GETTING A GRIP ON

Governance

THE 2004 BARCLAYS GLOBAL INVESTORS CANADA RESEARCH AWARD

This year's winning paper, written by a team from Simon Fraser University, examines the validity of measures of governance among different firm structures.

BY JAMES LEWIS

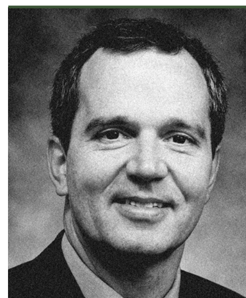
Although governance has become a buzzword of late, it's suffering something of an identity crisis. Many aren't sure which measures of governance actually make a difference to shareholders, and which might be mere window-dressing. Does executive compensation matter? What about shareholder rights, transparency and disclosure?

On the following pages, we present the winner of the 2004 Barclays Global Investors Canada Research Award. For the past four years, *Canadian Investment Review* and Barclays Global Investors Canada have jointly sponsored an award for the best Canadian capital markets research paper, and this year's winner—co-authored by Peter Klein, Daniel Shapiro and Jeffrey Young—reflects the recent surge of interest in governance. Their paper, "Board independance and the family-owned firm," also hints at what many governance gurus say: that one popular measure of good governance—board independence—is not a sure bet when it comes to maximizing shareholder value. In fact, the paper finds the inverse can be true in the case of family-controlled firms.

Even the managing director of the Canadian Coalition for Good Governance (CCGG) has a hard time with studies drawing a definitive link between board independence and the creation of shareholder value, for one simple reason: the timelines are often too short. "Tracking anything over, say, 10 years, you're going to find it [much more] difficult to find a correlation between the board and governance," says David Beatty.

Beatty, who is director of the Clarkson Centre for Business Ethics and Board Effectiveness at the University of Toronto's Rotman School of Management, points to such Canadian heavyweights as Power Corp., George Weston Ltd., ATCO Ltd. and Thomson Corp.—family-owned businesses all—as proof that non-independent directors and happy shareholders aren't mutually exclusive. "These are public companies [with] rates of return that are amazing. It's certainly true, I think, that a family interest in a corporation has led to some spectacular long-term successes." He adds that nearly all these firms have aspects to their structures that are governance no-nos, such as family appointments to boards and dual-share structures where controlling families get more votes per share than other owners.

However, another director of the CCGG, Stephen Jarislowsky, says any link between a non-independent board at a family-owned firm and shareholder value is tenuous. "I don't think you can generalize that if you have a family-owned firm, you'll be fairer to outside shareholders [with a non-independent board]," says Jarislowsky, chairman, CEO and founder of Jarislowsky Fraser in Montreal.



PETER KLEIN

Peter is an associate professor of finance at Simon Fraser University's Faculty of Business Administration. He is a CFA and chair of the Vancouver Society of Financial Analysts' continuing education committee, and has a law degree and MBA from the University of Western Ontario and a Ph.D. in finance from the University of Toronto. His research interests include return anomalies, taxation, derivative securities and credit risk.

The scandal at Hollinger International is a worst-case scenario when talking about governance, Jarislowsky says. "He [Conrad Black] ran it like a family firm," says Jarislowsky. "The moment [a director] got out of line, they got a blistering letter from him and dismissal from the board." Jarislowsky sat on the board of Southam Inc., a Hollinger acquisition, in the 1990s.

Jarislowsky points out that other positions requiring a similar amount of responsibility and trust, such as accountants or lawyers, have rigorous training and certification requirements. "To become a director all you have to have is someone invite you," he says, adding that usually that invite is made because a potential director is connected socially or a high-profile figure in the business world rather than a truly impartial and effective choice. "If you have really qualified, honest and independent directors, you're way ahead."

Inventions such as liability insurance may also have compounded the governance problem and caused directors to stray, Jarislowsky says. "I don't think directors should be insured—if you're a fiduciary, you have to do your fiduciary duty. If you do your fiduciary duty, and do it well, and don't hide behind insurance, than maybe you'd be a better director, because you're worrying about your missteps."

