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Impact of Corporate Governance Score on Abnormal Returns of Mergers and Acquisitions

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Abstract

The present study attempts to investigate whether differences in the quality of firm level corporate governance influence short-term performance of acquiring firms for a sample of companies by creating a corporate governance index. The study is based on a survey of sample of 155 companies having completed mergers and acquisitions deals announced during January 2003 to December 2008. We document a positive relationship between corporate governance score and short-term abnormal returns by constructing broad corporate governance Index (CGI) for Indian public listed companies.
We use a broad, multifactor corporate governance score, which is based on the responses to objective survey questions supplemented with interviews of senior management, directors, CFOs, board members, company secretaries, compliance officers, and investor relation officers. The questionnaire is designed on the basis of major standard qualities relevant to measure the corporate governance. The present study concludes that companies with higher rank for corporate governance score have better short-term performance which is revealed from positive and higher abnormal returns during the event windows.

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1. Introduction

Corporate governance aims at resolving conflicts of interest between managers and shareholders; between large shareholders and minority shareholders, and thus mitigates agency costs. Agency theory suggests that firms with better corporate governance standards perform better because of lower agency costs and more effective monitoring mechanisms. The market for corporate control is an important corporate governance

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mechanism. An important question in this regard is how corporate governance practices of acquirer firms directly influence performance outcomes of acquisitions decisions. The question deserves attention for several reasons. Mergers and Acquisitions serve as an important instrument of corporate governance to increase corporate efficiency. In fact, Mergers and acquisitions (M&A) are well-suited events where corporate values are tested over the times. The role of corporate governance has been explored on the measurement of the announcement affects on the acquiring firms. The present study investigates the impact of corporate governance score on the abnormal returns on the announcement. The present study provides the empirical evidence on relationship between corporate governance score and short-run M&A performance in Indian context.

2. Literature Review

The existing literature investigating the relationship between corporate governance and mergers and acquisitions examine the issue from various perspectives. The majority of prior literature on relationship between corporate governance and firm value documents a positive association between stronger corporate governance and firm valuation (Bebchuk et al., 2005; Bebchuk et al., 2009; Cremers and Nair, 2005; Core et al., 2006; Yermack, 1996; Gompers et al., 2003). Another set of the empirical studies analyze the impact of corporate governance in a cross-section of countries. Klapper and Love (2004) analyzed impact of corporate governance for 14 emerging markets, Durnev and Kim (2005) for 27 countries by using and Credit Lyonnais Securities Asia (CLSA) rating data.

A Few studies use primary and survey based data on firm level corporate governance structure within a specific country. Balasubramaniam et al. (2010); Beiner et al. (2006); Black et al. (2006); Drobetz et al. (2004); and Chen et al. (2007) report a positive relationship between governance practices and firm valuation for Indian, Swiss, Korean, German and Taiwan public firms respectively.

Carline, Linn and Yadav (2009) examine associations between corporate governance characteristics of acquiring firms and operating performance effects of 81 domestic corporate mergers in the United Kingdom during 1985-94. They find that board ownership, board size and block-holder have an economically and statistically significant impact on post-merger operating performance changes.

Swanstrom (2006) investigates abnormal returns associated with acquisitions announcements based on a sample of 294 acquisitions occurring from 1994 to 1998. He finds that acquiring firms have significant two day abnormal returns. He developed a multiple regression model that includes corporate governance variables which has Adjusted R-squared of 14.2 per cent with board size, the sensitivity of CEO's wealth to changes in share price, method of payment, and acquiring firm size all being significant explanatory variable. Grinstein and Hribar (2004) find that larger boards tend to pay smaller mergers and acquisition bonuses to managers.

Malekzadeh, McWilliams and Sen (1998) find that the structure of the board influences the market reactions to anti- takeover charter amendments. McWilliams and Sen (1997) observe negative market reaction to anti-takeover announcements. This reaction is more pronounced when the board is dominated by insider and gray directors and where the CEO is also the chairman of the board.

