Governance practices and firm performance: Does shareholders' proximity to management matter?

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ABSTRACT This article investigates the link between corporate governance practices and firm performance, a topic that received a lot of attention by regulators, interest groups and academics. Research in this field has recently shifted from the analysis of one or more specific governance provisions to the analysis of multiple aspects of corporate governance. In fact, most studies now use corporate governance indexes that capture a wide range of corporate governance provisions (index-based studies). The objective and main contribution of this article is to revisit the governance–performance relationship while taking into account shareholders' proximity to the locus of management. Shareholders' proximity is defined based on ownership concentration and whether or not the dominant/controlling shareholder holds top executive positions in the firm. The lowest level of proximity is evidenced in firms with dispersed ownership, the highest level in controlled entities where the controlling shareholder holds the CEO and/or Chair positions. Governance is measured on a global scale using the Report on Business (ROB) index. The study is conducted over a 4-year period (2002–2005) using panel regressions in a two-stage least squares framework on a sample of Canadian publicly traded companies (470 firm-year observations). The results of the study show a positive relationship between the ROB global index (and sub-indexes) and Tobin's Q whether ownership is dispersed or is concentrated in the hands of a dominant or controlling shareholder. Shareholders' proximity to management has no impact on the governance–performance relationship. Overall, the results support a one-size-fits-all approach to governance, a policy adherence that underlined the widespread adoption of Codes of Good Governance and legal/regulatory changes in the years following Enron's collapse in the United States. Initiatives were in large part supported by a general consensus toward a stock market-centered model of governance. However, with the recent debt crisis in the United States, public perception has changed.

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The credibility of such a model for governing our institutions is called into question. Our study tempers these concerns by showing that governance controls should not account for ownership differences in the context of publicly traded companies. Instead, good governance practices based on an independent board of directors that promotes transparency and protects shareholders' rights should be prioritized whether or not ownership is dispersed or concentrated. From a corporate governance standpoint, this study sheds new light on controlled companies. Our results show that improving transparency and control adds value to all publicly traded companies including those with concentrated ownership. Moreover, if holding the CEO and/or Chair positions has the potential to increase the power of a dominant/controlling shareholder, it does not seem to translate into higher agency costs to the firm, nor does the presence of insiders seem to affect the effectiveness of the controls in place. Publicly traded companies may therefore welcome dominant/controlling shareholders in key management positions without compromising on firm performance and value. In any case, putting in place good governance practices seems essential to ensure that managers/shareholders are kept in check and work in the best interests of their company.

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INTRODUCTION

Corporate governance refers to the process and structure for overseeing the direction and management of a corporation so that it carries out its mandate and objectives effectively. Adoption of Codes of Good Governance and legal/regulatory changes has spread worldwide, especially in the years following Enron's collapse in the United States. So far, initiatives were in large part supported by a general consensus toward a stock market-centered model of governance (Gilson, 2001). The Anglo-American model appeared to be the end point of corporate governance evolution at least until the recent Wall Street crisis, a crisis that was larger in scale than any prior crises since the Great Depression of the 1930s (Clarke, 2010). The collapse of many major financial institutions seriously calls into question the supremacy of the Anglo-American model of corporate governance and the modern economic orthodoxy. The crisis of confidence and credibility that marked the investment scene has increased public criticism of the stock market-centered approach in general, and of corporate governance controls in particular.

In academia, a growing number of researchers questioned this global policy of adhesion to the Anglo-Saxon style of ownership and control that gave rise to a one-size-fits-all approach to governance. Among those researchers, Bebchuk and Hamdani (2009) assert that academics and shareholder advisers should develop separate methodologies to account for firms' specificities. They highlight the fact that firms with a dominant/controlling shareholder require different governance arrangements than firms with dispersed ownership. In firms with concentrated ownership, the fundamental concern is the risk that the dominant/controlling shareholder may behave opportunistically at the expense of minority shareholders (risk of expropriation or Principal–Principal problems), whereas in widely held firms the fundamental concern is the risk that management may behave opportunistically at the expense of shareholders (interests misalignment or Principal–Agent problems). Bebchuk and Hamdani argued that ownership structure differences should call for different control devices. For instance, in firms with dispersed ownership, the board must be independent from

management, whereas in firms with a dominant/controlling shareholder, independence of the board should be from the dominant/controlling shareholder.

In response, in October 2011, the Canadian Coalition for Good Governance (CCGG) issued a set of governance recommendations for non-dual-class companies with concentrated ownership (CCGG, 2011). CCGG recognizes that a dominant/controlling shareholder may have a legitimate interest in being actively involved in the board of directors of the firm. However, CCGG believes that the dominant/controlling shareholder's representation on the board (related directors) should be limited to the proportion of his/her equity holding (but no more than two-thirds). Moreover, a related director is deemed not to be independent of management (even if he/she is in fact independent of management) if (i) the CEO is related to the dominant/controlling shareholder or (ii) the director is related to a controlling shareholder (legal control). Similar guidelines were issued in 2008 by the Institute for Governance of Private and Public Organizations (IGPPO, 2008).

Opponents to the one-size-fits-all approach to governance find support in recent empirical evidence (see La Porta *et al.*, 1999, among others) showing that corporate ownership around the world does not resemble that of the United States or the United Kingdom. Instead, ownership is generally concentrated in the hands of dominant/controlling shareholders. Moreover, proponents of the path dependency theory (Bebchuk and Roe, 1999) argue that these fundamental differences in ownership structures will persist over time even in the face of an emerging shareholder culture.

Despite increased attention devoted by academics and some interest groups to the contrasting reality of corporate ownership outside the United States and the United Kingdom, only few empirical studies have verified the claim that governance controls should account for ownership differences. Index-based studies include Connelly *et al.* (2012), Henry (2010) and Klein *et al.* (2005). Overall evidence on the

moderating effect of ownership on the governance–performance relationship is conflicting.

Prior studies suffer from the following limitations. First, attention has been devoted to only one aspect of shareholders' proximity to the locus of management, that is, ownership concentration. However, Lins (2003) shows that agency costs are expected to be higher when the management group has sufficient control to exploit minority shareholders. Entrenchment is also exacerbated when key strategic positions are held by the dominant/controlling shareholder (Hoi and Robin, 2010). Second, prior studies did not account for the increase risk of expropriation associated with the use of dual-class/multiple voting shares, pyramids and cross-holdings by dominant/controlling shareholders. These practices are quite common among publicly traded companies outside the United States and the United Kingdom as they allow continued founders control over a company while injecting new equity. However, dual-class/multiple voting shares, pyramidal and cross-ownerships structures create a separation between voting rights and cash-flow rights that increases expropriation costs and adversely affects firm performance (for example, Claessens *et al.*, 2002; Mitton, 2002; Baek *et al.*, 2004; Bozec and Laurin, 2008). Finally, prior studies only controlled for one aspect of endogeneity, that is, reverse causality or spurious correlation, and generally offered a weak cross-validation of the mitigating effect of ownership concentration on the governance–performance relationship.

The objective of this article is to revisit the governance–performance relationship in the context of publicly traded companies while improving of the methodology. First, we take into account shareholders' proximity to the locus of management. Shareholders' proximity is defined based on ownership concentration and whether or not the dominant/controlling shareholder holds a top executive position in the firm (CEO/Chair positions). The lowest level of proximity is evidenced in firms with dispersed ownership, the highest level, in controlled entities where the controlling shareholder holds the

CEO and/or Chair positions. Second, by taking the excess voting rights into account, that is, the difference between voting rights and cash-flow rights of the ultimate owner, we propose a refined classification of the sample firms along the ownership concentration spectrum. Third, we use a combination of methods to address the risk of endogeneity (panel regressions in a two-stage least squares (2SLS) framework) and to assess the moderating effect of shareholders' proximity on the governance–performance relationship (moderated regressions analysis and sub-group analysis).