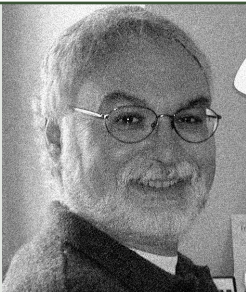
Are governance laws the answer? Emilian Groch, executive director of the Alberta Teachers' Retirement Fund and another CCGG director, says attempts to legislate good governance practices may ultimately fail. "In the end, a checklist isn't going to make it. My view is that you do need independence of some sort; you certainly need capable, motivated, ethical boards acting in the best long-term interests of shareholders. You cannot regulate a checklist of integrity, or capability, or any of those kinds of things."

Beatty says certification programs—such as those offered by the Rotman School of Management and McMaster University in Hamilton, Ont.—may be the best bet for training a new generation of independent and responsible directors. "We definitely need to be working harder to diversify boards beyond the old boy's network we've heard about."

Jarislowsky, however, remains skeptical about the usefulness of formal programs aimed at developing better directors. "You don't get people to think automatically by lecturing them, [and] I don't think you can teach ethics," he says. Rather, corporations should look for directors with a demonstrated history of prudent decision-making and moral character, not just business savvy and experience.

Barclays Global Investors Canada and *Canadian Investment Review* congratulate Peter Klein, Daniel Shapiro and Jeffrey Young on winning the Barclays Global Investors Canada Research Award, for their excellent work on a topic as important as governance.

Canadian Investment Review would like to thank the following for their support for and help with the 2004 Barclays Global Investors Canada Research Award: Paul Halpern, chair of *CIR*'s editorial advisory board, for his dedication and hard work in organizing the award judging; the judges who read and evaluated the submissions in their full versions; the Northern Finance Association executive and Canadian business schools for their past support in helping to publicize the award; and finally, Gerry Rocchi, president and CEO of Barclays Global Investors Canada, and Bill Chinery, head of business development and client service in Toronto, for their continued support and sponsorship of this event. ■



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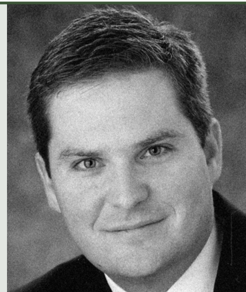

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Board Independence AND THE FAMILY-OWNED FIRM

This paper, which won the 2004 Barclays Global Investors Canada Research Award, shows that measures of governance can be hit or miss depending on a firm's ownership structure. This is a practitioner version of the full paper.

BY PETER KLEIN, DANIEL SHAPIRO AND JEFFREY YOUNG

The business and investment communities have taken a renewed interest in corporate governance over the past several years. Most interested parties believe proper corporate governance is a "good thing" that should, ideally, also lead to good corporate performance. Based on this belief, stock market analysts are starting to use measures of corporate governance when evaluating the investment merits of individual companies and their management. This belief has also lead to a number of regulatory initiatives, such as the Sarbanes-Oxley Act in the U.S.

A number of Canada's leading entrepreneurs have publicly stated their disagreement with this view. For example, Paul Desmarais Jr., chairman and co-chief executive officer of Power Corp., recently expressed the following opinion:

Some commentators on governance have suggested that, as a matter of policy, the boards of closely held companies should have a majority of directors who are independent from management and the controlling shareholder...The proposal seems to be based on a confused notion that independence from management and the controlling shareholder is synonymous with excellence. This is a fallacy. It implies that shareholders are better off if they entrust their wealth to a committee of trustees who may or may not share the controlling shareholder's interest and commitment...As with so many things, the best course is a middle course—in this case, a healthy combination of directors related and unrelated to the controlling shareholder and an important proportion of directors independent from management.[1]

Somewhat surprisingly, there is no overwhelming evidence to suggest that within developed markets firm performance is enhanced by better governance practices. In a survey article, Black (2001) concludes that intercompany differences in corporate governance have no economically significant effect on market value or performance of U.S. companies. He suggests that "the minimum quality of corporate governance, set by securities law, corporate law, stock exchange rules, and behavioral norms" is so widely accepted that there is little variance in governance practices among public firms. Other recent surveys (Leblanc and Gillies [2003]; Daily et al [2003]) also suggest that there is at best mixed evidence in support of the hypothesis that better corporate governance results in better performance. Many of the studies reporting a positive relationship between corporate governance and firm performance are for emerging markets (Bai et al [2002]; Campbell II and Keys [2002]; Klapper and Love [2002]; Black et al [2003]; Durnev and Kim [2003]).

