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Board effectiveness and firm performance of Canadian listed firms

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ABSTRACT

An effective board of directors is central to agency theory's prescription to solving the problems of separation of ownership from control in the modern corporation. The shareholders' confidence in the board's ability to fulfil its duties is an important measure of the success or otherwise of this cornerstone of agency theory. The Board Shareholder Confidence Index focuses on the board of directors and is the standard by which Canadian governance best practices are measured. This paper investigates the relationship between board effectiveness and company performance.

Using a sample of 699 firm year observations from 2003 to 2009, we find a positive association between the firm's measure of board effectiveness and the firm's contemporaneous and future market measure of performance, Tobin's Q. The results hold across a number of econometric models that control for different types of endogeneities.

1. Introduction

Asymmetry of information between managers and shareholders is the result of the separation of ownership from control in large public corporations (Fama & Jensen, 1983). The principal–agent model, espoused by Jensen and Meckling (1976), suggests that because shareholders cannot directly observe managers' efforts, moral hazard thus results in the market pricing agency risk. A possible solution to the problem of agency risk and information asymmetry, according to both the theoretical and empirical evidence, is through the monitoring of firms by financial and information intermediaries, (Beasley, Carcello, Hermanson, & Lapides, 2000; Dechow, Richard, Sloan, & Sweeney, 1996; Diamond, 1996; Titman & Trueman, 1986). Also, by implementing effective corporate governance mechanisms, information asymmetry and agency risk can be reduced (Jensen & Meckling, 1976; Renders, Gaeremynck, & Sercu, 2010). Jensen and Meckling (1976) agency theory suggests that there ought to be a positive impact on firm value for firms employing such governance devices and thus better governance and an effective board can raise firm value.

Canada's principles-based corporate governance regime for listed companies provides firms with the flexibility to tailor their corporate governance practices to their specific circumstances. It assumes that a "one size fits all" approach (a rules-based regime[1]) is not best policy, given the material differences between firms with regard to size and complexity. The underlying assumption of this governance regime is that the capital market will assess and monitor a firm's compliance with

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[1] Broshko & Li, 2006 compare the principles-based and rules-based corporate governance approaches in Canada and the U.S.

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the corporate governance code and, thus, reward or punish the firm via its share price (Easterbrook & Fishel, 1996) or accept the firm's disclosure for non-compliance (Anand, 2005).

The Board Shareholder Confidence Index (BSCI), published by the Clarkson Centre for Business Ethics and Board Effectiveness (CCBE) provides a finely focussed assessment of board effectiveness and "comprises factors used by active investors to assess Boards of Directors for corporate governance best practices...... we capture those factors that influence shareholders' confidence in a Board's ability to fulfil their duties".[2] This paper has two main objectives. Firstly, we investigate the relationship between a firm's BSCI composite grade, Board Effectiveness (and its component parts) and the firm's performance, where performance is measured by a contemporaneous and future Tobin's Q. Secondly, given that many of Canada's listed firms are either family run or closely held, we explore the firm's voting structure as a possible alternative corporate governance mechanism.

This paper is organised as follows: the following section reviews the literature and develops our hypotheses. Then, we introduce the data and the methodology, followed by the empirical results. Finally we summarise the paper and provide a concluding discussion.

2. Literature review and hypotheses development

The separation between ownership and control is the result of the modern corporation and its capital requirements which generally requires multiple owners (shareholders), (Berle & Means, 1932). These owners contract executives to manage the corporation on their behalf. Agency theory's "model of man" is that of the rational actor seeking to maximise his or her individual utility, (Jensen & Meckling, 1976). The owners (principals) employ the executives (agents) to maximise their investment in the corporation. The agent, while charged to maximise firm value, perceives opportunities to maximise his/her own utility. To protect owners' interests, minimise agency costs and ensure principal–agent interest alignment, agency theory prescribes compensation schemes and governance mechanisms. One such governance mechanism is the board of directors whose main task is to monitor executives on behalf of the shareholders. Thus, the shareholders' confidence in the board's ability to fulfil its duties is an important measure of the success of this cornerstone of agency theory. The Board Shareholder Confidence Index (BSCI), published by the Clarkson Centre for Business Ethics and Board Effectiveness (CCBE) is one such measure of shareholders' confidence.

Canada realises its corporate governance requirements through the implementation of National Instrument 58-101 Disclosure of Corporate Governance Practices, National Policy 58-201 Corporate Governance Guidelines, and Multilateral Instrument 52-110 Audit Committees. Whilst the latter is mandatory, the Canadian approach to corporate governance is a principles-based approach (comply or explain), similar to the practices adopted in the UK, other European countries and Australia. Thus, firms that constitute the S&P/TSX are required to disclose their compliance with the above instruments.

A central issue in agency theory is the information asymmetry between absentee owners and managers who are in charge of the day-to-day running of the firm. This requires the Board of Directors to put in place the mechanisms for reducing or eliminating such information asymmetries thereby ensuring shareholder confidence in the Board. From an economic perspective, well-functioning capital markets require resolution of the information, or "lemons", problem (Akerlof, 1970). Corporate disclosure solves this problem in capital markets and has been categorised into mandatory regulated financial statements and voluntarily disclosed information, with external information intermediaries such as financial analysts also reducing the information gap (Healy, Hutton, & Palepu, 1999). Firms that constitute the S&P/TSX index are required to disclose their compliance with the above instruments and thus their compliance with these instruments is an example of such corporate disclosure. The mandate of the CCBE "is to monitor Canadian corporate governance trends and to provide guidance to firms looking to improve their board effectiveness and disclosure". Since 2002, the CCBE's BSCI has become the standard by which Canadian governance best practices are measured. CCBE publishes the BSCI rating annually for each firm that is listed on the S&P/TSX composite index.

A number of prior studies suggest a link between well governed firms and firm value/performance, (for example, Bebchuk, Cohen, & Ferrell, 2009; Gompers, Ishii, & Metrick, 2003); others have been unable to indicate firmly that good governance actually impacts positively on firm value/performance, (Core, Guay, & Rusticus, 2006). Therefore, there is no empirical closure on the ongoing debate about the relationship between governance and firm valuation, which suggests the need for more evidence attesting to the link between governance and firm valuation.

Arcot and Bruno (2007) use the quality of explanation as a proxy for a firm's corporate governance choice. They examine the effects of corporate governance on performance for a sample of non-financial UK firms and find that "... a measure which accounts for different choices by companies of corporate governance is *significantly associated* with performance..." They find that firms that do not comply with best practices, for valid reasons, perform exceptionally well and out-perform fully compliant firms and that mere compliance with the Combined Code does not necessarily result in better performance. Selvaggi and Upton (2008) use the Association of British Insurers' Institutional Voting Information Service as a measure of the quality of a firm's corporate governance and report a strong negative correlation between performance and voting for firms that receive a red top (an indicator of major governance concern). They find that a portfolio of well governed firms delivers higher returns when adjusted for risk and has lower volatility of share-price returns. In contrast, no discernible link is found

[2] http://www.rotman.utoronto.ca/ccbe/.