Consistent with recent governance–performance relationship studies, we defined governance on a broader scale, making use of the ROB index. This index measures the quality of the corporate governance practices of Canadian companies. Published on a yearly basis by the *Globe and Mail*, the index distinguishes between four blocks of corporate governance, namely, board composition (BC), compensation, shareholder rights and disclosure. The firms selected are included in the ROB index. They are all listed on the Toronto Stock Exchange (TSX) and comprise Canada's benchmark S&P composite index.

The study is conducted in Canada. Like the United States, but contrary to most other non-US countries, Canada has a relatively good reputation in terms of its legal and extra-legal institutions aimed at protecting investors. Public equity markets are therefore well developed. At the same time, ownership may be highly concentrated. Overall, Canada features companies with a wide range of ownership structures from widely held firms to family controlled businesses. This provides an ideal setting to assess the potential moderating effect of shareholders' proximity on the relationship between governance practices and firm performance.

The results of the study show a positive relationship between the ROB indexes and Tobin's Q. This relationship remains positive whether ownership is dispersed or concentrated in the hands of a dominant or controlling shareholder. Ownership configuration has no

impact on the governance–performance relationship nor has the presence of insiders. Overall, the results support a one-size-fits-all approach to governance for publicly traded corporations.

The remainder of this study is structured in the following way. The next section presents the literature on the board governance–performance relationship and introduces shareholders' proximity to the locus of management as a potential moderating factor of this relationship. Research methodology is described in the section after that, including sample selection, corporate governance index and shareholders' proximity metrics. The penultimate section presents the empirical tests and reports the results. The final section summarizes and concludes the study.

PRIOR LITERATURE AND HYPOTHESES

Governance–performance relationship

Agency theory is gaining increasing acceptance as a useful theoretical approach in the field of corporate governance (Durisin and Puzone, 2009). Agency theory is the main theory used to predict the relationship between governance practices and firm performance. Rooted in economics and finance, agency theory informs the control approach aimed at curbing self-serving behaviors of managers (agent) that may negatively impact shareholders' (principals') wealth (Eisenhardt, 1989).

Early research on the governance–performance relationship usually focused on one or more governance attributes. The board of directors has generally been perceived as the backbone of corporate governance. The board contributes to alleviating agency costs to the firm by monitoring and rewarding top executives to ensure wealth maximization for the shareholders. Conceptualizing the board of directors from the Principal–Agent framework has been used to explain the way boards should

be structured and how they should be functioning (Zahra and Pearce, 1989; Weisbach and Hermalin, 2003). One of the most debated characteristics of the board is its independence from management.

Research in governance has recently shifted from the analysis of one or more specific governance provisions to the analysis of multiple aspects of corporate governance. In fact, most studies now use corporate governance indexes that capture a wide range of corporate governance provisions. The main objective of these studies is to investigate whether, overall, corporate governance predicts firm performance and value. Index-based studies are growing in number (see Bozec and Bozec, 2012, for a review of the literature). Overall, studies based on US firms show conflicting results (see, among others, Bhagat and Bolton, 2008; Chidambaran *et al.*, 2008; Bebchuk *et al.*, 2009; Spellman and Watson, 2009). In contrast, studies conducted in emerging countries and transitional economies (see, among others, Price *et al.*, 2007; Bauer *et al.*, 2008; Garay and Gonzalez, 2008; Black *et al.*, 2009), as well as those from Europe (Beiner *et al.*, 2006; Blom and Schauten, 2008; Clacher *et al.*, 2008; Renders *et al.*, 2010), generally found a positive relation between corporate governance practices and firm performance and value.

Evidence from Canadian markets includes Foerster and Huen (2004), Klein *et al.* (2005), Gupta *et al.* (2006) and Bozec *et al.* (2010). Firms selected for these studies are listed on the TSX and are ranked by the *Globe and Mail* ROB, based on a set of corporate governance provisions. Foerster and Huen (2004) find some evidence that when portfolios of firms are created based on their governance index scores, the top quintile of firms has significantly higher returns than the other quintiles. The study of Bozec *et al.* (2010) shows a positive relation between governance and firm technical efficiency. In contrast, results from Klein *et al.* (2005) as well as from Gupta *et al.* (2006) show no significant relation between the ROB index and firm value (Tobin's Q). However, Klein *et al.* (2005) find that sub-indexes measuring

effective compensation, disclosure and shareholder rights practices have a positive impact on firm value.

From an agency theory standpoint, better controls and improved transparency should lead to better performance. Index-based studies rely almost exclusively on provisions that are generally consistent with a US style approach to governance (Bozec and Bozec, 2012). Therefore, overall empirical results give credence to a one-size-fits-all approach to governance. We propose the following general hypothesis:

Hypothesis 1: There is a positive relationship between governance practices and firm performance.

Governance–performance relationship and ownership concentration

Under the agency framework, two offsetting effects emanate from ownership concentration: the potential substitution between ownership and internal controls (positive effect) and the risk of expropriation (negative effect). On the one hand, concentrated ownership means more power in the hands of a dominant/controlling shareholder that could translate into better monitoring. The dominant/controlling shareholders play a crucial role in disciplining the managers. This, in turn, may result in agency cost reductions. In fact, equity ownership has the potential to substitute for other control devices inside the firm, a notion that has a relatively long history in financial economics. The earliest instance of its formulation that we can find is Alchian and Demsetz (1972) who explain that, in addition to competition from outside and inside managers, control by shareholders over managers is facilitated by a temporary consolidation of shares votes into voting blocks owned by one or two contenders (p. 788).

On the other hand, concentrated ownership increases the risk of minority shareholder expropriation. The risk of expropriation emerges when the shareholder has not only the ability but also the incentive to expropriate.

As the ownership gets beyond a certain point, the large owners gain nearly full control and prefer to use firms to generate private benefits of control that are not shared by minority shareholders (Shleifer and Vishny, 1997). Diversion of corporate resources may take different forms. One frequent mechanism through which large shareholders can extract resources from the firm is by arranging disadvantageous transactions between their firm and other firms that they control. These deals are referred to as *related party transactions*.

In an attempt to determine the turning points, Morck *et al* (1988) note that the risk of expropriation is assumed to be higher when the percentage of ownership of the dominant shareholder falls between 5 and 25 per cent. In fact, with more than 5 per cent ownership, the dominant shareholder may have the ability to expropriate. But with less than 25 per cent of the cash-flow rights, the dominant shareholder has also the incentive to expropriate because he or she does not fully internalize the costs of expropriation. The methodology developed by Morck *et al* (1988) has been widely used in research. The model has been applied to a variety of samples and time periods. A 10 per cent threshold has often been used to identify the presence of a dominant shareholder. The results generally support a non-monotonic linear relationship between firm performance and ownership concentration – with a change from alignment to entrenchment and then back to alignment as ownership concentrates (for example, Hermalin and Weisbach, 1991; Chen *et al*, 1993; Faccio and Lasfer, 1999; Holderness *et al*, 1999; Short and Keasey, 1999).

Excess voting rights – that is the separation between the dominant shareholder's voting and cash-flow rights – exacerbates the risk of expropriation thus creating larger agency costs. Bebchuk *et al* (2000) explain how shares with multiple voting rights (dual-class shares), pyramidal ownership structures and cross-ownership can be used to obtain control of voting rights that are well in excess of cash-flow rights. As a result of this separation, dominant shareholders

could be in a position to enjoy all of the private benefits of control while internalizing only a small fraction of the costs. Voting and cash-flow rights divergence increases the risk of minority shareholder expropriation because it gives the dominant shareholder both the ability and the incentive to derive private control benefits. Empirical studies usually show that excess voting rights adversely affect firm performance when the dominant shareholder's share of the equity (cash-flow rights) is small (for example, Claessens *et al*, 2002; Mitton, 2002; Baek *et al*, 2004; Bozec and Laurin, 2008).

