The Program on ETHICS in LAW and BUSINESS

THE VALUE OF GOVERNANCE

Anita Anand

Professor of Law

Academic Director, Centre for the Legal Profession

University of Toronto[1]

[1] Professor of Law and Academic Director Centre for the Legal Profession email: anita.anand@utoronto.ca. The views expressed herein are the views of the author who was not compensated to write this article or the accompanying memorandum.

Corporate directors sometimes question the usefulness of "good governance," asking whether implementing corporate governance measures makes a difference. Using various proxies for good governance, the preponderance of research is clear on one point: that governance does matter. In fact, cross-country and Canada-specific research demonstrates a statistically significant and positive relationship between corporate governance measures and firm value.

Which specific governance measures are associated with an increase in firm value? As set out in the attached memorandum,[2] board composition, ownership structure and the presence of institutional shareholders have been found to relate to valuation outcomes. As well, effective compensation, disclosure and shareholder rights practices have also been found to have a positive relationship to firms' performance, regardless of their ownership structure. Thus, research across a broad spectrum of governance practices suggests the importance of governance to the bottom line.

One might say that this is a chicken-and-egg issue since much of the empirical data is correlational, rendering it impossible to state definitively that corporate governance *causes* higher performance. Perhaps, for example, firms that perform well are better able to maintain strong governance practices. But this issue does not negate the importance of governance given the positive correlation between governance measures and firm value as well as the existence of studies suggesting that board structure (measured by outside directors and audit committees) may be causally related to firm market performance. In short, governance matters.

Much of the governance research referred to here relates to data from the 1990s. More recently, U.S. governance expert Lucian Bebchuk and his colleagues studied firm behavior after the turn of the century. They found that, as was the case in the 1990s, corporations that scored highly on governance indexes continued to have a higher return on assets, net profit margin and sales growth than poorly-scoring firms in their industry. These corporations also had a higher "Tobin's Q", a measure based on the ratio of total market value to total book value of assets. Bebchuk concludes that, "[g]overnance is and will remain consequential for the wealth of shareholders and the value of companies."[3]

Are there other suggested benefits of good governance? Practising good corporate governance is likely important to both risk assessment and risk management,

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[2] Anita Anand, "Firm Value and Corporate Governance: Overview of the Academic Research" (attached).

[3] Lucian Bebchuk, "Investing in Good Governance" (2012) *The New York Times*, online: < http://dealbook.nytimes.com/2012/09/12/investing-in-good-governance/ >.

notwithstanding that the term "risk" can lack clarity. In particular, experts would agree that implementing governance measures can reduce risk, such as the risk of litigation. Of course, recalling the chicken-and-egg issue, it may be that high value firms might manage risk well. At the very least, it appears that good corporate governance is more than "window dressing"; it can lead to a stronger bottom line and also mitigate exposure to outside risks.

Overall, there is a strong consensus in the literature that corporate governance is linked positively to firm value, even when "governance" and "value" are defined and measured in various ways. Thus, the continued emphasis on good corporate governance in legal initiatives following on from the fall of Enron and more recently the global financial crisis is not misplaced.

Anita Anand
University of Toronto
February 1, 2013

The Program on ETHICS in LAW and BUSINESS

MEMORANDUM

To: Canadian Coalition of Good Governance

From: Anita Anand, Professor of Law, University of Toronto

Date: February 1, 2013

RE: Firm Value and Corporate Governance

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1. Introduction

This memorandum examines the relationship between corporate governance mechanisms and firm value.[4] It synthesizes the academic literature and presents the current state of empirical research on this issue. As discussed below, the academic literature demonstrates a statistically significant and positive correlation between corporate governance measures and firm value.

2. Foundational Literature

Academic discussions regarding the link between corporate governance and firm value typically begin with an analysis of a 2003 study by Gompers, Ishii and Metrick (GIM).[5]

[4] Thanks to Grant Bishop, Vlad Calina, Adam Curran, Parsa Pezeshki, and Chava Schwebel at the University of Toronto Faculty of Law for very helpful assistance in the research and preparation of this memorandum.

