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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.