CORPORATE GOVERNANCE AND FIRMS’ VALUE IN CANADA
2005-2010

by

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ABSTRACT

The purpose of this paper is to examine the relationship between corporate governance and the value of 115 Canadian companies for the period of 2005-2010, using such indicator as corporate governance index (CGI). This index includes four sub-indices: board composition (BC), compensation policies (C), shareholders rights (SR), and disclosure policies (D). The index is based primarily on values given by the Globe and Mail’s Report on Business (ROB) from various years and various measures of firms’ performance. It also compares various profitability indicators and other parameters obtained from balance sheets, income statements and financial data from the OSIRIS database and S&P Capital IQ, among others. Overall, this study does not find a relationship between corporate governance and the various measures of a firm’s value.
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The importance of corporate governance is a matter of considerable debate worldwide by academics, regulators, executives and investors. The episodes involving Enron, Tyco, WorldCom, Satyam, and others have pointed to the failures of corporate governance due to how it has finally led to the demise of these firms. Some of the episodes of inappropriate corporate governance failures indicate fraudulent accounting methods, tunnelling, asset stripping, overpaying executives and abuses of stock options. In the US, the corporate scandals led to the Sarbanes-Oxley Act of 2002 and to various amendments to US stock-exchange regulators.

“Corporate governance” refers to mechanisms that are put in place for what is commonly called as the “agency problem”: the process by which shareholders (owners) and creditors (those who lend money) of the firm in getting a return on their investment (Shleifer & Vishny, 1997). This process also includes managers (who control the firm), lenders and other stakeholders (unions, societies, etc.). If better governance means that investors’ funds are used for the purposes of productivity, then that would result in a better financial outcome.

Prior studies indicate that corporate governance is important to shareholders’ value (Kim & Nofsinger, 2007). Previous studies on corporate governance have highlight the board of directors, executive compensation, and the relation to owners and takeover defenses. The empirical literature on the impact of corporate governance
on firm performance is divergent. Studies conducted by Black (2001), Dedman (2002), Core, Guay and Rusticus (2006) have found a positive correlation between corporate governance and performance. On the other hand, studies led by Gompers, Ishii and Metrick (2003), Chen, Cheung, Stouraitis and Wong (2005), and Ferreira and Laux (2007) find a weak correlation between governance and firm performance.

In Canada, a study by Klein et al. (2005) finds that corporate governance does matter in the financial outcome. However, the empirical results are generally mixed. Given the divergent results, the present study examines the impact of corporate governance variables on the financial outcome of 115 Canadian firms for the period 2005 to 2010 using the corporate governance index (CGI) and comparing aspects of governance such as board composition, shareholders and compensation policies, and shareholder rights policies and disclosure policies, as well as numerous performance indicators such as ROA, ROE and Tobin's q, among others. It will also consider financial data for six years instead of just one year. Inference will be developed by looking at descriptive statistics in order to determine whether corporate governance plays an important role in company success.

The study is organised as follows: Chapter II presents a review of literature. Chapter III describes the database and methodology used in the study. Chapter IV presents the empirical results. Chapter V presents concluding observations.
Chapter II

LITERATURE REVIEW

There has been a considerable amount of research done on corporate governance and firm performance around the world. In this chapter, we briefly review the theoretical and empirical literature on the impact of corporate governance on company financial performance. This chapter is organized as follows: Section 1 discusses the corporate governance concept. Section 2 reviews the relationship between board composition and company performance. Section 3 examines the relationship between executive compensation and firm performance. Section 4 reviews the shareholders’ rights policies. Section 5 reviews the empirical literature on various indicators of corporate governance and firm performance. Section 6 records the conclusions of this chapter.

I. Corporate governance definition.

Trying to define corporate governance is a challenge because it is a subject that is difficult to quantify; despite this fact, Charkham (1991) describes corporate governance as “the system by which companies are run.”

Numerous studies have tried to use different theories to define corporate governance—the manager-oriented theory that originates in the USA, the labor-oriented theory embraced by Germany, the state-oriented theory adopted by France and many countries in Asia (Hansmann & Kraakman, 2000)—but they have failed to
leave space for the agency model where the CEO is considered the head of the managers. For that reason, it has been necessary to have a strong independent board that fulfills the governance functions (Murphy, 1985).

La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) say that “corporate governance is a set of mechanisms by which the outside shareholders protect themselves against the managers and controlling shareholders”; in the same sense, Cadbury (2003) defines corporate governance as the process by which individual corporations are managed and controlled (Claessens, International Finance Corporation, 2003).

The corporations have CEOs and directors that create strategies and policies to achieve their goals: profits without the need to invest, leading to the shareholders—the true owners—being able to enjoy those profits without participating in the company’s operations. The relationship derived from these activities is what corporate governance study includes (Monks & Minow, 1995). Cadbury disagrees with this assertion, since he considers shareholders to have three core rights or duties: to appoint the directors, to appoint the auditors, and to assure that the company has effective corporate governance (Naciri, 2008). Therefore, the shareholders do participate in the company’s operations.

Jensen and Meckling (1976), in early studies, point out that the firm’s goal is to maximize its value; however, the members may have different objectives, and the alignment between them should be a priority in order to have positive results. Making
the right decisions develops a good reputation, making more attractive the company for future investors and reducing the agency cost. However, at some point, the new members will lose interest in pursuing the company’s goals and find it more important to pursue their own interest (Jensen & Murphy, CEO incentives-it’s not how much you pay, but how, 1990).

According to other studies, corporate governance is the process where investors attempt to guarantee for themselves a return on their investment; therefore, the corporate manager should make decisions that consider the interests of shareholders, whether those shareholders have the right to vote or not (Foerster & Huen, 2004); (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000); (Shleifer & Vishny, 1997). Corporate governance addresses the issues whereby principle shareholders are the owners of the company, and they want to ensure that the managers act in the best interests of that principle (Foerster & Huen, 2004).