The use of a dual-class shares structure is quite common among public companies controlled by families. It allows continued founder control over a company to keep it growing while injecting new equity capital instead of debt. For instance, in Canada, Magna International holds both Class A and Class B shares. However, Class B shares carry 500 votes for every one Class A share vote giving Magna's founder and Chairman full control over the company with only 3.4 per cent of the company's equity. The use of dual-class shares has been very controversial especially when this device translates into legal control giving the controlling shareholder more incentive and more power to extract private benefits from the company. Therefore, we expect expropriation costs to be higher in companies where the controlling shareholder holds more than 50 per cent of the voting rights but less than 50 per cent of the cash-flow rights.

Figure 1 summarizes the expected levels of agency costs involved with ownership concentration. For the purpose of this article, we define a 'dominant shareholder' as one who owns less than 50 per cent of the votes but sufficient equity (10 per cent) to influence corporate decision making. We take into account the level of ownership concentration as a potential indicator of shareholders' proximity to the locus of management. On the one hand, more ownership by the dominant/controlling shareholder decreases the costs associated with misalignment of interests between

Figure 1: Ownership concentration and agency costs.

managers and shareholders (Principal–Agent problem). On the other hand, with the exception of controlled companies where voting and cash-flow rights are aligned (or cash-flow rights above 50 per cent), ownership concentration is expected to increase the risk of expropriation (Principal–Principal problem). The level of ownership concentration may moderate the governance–performance relationship in the following three ways:

1. *Misalignment effect hypothesis*: Dominant/controlling shareholders have greater incentives and more power to monitor management. Shareholders–managers misalignment can be resolved through effective monitoring by the dominant/controlling shareholder. Therefore, the presence of blockholders has the potential to decrease the agency costs from misalignment (Principal–Agent problem). Under the misalignment effect hypothesis, we should expect a *negative* impact of ownership concentration

on the governance–performance relationship.

2. *Expropriation effect hypothesis*: Ownership concentration is expected to increase the risk of expropriation (Principal–Principal problem) and therefore the need for internal controls to curb the extraction of the firm’s resources by the dominant/controlling shareholder. Under the expropriation effect hypothesis, we should expect a *positive* impact of ownership concentration on the governance–performance relationship.
3. *Reversal effect hypothesis*: As portrayed in Figure 1, any potential gain from shareholders–managers interest alignment could be canceled out by a loss from an increased risk of expropriation. If this offsetting effect is taking place effectively along the ownership concentration spectrum, ownership structure should not have any significant impact on the overall agency costs of the firm (costs from misalignment and

expropriation costs combined). Under the reversal effect hypothesis, we should not expect any impact of ownership concentration on the governance–performance relationship.

Few empirical studies analyzed the moderating effect of ownership concentration on the governance–performance relationship. The list of some of these studies is provided in Table 1 along with details on the methodology used, including sample selection, metrics, methods and results. Index-based studies include Connelly *et al* (2012), Henry (2010) and Klein *et al* (2005). Non-index-based studies (Anderson and Reeb, 2004; Dong-Song and Zootae, 2007; Setia-Atmaya, 2009) focus on one aspect of governance, namely, board independence. Overall, empirical evidence on the mitigating effect of ownership is conflicting. Results show that the impact of ownership concentration on the governance–performance relationship is either positive (Setia-Atmaya, 2009), negative (Dong-Song and Zootae, 2007), non-existent (Henry, 2010) or mixed (Klein *et al*, 2005). Additional evidence supports a positive relationship between governance and performance only for a sub-group of firms, that is, firms with no pyramidal structure (Connelly *et al*, 2012) and family firms (Anderson and Reeb, 2004).

With the exception of Connelly *et al* (2012), none of the studies reported in Table 1 incorporated excess voting rights in the analysis. Connelly *et al* (2012) used a dummy variable indicating the presence of a control-enhancing pyramidal ownership structure to create sub-groups. However, they do not measure the separation between voting rights and cash-flow rights of the ultimate owner. Not accounting for excess voting rights might result in a poor classification of the sample firms along the ownership spectrum. From the agency theory standpoint, Figure 1 shows that controlled companies that do not make use of any dual-class shares and/or pyramids/crossholdings do not present any particular issues. In this context, agency costs

are expected to be relatively low since shareholders–managers misalignment is resolved through effective monitoring by the controlling shareholder. Moreover, when the cash-flow rights held by the controlling shareholder are aligned with his/her voting rights, the incentive to expropriate minority shareholders is expected to be significantly reduced.

The risk of endogeneity includes spurious correlation and reverse causality. Panel regression is one common method to control for spurious correlation, whereas the use of instrument variables in a 2SLQ/3SLS framework (and/or in a system of simultaneous equations) helps to address reverse causality. Only by using both methods at once could one control for the overall risk of endogeneity. Moreover, two techniques can be employed to test the moderating effect of ownership concentration on the relationship between governance and performance: a moderated regression analysis incorporating two-way interactive terms (Ownership $\times$ Governance) and a sub-group analysis. A moderated regression analysis aims at assessing the form of the hypothesized relationship while a sub-group analysis helps to assess the strength of the contingent relationship. Cross-validation of the results is possible when incorporating both techniques. However, none of the index-based studies reported in Table 1 have combined these different methods (panel regressions with instrumented variables, moderated regressions and sub-group analysis) therefore decreasing the overall validity of the results.

Given the mixed empirical evidence and the possible theoretical predictions regarding the moderating effect of ownership structure on the governance–performance relationship, the following hypothesis is tested using a two-tailed approach.

Hypothesis 2: The ownership structure, whether dispersed or concentrated in the hands of a dominant or controlling shareholder holding less than 50% of the cash-flow rights, has no impact on the relationship between governance practices and firm performance.

Table 1: Moderating effect of ownership concentration on the governance–performance relationship review of empirical studies

Study	Country	Sample	Metrics			Methods				Results
			Governance (G)	Performance (P)	Ownership	Panel	2SLS	3SLS	Moderated regression analysis	
Index-based studies										
Connelly <i>et al</i> (2012)	Thailand	216 family firms (2005)	Self-constructed index (117 provisions)	Tobin's Q	High/Low (40% cut off point)	—	✓	—	✓	Positive G–P relationship only when cash-flow rights and voting rights are aligned
Henry (2010)	Australia	120 firms listed on the ASX (1992–2002)	Self-constructed index (8 provisions)	Agency costs	% equity held by insiders and outsiders (institutions, others)	✓	—	✓	—	Positive G–P relationship No moderating effect of ownership concentration
Klein <i>et al</i> (2005)	Canada	263 firms listed on the TSX (2002)	ROB index from the <i>Globe and Mail</i>	Tobin's Q	Type: Family, government, widely-held, mixed	—	✓	—	✓	No relationship between total ROB index and P Mixed results based on ownership type and sub-indexes
Non-index-based studies										
Setia-Atmaya (2009)	Australia	316 firms listed on the ASX (2000–2005)	Board independence	Tobin's Q	1/0 (20% cut off point)	✓	✓	✓	✓	Positive G–P relationship. Positive moderating effect of ownership concentration
Dong-Song & Zootae (2007)	Korea	347 firms listed on the KSE (1999)	Board independence	Profit	% equity held by insiders and outsiders (controlling and large shareholders)	—	—	✓	—	Positive G–P relationship Negative moderating effect of outside ownership concentration
Anderson & Reeb (2004)	The United States	403 firms from the S&P 500 (1992–1999)	Board independence	Tobin's Q	Family/Non-family	✓	✓	✓	✓	Positive G–P relationship only for family firms. No relationship for non-family firms

Governance–performance relationship and insider positions

The roles of chairperson and CEO are fundamental. The chairperson ensures that the board's activities are carried out with due diligence and information is provided to the directors on a timely basis. The board's chairperson has the greatest influence over the board's functioning. The CEO is responsible to the board for overall strategy and day-to-day affairs of the company. As the nature and emphasis of these two roles are clearly different, corporate governance codes usually recommend that the Chairman and CEO positions be assumed by different individuals (non-duality structure).

