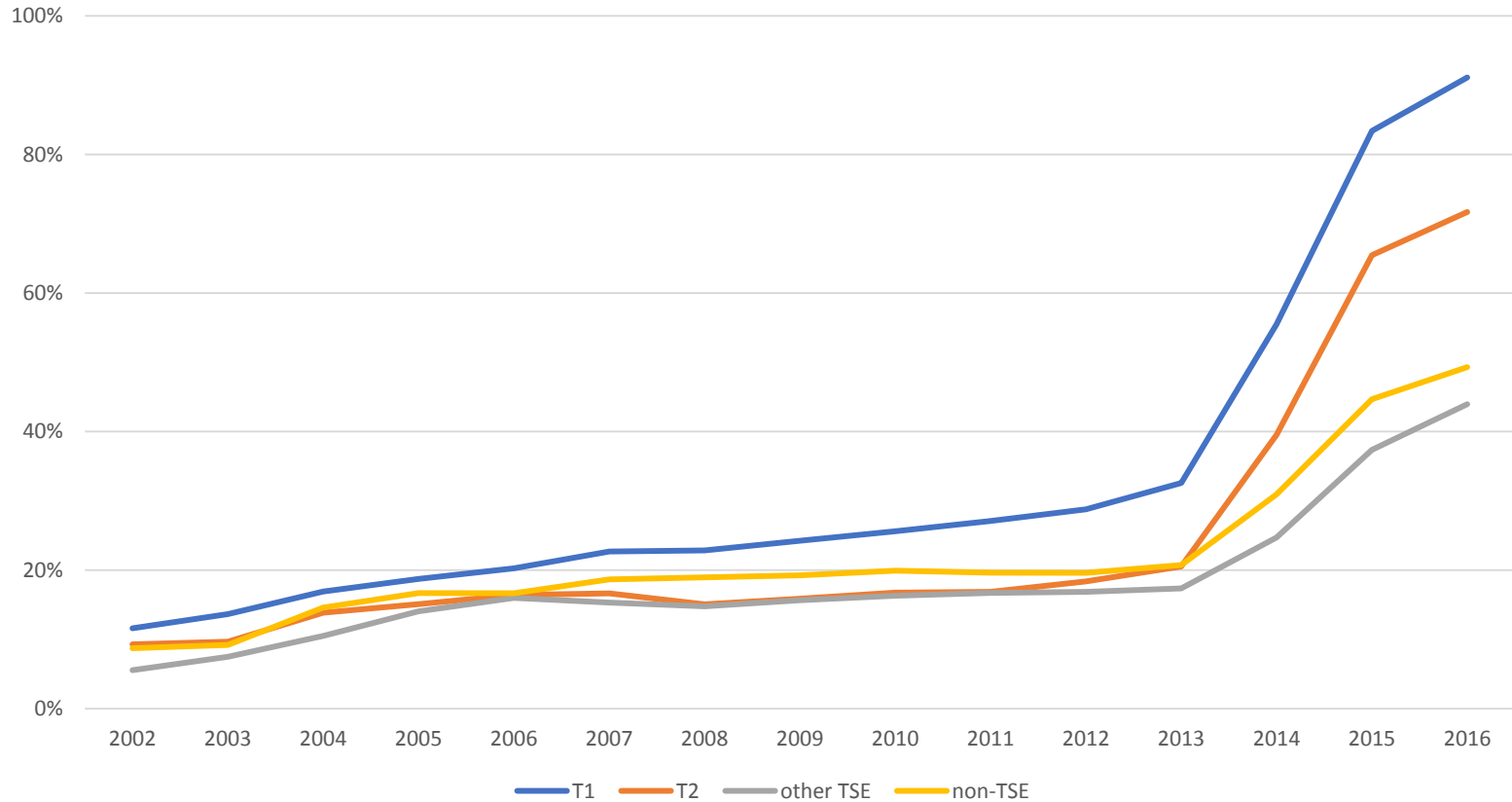
Panel A All firms

	Mean	SD	Min	Median	Max	Obs.
Tobin's Q	1.075	0.537	0.436	0.944	5.488	14915
Number of outside directors	1.560	1.288	0.000	1.000	6.000	14915
Percentage of outside directors	18.434	14.549	0.000	16.667	62.500	14915
Number of total directors	8.446	2.974	3.000	8.000	19.000	14915
Tangible assets/Assets	0.292	0.183	0.005	0.273	0.855	14915
Liabilities/Assets	0.511	0.207	0.098	0.507	1.151	14915
R&D expenses/Assets	0.014	0.021	0.000	0.005	0.112	14915
<u>Payouts/Assets</u>	0.013	0.015	0.000	0.008	0.111	14915
Cash flow/Assets	0.063	0.048	-0.141	0.060	0.260	14915
Ln(assets)	11.023	1.659	7.378	10.822	15.662	14915
Exports/Sales	0.182	0.260	0.000	0.000	1.175	14915
Foreign ownership (%)	11.506	11.947	0.000	7.335	50.147	14915
Financial institution ownership (%)	19.385	12.452	0.036	17.614	50.584	14915
Audit & supervisory committee	0.088	0.284	0.000	0.000	1.000	14915
Firm age	58.968	23.960	3.000	62.000	121.000	14915