According to Rezaee (2004), the main purpose of corporate governance is to minimize the conflicts between managers and shareholders through auditors who should monitor the quality of the financial reporting process. Corporate governance helps to improve the efficiency and quality of financial reporting, and it is based on the managers’ accountability to the board of directors, as well as on the responsibility that the board of directors has to align the interests of managers, directors, and stakeholders (Rezaee, 2004).
Corporate governance depends upon regulatory-level and firm-level mechanisms, which are set in place to ensure appropriate governance standards. Regulatory-level governance mechanisms include a country's laws, its culture and its norms (Shleifer & Vishny, 1997); therefore, governments have created more specific regulations for the people involved with the corporations; Canada has made numerous contributions in this matter, and the most important are: (1) the Dey Report, which was inspired by reports from the UK and USA and which introduced guidelines for board responsibilities for strategy and risk, independence, evaluation and disclosure, and those basic capabilities that any board should focus on; (2) the Saucer Report, inspired again by the UK and USA reports, this time including organizations such as the Toronto Stock Exchange (TSX) and the Canadian Institute of Chartered Accountants (CICA); and (3) the Canadian Security Administrators (CSA), who created a series of National Instruments, which covered divergent aspects of corporate governance such as independence of all members of the board, audit committees and compensations committees, and disclosure of accounting reports and stock-option plans (Naciri, 2008).

When investors finance a company, they generally gain certain rights and powers that are protected through regulations and laws such as accounting and disclosure rules (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000); (Shleifer & Vishny, 1997). However, those regulations do not have influence on the internal policies of the corporations; therefore, they do not guarantee improvement in the efficiency of corporate governance. Firm-level mechanisms are internal to the company, and these internally regulating mechanisms are heavily influenced by a
firm’s charter, regulations and policies (Aggarwal, Erel, Stulz, & Rohan, 2007). For that reason, many studies have tried to identify aspects that are important in good corporate governance and to discover whether those are related to corporate performance.

Many studies focus on the relationship between corporate governance and a firm’s value, but some recent studies examine if corporate governance can be measured and if the resulting score is related to good corporate performance. Companies such as Standards and Poor’s Rating Services (S&P) state that the measurements of corporate governance are key to a company’s performance; therefore, its criteria include “all fundamental quantitative and qualitative elements, analytical methodologies, and assumptions that” its employees “use in the ratings process to produce” their opinions (The McGraw-Hill Companies, 2009). This institution takes into consideration factors such as board structure, ownership and shareholder rights, location (global, regional or local), and industry, and it also takes note of all types of qualitative or quantitative assumptions, which cause it to arrive at a certain rating opinion.

Governance Metrics International (GMI) is an independent corporate governance research and rating agency that rates companies based on their inclusion in a market index followed by the MSCI EAFE index, Russell 1000 or S&P 500 Index, among others. This company gives corporate governance rating services on three levels: by geographic region (e.g., companies rated by GMI in North America, Europe or the Asia-Pacific region), by market sector or industry group (e.g., health
care) and, for smaller institutions, through customized portfolio coverage. It has found a consistent relationship between governance and performance and has pointed out governance weaknesses before events unfolded publicly at a number of high-profile companies (GMI).

Also, the Globe and Mail's Report on Business (ROB) is another source that provides analysis by sector (agriculture, mining, manufacturing, finance services; etc.), region (Africa, Asia, Europe, Latin America; etc.), and exchange (Abu Dhabi Securities Market, Amman Stock Exchange, Barcelona Stock Exchange, Chicago Board of Trade Electronic; etc.). It is believed that the corporate governance index is related to corporate performance. The corporate governance index published by this company is the one used in the present study.

II. Board composition and company performance.

The main purpose of corporate governance resides in minimizing the conflicts between managers and shareholders through auditors who monitor the quality of the financial reporting process. Corporate governance helps to improve the efficiency and quality of financial reporting; this governance is based on the managers' accountability to the board of directors and on the responsibility of that board to align the interests among managers, directors, and stakeholders (Rezaee, 2004); (Hermalin & Weisbach, The effects of board composition and direct incentives on firm performance, 1991). The literature reviewed has shown the relationship between shareholders, the board of directors and top management. The board composition of a
business may vary depending on different elements such as the percentage of the directors, audit committees, compensation committees and nominating committees that are independent, and the size of the board; the separation between the chair and CEO roles; the CEO’s commitments outside the firm with other boards; the frequency of the meetings; etc. In the following paragraphs, this study briefly reviews some of aspects of the board of directors.

Board size.

The literature indicates that the size of the board is important for the performance of a company, a strategic factor that can influence the structure and performance of the organization. Some studies support the idea that when the size of the board is bigger, it becomes more difficult to monitor, making management a problem due to a large board (Jensen M. C., The modern industrial revolution, exit and the failure of internal control systems., 1993). The boardrooms are dysfunctional places where the directors rarely discuss firm performance or any of the policies implemented by the top managers (Lipton & Lorsch, 1992).

The size of the board should not be equal for all firms. Researchers who have studied this issue have come to various (sometimes contradictory) conclusions. Some support the idea that when a board gets beyond seven or eight people, it is less likely to function effectively and will be controlled and manipulated by the CEO much more easily (Jensen M. C., The modern industrial revolution, exit and the failure of internal control systems., 1993); others maintain that the size of the board should be
ten members, with eight or nine being the ideal (Lipton & Lorsch, 1992). The Cadbury committee (Cadbury Committee, 1992) recommends eight to ten members maximum as an ideal size of the board.