At this stage, the concept of shareholders' proximity to management can easily be refined by considering whether or not the dominant/controlling shareholder is also a top executive of the firm. Proximity to management is assumed to be increased whenever the dominant/controlling shareholder is also the CEO and/or Chairman of the board. In this context, Hoi and Robin (2010) present supporting evidence that entrenchment is exacerbated when the dominant shareholder serves as a top executive. In the same vein, Lins (2003) shows that since it is the management group that administers a firm, the reduction in value from potentially higher agency costs is more when the management group has sufficient control to exploit minority shareholders. Holding strategic positions enhances the dominant shareholder's ability to expropriate, potentially increasing expropriation costs. Therefore, we expect the governance–performance relationship to be positive and stronger when the dominant shareholder or the controlling shareholder holding less than 50 per cent of the cash-flow rights is also a top executive of the firm.

One could argue that proximity to management means more power in the hands of a dominant/controlling shareholder that could be used to control the board therefore compromising its effectiveness. This situation is more likely to happen when dual-class shares are used to

achieve either absolute control or *de facto* control (control with less than 50 per cent of the votes). The dominant/controlling shareholder might have more incentive to expropriate (especially if the separation between his/her voting rights and cash-flow rights is significant) but also more ability to corrupt the board in order to extract private benefits from the firm (especially if the shareholder owns more than 50 per cent of the votes).

In such circumstances, Dahya *et al* (2008) argue that appointment of a strong board can still be a deterrent to diversion despite the fact that the dominant/controlling shareholder could easily remove directors and appoint new ones. First, the incentive for an outside director to carry out his/her tasks may come from the market for directors. Assuming that such a market is in place, any failure to monitor may result in losses in human capital for the director. Second, boards can be held liable for approving unfair or prejudicial transactions between the dominant/controlling shareholder and the firm. In addition, Dahya *et al* (2008) show that dominant/controlling shareholders may be willing to reduce their diversion of corporate resources by appointing independent directors in exchange for an increase in firm value.

In sum, in line with Dahya *et al* (2008), if we assume that the presence of insiders increases the agency costs without compromising the effectiveness of governance controls, we propose the following hypothesis:

Hypothesis 3: There is a positive and stronger relationship between governance practices and firm performance when the dominant or the controlling shareholder holding less than 50% of the cash-flow rights is also the Chairman and/or the CEO.

METHODOLOGY

Sample selection

This study covers a period of 4 years from 2002 to 2005. Canada experienced important

reforms during this period including the enactment of Bill 198 in 2002, the equivalent of the Sarbanes Oxley Act in the United States. Therefore, we expect more variation in corporate governance practices during this time frame, a precondition for the use of panel regressions. We also choose our sample period because of data availability considerations. The ROB index and the weight assigned to each provision are relatively consistent across the 4-year period under investigation. Substantial changes have been made in the construction of the index in the following years.

We initially selected firms covered in the 2005 *Globe and Mail* survey (hereafter, Report on Business or ROB). This survey is based on 209 firms listed on the S&P/TSX composite index. From that list, we eliminated financial institutions ($n=28$). We also excluded firms with incomplete time series data on the ROB index for the 2002–2005 period ($n=51$). The remaining sample consists of 130 firms or 520 firm-year observations. Next, we excluded companies with a controlling shareholder holding more than 50 per cent of the cash-flow rights ($n=32$ firm-year observations). These companies represent only a small portion of the controlled companies in our sample (25 per cent). Moreover, agency costs for these companies are expected to be relatively low (see Figure 1). We also excluded outliers defined as Q ratio over 4.00 ($n=18$ firm-year observations). Our final sample (470 firm-year observations) comprises companies with dispersed ownership ($n=187$ firm-year observations), dominant shareholders ($n=179$ firm-year observations) and companies controlled with less than 50 per cent of cash-flow rights ($n=104$ firm-year observations).

We collected financial data from StockGuide and ownership data from firms' proxy circulars (available on SEDAR Website).

Corporate governance metrics

We define governance practices using the index developed by ROB that captures a wide variety of governance indicators. More precisely, the

index distinguishes between four blocks of corporate governance. The first block, BC, (maximum of 37 marks out of 100), assesses the independence of the members serving on the board, the audit committee, the compensation committee and the remuneration committee. The second block deals with compensation (maximum of 25 marks) and captures, among other things, whether the directors and the CEO are required to own stocks. The third block, shareholder rights (maximum of 28 marks), evaluates different scenarios that could impair shareholder rights including the presence of non-voting or subordinate shares and employee stock options. Finally, the fourth block, 'disclosure' (maximum of 10 marks), measures the availability and quality of information on corporate governance. Appendix A presents the major criteria considered within the ROB rating categories for 2005.

As our study uses panel data, the index and the weight assigned to each provision must be consistent across the 4-year period under investigation. This condition is largely met for the ROB index from 2002 to 2005. When minor differences do exist, we re-estimated the weights of the indexes and sub-indexes in line with the weighting scales of the ROB index of 2005. For instance, the maximum allocated to the BC sub-index was 40 marks from 2002 to 2004 but only 37 marks in 2005. In that case, the adjustment consists of multiplying the sub-index 'Board Composition' from 2002 to 2004 by 37/40. A similar process was carried out to standardize the other sub-indexes.

The use of commercial ratings has been recently criticized for not equally weighting governance indicators and, as a result, for being too subjective (Daines *et al*, 2010). To test the reliability and credibility of the ROB index, we collected the 2004 corporate governance ratings for each firm in our sample from Institutional Shareholder Services (ISS), a well-established US governance index (CGQ ratings). The ISS index was available for the firms comprising our final sample. Pearson correlation tests reveal that the 2004 ROB and ISS global indexes are highly

correlated (57 per cent). Similar results are found for the 2004 ROB and ISS board of directors sub-indexes (58 per cent) adding credibility to the ROB index employed in our study.

Shareholders' proximity

Shareholders' proximity to management is defined based on ownership concentration and whether or not the dominant/controlling shareholder holds the Chairman and/or the CEO positions. Ownership concentration is measured based on voting rights. Following previous studies (La Porta *et al*, 1999; Claessens *et al*, 2002), we focus on the ultimate, rather than the immediate, dominant/controlling shareholder. Pyramidal structures in many corporations in Canada suggest that identifying an immediate dominant/controlling shareholder is not sufficient for defining corporate ownership structure (Bozec and Laurin, 2008). Therefore, when the principal shareholder of a firm is another corporate entity, we find the principal shareholder of that entity, and so on, until we find the ultimate dominant/controlling shareholder. The principal shareholder is defined as the shareholder that holds at least 10 per cent of the voting rights. If more than one shareholder has greater than 10 per cent of the voting rights, the dominant/controlling shareholder is the shareholder with the greatest voting rights. We manually collected the ultimate dominant/controlling shareholder's voting rights. The following categories are created:

- 1- *Firms with dispersed ownership (DISPERSED)*: Firms with no shareholder holding more than 10 per cent of the voting rights.
- 2- *Firms with a dominant shareholder (DOMINANT)*: Firms with a shareholder holding at least 10 per cent but less than 50 per cent of the voting rights (with the dominant shareholder holding (1) or not holding (0) an executive position).
- 3- *Controlled entities (CONTROLLED)*: Firms with a shareholder holding at least 50 per cent of the voting rights, but less than 50 per cent of the cash-flow rights

(with the controlling shareholder holding (1) or not holding (0) an executive position).

