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Governance Quality in a "Comply or Explain" Governance Disclosure Regime

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ABSTRACT

Manuscript Type: Empirical
Research Question/Issue: Do firms take advantage of the flexibility of the "comply or explain" corporate governance disclosure regime to adopt governance practices that are best suited to their needs and value-added to the firms as predicted by economic theories of the firm? Using the Canadian "comply or explain" corporate governance disclosure regime, we construct a board score measure based on the Canadian code's 47 "best practices." We employ a unique approach by positing that the "explain" disclosures indicate higher agency costs of best practice adoption or indicate the ability of the firm to improve its governance practices relative to "best practices" in light of firm specific circumstances.
Research Findings/Insights: We find that our measure is strongly and positively associated with higher firm value and weakly and positively associated with better operational performance. Further, our measure is more strongly associated with both than best practice adoption measures.
Theoretical/Academic Implications: Our unique measure of governance quality reveals differences in governance efficiency and effectiveness that are consistent with the theorized advantages of "comply or explain" governance disclosure regimes. Further, our results suggest that firms in a "comply or explain" regime are not employing, on average, the discretion permitted by such a regime to avoid improvements to their corporate governance practices.
Practitioner/Policy Implications: Our results support the proposition that the flexibility of a "comply or explain" governance regime provides tangible financial benefits to shareholders in terms of higher firm value and returns on shareholders' equity investment.

Keywords: Corporate Governance, Agency Costs, Comply or Explain, Firm Performance, Firm Value

INTRODUCTION

Nearly all countries that have addressed the regulation of corporate governance practices for public companies have adopted what has become known as the "comply or explain" governance regime (e.g., Aguilera & Cuervo-Cazurra, 2004, 2009; Haxhi & van Ees, 2010; Renders & Gaeremynck, 2012). Such regimes feature a regulator-endorsed code of best governance practices and require firms to either "comply" with those practices by adopting them or "explain" how they will achieve the underlying governance principle behind each practice that is not adopted. The disciplining power of this regime is the required public disclosure of governance practices that allows market participants to evaluate the effectiveness of the firm's governance system and to make informed assessments of whether noncompliance is justified in particular circumstances. The advantage of this governance approach is that firms can tailor their governance practices to meet their underlying needs based on the trade-off between costs and benefits resulting from additional monitoring, instead of incurring compliance costs for mandated practices that do not add value and/or create additional net costs for firms (Adams, Hermalin, & Weisbach, 2010).

As the ultimate goal of good governance is to maximize shareholder value, in this study we focus on the effect of a tailored governance system on firm value and return on shareholders' investment. Specifically, our study asks whether the flexibility to adopt alternative governance practices in a "comply or explain" regime results in more effective board monitoring that leads to better firm performance and higher firm value. Answering this question provides insights into whether the advantages of the "comply or explain" approach to governance are, on average, real, or whether this governance regime affords firms a means to avoid engaging in serious attempts to improve governance (Zadkovich, 2007). The latter contention underlies the more

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prescriptive approach to corporate governance that is followed in the US (e.g., Dodd-Frank, 2010; Sarbanes-Oxley Act of 2002 or SOX) and is based on the premise that alternative voluntary approaches have failed (at least in the US context).

The limited existing studies of "comply or explain" governance disclosure regimes focus on whether firms adopt the codified best governance practices (e.g., MacNeil & Li, 2006); they do not consider how the tailoring allowed by such regimes potentially allows firms to create more efficient and/or effective practices. In other words, most researchers convert the "comply or explain" regime into a *de facto* mandated governance "best practice" adoption regime, by treating anything but the adoption of best practice norms as "non-compliant."

Unlike the previous research, this study does not start from the assumption that the goal of "comply or explain" regimes is to encourage the adoption of a code of "best practices" (e.g., Hooghiemstra, 2012; MacNeil & Li, 2006). Rather, we take an innovative approach by positing that the "or explain" option can potentially result in greater benefits to the firm as it allows it to tailor its governance practices to its particular circumstances. We argue that while "on average" regulators may have identified "best practices" in their codes, this identification does not lead to an "on average optimal" best practice being optimal for individual firms. Thus, we posit that a departure from a "best practice" that includes an explanation of how the alternative approach achieves the goal of the non-adopted "best practice" suggests that there are significant benefits (or alternatively that significant costs are avoided) associated with the tailoring of this governance practice to firm-specific circumstances. Using the Canadian "comply or explain" corporate governance disclosure regime as our research setting, we construct a comprehensive board score measure based on the 47 governance dimensions embedded in the best governance practices codified and endorsed by the Canadian Securities Regulators (i.e., Canadian Securities Administrators [CSA], 2004a, 2004b). We code each firm's response to each of the 47 items using a simple three-point scale: "0" for noncompliance/non-disclosure; "1" for compliance with the guideline; and "2" for an explanation of an alternative governance practice that allows the firm to achieve the governance principle embedded in the best practice without actually adopting it. Noncompliance (by either non-disclosure or stated non-compliance with no explanation) suggests that managers are attempting to take advantage of information asymmetries with shareholders and to reduce the level of monitoring of their actions. The adoption of a "best practice" indicates that the costs of tailoring a firm-specific alternative to a recommended practice exceed the costs associated with the adoption of even a non-optimal "best practice."

Preliminary screening of our data suggests that less than 7 percent of our sample firms fully adopt all of the suggested best practices, indicating that the majority of our sample firms take advantage of the latitude allowed in the "comply or explain" regime to customize governance practice to firm-specific needs or, alternatively, evidence that firms are avoiding serious attempts to reform governance. About 45 percent of the firms complied with 42–46 of the 47 items, lending support to the argument that in a "comply or explain" regime, compliance "by explanation" rather than "by adoption" is applied to practices that have high costs for the firm. It is unlikely that so many firms would fail to comply with the remaining handful of practices unless the costs of complying outweighed the potential negative publicity associated with not having completely adopted regulator-endorsed "best practices." As is common with many "comply or explain" jurisdictions, Canada features regular media reporting on firm's adoption of governance best practices including rankings based on such adoptions (see, e.g., Globe & Mail, 2012).

Among the items that are frequently dropped by firms that are very close to full adoption are the guidelines related to the independence of the board and its subcommittees, for example, the independence of the board chairman, in-camera meetings by independent directors, seeking outside advisers, and the complete independence of compensation and nomination committees. Among these three items, the independence of board chairman is the least often "adopted" but most frequently "explained" item among the 47 best-practice guideline items in the entire sample. All these most frequently dropped items are related to the well-known problem of a limited talent pool of professionals qualified to sit on boards in the Canadian market resulting in firms having to compete for the limited pool of available directors or accept less qualified directors (e.g., McFarland, 2013). These examples of best practices that are not adopted demonstrate the value of the flexibility allowed in a "comply or explain" regime for if unmodified, mandatory regulations that require such practices to be adopted (e.g., completely independent composition of compensation and nomination committees) would likely be more costly for Canadian firms to implement.

In this study, we test the associations between our governance measures and the tangible financial benefits to shareholders: firm value and operating performance. We find that higher governance scores under our unique coding scheme are strongly associated with higher firm value, as measured by Tobin's Q, and weakly associated with better operational performance, as measured by return on equity (*ROE*). Such findings are consistent with the results of both survey and empirical studies indicating that investors are willing to pay more for companies with good corporate governance (Durnev & Kim, 2005; La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2002; McKinsey, 2002). Our results further support the arguments and findings from studies of the economic determinants of board effectiveness that some firms may be better served by a board that is different than the one essentially mandated by "one size fits all" regulations (Boone, Field, Karpoff, & Raheja, 2007; Coles, Daniel, & Naveen, 2008; Linck, Netter, & Yang, 2008).

We conduct additional analyses based on alternative measures used in prior "comply or explain" studies that are based on assumptions that "compliance by adoption" is superior to "compliance by explanation" or suggest that any action but adoption of best practice is "noncompliance." The positive association between our governance quality proxy and both firm value and performance becomes weaker, or even disappears, when employing these more conventional approaches to measuring governance quality in the "comply or explain" regime. The evidence supports our contention

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that governance quality measures based on our analysis of the value of the "or explain" provision of "comply or explain" governance codes is more diagnostic of differences in governance effectiveness, *in substance*. Our results remain robust when submitted to a battery of additional specification checks.

Taken together, these findings suggest that firms in a "comply or explain" regime are not employing, on average, the discretion permitted by such a regime to avoid making improvements to their corporate governance. On the contrary, our findings suggest that firms are benefiting by creating governance practices that are cost efficient and effective for them given their firm-specific governance needs. However, we are mindful that evidence of "on average" benefits has to be considered in light of the potentially large costs that could be incurred by investors in a few firms that use this discretion to avoid improving their governance practices. Regulators need to consider the possibility of extreme instances of governance failure occurring (e.g., Coates, 2007), including the costs incurred in those instances when considering the benefits we document in this paper for the "comply or explain" regime.

This paper proceeds as follows. First, we briefly review the context and theoretical advantages of "comply or explain" corporate governance disclosure codes. We then develop our economic theory-based predictions about the effects of the ability to tailor governance practices to firm-specific circumstances on firm value and firm performance. The subsequent section describes our research methods, sample selection, and results as well as robustness tests of our hypothesized relationships. We conclude with a discussion of the implications of our analyses for firms in "comply or explain" environments. Finally, we discuss the limitations of our study and opportunities for future research.

THEORY AND CONTEXT OF THE STUDY

According to agency theory, corporate governance is a set of monitoring mechanisms that exist when the separation of ownership and control make it necessary for capital providers to set up means to safeguard and to achieve a return on their investment (Shleifer & Vishny, 1997). Viewed as the "ultimate internal monitor" by Fama (1980), the board of directors and its subcommittees (especially the audit committee) have been the focus of the ongoing voluntary governance reforms in the private sector since the early 1970s (BRC, 1999) and gradually transformed into a heavily regulated environment after 2002. The resultant "one size fits all" corporate governance regulations (e.g., SOX, 2002 in the US) generally recommend the same corporate governance practices for all types of companies, despite the evidence that the type and severity of agency problems differs across companies with different ownership and control structures (Chen & Nowland, 2010; Jensen & Meckling, 1976; Shleifer & Vishny, 1986). These "one size fits all" mandatory regimes implicitly assume that they are more effective in protecting stakeholders than a private-sector oriented governance regime such as the "comply or explain" regime (Romano, 2005a, 2005b). However, mandated approaches are unlikely to be first best solutions, given the existence of moral hazard and the imperfect observation of an agent's actions in the principal-agent relationship (Adams et al., 2010).

In contrast to legislated mandatory governance models (the most well-known of which is the SOX-based regime in the US) that prescribes one set of practices for all firms, the "comply or explain" approach is the most common approach to corporate governance in the world (i.e., European Union, Australia, New Zealand, Singapore, Hong Kong, and many other countries) (see Arcot & Bruno, 2010; Zadkovich, 2007). The popularity of "comply or explain" governance regimes is based on the idea that the fundamental determinants of the type and severity of agency costs are companies' ownership and control structures, which differ across countries and industries, and that corporate governance practices should reflect such differences (Chen & Nowland, 2010). A "comply or explain" regime (e.g., CSA, 2004b; OECD, 2004) allows firms to either voluntarily adopt regulator-endorsed "best practices" or to explain why they have adopted an alternative practice that achieves the underlying governance principle embedded in the endorsed best practice. The disciplining power of such a regime is the legal requirement of mandatory disclosure by firms of their governance practices, including clear statements about whether they have adopted each regulator-endorsed "best practice" or an explanation of their alternative approach.