According to Monk and Minow (1995), the size of the board does matter, as it influences monitoring, controlling and decision making in the firm. Small boards are said to help in alleviating the effort problem and in becoming more effective (Jensen M. C., The modern industrial revolution, exit and the failure of internal control systems., 1993); (Lipton & Lorsch, 1992); however, when small firms grow too big, boards become more symbolic rather than being a part of the management process (Hermalin & Weisbach, Boards of directors as an endogenously determined institution: a survey of economic literature, 2003).

In opposition, some studies support the idea that bigger boards provide diversity that would help companies to secure critical resources and reduce environmental uncertainties; board size is related to the firm’s environmental needs (Pfeffer, 1972). He says “that board size and composition are not random or independent factors, but are, rather, rational organizational responses to the conditions of the external environment” (Pfeffer, 1972). Sanders and Carpenter (1998) support the idea that the size of the board is related to the level of necessity of the company; the firm’s internalization is complex, and this fact has to be reflected in the board structure (Sanders & Carpenter, 1998).
Core, et al. (1999), using a large sample of US data, finds no association between board size and firm financial performance; in contrast, Yermack (1996) finds a significant negative relation between the two of them based on Tobin’s q. A study that draws on a large sample of firms from 52 countries to investigate the relationship between firm performance and the number of directors finds that there is a positive relationship between past performance and changes in the number of directors (Heaney, et al., 2005); however, many scholars support the idea that board composition and size are related to the strategy of the company and its external environment (Pearce & Zahra, 1992).

**Board composition.**

The board composition is another strategic element in the corporate governance of internal organization. Today, corporations take into consideration many factors such as independence, gender, nationality, efficiency, and professional background; independence is determined by the number of inside and outside members. The board of directors is one of the important institutions of internal control; it provides governance safeguards (Baysinger & Hoskisson, 1990). Various researchers have different opinion about the number of outside and inside directors a company should have. The independent directors do not necessarily transform into better performance, since the inside director can contribute more with valuable information about the company’s long-term decisions. According to Klein (1998), there is a positive relationship between firm’s financial performance and the inside
directors, especially if they serve on finance and investment committees, since the firm’s accounting and market value will consequently improve (Klein A., 1998).

The different regulatory regimes in Canada and the United States have resulted in considerably different corporate governance practices. Canadian companies have smaller boards with few independent directors; the boards meet more frequently; their directors sit on a greater number of boards, are less likely to have a CEO also serving as chair of the board, and are less likely to have compensation. As well, the fraction of independent directors sitting on nominating and corporate governance committees is significantly lower. (Broshko & Li, 2006)

Canadian corporate governance follows the Anglo-American model; however, it is different from the US and UK structures of corporate ownership. According to Klein, Shapiro and Young “most Canadian companies are family owned, controlled by a principal shareholder” (Monks & Minow, 1995); (Klein, Shapiro, & Young, 2005). This structure is reflected in the board’s composition and the fact that the majority of inside directors keep a strong influence on decision making. Therefore, the minority of shareholders are becoming more active (Monks & Minow, 1995).

To determine the relationship of corporate governance and performance, most Canadian studies concentrate on the board’s independence or on the separation of CEO and chair; actually, however, it is more important to consider the process of how the boards work and make decisions. According to Leblanc and Gillies “improving process will not only improve board governance but will also prove that there really
is a link between a board of directors and a firm's financial performance.” (Leblanc & Gillies, 2003)

Other studies consider board independence to have a negative effect on the markets. Considering recent scandals, it seems a better alternative to have inside directors who do not misallocate the company’s resources (Bhagat & Bolton, Corporate governance and firm performance, 2008). According to Bhagat and Black (1999), there is a negative correlation between the proportion of independent directors and firm performance; the independence can overwhelm the company with excessive monitoring (Baysinger & Hoskisson, 1996) due to a lack of business knowledge, resulting in poor performance. Dahya, et al. (1996), Steward (1991), and Rechner and Dalton (1991) support the idea that effective performance can be achieved by reinforcing the manager’s control and responsibilities. As per Haniffa and Hudaib (2006), the non-executive directors or outsiders reduce the agency conflicts associated with the potential mismanagement of the company’s resources; however, they do not have the capacity to monitor the board’s activities due to a lack of knowledge of their responsibilities. Therefore, this characteristic does not necessarily reflect improvement in the firm’s performance (Haniffa & Hudaib, 2006).

Also, Prevost, Rao and Hossain (2002) find that firm performance and board composition have a positive correlated influence on each other, since a firm’s performance can be impacted by the composition of the board, and the composition of the board can be impacted by the performance of the company (Prevost, Rao, & Hossain, 2002).
According to the study by Erickson, Parka, Hyun, and Shin (2005), boards with more independence do not have a positive impact on firm performance, especially in the presence of significant ownership concentration such as in Canadian companies. Similarly, Dalton, Johnson, and Ellstrand (1999) and Bhagat and Black (2000) did not find any relationship between independence of the board and firm performance using performance indicators (accounting or market return) and “board composition” measured in terms of whether it is outside, interdependent, or affiliated. Dahya and McConnell (2003) examined UK companies over 1989-1996 and found that the companies that followed the Cadbury recommendation (which mandates at least three outside directors for publicly-traded corporations) improved their operating performance significantly.