Bertrand and Mullainathan (1998) examine the impact on executive compensation of changes in states' anti-takeover legislation. They argue that the adoption of anti-takeover legislation reduces pressure on top managers, and causes firms to substitute more intensive incentives elsewhere.

Datta, Iskandar-Datta and Raman (2001) find a strong positive relation between the acquiring firm's shareholder wealth and the proportion of total compensation awarded to acquiring firm managers in the form of new stock option grant. The study separates acquisitions into high and low base mangers' equity based compensation (EBC). They document that high EBC firm's experience significant positive stock price effect whereas low EBC firms suffer significant losses.

Roll (1986) suggests that managers driven by hubris try to maximize value, but overestimate the value of target and simply overpay for acquisition.

Shleifer and Vishny (1988) find that managers overpay not because they make valuation errors, but to reap personal benefits from acquisitions that are non-value maximizing to the acquiring shareholders.

Shivdasani (1993) examines the relationship between corporate governance structures and probability of takeover of a firm. His results provide evidence that outsider–directors have significantly lower equity ownership in target firms than in non target firms. Due to less ownership, the outsider-directors are not adequately motivated to improve the performance of the company and hence, such companies are more likely to become a takeover target.

Shleifer and Vishney (1986) develop a theoretical model which explains large external shareholders may facilitate takeovers by selling their shares to bidding firms when incumbent managers are underperforming and unwilling to implement reforms.

Bris and Cabolis (2002) show that when acquiring foreign firms are from countries with better governance investors' wealth increases, suggesting that cross-border mergers provide an alternative mechanism for the contractual transfer of corporate governance.

Rossi and Volpin (2004) study the determinants of mergers and acquisitions around the world by focusing on differences in laws and regulations across countries. They find that the volume of mergers and acquisition activity is significantly larger in countries with better accounting standards and stronger shareholder protection. They also document that the probability of an all- cash bid decreases with the level of shareholder protection in the acquirer country. Their findings indicate that a more active market for mergers and acquisitions is the outcome of a corporate governance regime with stronger investor protection. The majority of prior literature on relationship between corporate governance and firm value, documents a positive association between stronger corporate governance and firm valuation.

Although this evidence demonstrates the interest in corporate governance, the important question of whether good corporate governance leads to higher stock returns on the announcement of M&A and consequently to higher firm valuation and better financial performance has not received attention. Further, as far as literature in the Indian context is concerned, no survey has been conducted for Indian managers to the best of my knowledge. While corporate governance has received more attention in recent years, the role that such governance plays in merger and acquisition strategy has not attracted such attention particularly in India. Much of the recent academic attention on corporate governance has been focused on corporate accounting scandals and their prevention. Corporate governance and merger strategy however has not been the focus. Thus, the present study is modest attempt to fill these gaps. In light of this, the following issues have been identified for examination:

Does the corporate governance score of the acquiring firm have any impact on short-term abnormal returns of merger and acquisition?

3. Objectives

The research objectives of this study are:

- To gain insight into corporate governance practices of acquirers by developing a corporate governance index.
- To provide evidence for a possible relationship between corporate governance score and performance of acquiring firms in short-run.

Standard event methodology (Rani et al., 2012) has been used to measure short-term abnormal returns on announcement day (0,0), and during three days (-1,+1), five days (-2,+2) and eleven days (-5,+5) event

window.

4. Data Collection and Sample Selection

The universe of this study covers all M&As during the period January 1, 2003 to December 31, 2008. The rationale of the period of study emanates from the fact the major development and changes in SEBI clause 49 has been incorporated in year 2003 itself. Table 1 presents the year-wise distribution of the number of merger and acquisition announcements, the sample companies and the respondent companies between January 1st, 2003 and December 31st, 2008. Year–wise distribution shows that 803 companies made 1210 announcements. But there are companies which made multiple announcements across the year. So the sample consists of 541 companies that made 1210 mergers and acquisitions announcements during the sample period (Table 1).

