PRICE REACTION TO CORPORATE GOVERNANCE RATING ANNOUNCEMENTS AT THE ISTANBUL STOCK EXCHANGE

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Abstract

The purpose of this paper is to investigate the price reaction to corporate governance rating announcements at the Istanbul Stock Exchange and to identify the factors which could be driving the results. Using an event study analysis framework, the cumulative abnormal returns (AR) are calculated for various event windows surrounding the announcement day for each firm. The average AR is 0.5% on announcement day, followed by all positive average cumulative ARs for the next 18 days following the announcement. In the multivariate regression analysis, a number of variables are used to proxy for factors suggested as relevant by the agency theory and the corporate governance literature; such as the size of the Audit Committee, the size of the Board of Directors, Corporate Governance Rating of each firm, number of non-executive members on the board, percentage of firm's stock traded on the market, number of blockholders, family ownership, the price-earnings ratio, the market-to-book ratio and firm size. Audit committee size (P: 0.012) and board size (P: 0.043) together explained 32% of the variation in announcement day returns (F: 5.215, P: 0.018). Surprisingly, the corporate governance rating per se was not found to be significant. Overall, the price reaction on announcement day tends to be higher for firms with larger boards and smaller audit committees.

Key Words: *Corporate Governance Ratings; Istanbul Stock Exchange (ISE)*

JEL Classification: G3 (Corporate Finance and Governance)

1. INTRODUCTION

According to agency theory, agency conflicts are more likely to arise in firms characterised by poor governance and poor monitoring (Shleifer and Vishny, 1997). Therefore, good governance practices should enable firms to reduce agency costs and lead to better performance. In a cross-european sample, Renders et al. (2010) provide evidence that improved corporate governance ratings do lead to better performance indeed. They argue that corporate governance ratings are good proxies for the 'governance quality' of the firm. In an emerging markets context, Morey et al.(2009) look at firm-level data from 21 countries, spanning nearly 5 years, and report that firms with better governance ratings are associated with higher valuations. This study extends this line of argument and posits that an announcement of firm's corporate governance rating is expected to generate a price reaction in the markets, based on the 'expectation' of improved firm performance.

In Turkey, the 'Corporate Governance Code' was issued by the Capital Market Board (CMB) in July 2003. Although it merely constitutes a set of recommendations, all firms listed at the Istanbul Stock Exchange (ISE) are required to disclose in their annual reports any non-compliance along with the reasons for not doing so. Additionally, firms can choose to go through a corporate governance rating audit, carried out by one of the rating agencies authorised by the CMB[1].

In this context, the purpose of the study is to investigate the price reaction to corporate governance rating announcements at the ISE and to identify the factors which might have a bearing on the picture we observe.

The novelty of the study is that, it puts into perspective the market participants' perception regarding corporate governance ratings for the first time in Turkey. This perspective is especially valuable since from the start of the corporate governance debate in Turkey, the main view has been regulation and compliance, rather than a market –based view.

In the remainder of the paper, Section 2 describes the data and methodology used, Section 3 presents the findings and discussion and Section 4 concludes.

2. DATA AND METHODOLOGY

The sample includes all firms listed at the ISE which have gone through a corporate governance rating assessment during the four-year period from 2006 until the end of 2009.

The study defines an 'event' as the public announcement and distribution of the corporate governance rating report issued by the accredited rating agencies. The event date (Day 0) is the report issue date, which also corresponds to the public announcement date of the corporate governance rating by the ISE.

The price reaction is measured using the well established event study methodology (Brown and Warner, 1985). Abnormal returns are calculated based on the market model, hence giving a feel for the market's response to the event.

In order to explore which factors can help explain the magnitude of this market response, a number of other variables are employed. Following prior studies, to proxy for the corporate governance environment of the firm, the size of the Audit Committee, the size of the Board of Directors (BOD), the number of non-executive members on the BOD, the number of blockholders, the percentage of family ownership and the free float rate are used. Additionally, variables documented to be relevant in the agency theory are used. The firm's growth prospect is measured using the ratio of firm's market value to its book value. The current over-or-under valuation of the firm's stock is measured using the price earnings ratio. Finally, the size effect is measured using the natural logarithm of the firm's market capitalisation. The data source for all of the variables used is the ISE.