III. Executive compensation and firm performance.

In Canada, many of the largest firms are legally controlled by individuals, families or private holdings companies (Rao & Lee-Sing, 1996); for this reason, it has been necessary to establish independent mechanisms of control and monitoring, causing increase of payment to top executives for their performance. The level of compensation for chief executive officers (CEOs) has been a topic of considerable controversy in the academic and business world. Core, Holthausen and Larcker (1999) argue that the board of directors is subjected to the CEO’s decisions, and consequently, it does not structure the CEO’s compensation package to maximize the profit for the shareholders (Core, Holthausen, & Larcker, 1999).
The shareholders’ pressure has helped to control executive pay in Canada (McFarland, 2010); in the academic and business worlds, there is an extensive discussion about executive compensation, but it is not clear yet what kind of structure such compensation should have if it is to solve the agency problem and the performance of the company. Linking corporate performance and executive compensation policies can align the interests of the manager and shareholders (Murphy, 1985). In their study, Jensen and Murphy (1990) describe the problem of CEOs behaving according to compensation; if they are paid as bureaucrats, they will behave as bureaucrats. The solution is to pay CEOs more equity-based compensation as opposed to cash compensation, as it provides managers with the correct incentive to maximize firm value (Jensen & Murphy, CEO incentives-it's not how much you pay, but how, 1990). Contrarily, Mehran (1995) argues that there is little evidence on whether corporations whose executive compensation is more equity-based have better performance; he finds that both Tobin’s q and ROA are positively related to the percentage of executives’ total compensation that is equity-based as well as the percentage of shares owned by top managers. This finding suggests that executive compensation has a positive impact in the managers’ performance and prompts them to become more efficient and effective (Mehran, 1995).

Klein (1998) argues that the structure of the boards (the inside directors on finance and investment committees) and the firm performance are significantly related; board characteristics and ownership structures have a substantive cross-sectional association with the level of CEO compensation (Klein A., 1998). Basu, Hwang, Mitsudome, and Weintrop (2007) examine 174 Japanese corporations,
finding that corporate governance with weak structures have more agency problems, paying more to their CEOs and having a poor performance; therefore, the greater stock ownership by the board is associated with the higher income of the top executive (Basu, Hwang, Mitsudome, & Weintrop, 2007). Despite the extensive studies about corporate governance and its relationship with corporate governance, the results are contradictory, which makes it necessary to analyse more closely the influence that corporate governance has over firm performance.

IV. Shareholders' rights policies.

Public companies are characterized by the separation of ownership and control. The shareholders delegate the decisions (control) to corporate managers; however, the most effective way to control managers’ behaviour is by giving them the right to vote on the major issues. The same policy works as regards the shareholder’s equity stake in the firm (Gry, 2005).

According to Jiraporn (2006), companies where shareholders’ rights are weak tend to repurchase less stock due to the managers’ ability to identify this weakness and retain more cash within the company. On the contrary, companies with strong shareholders’ rights force managers to expel cash to stockholders in the form of repurchases. The companies where shareholders’ rights are weak are more likely to be industrially diversified due to the exploitation of shareholders by the managers and the unwise diversification of the company. As a result, industrially diversified firms exhibit a reduction in value. Companies with better corporate governance practices
tend to respect shareholders' rights much more than companies with weaker corporate governance practices (Jiraporn, Share repurchases, shareholder rights, and corporate governance provisions, 2006).

Claessens (2003) argues that in Asian countries, there is a negative association with the separation of ownership, voting rights and the performance of the company; it is also evident that countries with poor protection for investors have low performance, and countries with high protection for investors have better performance (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000).

La Porta Lopez-De-Silanes, Shleifer and Vishny (2002) state that there is evidence of higher firm valuations in countries where better protection is provided for minority shareholders and in firms with higher cash-flow ownership by the controlling shareholder. In their empirical research, they explain the consequences of corporate ownership for corporate valuation in different legal regimes, and it is empirically demonstrated that poor shareholder protection is penalized with lower valuations and that higher cash-flow ownership by the controlling shareholder improves valuation, particularly in countries with poor track records of investor protection (La porta, Lopez-De-Silanes, Shleifer, & Vishny, 2002).

V. Indicators of corporate governance and firm performance.

A substantial number of studies have attempted to identify elements of corporate governance that are related to firm value; several have been conducted to
examine the relationship between corporate governance and firm performance, but the results have not been unanimous because different elements have been taken into consideration. The question in corporate governance is what mechanism leads to an increase in the company’s value; is it “the legal protection of capitalists, the firm’s competitive environment, its ownership structure, board composition, [or] financial policy?” (Bocean & Barbu, 2012). Various corporate governance provisions affect the outcome of corporate performance, but how do they motivate managers to improve the performance and value of the company for the benefit of shareholders? (Kang & Shivdasani, 1995).

Heracleous (2001), argues that the reason that “best practices” in corporate governance have failed to find a clear connection between corporate governance and firm performance is that best practices are irrelevant and too narrow, so performance and the operationalization of theoretical concepts have a low validity because important factors have been ignored in the analysis (Heracleous, 2001).

In countries such as the US and the UK or in the block-holder-based systems of Europe and Japan, the impact of corporate governance behaviour on market value can be minor. In contrast, firm-level governance behavior has a huge effect on market value in developing countries (Dharwadkar, George, & Brandes, 2000). In developing countries, good governance is a crucial element in all economical transactions (Dharwadkar, George, & Brandes, 2000). In the analysis of corporate governance, if one wants to find the relationship between corporate governance and effective
performance, it is important to take into consideration the context in which
developing and developed countries interact (Heracleous, 2001).

**VI. Conclusions of this chapter.**

A Russian study examines corporate governance and firm performance using
the Brunswick Warburg corporate governance rankings; it finds that companies can
improve their value through better corporate governance practices and thus reduce the
cost of raising capital. This study demonstrates that investors should develop
measures of governance behavior and quantify how governance behavior affects firm
value (Black, The corporate governance behavior and market value of Russian firms,
2001). Another empirical study in Russia finds that firms that can cut unproductive
costs and are led capably with outside monitoring can be more competitive (Judge,
Naoumova, & Koutzevol, 2003).