Table 1. Distribution of sample, year-wise (2003-08)

year	No. of acquisitions announced	No. of mergers announced	No of companies	No. of respondent companies
2003	66	16	66	13
2004	54	32	73	11
2005	101	52	104	11
2006	198	50	159	27
2007	298	78	232	52
2008	211	49	169	41
Total	928	282	803	155

Source: CMIE database Prowess (3.2)

The unit of analysis for this study is acquiring firms in India. The scope of the study is limited to analyzing the performance of acquiring firms. The reference period for the study includes the five years after the M&A. The secondary data were collected from the Prowess databases of Centre for Monitoring Indian Economy (CMIE), Capitaline database and website of Bombay Stock Exchange. Data were also collected from the websites of the companies, Electronic Data Information Filing and Retrieval System (EDIFAR) website of SEBI. Besides, relevant data were also extracted from the annual reports and websites of the companies. The primary data was collected from senior management, directors, CFOs, board members, company secretaries, compliance officers, and investor relation officers of firms. Following the review of literature, questionnaire for corporate governance survey was designed. Questionnaire was based on corporate governance practices of the acquiring firms. The questionnaire carried questions seeking factual information and the perceptions of the firms wherein they were asked to mark their responses on Binary scale, where 1 to governance attribute if the company meets minimally acceptable standard on that attribute and 0 otherwise. The questionnaire was validated by seven experts. Modifications, wherever necessary, were made according to the feedback received from experts. Thereafter, a total of 541 companies were approached in four phases and 155 responded to the request. Out of the above respondents, nearly three-forth (72 per cent) are from manufacturing sector while one-forth (28 per cent) are from services sector, (depicted in Fig. 1). The majority of the respondent acquirers in the manufacturing sector are in Pharmaceuticals (n=21) followed by Chemicals (n=12). The remaining acquiring firms are quite evenly spread across the industries.

To utilize the responses of the two groups for analysis, an independent samples t-test is conducted. This is to determine if there is any significant difference between the two groups in their corporate governance scores. Table 2 depicts the respondents' profile; the respondents are primarily the executives who held top level management positions in their respective companies. They include: almost one-third (30.3 per cent) chairman,

managing directors, chief executive officers, chief financial officers and directors, one-forth (25.2 per cent) company secretary and deputy general managers, 22.2 per cent vice-presidents and chief legal officers and the remaining 21.3 per cent are general managers (finance) and investor relation officer.

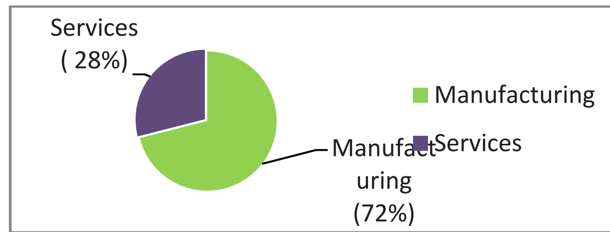

Fig. 1: Sector –wise distribution of respondent companies

Table 2. Respondents' profile

Respondents designation	Number
Chairman, Executive Directors (Finance) and Chief Financial Officers	47 (30.3 %)
Company Secretary and Deputy General Manager	39 (25.2%)
Vice Presidents, Head and Chief Legal Officers	36 (22.2%)
General Manager (Finance, Investor Relations Officer)	33 (21.3%)
Total	155 (100%)

5. Development of Corporate Governance Index

Primary data is used to prepare a Corporate Governance Index (CGI). We have designed a survey questionnaire on the broader definition of corporate governance. The questionnaire focused not only on the transparency and disclosures but broader issues like management discipline and social recognition and responsibility. The survey is based on the 67 broad attributes of corporate governance arranged into following seven key sub-categories. Questions related to one category are intentionally not arranged in one section and are dispersed.