We argue that under a "comply or explain" regime, a firm's explanation of its use of an alternative practice is an indication that the firm has developed a governance approach that is, for its specific circumstances and needs, more cost efficient or effective than the regulator-endorsed "best practice." In other words, firms deviate from a "best practice" and create an alternative practice, when the agency costs of adopting the best practice are too high relative to the benefits obtained from being seen as a "governance exemplar." Hence, a "comply or explain" regime allows discretion in the adoption of identified "best practices" by permitting deviation from these codified "best practices," as long as the deviations are justified. Furthermore, the regime requires firms to disclose the governance practices they have adopted (Aguilera & Cuervo-Cazurra, 2004, 2009; Haxhi & van Ees, 2010).

The "comply or explain" approach is built on the idea that with mandatory disclosure by firms, market participants can "price protect" themselves; thus, market forces will discipline the firms (e.g., Baiman & Verrecchia, 1996). For example, capital market participants can monitor firms' governance practices via their compliance with the regulator-endorsed "best practice" code by either penalizing noncompliance through lower share prices or accepting noncompliance that is justified as appropriate for firm-specific circumstances (MacNeil & Li, 2006; Steeno, 2006). In this regime, a firm's governance practices are driven by market competition, rather than by prescribed legal rules or fear of penalties for noncompliance (Zadkovich, 2007).[1] Voluntary compliance (either by adoption of best practices or explanation of an alternative approach) is alleged to represent an important improvement in regulatory modes, as it allows firms to adopt governance practices that are cost efficient and effective based on their specific circumstances (Adams et al., 2010).

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HYPOTHESES DEVELOPMENT

In a market-based economy, public companies have a strong incentive to adopt norms such as "best governance practices" or to provide a strong justification for non-adoption, as governance best practices are generally recognized as value enhancing (Renders & Gaeremynck, 2012). Extant research shows that weaknesses in governance structure or a lack of governance transparency are associated with lower financial reporting quality, earnings manipulation, and fraud (e.g., Bauwhede & Willekens, 2008; Beasley, Carcello, Hermanson, & Lapides, 2000; Carcello & Neal, 2000; Dechow, Sloan, & Sweeney, 1996). Unsurprisingly, surveys of investors suggest that governance quality may influence investors' decisions to acquire equity positions (Holder-Webb, Cohen, Nath, & Wood, 2008; McKinsey, 2002; Patel & Dallas, 2002). Given the general perception that "best practices" are normatively superior (Globe & Mail, 2012), boards would not want their firm to be considered potentially negligent in its governance practices by being part of the sub-set of the market not in compliance with the regulator-endorsed "best practices," unless the practice was very costly from the firm's perspective.[2]

Given the trade-offs associated with making "one size fits all" regulations, it is unlikely that regulator-endorsed "best practices" will be optimal for most firms (Adams et al., 2010). The marginal benefit and/or marginal cost of adopting each additional "best practice" guideline will differ across firms for at least two reasons. First, from the benefit perspective, the same level of monitoring may reduce agency costs to different degrees in different firms, as the type and severity of the agency problem differs across companies with different ownership and control structures or other firm-specific circumstances (Boone et al., 2007; Chen & Nowland, 2010; Coles et al., 2008; Linck et al., 2008; Raheja, 2005). Second, even if the benefits associated with the adoption of a "best practice" are relatively equal across all firms, the costs of adopting a "best practice" will vary considerably. The costs of adopting a suggested governance practice include: (1) the opportunity cost of compliance (i.e., the cost associated with adoption of the best practice guidelines compared to the cost of the optimal arrangement; MacNeil & Li, 2006); (2) the cost of shifting management's focus from creating wealth, as time and resources are used to satisfy the requirements of additional monitoring (Adams & Ferreira, 2007); and (3) the out-of-pocket compliance costs associated with adoption. Such out-of-pocket costs potentially include annual cash retainers paid to directors, fees paid for attending board meetings and committee meetings, extra fees for an independent board chair and chairs of board committees, non-cash equity pay including restricted stock grants, options, and the like among other costs.

The inherent appeal of the "comply or explain" governance regime is that it allows firms to adopt best practices where they are optimal and to use alternative means of achieving the governance principle where adoption of "best practices" would be costly in light of a firm's specific circumstances (Adams et al., 2010). In addition to being cost efficient, this allows firms to demonstrate the strength of their governance system, rather than just their compliance with mandated rules. In the context of a "comply or explain" governance regime, we argue that stronger governance is reflected in practices that are tailored to the specific needs of the firm and that such tailored governance is likely to be associated with higher firm value and better operational performance.

According to agency theory, the ultimate goal of an effective governance system is to maximize firm value (Jensen & Meckling, 1976). Hence, under a "comply or explain" regime, the ability of boards to tailor firms' governance practices should allow market participants to benefit from firms' selection of the most cost efficient and effective governance structures given their particular circumstances. In the long run, a firm's ability to dispense with inefficient or ineffective governance practices should lead to higher firm-specific value (e.g., Gompers, Ishii, & Metrick, 2003; Renders, Gaeremynck, & Sercu, 2010). We suggest that a more tailored set of governance practices, if the tailoring is justified with explanations for the departures from regulator-endorsed "best practices," is a clear indication of the relatively higher costs associated with the regulator-endorsed "best practices." Thus, the flexibility provided by a "comply or explain" regime gives firms the potential to improve firm value. Furthermore, according to the theory of market discipline (e.g., Baiman & Verrecchia, 1996), non-compliant firms (i.e., those who either do not disclose or disclose noncompliance without explanation) should have relatively lower market-based measures of value, as they have indicated to market participants that they have disregarded basic governance principles. Thus, our first hypothesis, stated in an alternative form, is as follows.

H1a. The more tailoring that a firm does via explaining departures from regulator-endorsed "best practices," the higher the firm value, ceteris paribus.

Prior empirical studies of mandatory governance regimes suggest a positive correlation between corporate governance and operating performance (e.g., Brown & Caylor, 2009; Larcker, Richardson, & Tuna, 2007), albeit these correlations tend to be weak compared to the associations with firm value measures. In the context of a "comply or explain" governance regime, we argue that a tailored governance practice supports the wealth creation process and contributes to the company's operational performance (Raheja, 2005). Thus, our second hypothesis, stated in alternative form, is as follows.

H1b. The more tailoring that a firm does via explaining departures from regulator-endorsed "best practices," the better the firm's operational performance, ceteris paribus.

For both hypotheses, if adopting the complete set of regulator-endorsed governance "best practices" is indeed the most cost efficient and effective set of governance practices for firms, the bias in our testing employing "or explain" as an indication of ability to tailor governance practices to those optimal for the firm would be against supporting the hypotheses. Our measure does not capture well settings where it is optimal for firms to adopt the complete set of governance best practices in their circumstances. However, given the reported rarity of complete adoption (less than 7

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percent in our sample), this does not seem to be a huge concern. Further, we address this issue by conducting additional analyses that use alternative interpretations of the goal of "comply or explain" regimes (e.g., by coding only those firms who adopt best practices as indicating higher quality governance).

RESEARCH METHODS

Measures of Governance Quality

Previous studies have empirically confirmed the associations between corporate governance and firm value/performance in the US (Gompers et al., 2003; La Porta et al., 2002; Larcker et al., 2007) and in various countries with "comply or explain" regimes (Black & Kim, 2012; Nowland, 2008). Our study uses an innovative coding system to investigate whether the tailoring permitted by a "comply or explain" regime allows firms to seek more efficient and/or effective governance practices. Coding the "or explain" choice as an indicator of a greater firm-specific benefit of the inherent flexibility in the regime as opposed to assuming that the goal of the regime is the adoption of a best practice is unique to our study. Many regulators (e.g., ASX, 2003) and researchers (e.g., Anuchitworawong, 2010) assume that the goal of the "comply or explain" system is to promote the adoption of the best practices (see the various reports published by regulators about adoption of best practices, e.g., ASX, 2003; OECD, 2004; and CSA, 2007). However, as there are costs associated with not adopting codified best practices, any firm that incurs the costs of an "explanation" is likely to be signaling that it has identified a substantially less costly means to achieve the governance principle (Adams et al., 2010) or has a more effective practice than adoption of the best practice norm allows.

Our board score measures are based on Canada's "best practice" governance code. The code originated with the TSE (Toronto Stock Exchange) commissioned Dey (1994) report, which was subsequently formalized and modified by the Canadian Securities Administrators (CSA) via Multilateral Instruments 58-101 (CSA, 2004a), 52-110 (CSA, 2004c), and 52-109 (CSA, 2005). In Canada, the "Statement of Corporate Governance Practice" in a firm's annual report or annual information circular is required to follow a tabular format to allow market participants to locate easily the relevant disclosures (CSA, 2004a). We divide the code into 47 governance "best practice" items (Appendix A). We code each of the 47 items based on a simple three-point scale: "0" represents noncompliance/non-disclosure; "1" represents the adoption of the endorsed "best practice"; and "2" represents an explanation for the adoption of an alternative governance practice that allows the firm to achieve the governance principle embedded in the "best practice." Noncompliance by non-disclosure or stated noncompliance with no explanation suggests that firms' managers are attempting to reduce the level of monitoring of their actions. We take adoption of a "best practice" as an indication that the costs of tailoring an alternative practice given a firm's specific circumstances exceeds the costs associated with the adoption of a non-optimal "best practice." We argue that an explanation of a departure from a "best practice" indicates that there are significant benefits (or alternatively the avoidance of significant costs associated with adopting a non-optimal "best practice") associated with tailoring the governance practice to firm-specific circumstances.

Given the nature of our items, it requires relatively little judgment to determine whether a firm has adopted the best practice, explained an alternative approach to achieving the governance principle, or has not complied by either omitting the disclosure or stating clearly that it did not comply.[3] We sum the scores for the items to construct two board score measures that we believe measure relative governance strength: (1) board score (abbreviated as *BDSC(EXPLAIN)*) measures firm-specific compliance with 38 board-level best practices using the above three-point scale; and (2) total board score (abbreviated as *TBDS(EXPLAIN)*) adds an additional nine items related solely to best practices for audit committees (AC) to the 38 *BDSC(EXPLAIN)* items. Our coding approach is among the most comprehensive indices developed for "comply or explain" research, as most researchers code only sub-sets of the "comply or explain" disclosures (see, e.g., MacAulay, Dutta, Oxner, & Hynes, 2009, who code 20 Canadian items selected from the 47 items in the Canadian code, and Hooghiemstra, 2012, who codes only explanations for noncompliance with the Dutch "best practices").

To test the validity of this coding scheme, we construct alternative governance scores using three conventional interpretations of the goal of the "comply or explain" governance regime. Our first pair of alternative measures, *TBDS(EQUAL)* and *BDSC(EQUAL)*, adjusts the coding so that "compliance by explanation" is viewed as equal to "compliance by adoption" and both are coded as 1, whereas noncompliance is coded as 0. This is a measure of governance quality employed in studies (see, e.g., Salterio, Conrod, & Schmidt, 2013), where "comply or explain" options are both considered as legitimate based on the fact that they are permitted options by the regulator that allows one to comply with the overall regulation.