Firm value

In line with prior research (see Table 1), we focus on a widely used market-based performance measure: Tobin's Q. More precisely, we use an approximation of Tobin's Q (Q), which is defined as the market value of equity plus the book value of debt divided by the book value of total assets. A high Q value indicates that the capital market expects the firm to have good growth perspectives and valuable intangibles (Cronqvist and Nilsson 2003). In this sense, Q particularly captures the expected capitalized value of agency costs resulting from different ownership structures (Morck *et al*, 1988). Note that the denominator of the Q ratio should be the replacement cost of assets. Since the data required to calculate the replacement cost of assets is not available, we follow previous research using the book value of assets.

Control variables

On the basis of prior studies, we introduce a set of firm-specific control variables, including firm size ($SIZE$), age (AGE), debt ($DEBT$), growth ($CAPEX$), industry ($SECTOR$) and years ($YEAR$). $SIZE$ is defined as the log of total assets, whereas AGE is a dummy variable that takes the value of 1 if the firm has been operating for at least 10 years and 0 otherwise. The impact of firm size and age on performance is, however, unclear. If large and old firms usually have more liquid trading and more diversified activities than small and young firms (Claessens *et al*, 2002), they also usually have fewer growth opportunities (Morck *et al*, 2002).

$DEBT$ is defined as the book value of long-term debt over total assets. Debt can play a positive role in motivating managers to be efficient in order to meet debt repayments (Stiglitz, 1985), or because it reduces agency costs associated with the existence of free cash

flows by reducing the cash flow available for managers to spend at their discretion (Jensen, 1986). However, debt can also exert a negative influence on firm performance because debt repayments may sometimes force managers to forego profitable investment projects (McConnell and Servaes, 1995).

Our proxy for growth opportunities (CAPEX) is measured as capital and R&D expenditures over total assets. Following previous studies using Tobin's Q (see, for instance, Morck *et al.*, 1988), we expect growth to positively affect firm performance. We also control for industry and year effects. Two series of dummy variables are created: *SECTOR* for each industry (using Stockguide classification), and *YEAR* for each year between 2002 and 2005.

In cases where the voting rights and cash-flow rights of the dominant/controlling shareholder were not aligned, we collected his/her cash-flow rights. We then measured the gap between voting rights and cash-flow rights (*WEDGE*). As additional metrics of excess voting rights, we use a dummy variable, which takes the value of either 1 if the ultimate shareholder's voting rights exceed his cash-flow rights or 0 otherwise (*SEPARATION*), and a ratio variable that consists of cash-flow rights over voting rights (*CFR/VR*). The following example will illustrate the process. Suppose that a family owns 40 per cent of the shares of a publicly traded firm A, which in turn owns 30 per cent of the equity of firm B. In this case, the family would be identified as the dominant shareholder of firm B. The family is said to control indirectly 30 per cent of the voting rights in firm B (that is, the weakest link in the chain of voting rights) and about 12 per cent of the cash-flow rights (that is, the product of 40 and 30 per cent). In this example, the magnitude of the separation between voting and cash-flow rights (*EXCESS*) would be 0.18, that is, the percentage of voting rights less the percentage of cash-flow rights ($0.30 - 0.12 = 0.18$).

Appendix B presents the definition of the variables used in our study.

2SLS panel regressions

Panel regressions help to control for spurious correlation. To control for reverse causality, we run instrumental variables in a 2SLS panel regressions framework. The challenge with this approach is to find good instruments, that is, variables that are correlated with the endogenous variable (ROB), but uncorrelated (or not directly correlated) with the dependent variables (Q). Given the lack of a specific theoretical framework, we follow previous Canadian studies using the ROB index (Klein *et al.*, 2005; Bozec and Bozec, 2007) and consider, as a potential instrument, a dummy variable indicating whether or not the firm is cross-listed on a US stock exchange (US-Listed). About 40 per cent of our sampled firms are listed on a US exchange. Consistent with Klein *et al.* (2005), we find US-Listed to be highly correlated with the ROB index and sub-indexes but uncorrelated with Q, a preliminary indication of the instrument's validity. In the first stage, ROB index is regressed on the instruments, including US-Listed, to obtain the fitted values. The second-stage regression uses the instrumented ROB variables (or fitted value from the first stage).

RESULTS

Descriptive and univariate analysis

Table 2 reports summary statistics of shareholders' proximity for firms with concentrated ownership. Results show large gaps between voting rights and cash-flow rights for controlled companies with an average separation ratio of 0.53 compared with 0.04 for companies with a dominant shareholder. High deviation from the one share-one vote principle was expected for the sub-sample of controlled companies as it comprises firms with a shareholder holding more than 50 per cent of the voting rights but less than 50 per cent of the cash-flow rights. Deviation from the one share-one vote principle only affects 22 per cent of the firms with a dominant shareholder.

Table 2: Summary statistics of shareholders' proximity

	<i>Dominant and controlled</i> <i>Mean (standard deviation)</i>	<i>Dominant</i> <i>Mean (standard deviation)</i>	<i>Controlled</i> <i>Mean (standard deviation)</i>
<i>Ownership concentration (%)</i>			
• Voting rights (VR)	0.3871 (0.2721)	0.1999 (0.1079)	0.7092 (0.1303)
• Cash-flow rights (CFR)	0.1620 (0.1152)	0.1554 (0.0938)	0.1734 (0.1447)
<i>Separation between voting rights and cash-flow rights</i>			
• Wedge (VR–CFR)	0.2251 (0.2702)	0.0446 (0.0996)	0.5358 (0.1694)
• Multiple voting shares (% of firms)	31.54	13.71	61.54
• Non-voting shares (% of firms)	20.07	6.86	42.31
• Pyramids (% of firms)	14.13	6.70	26.92
• Deviation from one share-one vote (% of firms)	50.88	22.35	100.00
<i>Insider positions held by the ultimate owner (%)</i>			
• Chair	68.46	49.71	100.00
• CEO	52.69	31.43	88.46
• CEO and/or Chair	68.46	49.71	100.00
<i>n</i>	283	179	104

Consistent with the agency theory framework portrayed in Figure 1, we expect the risk of expropriation to be higher in controlled companies.

Results from Table 2 show that controlling shareholders managed to achieve control via the use of (i) multiple voting rights in 61 per cent of the cases, (ii) non-voting shares in 42 per cent of the cases and (iii) pyramidal structures in 26 per cent of the cases. All the controlling shareholders were holding key positions in their respective firms, whereas only 50 per cent of the dominant shareholders did. Once control is achieved, the controlling shareholder seems to get more engaged in the strategic and daily activities of his/her firm. These results are similar to those of prior Canadian studies including King and Santor (2008) and Bozec *et al* (2010).

Table 3 reports summary statistics of the ROB indexes and firm performance (Q) for

the three sub-samples. Overall, results show that the average score of the ROB total index is higher for firms with dispersed ownership (74.05) compared with firms with a dominant shareholder (69.60) and a controlling shareholder (59.49). Similar results are obtained for the BC and shareholders' rights sub-indexes. Both sub-indexes appear to most strongly influence the ROB total index. Low scores on the BC sub-index for controlled companies is consistent with prior studies showing that ownership concentration has a significant negative impact on board independence (see, for instance, Anderson and Reeb, 2004; Setia-Atmaya, 2009). Low scores on shareholders' rights for controlled companies may be explained in part by the widespread use of non-voting or subordinate voting shares that affect 42 per cent of the controlled firms compared with only 7 per cent for the firms with a dominant shareholder (see Table 2). Ten

Table 3: Summary statistics of ownership concentration, corporate governance practices and firm performance (Q)

	Levels of ownership concentration			Tests for differences	
	Dispersed	Dominant	Controlled	P values	
				Dispersed versus dominant	Dominant versus controlled
ROB total index					
Mean	74.0549	69.6036	59.4977	0.0023	0.0000
Median	75.8952	70.1714	61.2641	—	—
Standard deviation	14.3200	13.3657	11.1542	—	—
BC sub-index					
Mean	30.4278	28.3073	24.6827	0.0084	0.0002
Median	32.0000	30.0000	25.0000	—	—
Standard deviation	7.1556	8.1337	6.7411	—	—
Compensation sub-index					
Mean	12.1946	11.8704	11.8572	0.4466	0.9757
Median	12.0000	12.0000	12.0000	—	—
Standard deviation	4.4618	3.6154	3.3066	—	—
Shareholder rights sub-index					
Mean	22.0809	20.4137	14.0624	0.0014	0.0000
Median	23.3333	21.6364	12.8333	—	—
Standard deviation	4.5289	5.3344	5.3150	—	—
Disclosure sub-index					
Mean	9.3515	9.0123	8.8955	0.3220	0.7830
Median	10.4000	9.5333	9.7667	—	—
Standard deviation	3.2224	3.3216	3.6240	—	—
Firm performance (Q)					
Mean	1.4571	1.4395	1.0672	0.8122	0.0000
Median	1.1944	1.2796	0.9092	—	—
Standard deviation	0.7268	0.6874	0.5562	—	—
n (total =)	187	179	104	—	—

marks were allocated to this provision alone (see Appendix A).