Finding 1. Target firms complied

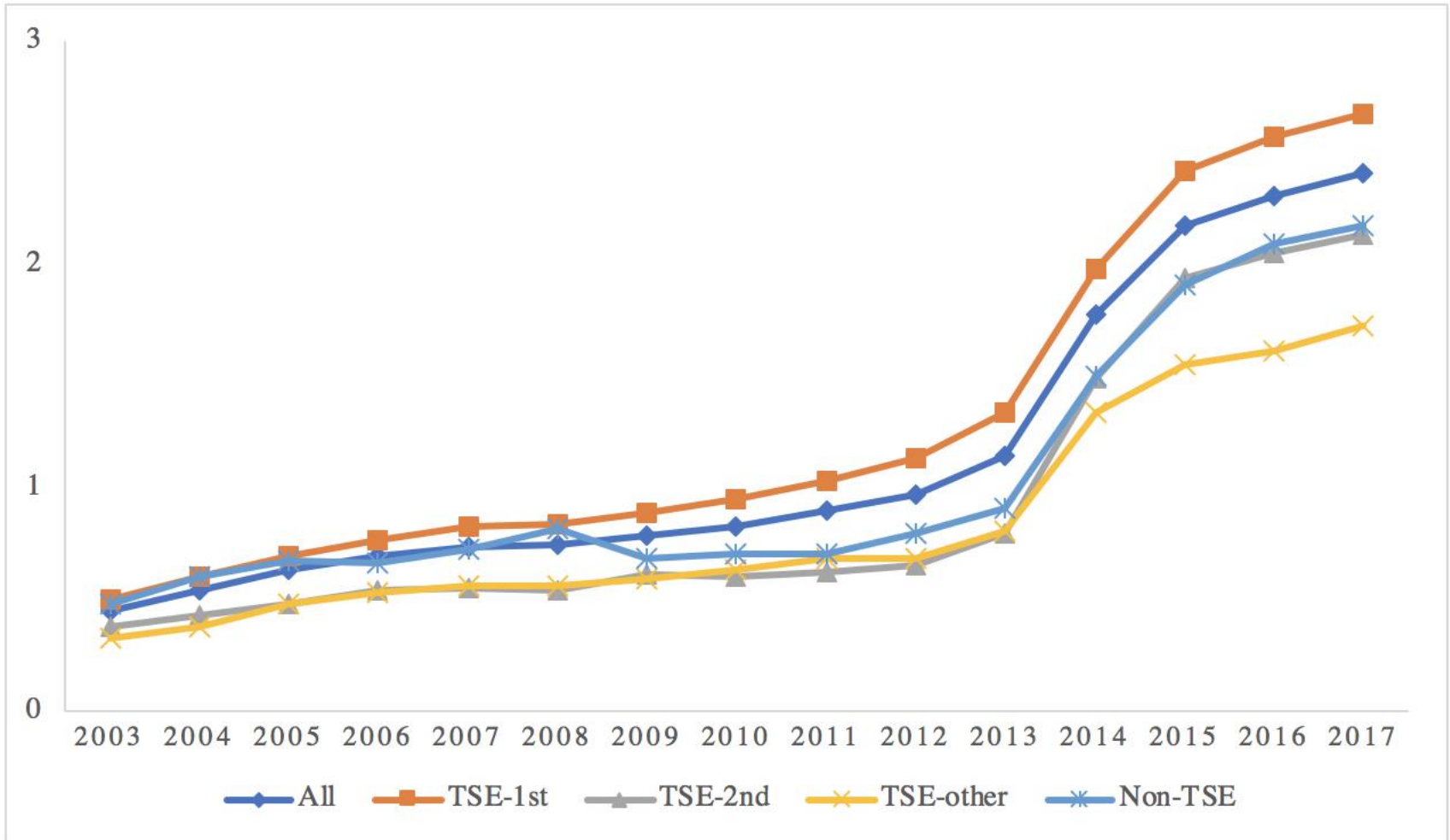


Finding 2. Non-target firms also complied



Finding 3. Outside directors grew

Figure 1A The number of outside directors



Finding 3. Outside directors grew

Panel A All firms

	Number of outside directors			Percentage of outside directors		
	(1)	(2)	(3)	(4)	(5)	(6)
Treat0* After	0.437*** (0.033)			7.950*** (0.431)		
Treat0d* After		0.755*** (0.046)			12.507*** (0.566)	
Treat1* After			0.612*** (0.041)			9.702*** (0.487)
Tangible assets/Assets	0.123 (0.182)	-0.094 (0.238)	0.049 (0.175)	-1.590 (2.433)	-3.461 (3.000)	-2.787 (2.324)
Liabilities/Assets	-0.195* (0.103)	-0.094 (0.141)	-0.171* (0.100)	-1.160 (1.424)	0.324 (1.936)	-0.784 (1.399)
R&D expenses/Assets	-0.508 (1.590)	-0.087 (1.910)	-1.197 (1.550)	18.264 (21.628)	25.246 (25.913)	8.360 (21.336)
<u>Payouts/Assets</u>	1.144 (0.717)	1.497* (0.902)	1.123* (0.681)	8.934 (9.154)	16.255 (10.890)	7.277 (8.746)
Cash flow/Assets	-0.299 (0.221)	-0.330 (0.299)	-0.152 (0.217)	-3.981 (2.985)	-4.181 (3.767)	-1.237 (2.940)
Ln(assets)	0.151** (0.067)	0.161* (0.089)	0.128** (0.065)	-0.270 (0.941)	-0.581 (1.214)	-0.732 (0.916)
Exports/Sales	-0.021 (0.097)	0.024 (0.119)	0.001 (0.090)	-0.142 (1.398)	0.606 (1.638)	0.167 (1.301)
Foreign ownership (%)	0.013*** (0.003)	0.012*** (0.004)	0.013*** (0.003)	0.132*** (0.035)	0.116** (0.048)	0.122*** (0.032)

Finding 4. Firm value declined

Panel A All firms

	Tobin's Q					
	(1)	(2)	(3)	(4)	(5)	(6)
Number of outside directors	-0.107*** (0.035)	-0.097*** (0.028)	-0.085*** (0.031)			