- Management Discipline (MDIS)
- Transparency (TRA)
- Independence (IND)
- Accountability (ACC)
- Responsibility (RES)
- Fairness (FAI)
- Corporate Social Responsibility, Corporate Governance Initiatives and Recognition (CGR).

Corporate Governance Score (CGS) is based on the responses of the 67 issues categorized under seven main aspects included in the questionnaire. The respondents are asked to indicate the company's practice on different level of scales; these points are later translated into numeric values as per the scale. The questionnaire is designed to give a numeric presenting overall Corporate Governance score stated as a percentage. CGS has been assigned a value of 1 to governance attribute if the company meets minimally acceptable standard on that attribute and 0 otherwise in case of binary scale. The answers to these questions

are also cross-checked from the information available in public domain as stated earlier. The scores are assigned in a highly conservative manner based on the response obtained in discussion with the respondent. Corporate Governance Index (CGI) is constructed on the basis of total scores obtained for these qualities. A higher corporate governance score indicates the good governance of the company. We are not interested in disaggregated score in each category as the categories are prone to be overlapping. There are several minimum accepted standards that are met by all companies in the sample. These minimum standards are the mandatory requirements of SEBI Clause 49 on Corporate Governance. On the basis of these scores companies are classified in four quartiles. Companies in top quartile are the companies having score above 90 per cent. These are the companies which have gone beyond the mandatory requirements and moved ahead in pursuit of excellence in corporate governance. Companies in the bottom quartiles are the companies complying with the minimum mandatory standards of corporate governance.

6. Empirical Results And Discussions

6.1. Analysis of corporate governance score

Corporate governance index (CGI) is constructed on the basis of total scores obtained for sixty seven attributes of corporate governance covered in questionnaire. Corporate governance score has been calculated for each attribute individually and total score has been used to rank the companies. There are several minimum accepted standards that are met by all companies in the sample. These minimum standards are the mandatory requirements of SEBI Clause 49 on Corporate Governance. Our questionnaire contains 18 such questions and the minimum average score for such minimum accepted standards is 26.9 % (this confirms to SEBI's requirement).

6.2. Distribution of corporate governance score

A survey of 155 companies was conducted to construct a corporate governance index. We then classify companies, using quartiles based on their corporate governance score, into four governance portfolios. Mean average score for the sample is 69.4 per cent.

Table 3 shows the distribution of survey-based corporate governance score for 155 Indian public-listed firms. It is evident that mean corporate governance score has increased from 64.5 in 2003 to 72.8 in 2008. The minimum and maximum score has also shown improvement over time. It appears from the relevant data that Indian corporate have learned and become conscious about the importance of good corporate governance over time.

Table 3. Frequency distribution of corporate governance score, Year-wise (2003-08)

Year	Mean CG score	Min CG score	Max CG score	Number of respondent companies
2003	64.5	30.6	77.6	15
2004	68.5	43.7	94.2	10
2005	68.8	44.8	86.6	15
2006	69.0	39.9	97.1	29
2007	68.9	37.7	91.4	49
2008	72.8	42.9	98.5	36
Total	69.4	30.6	98.5	155

Table 4. Mean corporate governance score of respondent companies (quartiles-wise)

Quartile	Mean corporate governance score (CGS)	Number of companies
Top Quartile(Q_1)	85.24 %	39(25.16%)
Q_2	74.3%	38(24.5%)
Q_3	66.1%	39(25.16%)
Bottom Quartile (Q_4)	51.86%	39(25.16%)
Sample	69.4%	155 (100%)

6.2.1. Independent samples t-test for manufacturing sector and service sector groups

The respondents are divided into two groups based on the industry they belong to, manufacturing and services. Table 5 reveals the sector-wise distribution of corporate governance score of the respondent companies. It is obvious from the relevant data that companies in service sector have better corporate governance score. It appears that companies in service sector are conscious for their corporate governance practices and put their corporate governance structures in place. An independent samples t-test is conducted to observe if there is a significant difference between the corporate governance score of these groups. Table 6 reports the findings of the independent samples t-test. The results illustrate that firms in service sector are more conscious for governance; however, the difference in corporate governance score is not significant (p-value = 0.429 > .05).