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[1]http://www.ise.org/initialpublicoffering/CompaniesLiabilities/CompaniesLiabilities_stockmarket/CorporateGovernance.aspx

The following section reports findings regarding the price reaction and looks at the drivers behind such reaction through a multivariate regression analysis framework.

3. FINDINGS AND DISCUSSION

3.1. Abnormal Returns

Table 1 presents the descriptive statistics of abnormal returns for various time windows surrounding the corporate governance rating announcement date. 'Day 0' is the event day which represents the issue date of the corporate governance rating report by the rating agencies. The terms 'issue date' and 'announcement date' are used interchangeably throughout the paper, since the corporate governance rating is announced and the report is released by the ISE to the public, on the same day that the report is officially issued by the rating agency.

There are a total of 20 events for the four-year period from April 2006[2] to November 2009. AR(0) and AR(1) are the abnormal returns generated on 'Day 0' and 'Day 1', respectively. CAR(2,0) and CAR(5,0) are the cumulative abnormal returns calculated for 2 days and 5 days after the announcement. Similarly, CAR(0,-2) and CAR(0,-5) are the cumulative abnormal returns calculated for 2 days and 5 days before the announcement, respectively. The numbers of days used are based on the trading days at the Istanbul Stock Exchange. Hence, for example, CAR(5,0) corresponds to the cumulative abnormal returns for the one-week period following announcement.

Table 1. Cumulative Abnormal Returns (CAR)- Descriptives

	CAR(5,0)	CAR(2,0)	AR(1)	AR(0)	CAR(0,-2)	CAR(0,-5)
MAX	20.70%	23.32%	15.21%	4.11%	9.99%	13.93%
MIN	-5.32%	-3.26%	-2.43%	-3.10%	-4.54%	-11.47%
MEDIAN	-0.13%	-0.20%	0.29%	0.86%	-0.41%	-1.98%
AVG	0.85%	1.32%	1.14%	0.53%	0.04%	-1.38%
P-value (1-tailed Z)	0.253	0.155	0.087	0.070	0.481	0.847
P-value (2-tailed K-S)	0.000	0.000	0.000	0.365	0.002	0.020

On announcement day, the average abnormal return, AR(0), is 0.53%. The median abnormal return is 0.86% and the range is about 7%, which can be considered quite high for an abnormal return measure on a single day. The average abnormal return on the day following the announcement is 1.14%. Additionally, the maximum abnormal return on day 1 is 15%, representing the highest one-day abnormal return.

The market response continues to be positive even after day1. The average cumulative abnormal returns for the 3-day and the one-week windows are 1.32% and 0.85%, respectively. This post-announcement drift continues well into the 4th week following the announcement. Additionally, the average cumulative abnormal returns from announcement day to day 18 are all positive[3].

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[2] The first ever corporate governance rating report was issued for Dogan Yayin Holding by ISS on 19.04.2006.

[3] These detailed results are not reported in the table for space reasons.

The post-announcement drift can be due to the fact that, it takes time for investors to fully assess the repercussions of the rating announced. Alternatively, the process of evaluating the contents of the report could be time consuming. For example, investors might want to know if the disparities documented in the report are large enough to affect the future cash flows of the firm.

Looking at the event windows before Day 0, there is also evidence of a pre-announcement reaction in the market. The average cumulative abnormal return increases from -1.38% for the (0,-5) window, to 0.04% for the (0,-2) window. In other words, there is a positive market reaction before the event actually occurs. One possible explanation could be that there is an 'information leak' before the rating reports are publicly announced and distributed. Another explanation could be that an expectation builds up in the market towards the completion of the corporate governance rating assessment, in the sense that, firms would be willing to go through an assessment only if they are confident that they satisfy the level required for a corporate governance index listing.

Table 1 also presents the P-values of a simple one-tailed z-test to see if the abnormal returns are statistically significantly greater than zero. At the 10% level, the average abnormal returns on only announcement and following day are significantly greater than zero. All the other abnormal returns are statistically insignificant.