Our second and third alternative governance quality measures take the approach that the aim of "comply or explain" regimes is to have firms adopt the governance "best practices" as endorsed by the relevant governance code (Anuchitworawong, 2010). Thus, we do two re-codings of our governance data. First, we create *TBDS(REVERSE)* and *BDSC(REVERSE)* in which we reverse the coding with respect to the adopting of "best practices" and the explaining alternative approaches to achieving the governance principle. In *TBDS(REVERSE)* and *BDSC(REVERSE)*, the highest score, 2, is associated with the adoption of the code-defined best practice, an explanation for noncompliance is coded as 1, and noncompliance is coded as 0. We know of no prior studies that have used this approach, but it is logically consistent with the argument that explanation of an alternative approach is better than non-disclosure or non-compliance being stated without any explanation but consistent with the belief that adoption of best practices is the goal (Anuchitworawong, 2010). Finally, consistent with the strict view that any departure from complete adoption of the "best practices" is noncompliant, we create *TBDS(ADOPT)* and *BDSC(ADOPT)*. In *TBDS(ADOPT)* and *BDSC(ADOPT)*, "best practice" adoption is coded as 1 and

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anything else is 0. This approach is consistent with the argument that the goal of codes is to encourage firms to adopt best practices (Anuchitworawong, 2010) and is the most frequent approach used in empirical studies to date (e.g., Bauwhede, 2009; Bauwhede & Willekens, 2008). Appendix B summarizes our operationalizations of the four different interpretations of the goal of "comply or explain" governance regimes.

Empirical Models: Governance Quality and Firm Value

We examine the association between our measures of governance quality and firm value to determine if higher scores on our governance measures are associated with higher firm value. Although such associations may seem to be straightforward based on both theory and conventional wisdom, compelling empirical evidence is very limited (Larcker et al., 2007). Larcker et al. (2007: 963) suggest that "the association between typical measures of corporate governance and various economic outcomes has not produced a consistent set of results. We believe that these mixed results are partially attributable to the difficulty in generating reliably and valid measures for the complex construct that is termed 'corporate governance'." Indeed, the most widely cited measures of corporate governance and firm value (e.g., the G-score developed in Gompers et al., 2003) have as much if not more to do with firms' government-legislated ability to mount takeover defenses and other such responses to the discipline of the market than to the G-score's traditional governance activities-based sub-indices (Brown & Caylor, 2006). In the rest of this paper, we employ the term *GOVERNBP* (governance best practices) as a placeholder in the models for our various measures of governance quality. Given our first hypothesis that higher quality governance is associated with higher firm value, after controlling for other known determinants of firm value (equation (1)), we predict positive and significant coefficients on the various proxies for *GOVERNBP*.

$$TOBINQ = \alpha_0 + \alpha_1 GOVERNBP + Control\ Variables + \varepsilon \qquad (1)$$

In equation (1), we measure firm value by Tobin's Q. We use two alternative approaches to calculate Tobin's Q. First, following the method used by Kaplan and Zingales (1997), Gompers et al. (2003), and Bebchuk, Cohen, and Ferrell (2009), we compute *TOBINQ1*, a variable equal to the market value of assets divided by the book value of assets, where the market value of assets is computed as the book value of assets plus the market value of common stock less the sum of book value of common stock and balance sheet deferred taxes. Second, following Klein, Shapiro, and Young (2005) we calculate *TOBINQ2*, a variable equal to the market value of assets divided by the book value of assets, where the market value of assets is computed as the sum of the book value of liabilities plus the market value of common equity.

Though Tobin's Q is the most commonly used market-based measure of firm value employed in recent index-based studies of the association between firm value and governance (e.g., Black, Jang, & Kim, 2006; Gompers et al., 2003; Klein et al., 2005; Renders & Gaeremynck, 2012; Villalonga & Amit, 2006), unfortunately, there is not a well-defined and widely accepted model of determinants of Tobin's Q. We select control variables for our model (1) by mainly following Klein et al. (2005). We control for 10 percent blockholding (*BLOCK*) and CEO-founder status (*CEO FOUNDER*), because both are widely prevalent in Canadian ownership structures. On the one hand, the majority shareholders and powerful shareholders (e.g., a founding family) are likely to extract private control benefits at the expense of smaller shareholders. On the other hand, Villalonga and Amit (2006) suggest that family ownership creates value only when the founder serves as CEO. Hence, we do not have clear directional prediction for *BLOCK* and *CEO FOUNDER*, ex ante. Second, we control for potential economies of scale, market opportunities, and market power using firm size (*ASSETS*), current assets, firm age (*AGE*), sales growth (*GROWTH*), book-to-market ratio, financial leverage (*LEVERAGE*), and the Herfindahl index (*CONINDEX*), which is a measure of market concentration. Third, we control for operational performance (*ZSCORE*, *ROA*, and *LOSS* indicator variables). Finally, we control for industry differences in the utilities, finance, and natural resource sectors (*UTILITY*, *FINANCE*, and *NATURAL*). These economic sector-based variables provide some control for the unique government regulations in the utilities industry, the special relationship between book and market values in the financial industry, and the difficulty of valuing reserves in the natural resource sector.

Empirical Models: Governance Quality and Operational Performance

According to agency theory, corporate governance is a set of monitoring mechanisms that help capital providers to safeguard and achieve a return on their investment. Accordingly, we examine the association between governance quality and operational performance, measured by return on shareholders' equity investment (*ROE*). Following Gompers et al. (2003), in principle, we include the natural logarithm of book-to-market ratio in our model to control for the "expected" cross-sectional differences among companies. Given our second hypothesis that higher quality governance is associated with better operational performance, we predict positive and significant coefficients on the various proxies for *GOVERNBP*.

$$ROE = \alpha_0 + \alpha_1 GOVERNBP + \alpha_2 LN(BooktoMarket) + \varepsilon \qquad (2)$$

Unlike Gompers et al. (2003), however, we measure all variables in the current period rather than examining the association between future *ROE* and *GOVERNBP* and the natural logarithm of book-to-market ratio measured at current period for two reasons. First, future *ROE* is calculated in the sample period of June 30, 2007 and June 29, 2008, when the global financial crisis began.[4] Second, we cannot adopt the alternative approach by examining the association between *ROE(t)* and lagged independent variables (*GOVERNBP* and natural logarithm of book-to-market ratio), because we have only one-year *GOVERNBP* data.

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Sample Selection and Data Sources

Our sample consists of one year of cross-sectional data from all Canadian firms with the necessary data for year ends immediately following June 29, 2006. Data for this study were collected for an unrelated project based on the adoption of internal control evaluations in Canada. Hence, the first fiscal year after the implementation of this regulation is the focus of data collection (CSA, 2006). The financial data were collected from Compustat North America. Any missing financial data was hand-collected from financial statements. All of the governance code compliance data were collected by hand from the proxy statements and annual information forms by 18 undergraduate research assistants who crosschecked all of each other's work. In addition, 20 percent of each undergraduate research assistant's work was subject to random quality audits by doctoral students (who had Master's degrees in accounting or a professional accounting designation). Any errors found by supervisors triggered a complete rechecking of the data by an independent coder.

The 2006 Compustat data file consists of 1,230 active firms. We were able to obtain a mostly complete sample of data for 790 firms in 2006, including the data on ownership, CEO founder status, and all financial variables used in the empirical analyses. We eliminated 135 Canadian-US cross-listed firms, to remove the confounding effects of cross-listing in the US – the cross-listed firms are not only subject to the US-mandated "one size fits all" governance regime but also face higher litigation risk and a more aggressive securities regulatory enforcement. Our final sample to test H1a consists of 655 Canadian-only listed companies. We lose five observations with negative book-to-market ratio in our tests for H1b because we need to control for the natural logarithm of the book-to-market ratio in model (2). Our final sample to test H1b consists of 650 companies.

Descriptive Statistics

Table 1 reports the descriptive statistics for all of the variables for firms in our analysis measured at the end of the 2006 firm fiscal year. The median total assets of the sample firms is $179 million (reported in log form in Table 1) and about one-third of the firms report a loss. Our sample firms have various ownership and control structures: 57 percent have blockholders with more than 10 percent shareholdings, and 15 percent have CEOs who are company founders. Such powerful CEOs and block owners with concentrated shareholdings are the dominant structure in non-US markets.

The descriptive statistics of our board scores suggest that noncompliance is common among companies with a wide range of board scores. Figures 1 and 2 illustrate the distribution of compliance of best practice governance. As expected, the reported number of compliant firms is higher if we consider compliance as either adopting the best practice or explaining why another practice was substituted (*TBDS*(*EQUAL*), Figure 2) than if we define compliance as only adopting the best practice (*TBDS*(*ADOPT*), Figure 1). The companies that are fully compliant according to the latter definition represent less than 7 percent (42 out of 655 companies in Figure 1) of the sample (i.e., those with a *TBDS*(*ADOPT*) score of 47); 13 percent (84 out of 655 companies in Figure 2) are compliant when we define compliance as either adopting the best practice or explaining why another practice was used as a substitute (i.e., those with a *TBDS*(*EQUAL*) score of 47).

Moreover, a significant proportion of firms failed to comply with one to five of the 47 items (those with *TBDS* scores of 42–46 in Figures 1 and 2); we call such firms "nearly complete adopters" (NCAs). There are 291 NCA companies if we consider compliance as "adoption only" (*TBDS*(*ADOPT*), Figure 1) and 343 NCA companies if we consider compliance as "adoption or explanation" (*TBDS*(*EQUAL*), Figure 2). Consistent with the limited supply of independent directors in the Canadian market, the five best practice guidelines that are most frequently not adopted by NCA companies are related to the structure of the board such as: independent chairman of the board (item 7 in Appendix A), complete independence of compensation committee (item 46), non-management composition of nomination committee (item 21), separate, regularly scheduled meetings of independent directors (item 8), and seeking outside advisors when needed (item 40). Intuitively, these items are likely to be non-optimal and costly when there is a limited talent pool of professionals qualified to serve on the board, as in the Canadian market (e.g., McFarland, 2013). Given the potential negative publicity (e.g., Globe & Mail, 2012) associated with not having completely adopted regulator-endorsed "best practices," the high number of companies that adopt most but not all of the best practices lends strong support to the argument that in a "comply or explain" regime, compliance by explanation is used only for non-adoption of governance code practices whose high costs to the firm outweigh the benefits of total adoption of code provisions.

Figure 3 documents the extent of adoption of best practice, explanation of an alternative, or noncompliance by each of the 47 best practice items as described in Appendix A for the entire sample of firms. The items that have the greatest level of noncompliance are: the firm must disclose if it has granted a waiver from a provision of the code of ethics in favor of a director or officer (item 44); the directors can seek external advisors when needed (item 40); and the firm must disclose the nominating committee's charter (item 12). For item 44, the most noncompliant item, about half of the 655 companies provide no disclosure or no explanation for non-adoption, and only 5 out of 655 companies provide an explanation for their non-adoption. Figure 3 shows that the best practice that is least often "adopted" but is most frequently "explained" is the chair of the board of directors is an independent director (item 7). Items 27–36, which are related to audit committees and disclosures of audit fees, are the most likely to be adopted.