[5] Paul A. Gompers, Joy L. Ishii & Andrew Metrick, "Corporate Governance and Equity Prices" (2003) 118:1 Quart. J. Econ. 107.

Studying about 1500 firms during the 1990s, GIM construct a governance index to proxy for shareholder rights. GIM find a statistically significant relationship between firms with stronger shareholder rights and higher firm value, higher profits, higher sales growth and lower capital expenditures.[6] Their proxies for shareholder rights include defensive tactics, voting rights and director/officer protections.

Subsequent empirical work distinguishes between these factors, called "external governance" mechanisms, and other factors called "internal governance" mechanisms, such as the number of independent directors, the separation of the Chair and CEO roles and the presence of an independent audit committee. Still other work focuses on factors such as compensation, disclosure and shareholder rights. The upshot is that all of these studies purport to be about "corporate governance" and there is no uniformity regarding the definition of this term.

Cremers and Nair, for example, examine percentage share ownership of blockholders and public pension fund ownership as proxies for internal governance provisions.[7] Using various accounting measures of performance, they find that internal and external governance mechanisms are both associated with long-term abnormal returns. They further conclude that corporate governance is stronger when internal governance is also considered.[8] Brown and Caylor build an index using 51 external and internal governance mechanisms.[9] They find that five internal governance factors and two external factors drive the relationship between the full index and firm value.[10]

Accepting the correlation between governance and firm performance, Bebchuck, Cohen and Ferrell study which governance provisions in particular influence this relationship.[11] Arguing against a "kitchen sink" approach to constructing governance indexes, they identify six provisions (staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments) [12] that are negatively correlated with firm valuation, as measured by

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[6] *Ibid* at 107.
[7] Martijn Cremers & Vinay B. Nair, "Governance Mechanisms and Equity Prices" (2005) 60:6 J. Finance 2859.
[8] Such as return on assets, return on equity and net profit margin: *ibid* at 2862.
[9] Lawrence D. Brown & Marcus L. Caylor, "Corporate Governance and Firm Valuation" (2006) 25:4 J. Account. Public Pol. 409.
[10] *Ibid* at 430. The factors include: annual board elections, no poison pill or one approved by shareholders, no option re-pricing, average options granted not in excess of 3% of outstanding shares, all directors attended 75% of board meetings, board guidelines in each proxy statement, and directors subject to stock ownership guidelines: *ibid* at 411.
[11] Lucian Bebchuk, Alma Cohen & Allen Ferrell, "What Matters in Corporate Governance?" (2009) 22:2 Rev. Finan. Stud. 783.
[12] *Ibid* at 797.

Tobin's *Q*, as well as with stock returns during the 1990–2003 period.[13] They argue that, "constitutional limitations on shareholder power do bring about… lower firm value…[and] the correlation that poison pills and golden parachutes have with lower firm value at least partly reflects the greater tendency of managers of firms with lower firm value to adopt takeover readiness provisions."[14]

Other authors have also identified specific governance provisions that lead to an increase in firm value.[15] Klein finds positive links between board composition, as measured by percentages of inside directors on finance and investment boards, and accounting and stock market measures of performance.[16] Henry, looking at data from Australia, finds no material valuation effects for eight internal governance attributes considered separately, but finds ownership structure to be significantly related to valuation outcomes.[17] He also finds that institutional shareholders act as a positive monitoring influence, and that the adoption of a comply-or-explain best practices regime is associated with enhanced valuation outcomes.[18]

Core, Guay and Rusticus (CGR) observe that GIM study a relationship between governance and stock market performance in addition to measures like sales growth and profit. But they claim that these measures are not appropriate proxies for studying the effects of governance on a firm's operating performance. Focusing on this relationship, CGR find that firms with weak shareholder rights exhibit significant operating underperformance. [19] Contrary to GIM, their results do not support the hypothesis that weak governance causes poor stock returns. [20]