Furthermore, the last line in Table 1 presents the P-values of the 2-tailed Kolmogorov-Smirnov test to see if abnormal returns for each event window are uniformly distributed or not. At the 5% level, only the distribution of announcement day abnormal returns is significantly different from a uniform distribution.

Therefore, based on both tests of central tendency and distribution, there is a statistically significant price reaction on announcement day only.

3.2. Drivers of the abnormal returns

This section explores the driving forces behind the abnormal return observed above through a multivariate regression analysis framework.

Table 2 presents the results of the multivariate stepwise regressions in which the dependent variable is Day 0 abnormal returns. The explanatory variables proxy for factors suggested by the agency theory and the corporate governance literature, such as the size of the Audit Committee (ACsize), the size of the Board of Directors (BODsize), Corporate Governance Rating of each firm (Rating), number of non-executive members on the BOD (BODnex), percentage of firm's stock traded on the market(PrcntTrd), number of blockholders (BlckHldrs), percentage of family ownership (FmlyOwns), the price-earnings ratio (PE), the market-to-book ratio (M2B) and firm size (LnMktCap).

The benefit of using the stepwise method is that it helps identify not only the model with the highest explanatory power, but also the contribution of each variable to the overall explanatory power of the model. Regressions using alternative models[4] did not change the significance of the

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[4] Univariate regressions using the enter method and multivariate regressions using the enter, forward and backward models were run.

results reported below.

Table 2. Multivariate Stepwise Regressions[*]

Variables	Step 1		Step 2	
	Coeff.	P-value	Coeff.	P-value
Intercept	0.023	0.021	0.007	0.542
ACsize	-0.007	0.048	-0.008	0.012
BODsize			0.002	0.043
F-value	4.560	0.048	5.215	0.018
Adj R^2	**0.165**		**0.319**	

(*) Rating, BODnex, PrcntTrd, BlckHldrs, FmlyOwns, PE, M2B, LnMktCap were also entered into the regression but the stepwise model excluded them in the final step.

In Table 2, the regression model in Step1 explains 16.5% of the variation in abnormal returns on Day 0. The only explanatory variable included in the model at this step is the size of the audit committee. There is a significant (P: 0.048) negative relationship between audit committee size and abnormal returns.

The regression model in Step 2 explains 31.9% of the variation in abnormal returns on Day 0. This model includes board size in addition to audit committee size which was included in Step 1. There is a significant (P: 0.043) positive relationship between board size and abnormal returns. The negative relationship between audit committee size and abnormal returns continues to be significant (P:0.012) in Step 2. None of the other variables entered into regression satisfy the inclusion criteria in the stepwise model.

Therefore, it is fair to say that audit committee and board size together explain 32% of the price reaction on corporate governance rating announcement day. Firms with larger boards and smaller audit committees are more likely to receive a higher price reaction to the announcement of their corporate governance rating. From an agency theory perspective, it could be that larger boards and smaller audit committees are perceived to be more effective by market participants in the monitoring of the firm.

Contrary to what one would expect, the magnitude of the rating itself is not relevant for the price reaction. One possible explanation is that, market participants see corporate governance ratings merely as the product of the corporate governance environment of the firm. Hence, the rating itself does not convey any new information to the market. Another explanation is that, regardless of the outcome, the simple act of having a corporate governance rating assessment leads to a price reaction, since it is interpreted as an indication of the firm's poise regarding corporate governance.

In the sensitivity analysis, all the explanatory variables were regressed over the dependent variable using the enter method (both univariate and multivariate) as well as the forward and backward

regression (multivariate) models. The significances and the direction of the relationships reported above remained unchanged.

4. CONCLUSION

This study contributes to the literature by investigating the market's price reaction to corporate governance rating announcements for the first time in Turkey. The study reports evidence of a statistically significant price reaction on announcement day which tends to be higher for firms with larger boards and smaller audit committees. An interesting finding is that the rating per se has no impact on the price reaction.

These findings are relevant for current and potential investors in the ISE, as well as market participants and market regulators. It is beyond the scope of this study to find out why larger boards and smaller audit committees lead to a higher price reaction. Future studies using alternative methodologies, models and variables to measure the price reaction in the market will make a valuable contribution to our understanding of the corporate governance environment of the firm and its consequences.

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