Taken together, these data on distribution of extent of compliance among companies and across the 47 best practice items suggest that mandatory policies that further limit freedom of Canadian public companies to adopt governance practices tailored to their needs may not serve the bests interests of public companies in Canada. In addition, they provide initial evidence that shareholders may not benefit from such regulation given more than sufficient time has

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TABLE 1
Descriptive Statistics

	Actual		Theoretical		Mean	Median	Std. Dev
	Min	Max	Min	Max			
TOBINQ1	.32	22.63	.00	+∞	1.94	1.37	1.98
TOBINQ2	.17	22.12	.00	+∞	1.72	1.21	1.94
ROE	−15.72	116.44	−∞	+∞	.17	.07	4.93
TBDS(EXPLAIN)	14.00	66.00	.00	94.00	43.63	45.00	5.74
BDSC(EXPLAIN)	5.00	55.00	.00	76.00	34.82	36.00	5.53
TBDS(EQUAL)	14.00	47.00	.00	47.00	41.76	43.00	5.39
BDSC(EQUAL)	5.00	38.00	.00	38.00	32.98	35.00	5.17
TBDS(REVERSE)	28.00	94.00	.00	94.00	81.57	85.00	11.34
BDSC(REVERSE)	10.00	76.00	.00	76.00	64.08	67.00	10.85
TBDS(ADOPT)	14.00	47.00	.00	47.00	39.82	42.00	6.19
BDSC(ADOPT)	5.00	38.00	.00	38.00	31.09	33.00	5.92
AGE	.00	3.78	.00	+∞	2.19	2.30	.82
ASSETS	10.52	25.59	.00	+∞	19.02	19.00	1.81
BLOCK	.00	1.00	.00	1.00	.57	1.00	.50
BOOK-TO-MARKET	−62.14	26.93	−∞	+∞	.60	.54	2.77
CEO FOUNDER	.00	1.00	.00	1.00	.15	.00	.36
CONINDEX	6.78	9.21	.00	+∞	7.47	7.34	.65
CURRENT ASSETS	.00	1.00	.00	1.00	.38	.33	.27
FINANCE	.00	1.00	.00	1.00	.11	.00	.32
GROWTH	−7.85	292.81	−∞	+∞	1.19	.11	12.02
LEVERAGE	.00	4.53	.00	+∞	.23	.17	.30
LOSS	.00	1.00	.00	1.00	.33	.00	.47
NATURAL	.00	1.00	.00	1.00	.30	.00	.46
ROA	−10.23	1.48	−∞	+∞	−.04	.03	.52
UTILITY	.00	1.00	.00	1.00	.02	.00	.14
ZSCORE	−192.11	391.32	−∞	+∞	7.39	2.59	28.92

Table 1 presents the descriptive statistics. All variables are measured as at year end with fiscal year-ends between June 30, 2006 and June 29, 2007. The number of observation is 655. TOBINQ1 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as book value of assets plus the market value of common stock less the sum of the book value of common stock and balance sheet deferred taxes. TOBINQ2 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as the sum of book value of liabilities plus market value of common equity. Return on equity (ROE) is the ratio of income before extraordinary items available for common equity to the sum of the book value of common equity and deferred taxes. TBDS and BDSC (EXPLAIN, EQUAL, REVERSE, ADOPT) are calculated based on the scoring scheme of our corporate quality measures in Appendix B. AGE is the natural logarithm of the number of years that the firm is publicly traded. ASSETS is the natural logarithm of total assets at the end of fiscal year 2006. BLOCK is an indicator variable which equals 1 if the firm has significant shareholders (greater than 10 percent) and 0 otherwise. BOOK-TO-MARKET is the book to market ratio. CEO FOUNDER is an indicator variable which equals 1 if the firm has the founder of the company serving as CEO and 0 otherwise. CONINDEX is the natural logarithm of the Herfindahl index of industry sales. CURRENT ASSETS is calculated as current assets divided by total assets. FINANCE is an indicator variable which equals 1 if the firm's SIC code equals 6000–6999 and 0 otherwise. GROWTH is the average growth rate of sales over the past three years. LEVERAGE is calculated as long-term debt plus short-term debt divided by total assets. LOSS is an indicator variable which equals 1 if earnings before extraordinary items is negative and 0 otherwise. NATURAL is an indicator variable which equals 1 if the firm's SIC code equals 1000–1119,1400–1499, 1200–1300, 1310–1339, 1370–1382, 1389, 2900–2910, and 2990–2999 and 0 otherwise. ROA is calculated as net income divided by total assets. UTILITY is an indicator variable which equals 1 if the firm's SIC code equals 4900–4949 and 0 otherwise. ZSCORE is Altman's (1968) Z-score to measure distress risk.

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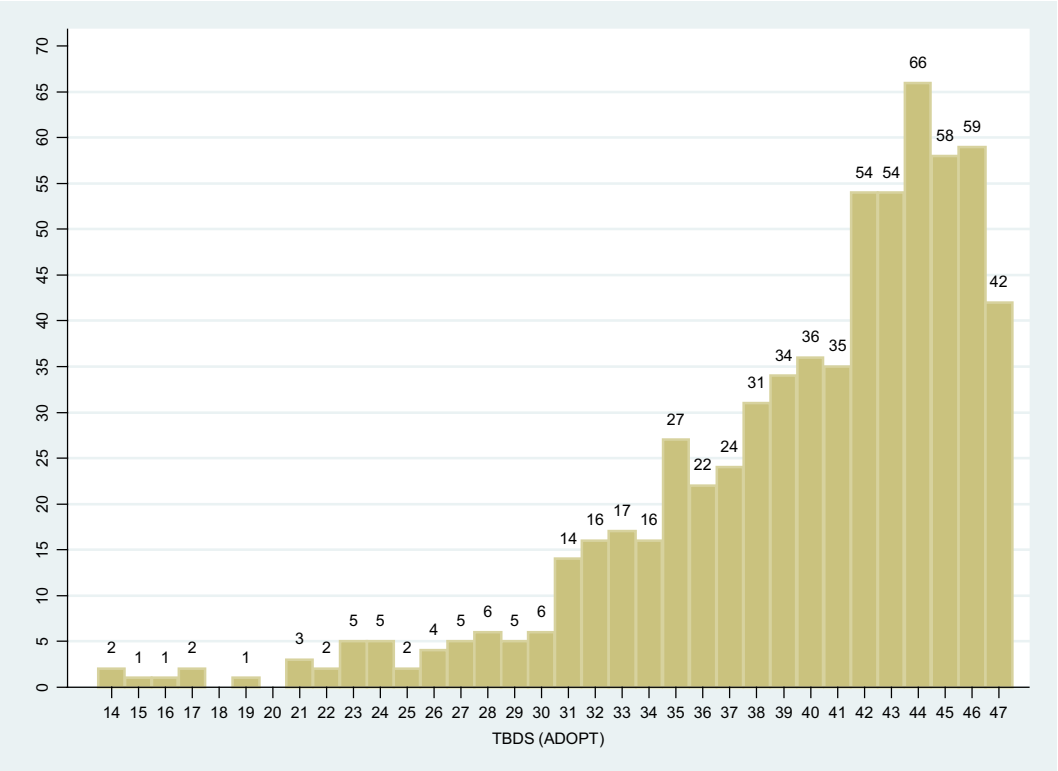
FIGURE 1
Frequency of Firm Compliance by Total Board Score (TBDS(ADOPT))



The *X*-axis is the board score, TBDS(ADOPT), representing firms that comply with best practices only through adoption of the best practice code. The calculation of TBDS(ADOPT) is described in Appendix B. The scores range from 14 to 47. The *Y*-axis is the number of companies receiving the score.

passed for most of these guidelines to be adopted by firms if they were in the best interest of shareholders, as the initial guidelines were in place in 1995.

Table 2 reports the Pearson correlations among our main variables. Our main measures of governance quality (*TBDS*(*EXPLAIN*) and *BDSC*(*EXPLAIN*)) are significantly and highly correlated with each other (greater than .90). However, the correlations between the governance quality measures (*TBDS*(*EXPLAIN*) and *BDSC*(*EXPLAIN*)) and Tobin's Q measures are not significant; all other governance quality measures other than these two measures are significantly negatively correlated with Tobin's Q (i.e., significantly in the opposite direction to that predicted in H1). The correlations between the governance quality measures and *ROE* are also not significant. Table 2 shows that the eight different measures of computing governance quality (*TBDS* and *BDSC*) are, as would be expected, highly correlated. However, the correlation coefficients range from .63 to .99, suggesting that potentially important differences are present among the alternative measures of governance quality. In all of the following multivariate analyses, we address potential multicollinearity concerns by examining the variance inflation factors (VIFs) in all of the models, whether they are tabulated or not. We find that the maximum VIF is less than 2 in all of the models (well below the conventional cut-off of 10), suggesting that the multicollinearity problem is minimal in our analyses.

RESULTS

Governance Quality Measures and Firm Value

We first examine whether our proxy for better corporate governance is associated with higher firm value. Panel A (raw values of Tobin's Q) and Panel B (industry median adjusted values of Tobin's Q) of Table 3 report a significant positive association between corporate governance quality (*TBDS*(*EXPLAIN*) and *BDSC*(*EXPLAIN*)) and firm value ($\beta = 0.03$, all p's < .05 with the exception of one association between the unadjusted *TobinQ2* and *TBDS*(*EXPLAIN*) that is significant at $p < .06$, two-tailed) after controlling for other known determinants of Tobin's Q. Further, the results for control variables are generally consistent with previous research (Bebchuk & Cohen, 2005; Black & Kim, 2012; Brown & Caylor, 2006; Chen & Nowland, 2010; Gompers et al., 2003; Klein et al., 2005; Yermack, 1996). Among the control variables that are significantly associated with Tobin's Q, we find negative and significant association between Tobin's Q and

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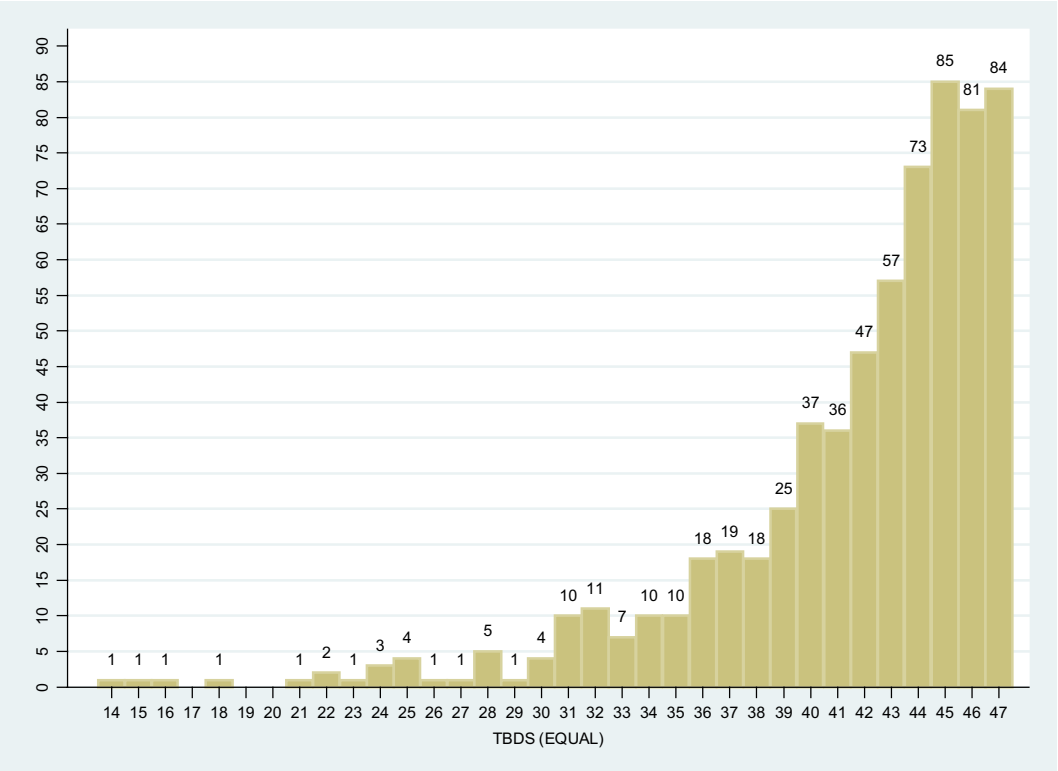
FIGURE 2
Frequency of Firm Compliance by Total Board Score (TBDS(EQUAL))