Overall, results show that firms with dispersed ownership complied with best practice provisions more rigorously than firms with concentrated ownership. There are two possible explanations for these results. One could argue that controlling shareholders may prefer to put in place weak controls or an opaque structure in order to facilitate acts at their discretion (expropriation argument). Alternatively, more power in the hands of a controlling shareholder

may translate into better monitoring that reduces the need of internal controls (substitution argument).

Average Tobin's Q, is significantly higher for firms with dispersed ownership (1.45) and firms with a dominant shareholder (1.43) compared with controlled companies (1.06). Concentration of ownership among non-controlled companies does not seem to impact firm performance. On the other hand, capital market participants seem to expect controlled companies to have lower growth perspectives than non-controlled firms.

Table 4: ROB indexes and firm value (Q) full sample (Hypothesis 1)

	<i>Expected sign</i>	<i>Total index</i>	<i>Board</i>	<i>Compensation</i>	<i>Shareholder rights</i>	<i>Disclosure</i>
Intercept	?	3.989 (4.890)***	3.931 (4.616)***	4.192 (5.149)***	4.021 (4.878)***	4.211 (5.642)***
ROB index	+	0.009 (2.918)***	0.009 (1.536)*	0.028 (4.058)***	−0.002 (−0.277)	0.026 (5.610)***
WEDGE	−	0.022 (0.121)	−0.140 (−1.037)	−0.167 (−1.528)	−0.249 (−3.457)***	−0.211 (−1.527)
SIZE	?	−0.234 (−5.649)***	−0.207 (−4.601)***	−0.228 (−5.288)***	−0.197 (−4.219)***	−0.227 (−5.472)***
DEBT	?	−0.587 (−3.057)***	−0.588 (−2.919)***	−0.598 (−2.735)***	−0.555 (−2.585)**	−0.505 (−2.179)**
CAPEX	+	2.531 (4.083)***	2.581 (4.360)***	2.554 (4.302)***	2.553 (4.478)***	2.466 (4.006)***
AGE	?	−0.005 (−0.031)	0.009 (0.055)	−0.008 (−0.049)	0.046 (0.287)	0.027 (0.176)
SECTOR	?	Yes	Yes	Yes	Yes	Yes
Year effect	?	Yes	Yes	Yes	Yes	Yes
Firm effect	?	Yes	Yes	Yes	Yes	Yes
Adjusted R^2		0.220	0.200	0.219	0.191	0.223
F		(10.452)***	(9.368)***	(10.378)***	(8.912)***	(10.587)***
n		470	470	470	470	470

*, **, ***: statistically significant for the threshold values of 10%, 5%, and 1% respectively.

Multivariate analysis

Governance–performance relationship (Hypothesis 1)

Table 4 reports the multivariate results on the relationship between ROB indexes and Q. Panel regressions (2SLS approach) are performed on the full sample. Overall, with the exception of the shareholders rights sub-index, results show a positive and significant impact of the ROB total index and sub-indexes on firm performance. These results are consistent with Hypothesis 1 and prior non-US index-based studies.

Results from Table 4 also show a negative and significant impact of firm size and debts on firm performance. These results suggest that larger firms may have fewer growth opportunities than smaller firms (Morck *et al.*, 2002). In addition, when the level of debts is increasing, managers may be forced to forego profitable

investment projects (McConnell and Servaes, 1995). As expected, the variable CAPEX, a proxy for growth opportunities, is positive and significant in all the regressions.

Governance–performance relationship and ownership concentration (Hypothesis 2)

This section addresses one aspect of shareholders' proximity to the locus of management, that is, ownership concentration. Panel regressions from Table 5 aim at analyzing the impact, if any, of ownership concentration on the relationship between the ROB total index and Tobin's Q. First, moderated regressions are performed on the full sample (see the first two columns of Table 4) while incorporating dichotomous ownership variables (concentrated versus dispersed; controlled versus dominant/dispersed) and two-way interaction variables

Table 5: ROB total index, firm value (Q) and ownership concentration (Hypothesis 2)

	<i>Expected sign</i>	<i>Full sample</i>		<i>Sub-samples</i>		
		<i>Dominant/ Controlled (1/0)</i>	<i>Controlled (1/0)</i>	<i>Dispersed</i>	<i>Dominant</i>	<i>Controlled</i>
Intercept	?	4.003 (4.520)***	4.035 (4.594)***	3.296 (5.036)***	4.795 (4.946)***	5.310 (3.623)***
ROB index	+	0.012 (1.972)**	0.011 (2.233)**	0.012 (1.965)*	0.011 (2.513)**	0.006 (4.470)***
Ownership (1/0)	None	0.174 (0.488)	0.567 (2.555)**	—	—	—
<i>OWNERSHIP/ROB</i>	None	-0.004 (-0.885)	-0.005 (-0.914)	—	—	—
<i>WEDGE</i>	-	0.117 (0.715)	-0.326 (-1.009)	—	0.279 (0.570)	-0.418 (-1.120)
<i>SIZE</i>	?	-0.245 (-5.539)***	-0.244 (-5.944)***	-0.175 (-3.789)***	-0.288 (-4.914)***	-0.336 (-3.728)***
<i>DEBT</i>	?	-0.548 (-2.942)***	-0.591 (-3.297)***	-0.993 (-1.524)	-0.275 (-3.590)***	-0.538 (-3.873)***
<i>CAPEX</i>	+	2.504 (4.084)***	2.504 (3.981)***	1.422 (2.194)**	2.665 (2.802)***	0.426 (0.764)
<i>AGE</i>	?	-0.009 (-0.059)	-0.018 (-0.114)	0.086 (0.381)	-0.354 (-1.098)	0.711 (4.070)***
<i>SECTOR</i>	?	Yes	Yes	Yes	Yes	Yes
Year effect	?	Yes	Yes	Yes	Yes	Yes
Firm effect	?	Yes	Yes	Yes	Yes	Yes
Adjusted R ²		0.219	0.219	0.112	0.262	0.265
<i>F</i>		(9.220)***	(9.229)***	(2.802)***	(6.755)***	(3.851)***
<i>n</i>		470	470	187	179	104

*, **, ***: statistically significant for the threshold values of 10%, 5%, and 1% respectively.

(*OWNERSHIP/ROB*). Then, the governance–performance relationship is analyzed for each of the three sub-groups (dispersed, dominant and controlled).

On the full sample, the coefficient of the ROB total index is positive and significant. However, as expected (Hypothesis 2), the coefficient of the interactive term *OWNERSHIP/ROB* is not suggesting that the positive relationship between the overall ROB index and Q is not derived from closely or widely held firms. Hypothesis 2 is further supported when panel regressions are run for each of the three sub-samples. In each case, the coefficient of the ROB total index remains positive and significant for each of the three sub-groups.