Table 5. Industry-wise frequency distribution of corporate governance score, (2003-08)

Industry	**Mean CG Score**	**Min CG Score**	**Max CG Score**	**Number of Respondent Companies**
Manufacturing	68.8	37.6	98.5	111
Services	70.8	30.6	98.5	44
Total	69.4	30.6	98.5	155

Table 6. Independent samples t-test of corporate governance score on manufacturing and services sector

Mean CGR for services group (N=44)	**Mean CGR for manufacturing group (N=111)**	**Mean difference**	**T-value**	**Significance level**
70.8	68.8	2.06	0.795	0.429

6.3. Impact of corporate governance score on short-run on abnormal returns

If the corporate governance structure is effective, the managers are less likely to pursue those mergers and acquisitions which results in shareholders' wealth reduction. This lead to the first hypothesis:

There is positive relationship between corporate governance score and shareholders' wealth due to announcements of mergers and acquisitions.

Table 7 summarizes the results of short-run event study of the respondent companies. The relevant data contained in the Table shows that respondent companies earn almost 1 per cent (0.99) average abnormal returns (AAR) on the announcement day; the returns are significant. Precision weighted cumulative average abnormal return (PWCAAR) is 0.76 percent and median abnormal return is 0.53 per cent. It is evident from

the Table that highest cumulative average abnormal returns (CAAR) of 1.96 per cent is observed during 5 days window (-2, 2); almost 60 per cent respondent companies earn positive abnormal returns. Moreover, the returns are significant as revealed by crude dependence adjustment test (CDA t) parametric test and generalized sign test (GSign Z) non-parametric test (Rani et al. 2012).

Fig. 2 and Fig. 3 portrays the graph of AAR and CAAR of the respondent companies during event window (-20, 20) respectively. The graph shows that share prices jump up to one per cent on the announcement day. It is evident from the graph (Fig. 3)that share prices start rising two days before event (-2) shoot up to almost two per cent on day 2 and start falling.

Table 7. Summary statistics of event study abnormal returns to respondent companies

Event window	**(0, 0)**	**(-1,+1)**	**(-2,+2)**	**(-5,+5)**
CAAR	0.99%	1.54%	1.96%	1.95%
PWCAAR	0.76%	1.07%	1.34%	1.22%
Median	0.53%	0.88%	1.61%	1.13%
Positive (%)	60%	58%	60%	55%
CDA t	4.898**	4.086**	3.812**	2.437*
GSign Z	4.126**	3.578**	4.400**	2.893**

* and **Denote significance at 5 per cent and 1 per cent respectively.