The *X*-axis is the board score, TBDS(EQUAL), representing firms that have achieved compliance with best practice code by either adopting best practice or explaining alternative approaches to achieve the best practice goal. The calculation of TBDS(EQUAL) is described in Appendix B. Score ranges from 14 to 47. The *Y*-axis is the number of companies receiving the score.

firm size (*ASSET*), operational loss (*LOSS*), and bankruptcy risk (*ZSCORE*, inversely related to bankruptcy risk). Consistent with the notion that leverage attenuates overinvestment and incentive to invest in poor projects (McConnell & Servaes, 1995), we find that leverage is positively and significantly associated with firm value. The negative and significant association between market concentration (*CONINDEX*, inversely related to market competition) and firm value is consistent with the notion that market competition from product market can work as a disciplinary mechanism to motivate managers to maximize long-term firm value by forcing poorly operating firms out of business (Giroud & Mueller, 2010, 2011; Machlup, 1967). Consistent with Klein et al. (2005), the coefficients for the dummies of finance and natural resource industries are significantly positive.[5]

We can compare alternative measurement approaches and interpretations of the goal of "comply or explain" governance regimes by comparing our primary measures with the three alternative measures we constructed. Recall that the *EQUAL*-coded measures are measured based on same interpretation of "or explain" (except that we code adopt or explain as each having equal value) as our primary measure, *EXPLAIN*. However, in contrast, both *REVERSE* and *ADOPT* measures are based on the interpretation that the goal of "comply or explain" regimes is similar to that of mandatory regimes – to achieve the adoption of best practices. Table 4 reports the replication of the results in our main analysis for tests of H1a using the three alternative measures (*EQUAL*, *REVERSE*, or *ADOPT*) of our two variables (*TBDS* and *BDSC*). Compared to our primary measures of governance quality (*TBDS*(*EXPLAIN*) and *BDSC*(*EXPLAIN)* repeated in Table 4, columns 1 and 2) to any of the alternative interpretations of "comply or explain" (columns 3–8 of Table 4), the statistical significance of the coefficients for the alternative governance proxies decreases. As would be expected, the measures based on the advantage of the "or explain" interpretation (*EQUAL*) are more similar to the results of our primary measures, *EXPLAIN* (Table 4, columns 1 and 2 compared to columns 3 and 4). Further, the coefficients for the measures relating to best practice adoption being the goal of the "comply or explain" regimes (*REVERSE* and *ADOPT*) are both smaller in magnitude and lower in statistical significance than those for our primary measure, *EXPLAIN* (compare Table 4, columns 1 and 2 with columns 5–8). These results hold no matter which measure of Tobin's Q is employed as the dependent variable or whether the *TBDS* or the *BDSC* measure of quality is the focus of the analysis.

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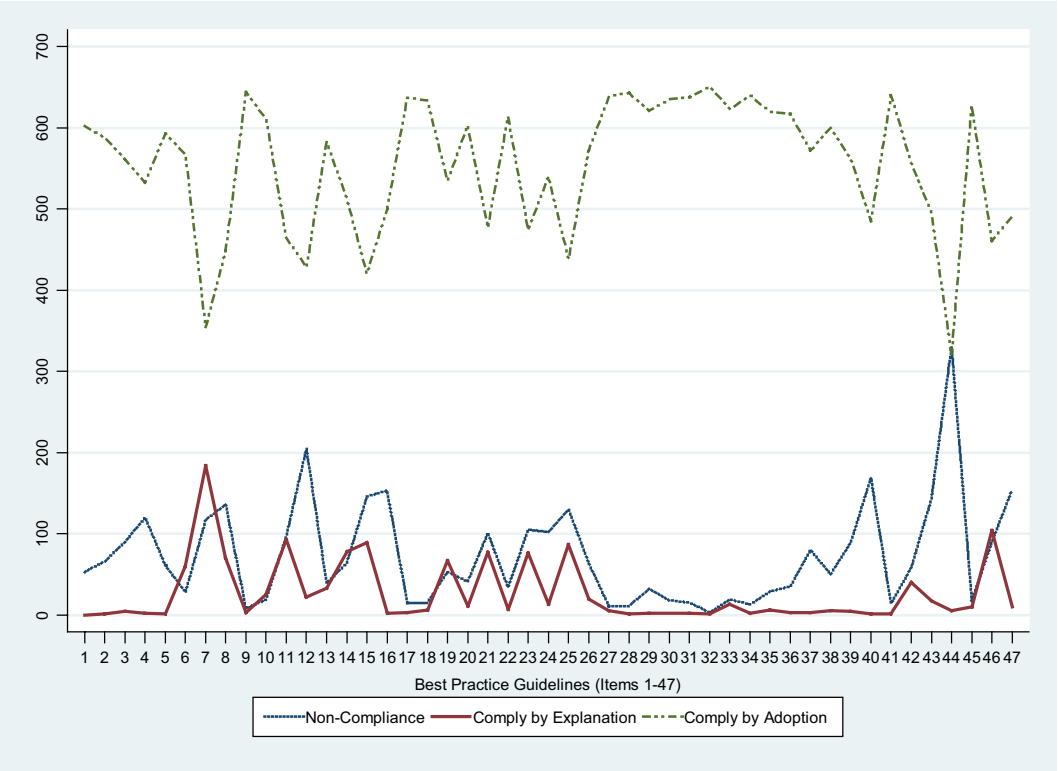
FIGURE 3
Frequency of Compliance by Item (See Appendix A for Definitions of 47 Items)



While statistical significance is an important and necessary condition in a study like ours, to have "real" significance one must also consider the economic magnitude of the finding. In our case, a one-unit increase in *TBDS(EQUAL)* and *BDSC(EQUAL)* (equivalent to one more governance provision being complied with by adoption or by explanation) is associated with an increase in Tobin's Q of about .03 (Table 4, Panel B), which translates into an approximately 2 percent greater market value (based on the median Tobin's Q, Table 1).[6] Hence, there appears to be room to argue that our finding is economically significant as well as statistically significant. Overall, we find support for H1a, that the "comply or explain" regime that allows for more tailored firm-specific corporate governance practices is associated with higher firm value.

Governance Quality Measures and Firm Performance

Next we examine whether our measure is associated with higher accounting-based performance. Results in Table 5 (columns 1 and 2 in Panels A and B) suggest that the associations between our primary measures (*TBDS(EXPLAIN)* and *BDSC(EXPLAIN)*) and *ROE* are positive and marginally significant ($\beta = .03$, $p < .10$, two-tailed) for three of the four associations between those measures and the two measures of *ROE* (unadjusted and industry median adjusted). The weak but positive association is consistent with those found by others employing accounting return measures (for similar results for *ROE*, see Bauwhede, 2009) when studying governance compliance.

Consistent with our findings for Tobin's Q, when we compare our primary governance quality measures, *EXPLAIN* (Table 5, columns 1 and 2) to the alternative measures of corporate governance quality (see columns 3–8 in Table 5), the statistical significance of the coefficients falls well below conventional levels of statistical significance (smallest p-value is greater than .20). Furthermore, the smallest coefficients and those with the least statistical significance are the measures *REVERSE* and *ADOPT* based on the interpretation that the "comply or explain" regime's goal is the adoption by firms of the "best practices." Overall, we find some support for H1b, that firms who take advantage of the "comply or explain" regime to tailor their firm's corporate governance to firm-specific needs is associated with a higher return on shareholders' investment.

The relative strength of the associations between alternative *GOVERNBP* measures and both Tobin's Q (Table 4) and *ROE* (Table 5) yields two important observations that have implications for the design for studies conducted in "comply or explain" regimes. First, *EQUAL* yields similar and slightly weaker results than *EXPLAIN* but stronger results than *REVERSE* and *ADOPT*. This suggests that in a "comply or explain" regime, it is more appropriate to treat "comply by explanation" as better than or at least as good as "comply by adoption." Second, the two "three-point" coding approaches

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TABLE 2
Pearson Correlations for Dependent and Test Variables

	TOBINQ1	TOBINQ2	ROE	TBDS (EXPLAIN)	BDSC (EXPLAIN)	TBDS (EQUAL)	BDSC (EQUAL)	TBDS (REVERSE)	BDSC (REVERSE)	TBDS (ADOPT)
TOBINQ2	.99**	1.00								
ROE	.14**	.13**	1.00							
TBDS(EXPLAIN)	–.04	–.05	.04	1.00						
BDSC(EXPLAIN)	–.05	–.05	.03	.99**	1.00					
TBDS(EQUAL)	–.10**	–.11**	.04	.89**	.89**	1.00				
BDSC(EQUAL)	–.10**	–.11**	.04	.89**	.90**	.99**	1.00			
TBDS(REVERSE)	–.12**	–.13**	.04	.78**	.77**	.97**	.96**	1.00		
BDSC(REVERSE)	–.12**	–.12**	.03	.77**	.78**	.97**	.97**	.99**	1.00	
TBDS(ADOPT)	–.14**	–.14**	.03	.64**	.63**	.91**	.90**	.98**	.97**	1.00
BDSC(ADOPT)	–.13**	–.14**	.03	.63**	.64**	.91**	.91**	.97**	.98**	.99**

Table 2 reports the Pearson correlations between the dependent and independent variables used to test the hypotheses. TOBINQ1 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as book value of assets plus the market value of common stock less the sum of the book value of common stock and balance sheet deferred taxes. TOBINQ2 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as the sum of book value of liabilities plus market value of common equity. Return on equity (ROE) is the ratio of income before extraordinary items available for common equity to the sum of the book value of common equity and deferred taxes. TBDS and BDSC (EXPLAIN, EQUAL, REVERSE, ADOPT) are calculated based on the scoring scheme of our corporate quality measures in Appendix B. †p < .10; *p < .05; **p < .01.

(*EXPLAIN* and *REVERSE*) yield significantly stronger results than the two respective "two-point" coding approaches (*EQUAL* and *ADOPT*). In particular, *EXPLAIN* yields stronger results than *EQUAL*, which is *EXPLAIN*'s respective two-point version when we treat explanation as being as good as adoption. *REVERSE* yields stronger results than *ADOPT*, which is *REVERSE*'s respective two-point version when we treat explanation as being as bad as noncompliance. This highlights the importance of differentiating between "comply by explanation" and "comply by adoption." Taken together, our results suggest that our *TBDS(EXPLAIN)* and *BDSC(EXPLAIN)* coding approaches are more appropriate measures to differentiate underlying governance quality among firms in "comply or explain" regimes.

Robustness Checks

As reported in the main analysis (Panel B in Tables 3 and 5 and Panels C and D in Table 4), following other index-based studies (Brown & Caylor, 2006; Gompers et al., 2003; Yermack, 1996) we checked the robustness of our results using Tobin's Q and *ROE* adjusted by the median of the two-digit SIC industries, to account for potential differences in industries (for initial discussion of this issue, see McConnell & Servaes, 1990). Further, our results (not tabulated) remain the same if the adjustments to Tobin's Q and *ROE* are made employing the median of Fama-French 12 industries or Fama-French 48 industries, instead of two-digit SIC industry median. Hence, our results do not depend on one interpretation of Tobin's Q but are robust to both alternative measures of Tobin's Q (*TOBINQ1* and *TOBINQ2*) as well as alternative industry median-based adjustments to both measures of Tobin's Q and the measure of *ROE*.