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[13] Tobin's Q ratio measures the value of a company's stock based on the relationship between its market value and the replacement cost of its assets: See James Tobin & W.C. Brainard, "Asset Markets and the Cost of Capital", in Richard Nelson & Bela Belassa, eds., *Economic Progress, Private Values and Public Policy: Essays in Honor of William Fellner* (Amsterdam: North-Holland Pub Co, 1977); Bebchuk, Cohen & Ferrell, *ibid* at 800.
[14] *Supra* note 11 at 823.
[15] April Klein, "Firm Performance and Board Committee Structure" (1998) 41:1 J. Law Econ. 275.
[16] *Ibid* at 277.
[17] Darren Henry, "Corporate Governance Structure and the Valuation of Australian Firms: Is There Value in Ticking the Boxes?" (2008) 35:7 & 8 J. Bus. Finan. Account. 912 at 938. In particular, valuations are maximized where directors and institutional investors own a significant share of total issued capital (at 929-30).
[18] *Ibid*. Henry finds positive and long-term impacts on valuation from adoption of the best practice recommendations by the Australian Stock Exchange for corporate governance, which included a "comply or explain" regime that emphasizes disclosure of compliance information. This implies value from "ticking the boxes" of a code of best practices (at 931-32, 938).
[19] In particular, finding a correlation between weak governance and lower performance: see John E. Core, Wayne R. Guay & Tjomme O. Rusticus, "Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations," (2006) 61:2 J. Finance 655; see also Xavier Giroud & Holger M. Mueller, "Corporate Governance, Product Market Competition, and Equity Prices" (2011) 66:2 J. Finance 563.
[20] *Ibid.*

A 2009 report by Mercer synthesizes data from 36 academic studies on the effects of environmental, social and governance (ESG) factors on corporate or portfolio performance.[21] The report explains that 20 of these studies showed a positive link between ESG factors and firm or investment performance while three studies found evidence of a negative relationship.[22] The report concludes that there is overall support for a strong positive correlation between governance and performance among the group of studies that examined governance factors in isolation.[23] For studies testing ESG materiality more broadly, the report found wide differences in the reported results depending on the sectors studied.[24]

2. Canadian Evidence

Canadian evidence on the link between performance and governance is less extensive. The most comprehensive study appears to be by Klein, Shapiro and Young (KSY), who examine the relationship between firm performance, as measured by Tobin's Q, and indices of corporate governance for 263 of the largest Canadian firms.[25] These indices measure board composition and effectiveness, compensation policies, shareholder rights (i.e., existence of employee stock options and subordinate shares that dilute ownership and voting rights) and disclosure practices (intended to measure a company's public commitment to good governance).[26]

KSY conclude that corporate governance is relevant to shareholder value in Canada but certain governance mechanisms are more important than others. In particular, KSY find that the valuation effects of governance elements differ according to firms' ownership structure, yet find no evidence that ownership is significant when the effect of the total governance index is considered. They find that effective compensation (understood as the alignment of management interests with those of shareholders),[27] disclosure and shareholder rights practices increase firms' performance regardless of their ownership

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[21] Including 20 from a previous report, Mercer LLC and the Asset Management Working Group of the United Nations Environment Programme Finance Initiative, "Demystifying Responsible Investment Performance," (October 2007); see Mercer LLC, "Shedding Light on Responsible Investment: Approaches, Returns and Impacts," (November 2009).
[22] The remainder revealed either a neutral-positive, neutral, or negative-neutral relationship: Mercer LLC, *ibid* at 2; see Appendix A to the 2009 report for an index of all 36 studies from both the 2007 and the 2009 report.
[23] *Ibid* at 43.
[24] According to the authors, this indicates that research needs to be conducted at the disaggregated rather than aggregate level: *ibid* at 2.
[25] Peter Klein, Daniel Shapiro & Jeffrey Young, "Corporate Governance, Family Ownership and Firm Value: the Canadian Evidence" (2005) 13:6 Corp. Gov. 769.
[26] *Ibid* at 771.
[27] *Ibid* at 780.

structure.[28] Interestingly, they find that board independence, the most heavily weighted provision, had no positive effect on firm performance.