In a recent study (Klein, Shapiro and Young [2003]), we examined the relationship between firm performance, as measured by Tobin's q, and the *Globe and*

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TABLE 1: ESTIMATED IMPACT OF CORPORATE GOVERNANCE ON FIRM PERFORMANCE

	All Firms (n = 263)	Family Firms (n = 84)	Widely Held Firms (n = 123)
Total Index	0.0056	0.0052	0.0105
	(1.05)	(0.69)	(1.17)
Board Composition	-0.0119	**-0.0190**	-0.9757
	(-1.46)	(-2.50)	(-0.60)
Compensation	**0.0289**	**0.0371**	**0.0356**
	(2.37)	(2.04)	(2.20)
Shareholder Rights	**0.0358**	**0.0383**	**0.0505**
	(2.76)	(2.33)	(2.24)
Disclosure	**0.0522**	0.0500	0.0948
	(2.07)	(1.32)	(1.73)

The numbers in the table are the estimated impact of each measure of corporate governance on firm performance, as measured by Tobin's q. Values in parentheses are t-statistics. Results significant at the 5% level are presented in bold. The estimates were obtained through regression analysis in which each of the governance variables was included individually in an equation which also included control variables for firm size, leverage, growth and industry. See Klein, Shapiro and Young (2003) for the complete results.

Mail/Report on Business index of corporate governance for 263 of Canada's largest firms. These indices measure board composition and effectiveness, compensation policies, shareholder rights, and disclosure practices. They are summarized in an aggregate corporate governance index (CGI), which is computed as the sum of four sub-indices. In our analysis, we therefore asked not only whether corporate governance broadly defined affects firm performance, but we also investigated whether some governance factors are more important than others.

In order to address the concern that good governance may not enhance corporate performance in all cases, we distinguished between different ownership types in our analysis. We focused in particular on family firms, the dominant ownership category worldwide, and widely prevalent in Canada. The study therefore contributes to the body of research on the effects of corporate governance on firm performance, as well as to the literature on the effects of family ownership.

Our results indicated that corporate governance does matter in Canada. However, not all elements of measured governance are important, and the effects of governance do differ by ownership category. We found no evidence that the total governance index improves firm performance, regardless of ownership. Consistent with previous studies, we also found no evidence that, on average, board composition affects firm performance; however, for family-owned firms we found that the effect is negative. In general, effective compensation, disclosure and shareholder rights practices enhance performance and this is true for most ownership types.

The rest of this summary article proceeds as follows: in the following two sections we discuss the governance indices and measures of ownership employed in the study. In section four, we discuss the empirical model that was estimated; the results are presented in section five, followed by discussion and conclusions.

The ROB Corporate Governance Index

Our study used the index of corporate governance in Canada published by the *Globe and Mail* newspaper in its *Report on Business* (ROB) section on October 7, 2002. This index is comprehensive in terms of the number of firms considered as well as the range of governance indicators. The ROB obtained its data from information the companies published in their most recent proxy information circular for shareholders. The ROB rated all but five of the firms in the S&P/TSX index at the beginning of September 2002. In all, 270 firms were ranked. For reasons related to data availability, our sample numbered 263 firms.

The overall corporate governance index (CGI), with a maximum value of 100, was obtained by summing four sub-indices:

• Board composition, which captures board autonomy, structure and effectiveness;
• Shareholding and compensation issues, which measures the degree to which managers and the board have incentives that align their interests with those of shareholders;
• Shareholder rights issues, the major components of which are the existence of employee stock options and subordinate shares that dilute ownership and voting rights, and;
• Disclosure issues, which attempts to measure a company's public commitment to good governance, largely through

“The finding that board composition is not positively related to performance is not unusual.”

compliance with government disclosure regulations.

