

UK CORPORATE GOVERNANCE AND TAKEOVER PERFORMANCE

Centre for Business Research, University of Cambridge
Working Paper No. 357

by

Andy Cosh
Centre for Business Research
University of Cambridge
Judge Business School Building
Trumpington Street
Cambridge CB2 1AG
Email: a.cosh@cbr.cam.ac.uk

Paul Guest
Centre for Business Research
University of Cambridge
Judge Business School Building
Trumpington Street
Cambridge CB2 1AG
Email: pmg20@cus.cam.ac.uk

Alan Hughes
Centre for Business Research
Judge Business School Building
University of Cambridge
Trumpington Street
Cambridge CB2 1AG
Email: a.hughes@cbr.cam.ac.uk

December 2007

This working paper forms part of the CBR Research Programme on Enterprise and Innovation.

Abstract

This chapter addresses the changing nature of corporate governance in the United Kingdom over recent decades and examines whether these changes have had an impact on the UK market for corporate control. The disappointing outcomes for acquiring company shareholders in the majority of corporate acquisitions, public discontent with some pay deals for top executives and some high profile corporate scandals led in the early 1990s to a call for governance reform. The scrutiny of governance in UK companies has intensified since the publication of the Cadbury Report in 1992 and has resulted in calls for changes in the size, composition and role of boards of directors, in the role of institutional shareholders, the remuneration and appointment of executives, and in legal and accounting regulations. We review the background to these changes and the consequences of the changes since 1990 for governance structures. Finally, we examine whether these changes have affected takeover performance in recent years. Our analysis is specific to the institutional circumstances of the UK although we refer where appropriate to takeover studies in other countries.

JEL Classification: G30

Keywords: Corporate governance; takeovers; UK; financial performance; Cadbury

Further information about the Centre for Business Research can be found at the following address: www.cbr.cam.ac.uk.

UK Corporate Governance and Takeover Performance

Merger Outcomes and Managerialism

In their seminal book on the emerging modern corporation Berle and Means demonstrated the growing separation of ownership from control with an increasing dispersion of shareholdings along with an increasing concentration of economic power. Taken together these forces required us to question the assumption that firms would be run in the interests of their shareholders since product market competition was inadequate to limit management discretion, and dispersed shareholdings limited cohesive shareholder control (Berle and Means, 1932).

In the late 1950s and early 1960s various authors developed alternative theories of the firm taking account of the separation of ownership from control. These models found their most developed form in the Marris model of managerial capitalism (Marris, 1964). This steady-state growth model explored a trade-off between profit and growth maximisation and explored alternative growth strategies for the firm, balancing the growth of demand with the financing of growth, and with higher growth of demand being achieved through diversification. This model gave a central role to takeovers as the ultimate constraint on excessive growth ambitions by managers as shareholder dissatisfaction would lead to falling share prices and the emergence of underpriced companies ripe for takeover. This aspect of Marris' work was echoed by Manne (1965) in his eloquent exposition of the market for corporate control.

In an important development Mueller (1969) recognised the dual role played by merger activity in a managerial world. Whilst acquisitions might be the principal method through which the abuse of managerial control might be limited, they also provided the mechanism by which managerial growth ambitions could be met and that this was most likely to be found in the case of the conglomerate merger.

‘The management intent upon maximising growth will tend to ignore, or at least heavily discount, investment opportunities outside the firm, since these will not contribute to the internal expansion of the firm. A growth-maximising management will then be assumed to calculate the present value of an investment opportunity using a lower discount rate than a stock-holder-welfare-maximiser would. As before, this will result in greater investment and lower dividends for the growth maximiser.’ (Mueller, 1969, pp. 647-648). This line of

argument clearly anticipated and is essentially the same as in the free cash flow theory of takeovers (Jensen, 1986) that explained why takeover outcomes were disappointing, particularly when they involved diversification.

These developments in the theory of the firm spawned a large number of studies examining the outcomes of merger activity in the period up to the early 1980s. It is not the purpose of this chapter to review this early evidence in depth since that has been done elsewhere (e.g., Mueller, 1980; Jensen and Ruback, 1983; Maggenheim and Mueller, 1988; Hughes, 1993, Gugler et al., 2002; Tuch and O'Sullivan, 2007). Instead, we will highlight some of the key points, particularly in relation to UK studies.