Another important study is one by Bozec and Bozec who investigate the governance-performance relationship while proposing an alternative measure of firm performance: the weighted-average cost of capital.[29] They use panel data for 155 Canadian firms (517 firm-year observations) over a four-year period from 2002 to 2005. They measure "corporate governance" based on the corporate governance index published by The Globe and Mail Report on Business. Bozec and Bozec find strong evidence that the cost of capital decreases as the quality of corporate governance practices increases. Canadian firms with higher governance scores have lower weighted average cost of capital.

Gupta, Kennedy and Weaver (GKW) examine 200-270 companies listed on the Globe and Mail's Report on Business governance index which measures corporate governance strength according to four sub-categories: board composition; board and CEO compensation; shareholder rights; and disclosures relating to board governance.[30] GKW examine the association between the composite or sub-category corporate governance scores and various measures of firm value between 2002 and 2005 using three distinct sets of metrics: relative market valuation as measured by Tobin's Q and market-to-book ratio, firm's operating performance as measured by its return on assets, and market reaction to the Globe and Mail rankings as measured by the 11-day stock returns and 2-day stock returns around the time they are published.[31]

GKW do not find a strong pattern of association between the annual corporate governance scores as reported by the Globe and Mail and other measures of firm value described above. They observe similar results when they consider this association at the sub-category level where some sub-categories were significant, but on an inconsistent basis. They conclude that the Globe and Mail rankings have no impact on firm value, accounting measures of firm performance or market reaction to these annual disclosures.[32]

3. Firm Environment and Firm Value

Some studies examine factors in a firm's environment that strengthen (or weaken) the link between good governance and firm value. Cremers and Ferrell construct the GIM

[28] *Ibid* at 770.
[29] Yves Bozec & Richard Bozec, "Overall Governance and Cost of Capital: Evidence from Canada Using Panel Data" (2010) 6:1 J. of Global Business Management 1.
[30] Parveen P. Gupta, Duane B. Kennedy, & Samuel C. Weaver, "Corporate Governance and Firm Value: Evidence from Canadian Capital Markets" (Spring 2009) 6:3 Corp. Ownership & Control Journal 293.
[31] *Ibid* at 297.
[32] *Ibid* at 301.

index for 30 years in order to account for the widespread governance changes that occurred between 1978 and 1989.[33] They find the correlation between the GIM index and firm value arises only after the decision of the Delaware Supreme Court in *Household,* which validated unilateral adoption by a board of a poison pill and anti-takeover defenses generally.[34] They conclude that the effects of poor governance are greater when a firm is in an industry that is experiencing high levels of M&A activity in a given year.[35]

Ammann, Oesch and Schmid build on research that shows that competition in the product market is a substitute for corporate governance by imposing pressure on managers to maximize firm value.[36] Using 64 governance attributes from Governance Metrics International, they suggest that the positive effects of good governance are: increased investments, less acquisition expenditure, and decreased value-destroying diversification. These translate to higher firm value as measured by Tobin's Q. They conclude that corporate governance is significantly related to firm value in non-competitive industries alone.[37] This is partly because in competitive industries, competition in the product market acts as a selection mechanism against firms with poor governance practices and imposes disciplinary pressure on managers to maximize firm value (thus, decreasing agency costs).

Chen et al. explore the relationship between external financing needs, corporate governance and firm value.[38] They confirm that high firm value is associated with good governance practices but also raise a caveat. When firms require credit, they face incentives to improve corporate governance. These incentives include positive signal to investors that can in turn result in easier capital raising and higher firm value. Chen et al. argue that there may be incentives in terms of reduced financing costs for firms that seek external financing to improve their governance in areas that will lead to greater firm value.[39] Good governance can reduce the costs of external financing by lessening information asymmetries between firms and their investors.[40]

4. Governance Prediction Studies

[33] Martijn Cremers & Allen Ferrell, "Thirty Years of Shareholder Rights and Firm Valuation" (2010) CELS 2009 4th Annual Conference on Empirical Legal Studies Paper, online: Social Science Research Network <http://ssrn.com/abstract=1413133>.
[34] *Moran v. Household Int'l Inc.*, 500. A.2d 1346, 1356 (Del. 1985); Cremers & Ferrell, *ibid* at 3.
[35] Cremers & Ferrell, *ibid* at 4.
[36] Manuel Ammann, David Oesch & Markus M. Schmid, "Product Market Competition, Corporate Governance and Firm Value: Evidence from the EU Area" (2011) Europ. Finan. Manage. [forthcoming]
[37] *Ibid.* See also Giroud & Mueller, *supra* note 19.
[38] Wei-Peng Chen et al., "External Financing Needs, Corporate Governance and Firm Value" (2010) 18:3 Corp. Gov. 234.
[39] *Ibid* at 244.
[40] *Ibid* at 236.