While examining alternative corporate governance mechanisms to increase
firm value among Japanese manufacturing companies, Hiraki, Inoue, Ito, Kuroki and
Masuda (2003) use a panel data on equity ownership and bank loans of individual
manufacturing companies from the period of 1985 to 1998; they analyze governance
roles undertaken by a main bank, interoperate shareholding, and managerial
ownership. They argue that the effective mechanism of corporate governance should
improve firm performance and be reflected in the shares price; therefore, the banks
(lenders) can influence effective governance of Japanese firm by monitoring (Hiraki,
A Korean study examines the relation between corporate governance measures and firm value in times of crisis. According to Baeka, Kangb and Park (2004), firms with foreign ownership concentration and higher disclosure quality experience a smaller reduction in share price than firms with managers’ ownership concentration, which experience a larger reduction in share price. Also, they find that companies in which controlling shareholders’ voting rights exceed the cash flow rights, as well as those that are indebted more to the main banks, have significantly lower returns. Consequently, during a crisis, governance practices determine firm value (Baeka, Kangb, & Parkc, 2004).

Haniffa and Hudaib (2006) have studied the relationship between six corporate governance structures (board size, board composition, CEO duality, multiple directorships, shareholdings held by the top 5 major shareholders, and shareholdings held by directors), as well as (1) market (measured by Q-Ratio) and (2) accounting (measured by ROA), and found that large boards are seen as less effective in monitoring performance, a fact reflected in the market price. These boards can also increment the compensation packages; however, in the accounting return, Haniffa and Hudaib (2006) found that big boards can provide their companies with the expertise to enhance performance. According to their study, the non-executive directors or outsiders reduce the agency conflicts associated with the potential mismanagement of the company’s resources; however, they do not have the capacity to monitor the board’s activities due to a lack of knowledge of their responsibilities. Therefore, this characteristic does not necessarily reflect improvement in the firm’s performance (Haniffa & Hudaib, 2006).
Bauer, Frijhns, Otten and Tourani-Rad (2008) analyze Japanese companies combining elements of corporate governance (board accountability, financial disclosure and internal controls, shareholder rights, remuneration, market for control, and corporate behavior) in an index, finding that well-governed firms outperform poorly governed companies by up to 15% a year, even after correcting for market risk, size, and book-to-market effect. They argue that not all elements affect corporate value; elements related to financial disclosure, shareholder rights and remuneration impact the stock price, and elements related to board accountability, market for control and corporate behavior do not affect the stock price (Bauer, Frijhns, Otten, & Tourani-Rad, 2008).

Javed and Iqbal (2007) analyse the relationship between a firm’s value as measured by Tobin’s q; and the total corporate governance index (CGI) that they use is integrated by three sub-indices: board, shareholdings and ownership, and disclosures and transparency. In contrast to the corporate governance index used in the present study, the index in this study does not contain compensation policies. Javed and Iqbal (2007) suggest that corporate governance does matter, and their conclusions coincide with other research indicating that not all elements of governance are important; they argue that the two first sub-indices (board composition and shareholders) increase the company’s value, and that the third sub-index (disclosure and transparency) does not have an effect on firm performance. The poor productivity and the bad corporate governance in a company cannot be covered by disclosure standards (Javed & Iqbal, 2007).
CORPORATE GOVERNANCE AND FIRMS' VALUE IN CANADA 2005-2010

When one uses different ranking systems such as Standards & Poor's index, the FTSE rating, and W&C, there is a discrepancy in the scores obtained from the same sample (companies from UK, Ireland, Germany, France, Italy, Spain and Sweden); in the indices where more weight is placed on disclosure, the scores are similar, but some countries’ results variation is higher in the sense that the institutions focus on measuring different indicators of the company, having different criteria when assigning a number to the financial indicator, board composition, etc. (Carlin, 2009). However, the results coincide with the fact that if companies have good levels of disclosure and the institution rating gives a high number to that indicator, then there is evidence of the association between performance and corporate governance (Carlin, 2009).

While analysing the relationship between corporate governance and firm performance, Donker and Zahir (2008) argue that the relationship, if any, is weak because the rating score is set arbitrarily. They also point out that the rating systems converge to a single number and this does not reflect any details, probably resulting in inaccurate assumptions. As well, the information is usually provided by the companies, so it cannot be totally reliable (Donker & Zahir, 2008).

In this context, it is important to realize that corporate governance will remain the centre of many discussions; however, aspects such as the country in which the company operates, the political opportunities, the law and regulations must be considered when one is evaluating firm performance.
Chapter III
DATABASE AND METHODOLOGY

The primary interest of this study is the relationship between corporate governance and firms’ value in Canada; this chapter describes, in turn, the database and the methodology used in this study.

**Database**

The present examination uses the corporate governance index (CGI) published by the Globe and Mail’s Report on Business (ROB). This data is available at www.theglobeandmail.com/globe-investor/, an online investment website affiliated with the ROB. The data comes from the proxy circulars that Canadian companies file at the Ontario Securities Commission (OSC).

Although 270 firms were initially ranked by the ROB, comparable data is available for only 115 firms on a consistent basis; consequently, the present study is based on 115 Canadian companies over six years (2005-2010), which better reflects the performance of a company than would using just one year.

The Globe and Mail publishes overall corporate governance index (CGI), which has a maximum value of 100. This index is a compilation of corporate governance characteristics obtained by summing up four sub-indices: (1) Board composition (BC), (2) Shareholding and compensation policies (C), (3) Shareholder
rights policies (SR) and (4) Disclosure policies (D), described in the following table.