In Table 6, we rerun the tests from Table 5 while replacing the ROB total index by the BC sub-index. BC sub-index includes key governance provisions related to the composition and functioning of the board of directors. Consistent with Table 5, results from Table 6 show no significant relationship between the interactive term *OWNERSHIP/BC* and Q. However, the coefficient of the BC sub-index is positive and significant only for the sub-sample of firms with concentrated ownership (dominant and controlled) suggesting a stronger relationship between BC and Q for closely-held firms. These results are consistent with those of Setia-Atmaya (2009) who studied board independence (see Table 1).

Table 6: BC sub-index, firm value (Q) and ownership concentration (Hypothesis 2)

	<i>Expected sign</i>	<i>Full Sample</i>		<i>Sub-Samples</i>		
		<i>Dominant/ Controlled (1/0)</i>	<i>Controlled (1/0)</i>	<i>Dispersed</i>	<i>Dominant</i>	<i>Controlled</i>
Intercept	?	4.076 (4.387)***	3.984 (4.447)***	2.882 (3.435)***	4.886 (5.184)***	5.057 (3.177)***
Board index	+	0.008 (0.744)	0.010 (1.203)	0.007 (0.734)	0.011 (1.874)*	0.009 (5.966)***
Ownership (1/0)	None	−0.150 (−0.588)	0.235 (1.254)	—	—	—
<i>OWNERSHIP/BOARD</i>	None	0.001 (0.135)	−0.001 (−0.166)	—	—	—
<i>WEDGE</i>	−	−0.014 (−0.106)	−0.450 (−1.376)	—	−0.043 (−0.090)	−0.403 (−0.974)
<i>SIZE</i>	?	−0.211 (−4.510)***	−0.211 (−4.573)***	−0.108 (−2.650)***	−0.266 (−4.252)***	−0.313 (−3.254)***
<i>DEBT</i>	?	−0.565 (−2.893)***	−0.599 (−3.118)***	−1.151 (−1.679)*	−0.220 (−2.348)**	−0.503 (−4.896)***
<i>CAPEX</i>	+	2.579 (4.288)***	2.568 (4.283)***	1.502 (2.262)**	2.744 (2.940)***	0.300 (0.434)
<i>AGE</i>	?	−0.008 (−0.047)	0.005 (0.027)	0.088 (0.381)	−0.295 (−0.871)	0.687 (4.760)***
<i>SECTOR</i>	?	Yes	Yes	Yes	Yes	Yes
Year effect	?	Yes	Yes	Yes	Yes	Yes
Firm effect	?	Yes	Yes	Yes	Yes	Yes
Adjusted R^2		0.198	0.197	0.088	0.240	0.259
<i>F</i>		(8.242)***	(8.172)***	(2.381)***	(6.109)***	(3.772)***
<i>n</i>		470	470	187	179	104

*, **, ***: statistically significant for the threshold values of 10%, 5%, and 1% respectively.

Results from panel regressions using the Compensation, Shareholders' Rights and Disclosure ROB sub-indexes are not reported here but are overall similar to those presented in Tables 5 and 6.

Governance performance relationship and insider positions (Hypothesis 3)

This section addresses the second dimension of shareholders' proximity that takes into account the level of involvement of the dominant/controlling shareholder in the daily activities of the firm. Regressions are performed on the full sample and sub-samples with the ROB

total index and the BC sub-index. Results are reported in Table 7. The variable *INSIDER* takes the value of 1 if the dominant/controlling shareholder is holding the CEO and/or Chair position. No test is performed on the sub-sample of controlled companies because all the controlling shareholders are insiders (see Table 2).

In all the regressions, neither the *INSIDER* variable nor the interactive term *INSIDER/ROB* are significant. Contrary to Hypothesis 3, the results show that holding strategic positions by a dominant/controlling shareholder does not have any impact on the governance–performance relationship. Moreover, the presence of insiders

Table 7: ROB Index, firm value (Q) and insider positions (Hypothesis 3)

	<i>Expected sign</i>	<i>ROB Total Index</i>			<i>BC Sub-Index</i>		
		<i>Full sample</i>	<i>Dominant and controlled</i>	<i>Dominant</i>	<i>Full sample</i>	<i>Dominant and controlled</i>	<i>Dominant</i>
Intercept	?	3.446 (2.863)***	3.884 (3.512)***	4.584 (3.830)***	3.588 (3.304)***	4.076 (4.252)***	4.701 (4.652)***
ROB index	+	0.017 (2.070)**	0.016 (1.737)*	0.018 (1.901)*	0.020 (1.286)	0.020 (1.319)	0.022 (1.498)
Insider (1/0)	–	0.752 (1.514)	0.706 (1.162)	0.726 (1.136)	0.459 (1.235)	0.365 (0.793)	0.425 (1.000)
<i>INSIDER/ROB</i>	–	–0.009 (–1.180)	–0.011 (–1.074)	–0.011 (–1.164)	–0.013 (–1.098)	–0.015 (–1.029)	–0.018 (–1.267)
<i>WEDGE</i>	–	–0.029 (–0.201)	0.022 (0.189)	0.387 (0.564)	–0.170 (–1.957)*	–0.055 (–0.380)	0.157 (0.230)
<i>SIZE</i>	?	–0.240 (–5.827)***	–0.272 (–6.135)***	–0.302 (–5.708)***	–0.210 (–4.420)***	–0.251 (–4.964)***	–0.273 (–4.482)***
<i>DEBT</i>	?	–0.592 (–2.585)**	–0.310 (–2.728)***	–0.333 (–1.809)*	–0.592 (–2.571)**	–0.298 (–2.401)**	–0.288 (–1.451)
<i>CAPEX</i>	+	2.504 (3.970)***	2.646 (3.215)***	2.629 (2.686)***	2.601 (4.536)***	2.793 (3.751)***	2.822 (3.125)***
<i>AGE</i>	?	–0.019 (–0.128)	–0.030 (–0.172)	–0.362 (–1.159)	–0.007 (–0.040)	–0.017 (–0.091)	–0.310 (–0.973)
<i>SECTOR</i>	?	Yes	Yes	Yes	Yes	Yes	Yes
Year effect	?	Yes	Yes	Yes	Yes	Yes	Yes
Firm effect	?	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted R^2		0.221	0.274	0.262	0.199	0.257	0.240
<i>F</i>		(9.333)***	(7.638)***	(5.873)***	(8.266)***	(7.084)***	(5.317)***
<i>n</i>		470	283	179	470	283	179

*, **, ***: statistically significant for the threshold values of 10%, 5%, and 1% respectively.

has no direct impact on Q which suggests that the overall agency costs of the firm are not influenced by insiders. Ownership concentration alone may give the dominant/controlling shareholder sufficient power to expropriate.

Similar results are obtained when governance is measured based on the Compensation, Shareholders' Rights and Disclosure ROB sub-indexes.

Robustness checks

The following additional tests were performed in order to verify the robustness of our results.

First, following previous studies (see, for instance, Villalonga and Amit, 2006; Bozec and Laurin, 2008), we re-conducted our panel regressions using industry-adjusted Q instead of Q. For each firm, industry-adjusted Q is defined as the difference between Q and industry average Q. *Second*, prior evidence (see Black *et al*, 2009) shows that governance has influence on future performance. Since our tests consider only the contemporaneous relationship between ROB indexes and firm value, we rerun our multivariate analysis adding lagged ROB indexes. *Third*, we re-conducted our tests using

OLS estimations instead of panel regressions. OLS were performed using pooled and cross-sectional data (for each year from 2002 to 2005). *Fourth*, we replaced *WEDGE* by different metrics which all capture the separation of cash-flow rights and voting rights (ratio *CFR/VR* and *SEPARATION*: see Appendix B). None of these additional tests changed the overall results reported in Tables 4–7.