Following Bebchuk and Cohen (2005), Black and Kim (2012), and Yermack (1996), we check the robustness of our results to additional control variables by including a proxy for investment opportunities (the ratio of capital expenditure to total assets) because many theorists including Myers (1977) and Smith and Watts (1992) argue that firm value depends on future investment opportunities. The results (not tabulated) suggest that the coefficients of *BDSC(EXPLAIN)* and *TBDS(EXPLAIN)* remain significant at conventional levels ($p < .04$ to $p < .07$, two-tailed) for Tobin's Q with or without the industry median adjustment.

Following Larcker et al. (2007), we further check the robustness of our *ROE* results to alternative control variables by replacing the natural logarithm of book-to-market ratio with the natural logarithm of market value. The results (not tabulated) suggest qualitatively similar but weaker results than in Table 5. In particular, the p-value of the coefficients of *TBDS(EXPLAIN)* is .15 or higher; but the diminishing pattern remains when *GOVERNBP* moves from *EXPLAIN* to *EQUAL*, then from *EQUAL* to *REVERSE*, and finally from *REVERSE* to *ADOPT*.

We also check the robustness of our results to a simplified Tobin's Q determinants model used by previous studies (e.g., Gompers et al., 2003) by including only firm size and firm age as the control variables. The results (not tabulated) are not significant but are directionally the same. This finding suggests that the careful modeling of the

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TABLE 3
Governance Quality Measures and Firm Value

Panel A: Dependent Variables = Tobin's Q – Unadjusted

	TOBINQ1		TOBINQ1		TOBINQ2		TOBINQ2	
TBDS(EXPLAIN)	.03	(2.16)*			.03	(1.93)†		
BDSC(EXPLAIN)			.03	(2.21)*			.03	(1.99)*
BLOCK	–.15	(–1.11)	–.16	(–1.12)	–.16	(–1.13)	–.16	(–1.14)
CEO FOUNDER	–.20	(–1.46)	–.20	(–1.48)	–.18	(–1.35)	–.18	(–1.37)
CONINDEX	–.29	(–2.59)**	–.29	(–2.59)**	–.28	(–2.52)*	–.28	(–2.52)*
ASSETS	–.17	(–3.15)**	–.16	(–3.16)**	–.17	(–3.34)**	–.17	(–3.35)**
CURRENT ASSETS	2.08	(6.41)**	2.08	(6.41)**	1.81	(5.53)**	1.81	(5.54)**
LEVERAGE	.50	(2.17)*	.50	(2.19)*	.52	(2.38)*	.52	(2.40)*
BOOK-TO-MARKET	–.03	(–.860)	–.03	(–.86)	–.02	(–.68)	–.02	(–.68)
GROWTH	–.00	(–.82)	–.00	(–.83)	–.00	(–.81)	–.00	(–.82)
AGE	.02	(.29)	.02	(.28)	.01	(.09)	.01	(.08)
LOSS	–.70	(–5.78)**	–.70	(–5.79)**	–.68	(–5.68)**	–.69	(–5.69)**
ZSCORE	.01	(3.53)**	.01	(3.54)**	.01	(3.63)**	.01	(3.63)**
ROA	–1.99	(–7.02)**	–2.00	(–7.03)**	–1.91	(–6.64)**	–1.92	(–6.64)**
FINANCE	.79	(2.57)*	.79	(2.58)*	.73	(2.49)*	.73	(2.49)*
NATURAL	.53	(3.13)**	.54	(3.15)**	.60	(3.52)**	.60	(3.54)**
UTILITY	.06	(.42)	.06	(.42)	.11	(.73)	.11	(.73)
Constant	5.03	(3.45)**	5.21	(3.53)**	5.08	(3.57)**	5.24	(3.63)**
R^2	.44		.44		.42		.42	

Panel B: Dependent Variables = Tobin's Q adjusted by median of 2-digit SIC industry Tobin's Q

	TOBINQ1-ADJ		TOBINQ1-ADJ		TOBINQ2-ADJ		TOBINQ2-ADJ	
TBDS(EXPLAIN)	.03	(2.26)*			.03	(2.10)*		
BDSC(EXPLAIN)			.03	(2.31)*			.03	(2.16)*
BLOCK	–.10	(–.71)	–.10	(–.72)	–.11	(–.77)	–.11	(–.78)
CEO FOUNDER	–.19	(–1.38)	–.19	(–1.40)	–.16	(–1.16)	–.16	(–1.18)
CONINDEX	–.20	(–1.73)†	–.20	(–1.73)†	–.18	(–1.61)	–.18	(–1.61)
ASSETS	–.12	(–2.23)*	–.12	(–2.23)*	–.12	(–2.32)*	–.12	(–2.32)*
CURRENT ASSETS	1.66	(5.27)**	1.66	(5.27)**	1.49	(4.72)**	1.49	(4.72)**
LEVERAGE	.58	(2.56)*	.58	(2.59)**	.55	(2.54)*	.56	(2.57)*
BOOK-TO-MARKET	–.02	(–.82)	–.02	(–.82)	–.01	(–.53)	–.01	(–.53)
GROWTH	–.00	(–.17)	–.00	(–.18)	.00	(.17)	.00	(.17)
AGE	–.01	(–.22)	–.02	(–.23)	–.03	(–.43)	–.03	(–.44)
LOSS	–.82	(–6.67)**	–.83	(–6.67)**	–.83	(–6.69)**	–.83	(–6.70)**
ZSCORE	.01	(3.02)**	.01	(3.03)**	.01	(3.21)**	.01	(3.22)**
ROA	–1.92	(–6.71)**	–1.92	(–6.71)**	–1.83	(–6.34)**	–1.84	(–6.34)**
FINANCE	.83	(2.78)**	.83	(2.78)**	.78	(2.68)**	.79	(2.68)**
NATURAL	.18	(.99)	.18	(1.00)	.17	(.94)	.17	(.95)
UTILITY	.03	(.19)	.03	(.19)	.03	(.21)	.030	(.21)
Constant	2.11	(1.43)	2.30	(1.54)	2.22	(1.52)	2.387	(1.61)
R^2	.37		.37		.35		.35	

This table presents the results of analyses of the association between measures of governance quality and firm value (as specified in H1a) in the sample of 655 companies. The dependent variables in Panel A are Tobin's Q. The dependent variables in Panel B are Tobin's Q, adjusted by the median Tobin's Q of two-digit SIC industries. TOBINQ1 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as book value of assets plus the market value of common stock less the sum of the book value of common stock and balance sheet deferred taxes. TOBINQ2 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as the sum of book value of liabilities plus market value of common equity. TBDS and BDSC (EXPLAIN) are calculated based on the scoring scheme of our corporate quality measures in Appendix B. AGE is the natural logarithm of the number of years that the firm is publicly traded. ASSETS is the natural logarithm of total assets at the end of fiscal year 2006. BLOCK is an indicator variable which equals 1 if the firm has significant shareholders (greater than 10 percent) and 0 otherwise. BOOK-TO-MARKET is the book to market ratio. CEO FOUNDER is an indicator variable which equals 1 if the firm has the founder of the company serving as CEO and 0 otherwise. CONINDEX is the natural logarithm of the Herfindahl index of industry sales. CURRENT ASSETS is calculated as current assets divided by total assets. FINANCE is an indicator variable which equals 1 if the firm's SIC code equals 6000–6999 and 0 otherwise. GROWTH is the average growth rate of sales over the past three years. LEVERAGE is calculated as long-term debt plus short-term debt divided by total assets. LOSS is an indicator variable which equals 1 if earnings before extraordinary items is negative and 0 otherwise. NATURAL is an indicator variable which equals 1 if the firm's SIC code equals 1000–1119,1400–1499, 1200–1300, 1310–1339, 1370–1382, 1389, 2900–2910, and 2990–2999 and 0 otherwise. ROA is calculated as net income divided by total assets. UTILITY is an indicator variable which equals 1 if the firm's SIC code equals 4900–4949 and 0 otherwise. ZSCORE is Altman's (1968) Z-score to measure distress risk. Robust t statistics in parentheses are reported below coefficients. †p < .10; *p < .05; **p < .01, using two-tailed tests.

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TABLE 4
Alternative Governance Quality Measures and Firm Value

Panel A:	Dependent Variable = TOBINQ1							
GOVERNBP	TBDS (EXPLAIN)	BDSC (EXPLAIN)	TBDS (EQUAL)	BDSC (EQUAL)	TBDS (REVERSE)	BDSC (REVERSE)	TBDS (ADOPT)	BDSC (ADOPT)
	.03	.03	.03	.03	.01	.01	.02	.02
	(2.16)*	(2.21)*	(1.82)†	(1.92)†	(1.62)	(1.73)†	(1.31)	(1.41)
R^2	.44	.44	.44	.44	.44	.44	.44	.44
Panel B:	**Dependent Variable = TOBINQ2**							
GOVERNBP	TBDS (EXPLAIN)	BDSC (EXPLAIN)	TBDS (EQUAL)	BDSC (EQUAL)	TBDS (REVERSE)	BDSC (REVERSE)	TBDS (ADOPT)	BDSC (ADOPT)
	.03	.03	.03	.03	.01	.01	.02	.02
	(1.93)†	(1.99)*	(1.63)	(1.73)†	(1.43)	(1.55)	(1.15)	(1.26)
R^2	.42	.42	.42	.42	.42	.42	.42	.42
Panel C:	**Dependent Variable = TOBINQ1 adjusted by industry median Tobin's Q**							
GOVERNBP	TBDS (EXPLAIN)	BDSC (EXPLAIN)	TBDS (EQUAL)	BDSC (EQUAL)	TBDS (REVERSE)	BDSC (REVERSE)	TBDS (ADOPT)	BDSC (ADOPT)
	.03	.03	.03	.03	.01	.02	.02	.02
	(2.26)*	(2.31)*	(2.05)*	(2.12)*	(1.87)†	(1.96)†	(1.58)	(1.66)†
R^2	.37	.37	.37	.37	.37	.37	.37	.37
Panel D:	**Dependent Variable = TOBINQ2 adjusted by industry median Tobin's Q**							
GOVERNBP	TBDS (EXPLAIN)	BDSC (EXPLAIN)	TBDS (EQUAL)	BDSC (EQUAL)	TBDS (REVERSE)	BDSC (REVERSE)	TBDS (ADOPT)	BDSC (ADOPT)
	.03	.03	.03	.03	.01	.02	.02	.02
	(2.10)*	(2.16)*	(1.95)†	(2.04)*	(1.80)†	(1.90)†	(1.54)	(1.64)
R^2	.35	.35	.35	.35	.35	.35	.35	.35

This table presents the results of analyses of the association between alternative measures of governance quality (GOVERNBP) and firm value (as specified in H1a) in the full sample of 655 companies. The models employed in the analysis are the same as those reported in Table 3, but differ in measure of governance quality through differences in coding board scores. The results for the control variables remain consistent with those reported in Table 3. For brevity the results for the control variables are not reported. Panels A and B report the results for the model with TOBINQ1 (TOBINQ2). Panels C and D report the results for the model with TOBINQ1 (TOBINQ2), adjusted by the median of two-digit SIC industry. TOBINQ1 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as book value of assets plus the market value of common stock less the sum of the book value of common stock and balance sheet deferred taxes. TOBINQ2 is calculated as the market value of assets divided by the book value of assets, where the market value of assets is computed as the sum of book value of liabilities plus market value of common equity. TBDS and BDSC (EXPLAIN, EQUAL, REVERSE, ADOPT) are calculated based on the scoring scheme of our corporate quality measures in Appendix B. Robust t statistics in parentheses are reported below coefficients; †p < .10; *p < .05; **p < .01, using two-tailed tests.