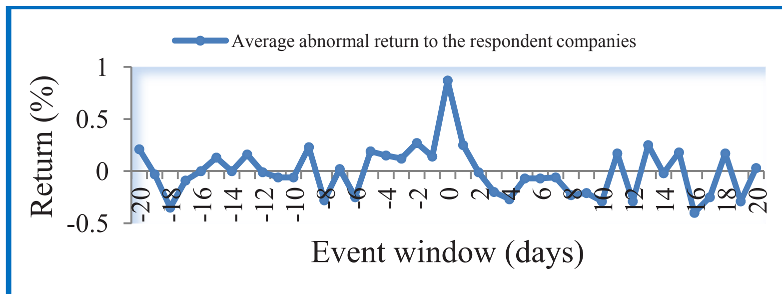

Fig. 2: Average abnormal returns to the respondent companies during event window

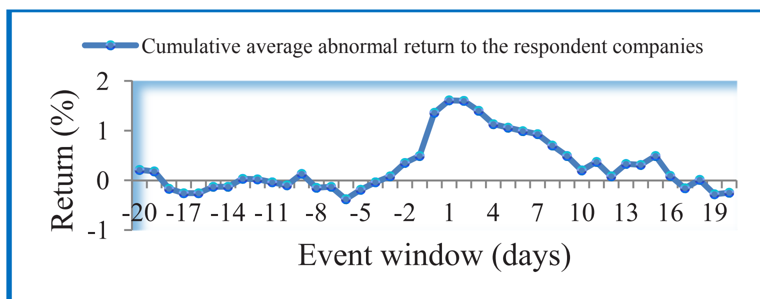

Fig. 3: Cumulative average abnormal returns to the respondent companies during event window

Table 8. Cumulative average abnormal returns of respondent companies (Quartiles-wise)

Quartile Corporate Governance Ranking	**(0, 0)**	**(-1,+1)**	**(-2,+2)**	**(-5,+5)**
Top Quartile(Q_1)	3.45%	6.6%	7.8%	8.5%
Q_2	1.3%	1.51%	1.94%	1.6%
Q_3	-0.1%	-0.09%	0.32%	1.1%
Bottom Quartile (Q_4)	-0.78%	-1.87%	-2.3%	-3.4%
Mean	0.99%	1.54%	1.96%	1.95%

Table 9. Independent samples t-test statistic (Cumulative abnormal return)

Event Window	**Mean CAR (Q_1)**	**Mean CAR (Q_4)**	**Mean difference**	**t-value**	**Significance value**
(0, 0)	3.45%	-0.78%	4.23%	4.69**	0
(-1,+1)	6.6%	-1.87%	8.4%	6.03**	0.001
(-2,+2)	7.8%	-2.3%	10.1%	5.9**	0
(-5,+5)	8.5%	-3.4%	11.9%	5.9**	0

* and **Denote significance at 5 per cent and 1 per cent respectively.

Table 8 presents the quartile–wise cumulative average abnormal returns of the respondent companies. The respondent companies have been classified, using quartiles based on their corporate governance score, into four governance portfolios. It is evident from the Table that average abnormal return on the announcement day for the respondent companies is 0.99 percent while the companies in upper quartile have positive average abnormal return of 3.45 percent which is significantly (p-value = 0 <0.05) higher than the abnormal return of companies in lower quartile. Companies in the lower quartile have negative average abnormal return (-0.78 percent).

Table 9 depicts that a significant mean difference of 8.4 per cent (p-value = 0.001 <0.05), 10.1 per cent (p-value = 0 <0.05) and 11.9 per cent (p-value = 0 <0.05) respectively, between CAAR of companies in upper quartile and lower quartile has also been observed for event window of 3 days (-1, 1), 5 days (-2, 2) and 11 days (-5, 5). On the basis of empirical results, it is reasonable to conclude that there is a positive association between corporate governance score and shareholders' wealth due to announcements of mergers and acquisitions. Companies with better corporate governance create higher shareholders wealth in short-run.

7. Concluding Observations

The present chapter examines the impact of corporate governance practices of the acquirers on short-term abnormal returns and long-term financial performance. The results are revealing. The empirical findings show that companies with high corporate governance score have positive abnormal returns in the short-run, better financial performance and higher valuations post-M&A; while companies with lower corporate governance score have lower financial performance and lower valuations post-M&A. The results are consistent with La Porta et al. (2002) that firms with better corporate governance enjoy higher valuation. These findings have important implications. For investors, the findings reveal that, as far as agency costs are concerned, investments in companies with better corporate governance score are more profitable. For corporate managers, the results imply that the management should be aware of the need for efficient corporate governance structure and mechanism to control agency problems. Better governance and disclosure practices increase investor

confidence which in turn have positive influence on valuation. Companies with good governance are likely to be valued more. For policy makers, the findings that firm performance is significantly influenced by effective corporate governance could serve to justify regulative measures and towards enforcing healthy corporate governance regime and initiatives to encourage corporate to adopt and adhere to these measures.

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