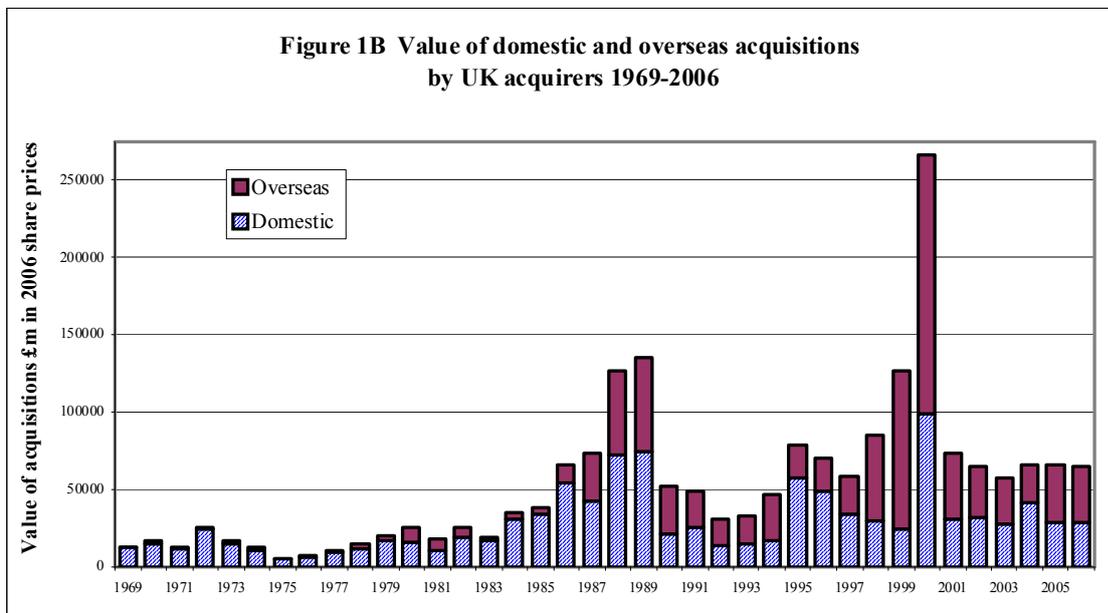
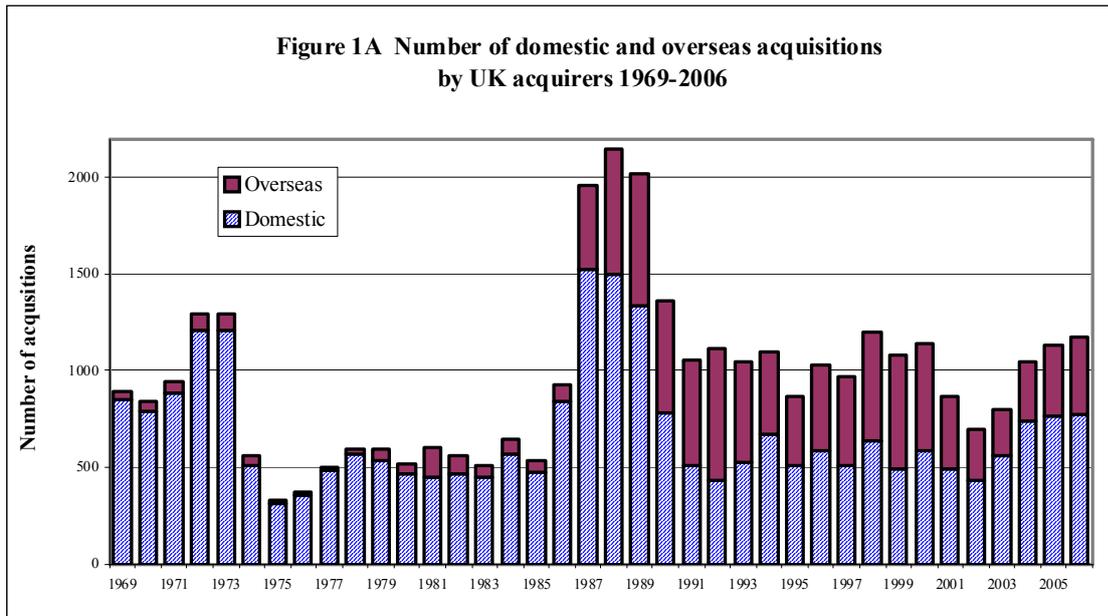
The first UK study of takeovers to formally address the implications for takeovers of managerial models of the firm was by Singh (1971). This study particularly focused on the natural selection role for the market for corporate control by examining the characteristics of the acquirer and the acquired. The findings cast some doubt on the workings of the market for corporate control and gave support to managerial models.