Percentage of outside directors				-0.006*** (0.002)	-0.006*** (0.002)	-0.005*** (0.002)
Tangible assets/Assets	-0.620*** (0.096)	-0.582*** (0.121)	-0.623*** (0.096)	-0.643*** (0.097)	-0.593*** (0.123)	-0.642*** (0.097)
Liabilities/Assets	0.412*** (0.083)	0.277*** (0.102)	0.416*** (0.084)	0.426*** (0.084)	0.288*** (0.103)	0.426*** (0.084)
R&D expenses/Assets	-1.312* (0.777)	-1.619* (0.877)	-1.311* (0.775)	-1.150 (0.778)	-1.463 (0.893)	-1.164 (0.772)
<u>Payouts/Assets</u>	4.658*** (0.541)	4.471*** (0.726)	4.645*** (0.540)	4.588*** (0.537)	4.421*** (0.722)	4.589*** (0.537)
Cash flow/Assets	1.170*** (0.175)	1.166*** (0.222)	1.173*** (0.174)	1.179*** (0.175)	1.174*** (0.222)	1.179*** (0.175)
Ln(assets)	-0.008 (0.062)	-0.012 (0.084)	-0.010 (0.062)	-0.025 (0.063)	-0.031 (0.085)	-0.025 (0.063)
Exports/Sales	0.050 (0.052)	0.047 (0.072)	0.051 (0.052)	0.051 (0.052)	0.048 (0.072)	0.052 (0.052)
Foreign ownership (%)	0.010*** (0.001)	0.008*** (0.002)	0.010*** (0.001)	0.009*** (0.001)	0.007*** (0.002)	0.009*** (0.001)

Finding 5. Young firms suffer more

Young: Age 50 or below; 31.5% of firms are young

	Tobin's Q					
	Young	Mature	Young	Mature	Young	Mature
	(1)	(2)	(3)	(4)	(5)	(6)
Number of outside directors	-0.197**	-0.077***	-0.157**	-0.068***	-0.121*	-0.067**
	(0.083)	(0.029)	(0.063)	(0.022)	(0.065)	(0.027)
Firm fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
First stage F-value	51.26	132.56	92.73	183.28	86.48	139.88
Observations	4691	10224	2865	6072	4691	10224