While many studies illustrate a link between good corporate governance and firm value, none show this relationship to be a causal one, which understandably would be difficult to demonstrate empirically. However, there is a relatively new line of research that investigates factors that influence firms' corporate governance practices. Black, Jang and Kim (BJK) investigate factors that may predict the governance practices of Korean firms and test the relative significance of regulatory, industry and firm-level factors.[41] They find that regulatory factors are highly important for large firms as the rules impose special requirements on larger firms.[42] Overall, they conclude that while better corporate governance does not necessarily predict higher firm profitability, it does appear to predict lower cost of external capital (reasoning that perhaps investors expect insiders to engage in less self-dealing).[43]

Black and Kim attempt to build on BJK's research and strengthen the causal connection that they observe between governance reforms and market values.[44] They use a legal shock to governance as a basis for identifying a causal relationship between board structure and firm value. Korea adopted governance rules that mandate 50 percent outside directors and an audit committee for large public firms, but not smaller firms. They find that the legal shock produces large share price increases for large firms relative to mid-sized firms.[45]

Braga-Alves and Morey extend this research by examining which factors predict firm governance in emerging markets using time series data.[46] They draw two main conclusions: first, there is a positive and significant relationship between changes in firm size and changes in firm governance; and, second, the level of political risk of the country where the firm resides or conducts business has a negative and significant effect on the level of firm governance but a positive and significant effect on changes in firm governance.[47] Thus, firm governance is high in countries with lower political risk but firms are more likely to improve governance practices in countries with higher political risk.

In terms of the international regulatory environment, firms appear to have incentives to adopt corporate governance mechanisms even if such mechanisms are not mandatory.

[41] Bernard S. Black, Hasung Jang & Woochan Kim, "Predicting Firms' Corporate Governance Choices: Evidence from Korea" (2006) 12:3 J. Corp. Finan. 660.
[42] *Ibid* at 661.
[43] *Supra* note 42.
[44] Bernard S. Black & Woochan Kim, "The effect of board structure on firm value: A multiple identification strategies approach using Korean data" (2012) 103:1 J. Finan. Econ. 203.
[45] *Ibid* at 204.
[46] Instead of cross-sectional data such as used by previous studies in the area: Marcus V. Braga-Alves & Matthew Morey, "Predicting Corporate Governance in Emerging Markets" (2012) 31:6 J. Int'l Money & Finance 1414.
[47] *Ibid.*

Anand, Milne and Purda examine the extent to which Canadian firms complied with domestic corporate governance best practice guidelines and U.S. corporate governance law including the Sarbanes-Oxley Act. They ask whether voluntary compliance under both regimes occurred and whether cross-listing status and ownership concentration influenced firm behavior. Their results show increasing compliance rates with both regimes over a five-year period, although adoption rates for U.S. standards exceeded rates for Canadian best practices in later years, even for non-cross-listed firms. When given a choice in a best practice regime such as Canada's, firms appear to look beyond domestic law in establishing their governance structures.[48]

5. Conclusion

Overall, there is a strong consensus in the literature that corporate governance is linked positively to firm value. Further, many studies show that the environment in which the firm operates may influence this relationship. The findings show only a correlation between governance and firm value; the question of causation remains for the most part unanswered. A more recent line of research aims to demonstrate a causal connection between governance and market value by looking at exogenous factors that predict governance (such as firm size and political risk).

[48] Anita Anand, Frank Milne and Lynnette Purda, "Domestic and International Influences on Firm-Level Governance: Evidence from Canada," (2012) 14(1) *American Law and Economics Review*, 68-110.