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Corporate governance in publicly traded small firms: A study of Canadian venture exchange companies

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Abstract Most evidence regarding the determinants and effects of corporate governance practices is based on large firms. Herein, we explore these issues in the context of small publicly traded Canadian companies. We exploit the fact that such firms were not subject to corporate governance guidelines prior to 2005 and thus analyze the determinants of voluntary governance practice choices, as well as the effects of those practices on firm performance. Using a unique data set, we construct a corporate governance index for each firm. We measure performance by two variables: quality of accounting earnings and financial performance. The results indicate that corporate governance does matter for smaller traded Canadian firms. We find that both accounting and financial performance are positively related to corporate governance; however, their underlying mechanisms may differ somewhat. Given this result, it would be natural to expect all firms to choose higher levels of governance. However, our results also suggest small firms face resource constraints that limit their choices. We conclude that good governance is an important driver of small firm performance that cannot be neglected by the owners and managers of these firms.
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1. Why study small firms in Canada?

Corporate governance, the system by which companies are directed and controlled, has been subject to much discussion by practitioners, academics, and regulators. There is now some consensus regarding what constitutes good governance (OECD, 2004) and the various policy measures to ensure firms adopt effective practices. In Canada, firms listed on the Toronto Stock Exchange (TSX) must adhere to corporate governance guidelines or explain why they do not (Klein, Shapiro, & Young, 2005). Not surprisingly, a majority of listed firms now—more or less—stick to these guidelines. This is the case for most firms listed on major stock markets in the developed world. While it is true that most large firms operating in developed capital markets generally conform

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to good governance practices, there is no overwhelming evidence to suggest that firm performance is enhanced by better corporate governance. In a Canadian setting, there is limited evidence regarding whether governance matters, and what does exist correlates to larger listed companies (Klein et al., 2005; MacAulay, Shantanu, Oxner, & Hynes, 2009; Niu, 2006).

The absence of strong evidence for the positive impact of corporate governance on firm performance may, in fact, be a result of the successful diffusion of good governance practices. In the mid-1990s, the TSX issued 14 corporate governance best practice guidelines that Canadian companies listed on the exchange were encouraged to follow. Although implementing the guidelines is voluntary on an individual firm basis, TSX-listed companies are required to annually disclose and compare their corporate governance practices to the 14 best practices. As such, there are strong incentives for large firms to adopt common governance practices, thereby resulting in lower variation in such practices across listed firms. This convergence of best practices across firms is heightened because large firms also have the resources to implement the guidelines. In addition, many TSX firms are cross-listed on the U.S. exchanges, and are thus affected by U.S. mandatory governance practices (Charitou, Louca, & Panaydies, 2007). All of these factors tend to make measured governance practices relatively similar across the TSX firms. In turn, this makes it difficult to find a robust statistical relationship between corporate governance and firm performance.

For example, MacAulay et al. (2009) investigated how the introduction of the TSX governance regulations affected compliance and firm performance for all Canadian companies listed on the TSX. The authors found that while compliance with corporate governance regulations increased during the period, the relationship between corporate governance and firm performance weakened.

In this article, we focus on the smaller companies listed on the TSX Venture Exchange before 2005 because prior to that date, both adoption and disclosure were left to individual companies' management. That is, TSX Venture Exchange firms were not subject to the TSX governance guidelines. Given the TSX Venture Exchange companies' size and limited resources to enhance governance, voluntary adoption and disclosure should vary across firms. This variation allows us to better evaluate the effectiveness of voluntary governance practices.

Our contribution to the understanding of the importance of corporate governance arises from our analysis of the unique context of small publicly traded TSX Venture Exchange companies prior to 2005. We develop a new database (described later) that permits us to construct an index of corporate governance for each firm in our sample and to measure its performance. We find that more effective corporate governance practices are related to firm characteristics, including the size of their boards, the ownership structure of the company, leverage, market value of equity, and the nature of the auditor. Further, we provide evidence that earnings quality and financial performance are both positively related to effective corporate governance. These results suggest that small firms with resource constraints are less likely to choose effective governance structures even though doing so will improve performance. Thus, managers and owners must pay careful attention to the costs and benefits of improved governance.

2. Does corporate governance matter? Three research questions

Herein, we address three fundamental research questions related to the determinants and effects of corporate governance practices for small firms:

1. What kinds of firms will choose effective governance in a non-regulated environment, and in particular, do resource constraints limit the adoption of good corporate governance?

2. Does effective corporate governance contribute to accounting performance—measured by earnings quality—and if so, what elements of governance are most important?

3. Are more effective corporate governance practices positively reflected in a firm's value by the market, and if so, what elements are most important?

The first question addresses the issue of choice. Given the absence of regulatory requirements, to what extent will small firms voluntarily choose to adopt best practice governance? If they do not choose to adopt these practices voluntarily, to what extent do resource constraints limit their choices? In addressing this latter question, we draw on the limited extant literature regarding small firm governance to inform our analysis (Eisenberg, Sundgren, & Wells, 1998; Lin, 2011; Malin & Ow-Yong, 1998; Switzer, 2007). This literature does point to the importance of resource constraints in limiting the adoption of best practice governance. However, it does not address the question of governance choice when that choice is voluntary.

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