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TABLE 5
Governance Quality Measures and Operational Performance

Panel A: Dependent Variable = ROE (t), not adjusted

	TBDS (EXPLAIN)	BDSC (EXPLAIN)	TBDS (EQUAL)	BDSC (EQUAL)	TBDS (REVERSE)	BDSC (REVERSE)	TBDS (ADOPT)	BDSC (ADOPT)
GOVERNBP	.03	.03	.04	.04	.02	.02	.03	.03
	(1.80)†	(1.65)†	(1.16)	(1.09)	(.99)	(.93)	(.84)	(.81)
BOOK-TO-MARKET(LN)	–1.08	–1.08	–1.11	–1.11	–1.12	–1.11	–1.13	–1.12
	(–1.14)	(–1.14)	(–1.15)	(–1.15)	(–1.14)	(–1.14)	(–1.14)	(–1.14)
Constant	–.67	–.32	–.84	–0.48	–.70	–.38	–.48	–.22
	(–1.53)	(–.80)	(–1.05)	(–0.82)	(–.79)	(–.59)	(–.55)	(–.35)
R-squared	.006	.006	.006	.006	.006	.006	.006	.006

Panel B: Dependent Variable = ROE (t), adjusted by the industry median ROE of two-digit SIC industry

	TBDS (EXPLAIN)	BDSC (EXPLAIN)	TBDS (EQUAL)	BDSC (EQUAL)	TBDS (REVERSE)	BDSC (REVERSE)	TBDS (ADOPT)	BDSC (ADOPT)
GOVERNBP	.03	.03	.03	.03	.02	.02	.03	.03
	(1.70)†	(1.54)	(1.07)	(1.00)	(.91)	(.85)	(.77)	(.73)
BOOK-TO-MARKET(LN)	–1.11	–1.11	–1.134	–1.13	–1.14	–1.14	–1.15	–1.14
	(–1.17)	(–1.17)	(–1.17)	(–1.17)	(–1.16)	(–1.16)	(–1.16)	(–1.16)
Constant	–.61	–.27	–.743	–.40	–.61	–.31	–.40	–0.16
	(–1.40)	(–.69)	(–.93)	(–.70)	(–.69)	(–.48)	(–.46)	(–0.25)
R-squared	.006	.006	.006	.006	.006	.006	.006	.006

This table presents the results of analyses of the association between governance quality measures and return on equity (as specified in H1b) in the sample of 650 companies. Dependent variables in Panels A (B) are ROE without (with) adjustment by median ROE of two-digit SIC industries. Return on equity (ROE) is the ratio of income before extraordinary items available for common equity to the sum of the book value of common equity and deferred taxes. TBDS and BDSC (EXPLAIN, EQUAL, REVERSE, ADOPT) are calculated based on the scoring scheme of our corporate quality measures in Appendix B. Robust t statistics in parentheses are reported below coefficients; †p < .10; *p < .05; **p < .01, using two-tailed tests.

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determinants of performance/value measures is an important part of studying the association between governance quality and firm value.

We follow Brown and Caylor (2006) by including a lagged Tobin's Q in our Table 3 model and lagged *ROE* in Table 5 to address the endogeneity issue. Brown and Caylor's (2006) results, using data from the US mandatory governance environment, show a positive association between a one-year-lagged Tobin's Q and the current year Tobin's Q, hence the decision to include the lagged measure as a robustness check in their study. They find that the magnitude of the coefficient on their governance proxy drops by 50 percent and the significance level drops from conventional significance ($p < .05$ two tailed) to marginal significance at best ($p < .08$ up to $p < .19$, two-tailed). We find a similar pattern of results (not tabulated). Specifically, our modified model has a drop in the size of the coefficient (roughly 50 percent) and the level of significance increases to marginal at best, similar to those documented by Brown and Caylor (2006).[7]

These latter two robustness limitations suggest a conclusion similar to Larcker et al. (2007). Larcker et al. (2007: 990) note that "prior research has shown that measures of operating performance are very persistent (e.g., Fama & French, 2000; Penman, 1992). Thus, the natural candidate for expected future operating performance is current operating performance. However, to the extent that governance structures are stable over time and likely determine the operating, investing and financing activities of the firm, the inclusion of current operating performance is likely to remove the impact of governance that we are trying to estimate." Our results reinforce that interpretation of the issues associated with research in this area. Overall, the strength of the association between our primary governance measures (*EXPLAIN*) and Tobin's Q and *ROE* as well as in comparison with measures (*REVERSE* and *ADOPT*) based on a different interpretation of the goal of "comply or explain" regimes provides support that our primary measures allow us to document real differences in governance effectiveness, *in substance*.

CONCLUSION AND DISCUSSION

In this study, we examine the properties of corporate governance quality based on the disclosures made under a "comply or explain" governance disclosure regime. We interpret the "comply or explain" regime as allowing firms the ability to reduce their agency costs by tailoring their governance processes to their firm-specific circumstances. Hence, we employ a unique approach to measuring corporate governance quality based on the belief that firms will only continue to explain differences from best practice approaches where not adopting the best practice advocated by regulators is indicative of high firm-specific costs. We find that our computed governance scores based on this interpretation are strongly associated with higher firm value, as proxied by Tobin's Q, and weakly associated with higher return on equity, both of which suggest that more tailored corporate governance in "comply or explain" regimes provide real benefits to equity shareholders. Moreover, by comparing our measure's results with the results based on measures consistent with alternative interpretations of the goal of "comply or explain" governance regimes (i.e., to encourage adoption of best practices), we find that our measures yield stronger association with higher firm value and performance. Thus, we conclude that there is empirical support for the contention that "comply or explain" governance disclosure regimes allow firms to develop governance practices that are tailored to their unique set of circumstances and that, on average, these practices are associated with higher firm value and better performance.

Our study has at least five limitations. First, our governance scores give an equal weight to each of the provisions in the regulator-endorsed "best practices" guidelines. Clearly, some provisions might deserve more weight than others, and the appropriate weight of a provision might depend on the presence or absence of other provisions (that is, interactions could matter). The standard equal-weight construction is an approach that we, like most others in the literature, use for its simplicity and objectivity in scoring.

Second, following others in the literature (e.g., Hooghiemstra, 2012; MacNeil & Li, 2006), we assume that relative costs of different options in "comply or explain" regimes – noncompliance, compliance and noncompliance with explanation – are measurable and rankable and we use zero, one and two to rank the relative costs among the three options. Implicitly this scoring approach assigns equal distance between noncompliance and adoption and from adoption to explain. It is likely that such an equidistant assumption is not correct, but it is very difficult to find ways to measure the actual distance in order to capture the relative costs associated with three tailoring options.

Third, our approach to scoring assumes that providing an explanation instead of adopting a "best practice" is an indication of a firm-specific governance approach that is more cost efficient or provides more effective governance than the adoption of the "best practice." To the extent that best practice adoption may be optimal in many cases for firms, our measure may understate the quality of these firms' governance. However, we note that less than 7 percent of our firms adopt the complete set of best practices and our additional tests using alternative governance quality codings imply that some degree of departure from "best practice" adoption is optimal for most firms, at least as measured by the associations between the various governance measures we constructed and firm value/performance. Further, our measures are not designed to rank firms on corporate governance quality but rather to identify those firms that choose to tailor their governance practices to reduce agency costs.

Fourth, our cross-sectional analysis is based on one-year data from 2006 only. However, other influential papers involving governance measures are also restricted to a single year (e.g., Ashbaugh-Skaife, Collins, & LaFond, 2006; Brown & Caylor, 2006; Larcker et al., 2007). In our case, the use of a single year is further justified by the large amount of hand-collected data that took nearly 2,000 person hours to collect.

Our fifth limitation relates to the problem of reverse causality, also known as endogeneity. However, our preliminary path analysis embedded in a structural model suggests

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that the simultaneous estimation of the coefficients does not change the reported results.

Further, we argue that the differences in the comprehensiveness of best practice guidelines across countries should not impact the generalizability of our findings to other "comply or explain" countries that follow the voluntary adoption with mandated disclosure of adoption or provision of an explanation approach. Our analysis is based on a comprehensive measure of overall governance quality, constructed from the regulator-endorsed Code of Governance Best Practices that is regularly compared to OECD guidelines and is considered by the OECD as one of the most comprehensive governance guidelines in the world (OECD, 2004).[8] Further, unlike some studies (e.g., MacAulay et al., 2009) we did not "cherry pick" a sub-set of items from best practice guidelines to code nor do we trust the judgment of a third-party agency (e.g., Bauwhede, 2009) whose criteria for scoring compliance are unknown.

Because the credibility of disclosure and market disciplinary power on governance practice is critical to success of "comply or explain" governance regimes, our findings may not generalize to countries like the UK, where the disclosure on governance practice is not mandatory or enforceable under statutory authority (MacNeil & Li, 2006). Without mandatory disclosure, the company has to make two decisions: whether to comply with best practice and whether to disclose the governance practice. As a result, it is difficult for investors to make informed assessments of whether noncompliance is justified in the particular circumstances. In addition, investors cannot differentiate nondisclosure from noncompliance in regimes where disclosure is not mandated. Moreover, such a voluntary adoption, voluntary disclosure regime likely triggers self-selection effects by firms making disclosures. That is, companies with better governance practices or those whose alternative practices are easier to justify or explain are more likely to disclose their governance practices. As a result, in such a non-mandatory disclosure regime it is harder for investors to use the incomplete disclosures to differentiate the governance quality across companies. Therefore, we caution that all "comply or explain" regimes are not created equal and that the absence of mandatory disclosure in a given country's regime may result in our results not generalizing to that regime.

There are two key implications of our study. The first implication is that heterogeneity among firms' governance needs can be, on average, allowed for in a "comply or explain" governance disclosure regime and incentives to adopt "best practice" norms do not overwhelm the willingness of firms to tailor their governance practices when the costs of compliance are especially large (Adams et al., 2010). Furthermore, it appears that such disclosures are, on average, credible given their association with higher firm value and operational performance. The low rate for the complete adoption of all 47 items in our study (less than 7 percent) suggests that the flexibility provided by such a regime benefits a large number of firms. Hence, our evidence suggests that imposing regulator-determined "best practice" norms on firms' corporate governance activities could impose significant added costs for firms.

Although our evidence is "on average" supportive of the credibility of "comply or explain" governance disclosures and their efficacy in enhancing firm value and long-term performance, the evidence is based on research methods that focus on the average firm's response. The mandated disclosure obligation in a "comply or explain" regime allows investors to make informed assessments of whether noncompliance is justified in the particular circumstances. However, the disclosures of compliance and/or the explanations for the alternative means to achieve the best practice's goal without adopting the best practice may not be truthful. Further, in instances of noncompliance through either no explanation or no disclosure, market participants have nothing to evaluate. To the extent that investors incur large economic costs by investing in firms that do not truthfully disclose their governance practices or that use nondisclosure to hide egregious governance practices, our evidence cannot be taken as clearly supporting the superiority of this regime over mandated approaches to corporate governance. It may well be that mandated approaches to governance, with their emphasis on regulatory enforcement of governance "best practices," increase governance costs and lower governance effectiveness across many firms; however, at the overall market level, these added costs may be offset by the huge reduction in costs that occur if the mandated governance practices lead to even a single firm failure (e.g., bankruptcy due to fraud) being avoided.