In compiling the overall index, the ROB weighted the sub-indices as 40%, 23%, 22% and 15%, respectively. A more complete description of these sub-indices is contained in Klein, Shapiro and Young (2003).

Ownership Structures

In order to determine the ownership of each firm we employed the Inter-Corporate Ownership Directory published quarterly by Statistics Canada, and individual corporate SEDAR filings. Family ownership was defined using a 10% cut-off rule, i.e., if the final beneficial owner of any equity position was a family (or individual) that controlled 10% or more of the voting rights of any individual company, it was classified as family-owned. If there was no single shareholder above 10% then it was classified as widely held. The final sample comprised 123 widely held firms and 84 family-owned firms.[2]

Methodology

In order to analyze the relationship between firm performance and corporate governance, we estimated a model in which firm performance, measured by Tobin's q, is regressed on the corporate governance indices discussed above, as well as the ownership indicator variables, and various other control variables. Following Black, Jang and Kim (2002), we included as control variables measures of firm size (Ln assets), leverage (debt/equity ratio), average sales growth, and profit variability. Firm size and growth control for potential advantages from economies of scale and scope, market power, and market opportunities. The leverage and the variance of profitability terms control for different risk characteristics of firms.[3]

With the exception of market capitalization information, which was included in the ROB data, the firm financial data were taken from balance sheet and income statements obtained from Globeinvestor.com, an online investment website affiliated with the *Globe and Mail* newspaper.

Empirical Results

Total Sample Results - The results for the relevant variables are summarized in Table 1. The first column presents the estimated impact of each measure of corporate governance on firm performance as measured by Tobin's q. The first entry in this column indicates that the total index score was not found to be statistically significant. This result is consistent with the view that the high level of governance regulation in developed nations such as Canada makes the overall level of corporate governance high enough that interfirm differences are not important to investors. As will be discussed shortly, this conclusion is not necessarily correct because it does not take into account the various sub-indices of corporate governance, and it ignores the nature of firm ownership.[4]

The results based on the total governance index do not fully reveal the importance of corporate governance to firm performance. In the first column of Table 1, we also present results for each sub-index individually. These results indicate that, in fact, all of the governance sub-indices with the exception of the board composition sub-index are statistically significant and positively related to performance. Thus, investors are willing to pay a premium for companies that protect shareholder rights, engage in open and full disclosure, and have compensation practices that align the interests of managers and owners. Markets do reward some good governance practices.

The same is not true for the board composition sub-index. When entered alone, board composition has a negative sign, but is not statistically significant, and when entered with the other sub-indices the coefficient is negative and statistically significant. Because the board composition sub-index comprises 40% of the total

index, this explains why the total index is not found to be statistically significant.

The finding that board composition is not positively related to performance is not unusual. Past empirical evidence has generally failed to find any significant relationship between board composition and firm performance, and recent surveys of the literature conclude that the evidence on this matter is at best ambiguous (Dalton et al, [1998]; Bahjat and Black [1999; 2001]; Hermalin and Weisbach [2003]). However, the negative sign is unusual.

Results for Ownership Categories - The second column of Table I presents results for the sub-sample of family-owned firms. For this sub-sample the total index remains statistically insignificant. Of note, however, is that the coefficient on the board composition subindex is negative and statistically significant. For family-owned firms, it is apparently the case that measures of board effectiveness are associated with inferior performance. The remaining sub-indices maintain their positive signs, and two out of three continue to be statistically significant.

The third column of Table I presents results for the group of widely held firms. The total index continues to be insignificant for this sub-sample. In contrast with the result for family-owned firms, board composition has no statistically significant effect on performance. As was found for the family-owned firms, the remaining sub-indices are typically of positive sign and statistically significant at 90% levels.

Thus, we conclude that the impact of governance practices on firm performance varies by ownership category, and also by which governance practice is being measured.[5] The major difference between the sample of family-owned and widely held firms clearly revolves around the effects of board composition on performance. For family firms, the coefficient is negative and statistically significant. Family firms are apparently penalized for having a board that is independent of company management. For widely held (and indeed other non-family) firms, the relevant coefficient is negative, but not statistically significant. Thus board composition matters for family firms, but not in the expected way. Instead, we find that board independence may not be detrimental to minority shareholders in the case of family-controlled firms, and, in fact, it may be positive.