(Table 1)

<table>
<thead>
<tr>
<th>Index</th>
<th>Description</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total index</td>
<td>Measures the sub-indices of board composition and effectiveness, compensation policies, shareholder rights and disclosure practices.</td>
<td><em>Globe and Mail, Report on Business (various years)</em></td>
</tr>
<tr>
<td>(CGI)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Board</td>
<td>Measures the autonomy, structure and effectiveness of directors, audit committee, compensation committee and nominating committee.</td>
<td><em>Globe and Mail, Report on Business (various years)</em></td>
</tr>
<tr>
<td>composition</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(BC)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compensation</td>
<td>Measures the insiders’ access to compensation in the form of stock options.</td>
<td><em>Globe and Mail, Report on Business (various years)</em></td>
</tr>
<tr>
<td>(C)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders’</td>
<td>Measures the rights of shareholders in relation to the stock of the insiders.</td>
<td><em>Globe and Mail, Report on Business (various years)</em></td>
</tr>
<tr>
<td>rights</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(SR)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disclosure</td>
<td>Measures company’s transparency and disclosure practices.</td>
<td><em>Globe and Mail, Report on Business (various years)</em></td>
</tr>
<tr>
<td>(D)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The first sub-index is board composition; it takes in consideration the autonomy, structure and effectiveness of the company. Autonomy is measured by the percentage of the company’s directors and committees (audit, compensation, executive pay, nominating, and recommendation of new directors of committees) that are independent, meaning no affiliation with the firm, the members of the firm, or any business related to the firm. Structure is measured by whether or not the chair and CEO are split, or if there is a senior director. Effectiveness is measured by considerations such as the relationship among directors, if the CEO is busy with outside commitments, if the company has a system to evaluate performance, and frequency of meetings (Klein, Shapiro, & Young, 2005).
The second sub-index is shareholding and compensation policies; it takes into consideration the degree of alignment between managers’ and shareholders’ interests: in other words, executive pay and performance. These policies measure whether or not the directors and CEO are required to own stock, if they own stock or shares, if they have their own separate option plan, and if the firm gives loans (Klein, Shapiro, & Young, 2005).

The third sub-index is shareholders’ rights; it takes in consideration employees’ stock options and subordinate shares that dilute ownership and voting rights. These policies measure whether or not all the directors stand for re-election annually; if the employees’ stock options are excessively dilutive for shareholders; and if the firm’s shares are non-voting or subordinate voting, among other issues (Klein, Shapiro, & Young, 2005).

The fourth sub-index is disclosure policies; it takes into consideration the corporate governance commitment to follow the Ontario Securities Commission regulations. These policies measure whether the company engages in statement of corporate governance practices, disclosure of directors that are related and why, disclosure of payments that the firm has made to auditors, disclosure of biographies of the board members, disclosure of directors that have seats on other boards, and whether the firm discloses the attendance of its directors in meetings (Klein, Shapiro, & Young, 2005).
The corresponding financial data (including a number of profitability indicators such as return on assets, return on equity, earnings before interest and taxes, earnings before interest, taxes and depreciation allowance, Tobin’s q, etc.) and size and leverage indicators 2005-2010 have been collected from the OSIRIS database, S&P Capital IQ and investing.money.msn.com. The profitability indicators are described in the table below. (Table 2)

**Table 2. Description of Financial Variables.**

<table>
<thead>
<tr>
<th>Profitability indicators</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>Earnings before interest and taxes</td>
</tr>
<tr>
<td>EBITABV</td>
<td>Earnings before interest and taxes divided by book value</td>
</tr>
<tr>
<td>EBITDA</td>
<td>Earnings before interest, taxes, depreciation and amortization</td>
</tr>
<tr>
<td>EBITDABV</td>
<td>Earnings before interest, taxes, depreciation and amortization divided by book value</td>
</tr>
<tr>
<td>EBITDATA</td>
<td>Earnings before interest, taxes, depreciation and amortization divided by total assets</td>
</tr>
<tr>
<td>EBITTA</td>
<td>Earnings before interest and taxes divided by total assets</td>
</tr>
<tr>
<td>NI</td>
<td>Net income</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on assets</td>
</tr>
<tr>
<td>ROA1</td>
<td>Return on assets divided by the average of total assets</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on equity</td>
</tr>
<tr>
<td>ROE1</td>
<td>Return on equity divided by the average of total assets</td>
</tr>
<tr>
<td>Tobin’s q</td>
<td>Equity market value plus liabilities book value, divided by the book value plus liabilities book value</td>
</tr>
</tbody>
</table>
Methodology

In order to examine the dynamics of corporate governance and the relationship with performance in a sample of 115 Canadian companies for six years (2005-2010), this study uses simple statistical tools such as descriptive statistics and correlation of various variables to analyze the dynamics of the relationship between corporate governance indicators and profitability.

In the descriptive statistics, the performance of the company was measured first by the total of the corporate governance index and each one of its sub-indices; second by the profitability indicators such as EBIT, EBITABV, EBITDA, EBITDABV, EBITDATA, EBITTA, NI, ROA, ROA1, ROE, ROE1 and Tobin's q; and third by other parameters such as BV, LTA, MV, NS, G and TA (See Table 1 for descriptions of variables).

After the analysis of the corporate governance variables, the corporate governance total index, the four sub-indices, the profitability indicators and other parameters were examined through a correlation coefficient.
Chapter IV

EMPIRICAL RESULTS

This chapter presents results of the empirical exercise as discussed in chapter III. This chapter is organized as follows: Descriptive Statistics of 115 Canadian companies for CGI, financial indicators and other parameters for the period of six years (2005-2010), and correlation between all performance indicators of the sample for the same period of six years.

Descriptive Statistics.

The initial review of the set of data in Table 3 reveals that the mean score of 115 Canadian companies on the CGI index is 69, with a median score of 70. The maximum score of this cohort of companies is as high as 98, but the variation in CGI is high as reflected in a standard deviation of 17.

As far as board composition (BC), which measures the autonomy, structure and effectiveness of the board, goes, the average score and median score is 26. The maximum score in this category is 38, and the low score is 8. The standard deviation is 7.