The second implication of our research is that it is feasible to develop a proxy for corporate governance quality that is value relevant and that has a direct and clear connection to governance activities. Our approach to measuring governance quality is in contrast to the inductively derived data-dependent scores (e.g., G-score by Gompers et al., 2003), whose associations with corporate governance quality as traditionally understood are difficult to understand (Bhagat, Bolton, & Romano, 2008). Our evidence suggests that, at least in a "comply or explain" environment, our governance disclosure-based measures are viable alternatives to the standard, difficult to operationalize data-driven governance measures and they effectively capture cross-sectional differences in governance quality across firms.

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NOTES

1. In a "comply or explain" regime, regulatory penalties may be imposed when there is nondisclosure of governance practice(s), disclosure of noncompliance with no explanation, or in rare cases where the explanation is considered to be insufficient (for the results of a random regulatory check of 100 firms' corporate

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governance disclosures, see CSA, 2007). Normally, the penalty is administrative in nature (see CSA, 2007).

2. "Comply or explain" is not a panacea as the disclosure of noncompliance raises the possibility of disclosure of sensitive, perhaps proprietary, information (e.g., the firm's governance weakness and lack of resources) (Dye, 2001; Healy & Palepu, 2001; Verrecchia, 2001); this may create competitive disadvantages or result in more scrutiny from external stakeholders (e.g., credit or governance rating agencies, creditors, regulators and institutional investors). Second, it may provide disgruntled stakeholders with a public justification for challenging a board and management that did not adopt "best" practices in governance, even if the reason for their dissatisfaction with the board or management has little to do with this issue (Baxt, 2009; Zadkovich, 2007).
3. Of course, there is always the possibility that an explanation of an alternative approach claims to achieve the governance goal, but does not in fact do so. This would induce noise in our data, making it more difficult to find the predicted associations. See Hooghiemstra (2012) for a potential approach to dealing with this issue.
4. Our untabulated results show that the findings of Table 5 do not hold if we change the dependent variable into future *ROE*.
5. It is somewhat unexpected to find negative association between the current period's *ROA(t)* and Tobin's Q. It may indicate that the market does not value to the self-reported operational outcomes, probably due to the concern of manipulation of accounting-based measures of performance. We conduct the analyses with *ROA* both in the current period (t) and in the future period (t+1). The results (not tabulated) suggest that Tobin's Q's negative association with *ROA(t)* remains but the associations between Q and *ROA(t+1)* is positive though insignificant.
6. The inference about the economic significance of the impact on firm value of adopting one more governance provision can be drawn from the results based on the coefficients of *TBDS(ADOPT)* and *BDSC(ADOPT)* in Table 4. However, their coefficients are not statistically significant. Hence, it does not make sense to calculate economic significance.
7. As discussed in Brown and Caylor (2006), endogeneity issue can be dealt with by using simultaneous equations such as 2SLS. However, such an approach requires finding suitable instruments for our governance indices. Unfortunately, the appropriate instrument or set of instruments for our summary governance measures is theoretically unclear and there are no appropriate instruments in the literature. Larcker and Rusticus (2010) argue that in the corporate governance literature it is extremely difficult to find a good instrument, namely one that is highly correlated with the variable of interest but uncorrelated with the error term of the true structural model. As a result, they contend that OLS estimates are sometimes better than 2SLS estimates.
8. The comparative studies (WGM, 2001a, 2001b) of 33 best practice guidelines of 23 countries in "comply or explain" regimes listed on European Corporate Governance Institute website suggest that best practice guidelines differ significantly across countries. For example, succession planning is not included in the best practice guidelines in 12 out of 23 countries (Australia, Belgium, Hong Kong, India, Italy, Japan, Mexico, Sweden, South Korea, Spain, Thailand, and the UK); no formal evaluation of the performance of the board or CEO is recommended in the codes of 8 out of 23 countries (Belgium, Hong Kong, India, Japan, Mexico, Netherlands, South Africa, and Sweden); guideline on separation of CEO and chairman is missing in the codes of 6 out of 23 countries (Hong Kong, Mexico, Netherlands, Portugal, South Korea, and Thailand).

APPENDIX A

Coding Scheme Based on Canadian "Best Practices" Governance Code

The principles of the endorsed "best practices" are in **bold** type below. The plain text lists the items coded to meet the requirement for adoption. The principles and required items are organized by the original 14 guidelines from Dey (1994) as codified by CSA in 2004 with additions for later requirements added, including those items found in

- CSA (2004a) Multilateral Instrument 58-101
- CSA (2004c) Multilateral Instrument 52-110
- CSA (2005) Multilateral Instrument 52-109

Guideline 1

The Board of Directors should explicitly assume responsibility for stewardship, specifically for the strategic planning process, the identification of risks and risk management systems, succession planning, communications policy, and internal control and management information systems.

1. The Board of Directors explicitly assumes responsibility for the strategic planning process.
2. The Board of Directors explicitly assumes responsibility for the identification of risks and risk management systems.
3. The Board of Directors explicitly assumes responsibility for succession planning.
4. The Board of Directors explicitly assumes responsibility for the company's communications policy.
5. The Board of Directors explicitly assumes responsibility for the company's internal control and management information systems.

Guideline 2

The board of directors should be constituted of a majority of unrelated directors.

6. The board of directors is constituted of a majority of unrelated directors.
7. The chair of the board of directors is an independent director.
8. Independent directors hold separate, regularly scheduled meetings.

Guideline 3

The circumstances of each individual director should be examined in determining their relationship. Firms should disclose annually whether a majority of directors are unrelated.

9. The firm has explicitly disclosed for each individual director whether he/she is unrelated.

Guideline 4

Firms should have a committee of directors for nominating new directors and assessing directors on an ongoing basis. The members of this committee should all be non-management.

10. There is a committee that has responsibility for nominating new directors.

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11. All members of the nominating committee are non-management.
12. The firm must disclose the nominating committee's charter.

Guideline 5
Firms should implement a process of assessing the effectiveness of the board, its committees, and individual directors.

13. A process has been put in place to assess the effectiveness of the board or individual directors.

Guideline 6
An orientation and education program should be implemented for new board members.

14. An education/orientation program is in place for new board members.
15. Measures have been taken to provide continuing education for members.

Guideline 7
The board should consider its size and the potential for reduction.

16. The board has discussed whether its size has been considered.

Guideline 8
The board should review the adequacy and form of the directors' compensation.

17. Director compensation has been reviewed and determined appropriate by the board or a committee of the board.

Guideline 9 (see also Guideline 17)
Committee members for compensation/human resources (HR) and governance committees should be outside directors (non-management) and a majority should be unrelated.

18. The firm must disclose the compensation/HR board committee membership.
19. Every member of the compensation committee is non-management and the majority is unrelated.
20. The firm must disclose the governance committee membership.
21. Every member of the governance committee is non-management and the majority are unrelated.

Guideline 10
Firms should have a committee with responsibility for governance issues.

22. A committee has been created that is responsible for corporate governance.

Guideline 11 (see also Guideline 15)
Position descriptions should be developed for the board and the CEO. Corporate objectives should be approved/developed by the board.

23. Written position descriptions exist for the corporation's senior officers (e.g., CEO) and board members.
24. The board approves and develops the CEO's corporate objectives and goals.
25. Written position descriptions exist for the chair and chairs on each board committee.

Guideline 12
Firms should have structures and procedures so the board can function independently of management.

26. Procedures exist that allow the board to operate independently of management.

Guideline 13
The audit committee should: be composed only of outside directors, have its responsibilities specifically defined, have direct communication channels with internal and external auditors, and have oversight responsibility for the system of internal control.

27. The audit committee is composed only of outside directors.
28. The audit committee has specifically defined responsibilities.
29. The audit committee has direct access to external and internal auditors.
30. The audit committee has oversight responsibility for the system of internal control.
31. The firm must disclose the text of the audit committee's charter.
32. The firm must disclose the name of each audit committee member.
33. The audit committee is composed entirely of independent directors.
34. The audit committee is composed entirely of directors who are financially literate.
35. The firm must disclose the education and experience of each audit committee member that is relevant to the performance of his or her responsibilities.

Guidelines for Auditor Fees

36. The firm must disclose under the caption "**Audit Fees**" the aggregate fees billed by the issuer's external auditor in each of the last 2 fiscal years.
37. The firm must disclose under the caption "**Audit-Related Fees**" the aggregate fees billed in each of the last two fiscal years for assurance and related services by the external auditor that are reasonably related to the performance of the audit or review.
38. The firm must disclose under the caption "**Tax Fees**" the aggregate fees billed in each of the last 2 fiscal years for professional services rendered by the issuer's external auditor for tax compliance, tax advice, and tax planning.
39. The firm must disclose under the caption "**All Other Fees**" the aggregate fees billed in each of the last two fiscal years for products and services provided by the issuer's external auditor, other than the Audit Fees, Audit-Related Fees, and Tax Fees.

Guideline 14
A system should exist to permit individual directors to engage outside advisers at the expense of the corporation in appropriate circumstances.

40. Directors can seek outside advisers when they need to.

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Guideline 15 (relates to Guideline 11)
This requirement comes from Multilateral Instrument 52-109

41. The firm must disclose that the CEO, CFO, or management has signed off on the financial statements.

Guideline 16 (relates to Guideline 1)
Form 58-101F1 (This form tells us which corporate governance disclosures are required in an Annual Information Form (AIF)).

42. The firm has adopted a code of business conduct and ethics for its directors, officers and employees.
43. The Board of Directors specifically assumes responsibility for monitoring compliance with its code of business conduct and ethics.
44. The firm must disclose if it has granted a waiver from a provision of the code of ethics in favor of a director or officer. The nature of the waiver, the name of the person to whom the waiver was granted, the basis for granting the waiver, and the waiver date must also be included.

Guideline 17 (relates to Guideline 9)
From Disclosure form 58-101F1 – Executive Compensation Committees.

45. The firm has a compensation committee.
46. The compensation committee is composed entirely of independent directors.
47. The firm must disclose the text of the compensation committee's charter.

APPENDIX B

Scoring Scheme of Corporate Governance Quality Measures

Board score – BDSC made up of 38 items in Appendix A, that is, all items except Guideline 13 Audit Committees (9 items).

Total board score – TDBS made up of 47 items in Appendix A.

BDSC(EXPLAIN) and *TBDS(EXPLAIN)* Governance best practice **tailoring** measures **employing three-point scale** – main independent variable

- 2 = Not complied with best practice but disclosed and gave reason as permitted as to how goal was attained without adoption of best practice.
- 1 = Complied with best practice
- 0 = Not complied with best practice and did not give reason; or did not disclose at all despite requirement to do so.

Alternative corporate governance quality measures

BDSC(EQUAL) and *TBDS(EQUAL)* Governance best practice **tailoring** measures **employing two-point scale**

- 1 = Complied with best practice; or, not complied with best practice but disclosed and gave reason as permitted as to how goal was attained without adoption of best practice.
- 0 = Not complied with best practice and did not give reason; or did not disclose at all despite requirement to do so.

BDSC(REVERSE) and *TBDS(REVERSE)* Governance best practice **adoption** measures **employing a three-point scale**

- 2 = Adopted best practice
- 1 = Did not adopt best practice but disclosed and gave explanation as to how the governance principle was attained.
- 0 = Did not adopt best practice and did not give explanation; or did not disclose adoption despite requirement to do so.

BDSC(ADOPT) and *TBDS(ADOPT)* Governance best practice **adoption** measures **employing a two-point scale**

- 1 = Adopted best practice
- 0 = otherwise.

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