Young: Age 45 or below; 26.5% of firms are young

	Tobin's Q					
	Young	Mature	Young	Mature	Young	Mature
	(1)	(2)	(3)	(4)	(5)	(6)
Number of outside directors	-0.237**	-0.063**	-0.182**	-0.055**	-0.130*	-0.054**
	(0.097)	(0.031)	(0.075)	(0.023)	(0.074)	(0.026)
Firm fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
First stage F-value	36.03	146.27	66.55	201.06	68.6	151.97
Observations	3948	10967	2432	6505	3948	10967

Finding 6. R&D intensive firms suffer more

Panel A All firms

	Tobin's Q					
	Low R&D	High R&D	Low R&D	High R&D	Low R&D	High R&D
	(1)	(2)	(3)	(4)	(5)	(6)
Number of outside directors	-0.099 (0.062)	-0.106*** (0.039)	-0.079* (0.047)	-0.106*** (0.032)	-0.057 (0.049)	-0.104*** (0.038)
Firm fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
First stage F-value	64.14	121.28	103.64	179.69	88.98	141.21
Observations	7462	7453	4525	4412	7462	7453

Similar results for Osaka Exchange

Panel A All OSE firms

	Tobin's Q All OSE		
	(1)	(2)	(3)
Number of outside directors	-0.149**	-0.112*	-0.097
	(0.074)	(0.066)	(0.075)
Other control variables	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes
First stage F-value	75.74	118.08	95.10
Observations	3351	2130	3351

Placebo test

Hypothetical year of the reform	Tobin's Q					
	2008			2009		
	(1)	(2)	(3)	(4)	(5)	(6)
Number of outside directors	-0.710 (0.489)	-0.538 (0.426)	-0.537 (0.548)	0.350 (0.283)	0.516 (0.519)	0.657 (0.862)
Other control variables	Yes	Yes	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
First stage F-value	2.84	2.45	1.44	2.83	1.33	0.70
Observations	13906	10836	13906	14186	10889	14186

Main conclusions and policy implications

1. Corporate governance reforms in Japan have not succeeded in enhancing **aggregate firm value**
 2. Even the companies that had the **option not to comply** chose to comply.
 3. **Smaller, younger** and **R&D-intensive** firms suffered.
 4. We argue this is due to **socio-cultural pressures**
-

Thank you...

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Discussion of "Corporate
governance compliance and
firm value: A cultural
perspective"

Paper by Masanori Orihara and
Arman Eshraghi

Discussion by Ambrus Kecskés

Summary

- Find that corporate governance reforms introduced by Japanese government in 2014 have not actually destroyed firm value
- These policies, of which voluntary disclosure in the form of ‘comply or explain’ is a major element, have inadvertently led to overcompliance by target firms (TSE Tiers 1 and 2) and also non-target firms (other TSE tiers)
- Argue that this overcompliance behavior is correlated with cultural values that permeate Japanese corporate culture: ‘conformity’, ‘respect for authority’, and ‘power distance’
- This results in smaller firms (typically not Tiers 1 or 2) following the compliance behavior of larger firms listed (typically Tiers 1 or 2)
- Find a decrease in firm value concurrent with reforms
- Also: Larger decrease in firm value for young and R&D intensive firms and firms appointing lower quality outside directors

Cross-sectional contrasts with cultural characteristics?

- General Japanese cultural characteristics hypothesized to be also relevant for Japanese business culture
 - Conformity
 - Respect for authority
 - Power distance
 - Uncertainty avoidance
 - Long-term orientation
- Are there firm-level proxies for such cultural characteristics?
 - Survey data on TSE firms?
 - Data unique to TSE firms?
 - Others?
- Possible to show strong effects for firms that are more vs. less "Japanese"?
 - Compliance with governance reforms?
 - Value destruction?

Two really interesting results – but why?

- Compliance results: Interesting because counterintuitive given that compliance is costly (even absent value destruction result)
 - Or else would have complied absent the reform
 - Unintended consequence: All firms pressured to comply
- Value destruction result: Intriguing because managers comply anyway
 - Why? What's in it for managers?
 - And why don't investors oppose it?
 - Why doesn't the government not oppose? (BOJ owns large minority of Japanese shares!)
- Why do firms / managers / investors / government say they go along?
 - Opportunity for a survey?
 - Sample sizes seem reasonable: About 65% Tier 1 firms, 15% Tier 2 firms, 20% rest of firms