Conclusion

We find that corporate governance matters in Canada but that the specific aspects of corporate governance which matter depend on firm ownership. In general strong shareholder rights, compensation polices that align manager and shareholder interests and open disclosure and transparent mechanisms that reduce information asymmetry are highly valued by investors. However, we find no evidence that board composition and independence are valued as governance mechanisms. For family firms, board independence is in fact negatively correlated with performance. This finding supports the claim of many family-owned companies that a high level of board independence does not automatically lead to better performance.

These results call into question the usefulness of aggregate measures of corporate governance. Financial analysts need to examine carefully the specific construction of corporate governance measures when trying to draw a link with firm performance. Regulators also need to exercise caution when formulating policy based on such aggregate indices.

These caveats also extend to the nature of ownership of the firm under consideration. The importance of governance does appear to differ for family-owned firms as compared to firms that are widely held. This is a significant finding due to the differences in ownership in the U.S. as compared to many other countries, including Canada. It also implies that a global standard for good corporate governance may not be an appropriate pursuit. ∎

Endnotes

1. Quoted in the *Report on Business*, Friday, May. 16, 2003.
2. The study also included firms that were government-owned, in whole or in part, and firms that were owned by other corporations or institutions. Results for these firms are discussed in Klein, Shapiro and Young (2003).
3. In addition, we added dummy variables for companies in the utility,

financial services and resource sectors because unique government regulation in the utilities industry, the special relationship between book and market values in the financial industry and the difficulty of valuing reserves in the resource sector can affect the calculation of Tobin's q. We also added financial control variables which are for the most part statistically significant; firm size is consistently negatively related to performance, as is firm leverage; growth and performance are positively related.

4. We also found very little evidence that ownership type affects performance. Although the mean Tobin's q for family-owned firms is lower than the mean for the entire sample, family firms are also on average larger than other firms, and when size is accounted for the family ownership term is never statistically significant. Family firms perform less well because they are larger, and size is penalized. This finding is in contrast to the results in Anderson and Reeb (2003).
5. As discussed in Klein, Shapiro and Young (2003), Chow tests (Greene [2003]) reject the hypothesis of unequal coefficients when the two samples are compared. However, when the sub-indices are used either alone or together, the hypothesis of unequal coefficients is accepted.

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A BRIEF HISTORY OF THE BARCLAYS AWARD

The inaugural Barclays Global Investors Canada Research Award was presented in 2001 to Lawrence Kryzanowski, the Ned Goodman Chair in Investment Finance at Concordia University in Montreal, and research analyst Jocelyne Ménard of TD Bank Financial Group. They co-authored the paper, "Migration behaviour of long-term bond ratings of Canadian corporate issuers." Kryzanowski and Ménard found that credit risk management had undergone an evolution from individual to portfolio risk management, where the co-movements in the rating migrations of individual bonds are important.

A research paper on equity markets garnered the 2002 award. Kai Li, assistant professor of finance at the University of British Columbia in Vancouver, won for her paper, "What explains the growth of global equity markets?" The paper examined, in the broadest sense, how and why equity markets in some countries grow faster than others. Li attributed the growth of equity markets to three factors, including changes in valuation technology.

In 2003, the award was presented to Scott Anderson, associate professor of finance at the School of Business Management at Ryerson University in Toronto, and Yisong Tian, an associate professor of finance at the Schulich School of Business at York University, also in Toronto. Anderson and Tian co-authored the paper, "Incentive fees, valuation and performance of labour-sponsored investment funds," which found that manager compensation and fee structures had a significantly negative impact on the performance of labour-sponsored investment funds. Their research concluded that these funds underperform other investment vehicles and market indexes.

A practitioner version of each Barclays Global Investors Canada Research Award paper is available for download in PDF format from the *Canadian Investment Review* website (www.investmentreview.com), under 'archives'. The winning papers appeared in the fall issue of each year.

—Jim MacDonald