Similarly, in terms of compensation (C), the second component of CGI, which measures the degree of alignment between managers and shareholders interest, the average score, is relatively low, 16. The median is slightly higher at 17; the maximum
is 26, and the minimum is 1. The variation in CGI is low as reflected in a standard deviation of 5.

In terms of the shareholders' rights (SR), the third component of CGI, which measures employees' stock options and subordinate shares that dilute ownership and voting rights, the average score and median score are 20, which is relatively high. The maximum is 33 and the minimum 2. The variation in CGI is low as reflected in a standard deviation of 7.

Regarding disclosure (D), the fourth component of CGI, which measures the corporate governance commitment to follow the OSC regulations, the average is 7 and the median 8, relatively low. The maximum score of this cohort is 12 and the deviation 3.

<table>
<thead>
<tr>
<th>Corporate governance indicators</th>
<th>Mean</th>
<th>Median</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>CGI</td>
<td>69</td>
<td>70</td>
<td>0</td>
<td>98</td>
<td>17</td>
</tr>
<tr>
<td>BC</td>
<td>26</td>
<td>26</td>
<td>8</td>
<td>38</td>
<td>7</td>
</tr>
<tr>
<td>C</td>
<td>16</td>
<td>17</td>
<td>1</td>
<td>26</td>
<td>5</td>
</tr>
<tr>
<td>SR</td>
<td>20</td>
<td>20</td>
<td>2</td>
<td>33</td>
<td>7</td>
</tr>
<tr>
<td>D</td>
<td>7</td>
<td>8</td>
<td>0</td>
<td>12</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: (1) *Globe and Mail*, Report on Business (various years).
The review of the set of data in Table 4 reveals that on average, each of the 115 Canadian companies has total assets of $33,755,863.78, with the median size being $3,808,350.00, which indicates that there are large firms in the sample. The standard deviation is $101,239,084.00, also possible in high dispersion in the sample (and also the large size). This wide rate is also reflected in market value (market capitalization) of the firms. The average market value at $8,888,038.32 is far different from the median market value of $2,791,001.02. The average value of equity at $5,739,540.40 is totally different from the median value of $1,552,075.50. Similarly, gearing also totally varies from zero to 370.93 percent.

### Table 4. Size and Related parameters of the sample 2005-2010 (N=115).

<table>
<thead>
<tr>
<th>Other parameters</th>
<th>Mean</th>
<th>Median</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Book Value (BV)</td>
<td>5.7</td>
<td>1.5</td>
<td>0.001</td>
<td>209.7</td>
<td>18.4</td>
</tr>
<tr>
<td>Long-Term Assets (LTA)</td>
<td>5.9</td>
<td>2.1</td>
<td>-</td>
<td>61.4</td>
<td>9.0</td>
</tr>
<tr>
<td>Market Capitalization (MV)</td>
<td>8.8</td>
<td>2.7</td>
<td>-0.02</td>
<td>77.6</td>
<td>13.4</td>
</tr>
<tr>
<td>Net Sales (NS)</td>
<td>5.6</td>
<td>2.3</td>
<td>-</td>
<td>37.1</td>
<td>7.3</td>
</tr>
<tr>
<td>Gearing (G)</td>
<td>3.9</td>
<td>0.71</td>
<td>-0.00037</td>
<td>0.000026</td>
<td></td>
</tr>
<tr>
<td>Total Assets (TA)</td>
<td>33.7</td>
<td>3.8</td>
<td>0.019</td>
<td>0.000072</td>
<td>101.2</td>
</tr>
</tbody>
</table>

Source: (1) OSIRIS database; (2) S&P Capital IQ; and (3) http://investing.money.msn.com

A corresponding review of the financial data in Table 5 reveals that the average profitability of 115 Canadian sample companies as revealed by Earnings before Interest and Taxes comes to $883,137, with the median well below at $327,300. The maximum profit of this cohort of companies is as high as $7,939,000, but the variation is high, as reflected in the standard deviation of $1,471,542.06. As a proportion of book value (EBITABV), the average is $9.39, with a median score of
The maximum score of this cohort of companies is as high as $642.91, but the variation is high, as reflected in a standard deviation of $57.88.

Finally, the Tobin’s q average is as high as 2.36%, and the median is 1.93%. The maximum score of this cohort of companies is as high as 27.54%, and the variation is high, as reflected in a standard deviation of 1.95%.

Table 5. Profitability indicators of the sample 2005-2010 (N=115).

<table>
<thead>
<tr>
<th>Profitability indicators</th>
<th>Mean</th>
<th>Median</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBIT</td>
<td>883,137.11</td>
<td>327,300.00</td>
<td>-6,320,000.00</td>
<td>7,939,000.00</td>
<td>1,471,542.06</td>
</tr>
<tr>
<td>EBITABV</td>
<td>9.39</td>
<td>0.20</td>
<td>-117.31</td>
<td>642.91</td>
<td>57.88</td>
</tr>
<tr>
<td>EBITDA</td>
<td>1,238,653.07</td>
<td>532,235.00</td>
<td>-6,223,000.00</td>
<td>10,622,000.00</td>
<td>1,777,584.59</td>
</tr>
<tr>
<td>EBITDABV</td>
<td>9.81</td>
<td>0.29</td>
<td>-105.74</td>
<td>648.45</td>
<td>59.28</td>
</tr>
<tr>
<td>EBITDATA</td>
<td>1.17</td>
<td>0.13</td>
<td>-10.15</td>
<td>136.41</td>
<td>7.87</td>
</tr>
<tr>
<td>EBITTA</td>
<td>0.09</td>
<td>0.08</td>
<td>-11.26</td>
<td>135.24</td>
<td>7.74</td>
</tr>
<tr>
<td>NI</td>
<td>523,408.20</td>
<td>164,891.00</td>
<td>-4,274,000.00</td>
<td>5,633,000.00</td>
<td>980,417.56</td>
</tr>
<tr>
<td>ROA</td>
<td>0.04</td>
<td>0.04</td>
<td>-1.18</td>
<td>0.43</td>
<td>0.11</td>
</tr>
<tr>
<td>ROA1</td>
<td>0.05</td>
<td>0.05</td>
<td>-1.07</td>
<td>0.55</td>
<td>0.11</td>
</tr>
<tr>
<td>ROE</td>
<td>0.10</td>
<td>0.13</td>
<td>-2.62</td>
<td>0.84</td>
<td>0.23</td>
</tr>
<tr>
<td>ROE1</td>
<td>0.12</td>
<td>0.13</td>
<td>-1.34</td>
<td>1.40</td>
<td>0.20</td>
</tr>
<tr>
<td>Tobin’s q</td>
<td>2.36</td>
<td>1.93</td>
<td>-0.15</td>
<td>27.54</td>
<td>1.95</td>
</tr>
</tbody>
</table>