CONCLUSION

Summary

The objective of this article is to revisit the governance–performance relationship while taking into account shareholders’ proximity to the locus of management. Shareholders’ proximity is defined based on ownership concentration and whether or not the dominant/controlling shareholder holds top executive positions in the firm (CEO/Chair positions). Governance is measured on a global scale while taking into account the ROB index. The study is conducted over a 4-year period (2002–2005) using unbalanced panel regressions on a sample of Canadian publicly traded companies (470 firm-year observations).

The results of the study show a positive relationship between the ROB global index and sub-indexes and Tobin’s Q (Hypothesis 1). This relationship remains positive whether ownership is dispersed or concentrated in the hands of a dominant or controlling shareholder. Therefore, ownership concentration has no impact on the governance–performance relationship (Hypothesis 2). Contrary to our expectations (Hypothesis 3), the results also show that holding key strategic positions by the dominant/controlling shareholders does not affect the relationship between governance and Q.

Contributions to the literature

From an agency theory standpoint, the results of our study suggest that the agency costs of the firm are relatively stable along the ownership

concentration spectrum. If ownership by a dominant/controlling shareholder is likely to decrease agency costs associated with misalignment of interests between managers and shareholders (Principal–Agent problem), it increases the risk of expropriation (Principal–Principal problem), canceling out any expected gains from interests alignment. Our results show that good corporate governance practices in the context of high agency costs (interests misalignment and expropriation costs combined) have the potential to deter diversion of firm resources. Improving transparency and control adds value to all publicly traded companies including those with concentrated ownership.

However, if holding the CEO and/or Chair positions has the potential to increase the power of a dominant/controlling shareholder, it does not seem to translate into higher agency costs to the firm nor does the presence of insiders seem to affect the effectiveness of the controls in place. Publicly traded companies may therefore welcome dominant/controlling shareholders in key management positions without compromising on firm performance and value. In any case, putting in place good governance practices seems essential to ensure that managers/shareholders are kept in check and work in the best interests of their company. In this regard, as the nature and emphasis of the CEO and Chairman roles are clearly different, it remains critical that these two positions be assumed by different individuals (non-duality structure).

Our study contributes to the methodology on many fronts. First, contrary to prior index-based studies including Klein *et al* (2005), we propose shareholders’ proximity to management as a better predictor of the level of a firm’s agency costs than ownership type or category. Second, we address the case of dual-class firms while carefully collecting the voting rights and the cash-flow rights of the ultimate owner. By doing so, we propose a refined classification of our sample firms along the ownership continuum (dispersed, dominant, controlled). Third, the risk of endogeneity that plagues research in corporate governance has been tackled while

analyzing the governance–performance relationship using fixed effects methodologies (to control for spurious correlation) and a 2SLS setting with instrumental variables (to control for reverse causality).

Contributions to practice

Overall, the results support a one-size-fits-all approach to governance despite growing concerns from academics and interest groups about the appropriateness of pursuing such strategy when ownership is concentrated in the hands of a dominant/controlling shareholder. The one-size-fits-all approach to governance has also been criticized in the aftermath of the 2008 US debt crisis that called into question the supremacy of the US market-centered model of governance. Our study rejects these claims by showing that governance controls should not account for ownership differences in the context of publicly traded companies. Instead, good governance practices based on an independent board of directors that promotes transparency and protects shareholders' rights should be prioritized whether or not ownership is dispersed or concentrated.

Limitations and direction for future research

Only controlled companies with a controlling shareholder holding less than 50 per cent of the cash-flow rights are selected in this study. Dual-class companies represent a large portion of Canadian controlled companies listed on the TSX. On the other hand, non-dual-class controlled companies are more prevalent among private companies. Misalignment and expropriation costs are expected to be relatively low in these entities where shareholders' identification with and commitment to the firm should be strengthened. In these circumstances, the role of the board should be less about accountability and monitoring and more about growing the enterprise. As such, the board should be engaged in building an organizational

reputation, formulating or ratifying organizational strategy and networking for the firm. Boards should also be called on to advise and enhance strategy formulation. Insiders should be valued for their operational expertise and the CEO/Chair should provide a unity of command. Future research should test whether or not special control arrangements are required for non-dual-class controlled companies. The governance–performance relationship should be analyzed in that unique context.

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APPENDIX A

Major criteria considered within the ROB corporate governance rating categories for 2005

The overall ROB index comprises four categories or sub-indexes that in turn include different factors. The data were obtained from the proxy information circular for shareholders. The maximum weight assigned to each factor is shown in brackets.

1. BC (37 marks)
  - Independence of the board of directors, the audit committee, the compensation committee and the nominating committee (19 marks)
  - Duality structure (position held by the Chairman and the CEO) (5 marks)
  - Relationship between directors (3 marks)
  - Engagement of the CEO versus other outside commitments (2 marks)
  - Women on the board (2 marks)
  - Performance evaluation of the board (3 marks)
  - Meetings of the board without management (3 marks)
2. Compensation (25 marks)
  - Stocks owned by directors and CEO (13 marks)
  - Loans to senior executives (2 marks)
  - Disclosure of compensation policies regarding CEO bonuses (4 marks)
  - Disclosure of compensation policies regarding CEO and top executives (6 marks)
3. Shareholder rights (28 marks)
  - Election of the board (6 marks)
  - Degree of dilution when stock options are owned by employees (6 marks)
  - Other option plans (6 marks)
  - Presence of non-voting or subordinate voting shares (10 marks)
4. Disclosure (10 marks)
  - Related directors (1 mark)
  - Directors' biography (1 mark)
  - Disclosure of fees paid to an outside compensation consultant (1 mark)
  - Attendance record of directors at committees and meetings (2 marks)
  - Disclosure of the compensation paid to directors last year (3 marks)
  - Disclosure of directors' ages and retirement policies (2 marks)

APPENDIX B

Table B1: Variables description

<i>Governance index</i>	
<i>TOTAL</i>	ROB total index
<i>BOARD</i>	ROB sub-index related to the board structure and composition
<i>COMPENSATION</i>	ROB sub-index related to the directors' and CEO's stock ownership
<i>SHAREHOLDER RIGHTS</i>	ROB sub-index related to employees' stock options and the presence of non-voting shares
<i>DISCLOSURE</i>	ROB sub-index related to the quality and availability of information on corporate governance
<i>LAG TOTAL</i>	1 year lag period of the ROB total index
<i>Performance</i>	
<i>TOBIN'S Q (Q)</i>	[Market value of equity + book value of total debt/Total assets] of the firm
<i>Proximity:</i>	
<i>DISPERSED</i>	Firms with no shareholder holding more than 10% of the voting rights
<i>DOMINANT</i>	Firms with a shareholder holding at least 10% but less than 50% of the voting rights
<i>CONTROLLED</i>	Firms with a shareholder holding at least 50% of the voting rights but less than 50% of the cash-flow rights
<i>CEO/CHAIR</i>	1 if the dominant/controlling shareholder holds the CEO and/or the Chair positions, otherwise 0
<i>Control variables</i>	
<i>AGE</i>	1 if the firm is listed on StockGuide for at least 10 years, otherwise 0
<i>DEBT</i>	Long-term debt over assets
<i>SIZE</i>	Logarithm of assets at the end of the financial year
<i>CAPEX</i>	Total capital expenditures (including R&D expenditures) / total assets
<i>SECTOR</i>	Dummies for sector
<i>YEAR</i>	Dummies for 2002, 2003, 2004 and 2005 (2005 is the reference year)
<i>WEDGE</i>	Voting rights (VR) minus cash-flow rights (CFR)
<i>SEPARATION</i>	1 if the voting rights (VR) exceed the cash-flow rights (CFR), otherwise 0
<i>CFR/VR</i>	Ratio of cash-flow rights (CFR) over voting rights (VR)