Source: (1) Globe and Mail, Report on Business (various years); (2) OSIRIS database; (3) S&P Capital IQ; and investing.money.msn.com.

Correlation of all performance indicators.

Table 6 reports the correlation matrix of corporate governance variables and financial indicators. Using the parameters of 0.1 to 0.5 as a weak correlation and 0.6 to 1.0 as a strong correlation, the results support a strong correlation between CGI
and board composition, compensation of the shareholder, and shareholder rights and disclosure practices in the aggregate set of the 115 Canadian companies.

The literature supports the hypothesis that there exists an association between the corporate governance index and corporate performance measures. However, using the same parameters, it was found that the corporate governance variables (board composition, compensation, shareholder rights and disclosure) were not significantly correlated to these profitability indicators (such as Tobin q, ROA and ROE).
Table 6. Correlation metrics between corporate governance index and profitability ratios of Canadian companies 2005-2010.

<table>
<thead>
<tr>
<th></th>
<th>TI</th>
<th>BC</th>
<th>C</th>
<th>SR</th>
<th>D</th>
<th>EBIT</th>
<th>EBITBV</th>
<th>EBITDA</th>
<th>EBITDATA</th>
<th>NI</th>
<th>ROA</th>
<th>ROA1</th>
<th>ROE</th>
<th>ROE1</th>
<th>TOBIN'S Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>TI</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BC</td>
<td>0.67</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>0.69</td>
<td>0.41</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>SR</td>
<td>0.61</td>
<td>0.19</td>
<td>0.38</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>0.57</td>
<td>0.22</td>
<td>0.54</td>
<td>0.47</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBIT</td>
<td>0.29</td>
<td>0.09</td>
<td>0.29</td>
<td>0.28</td>
<td>0.24</td>
<td>1</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITBV</td>
<td>-0.13</td>
<td>-0.18</td>
<td>-0.03</td>
<td>-0.11</td>
<td>-0.12</td>
<td>0.19</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDA</td>
<td>0.26</td>
<td>0.06</td>
<td>0.27</td>
<td>0.26</td>
<td>0.22</td>
<td>0.95</td>
<td>0.13</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDABV</td>
<td>-0.13</td>
<td>-0.18</td>
<td>-0.03</td>
<td>-0.11</td>
<td>-0.12</td>
<td>0.19</td>
<td>1.00</td>
<td>0.11</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITDATA</td>
<td>-0.09</td>
<td>-0.12</td>
<td>0.01</td>
<td>-0.11</td>
<td>-0.08</td>
<td>0.15</td>
<td>0.88</td>
<td>0.10</td>
<td>0.88</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EBITTA</td>
<td>-0.09</td>
<td>-0.17</td>
<td>0.01</td>
<td>-0.11</td>
<td>-0.08</td>
<td>0.15</td>
<td>0.88</td>
<td>0.10</td>
<td>0.88</td>
<td>1.00</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NI</td>
<td>0.33</td>
<td>0.13</td>
<td>0.31</td>
<td>0.35</td>
<td>0.26</td>
<td>0.82</td>
<td>-0.03</td>
<td>0.74</td>
<td>-0.08</td>
<td>-0.07</td>
<td>-0.068</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA</td>
<td>0.04</td>
<td>0.03</td>
<td>0.03</td>
<td>0.01</td>
<td>0.00</td>
<td>0.12</td>
<td>-0.02</td>
<td>0.10</td>
<td>-0.02</td>
<td>0.00</td>
<td>0.007</td>
<td>0.78</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA1</td>
<td>0.02</td>
<td>0.03</td>
<td>0.01</td>
<td>0.00</td>
<td>-0.03</td>
<td>0.11</td>
<td>-0.03</td>
<td>0.09</td>
<td>-0.03</td>
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There is a growing body of international evidence supporting the existence of a correlation between a corporate governance structure and firm performance and valuation outcomes. The study examines the broad relationship between corporate governance variables in Canada and financial outcomes, using a cohort of 115 Canadian firms for the period 2005-2010. The study finds a generally weak correlation between corporate governance variables and financial outcomes. This result does not mean the corporate governance variables do not impact firm performance. There are several reasons that the nature of the relationship between corporate governance variables and firm valuation may be opposed. For example; firms with higher market values may choose to adopt better corporate governance practices. Hence one has to look at the channel through which governance mechanisms derive their impact. Prior studies have suggested a number of potential channels for corporate governance effects, such as stronger shareholder rights and legal protection mechanisms, which lower investor capital costs, or incentive effects associated with takeover vulnerability. Other suggested channels include greater coverage and reporting by ratings agencies, improved management structure and oversight through voluntary or legislative enforcement of codes of governance practice and enhanced disclosure in formativeness.
BIBLIOGRAPHY


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