‘To sum up, the take-over mechanism on the stock market, although it provides a measure of discipline for small firms with below average profitability, does not seem to meet the motivational requirements of the orthodox theory of the firm as far as the large firms are concerned. The evidence suggests that these firms are not compelled to maximise or to vigorously pursue profits in order to reduce the danger of takeover, since they can in principle achieve this object by becoming bigger without increasing the rate of profit. ... The results of this study suggest that the fear of takeover, rather than being a constraint on managerial discretion, may also encourage them in the same direction.’

Whilst Singh did examine the performance of the firm post-takeover, this aspect was modestly explored in comparison with the mass of studies that followed. Merger activity since the period analysed by Singh is shown in Figure 1. Early studies of these years for the UK examined accounting measures as a means of judging merger success (e.g., Meeks, 1977; and Cosh et al., 1980). These studies examined the performance of the acquirer post-merger with the weighted average performance of the acquirer and the acquired before the event. This requires a counterfactual assumption about how the acquirer and acquired would have performed in the post-merger period had they remained independent. This assumption could be drawn from the average performance of the industry, but this does not allow for individual firm characteristics, so it is more common today to use a control group of firms matched to the event firms

by certain criteria. Despite the fact that accounting measures are capable of being manipulated in ways that distort the true picture and that a variety of alternative counterfactual assumptions can be made about what would have happened in the absence of merger, the findings of studies of UK takeovers up to and including the 1980s (e.g., Cosh et al., 1989; and Dickerson et al., 1997) generally supported the view that profitability did not improve and generally fell following a takeover.

Figure 1 Merger Activity in the United Kingdom 1969-2006



Accounting studies were rapidly submerged by a flood of mainly US studies based on share prices, initially of their behaviour surrounding the announcement of the takeover, but subsequently over an extended event window of a few years. These event studies face the same sort of problems in tackling the counterfactual and the sophistication of the methods has increased substantially in recent years (e.g., Jaffe, 1974; Mandelker, 1974; Brown and Warner, 1985; Barber and Lyon, 1997; Fama, 1998; and Lyon et al., 1999). Apart from some early studies (Asquith et al., 1983; and Franks and Harris, 1989), the findings concerning announcement returns for both the UK and the US are fairly consistent in showing insignificant, or negative returns to acquirer shareholders and positive gains to the shareholders of the acquired. The picture becomes even more bleak if we extend the event window to a few years following the acquisition. UK studies (e.g., Limmack, 1991; and Gregory, 1997) provided convincing evidence of significantly negative returns on average over this period for acquirer shareholders.

In summary, the evidence available at the time of the Cadbury Report in 1992 and its successors was that the selection mechanism in the market for corporate control was highly imperfect; and that takeovers were not returning performance gains either in terms of profitability, or for their shareholders. Therefore, the conclusion of this brief review is that we are faced with a dilemma. The failure of owners to directly monitor and control managers in order to ensure that value-maximising decisions are taken led to a reliance on the market for corporate control to discipline management. However, the evidence briefly reviewed above suggests that:

- the market for corporate control is an imperfect disciplinarian; and
- an active takeover market provides the means for greater non-value-maximising behaviour by management, particularly amongst the largest companies.

In other words, rather than providing a check on managerial discretion, the market for corporate control was a means of exploiting it. In these circumstances the emphasis turns back on shareholders to develop governance mechanisms to elect boards of directors and design monitor and enforce incentives for management as the means of ensuring that companies are run in their interests.

The Regulation of Corporate Governance

The concerns about the apparent failure of corporate acquisitions to deliver the promised returns to shareholders were heightened by high profile cases of high rewards to top management that were not associated with exceptional corporate performance. These were reinforced by a series of corporate collapses and scandals in the 1980s and 1990s in the UK and abroad and this meant that corporate governance came under increasing scrutiny. The principal concerns were about the effectiveness of the board of directors as guardians of the shareholders' interests and the transparency of company accounts and reports. The City of London has a long history of self-regulation and so the first move took the form of the Cadbury Committee set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance.

‘Its sponsors were concerned at the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguards which the users of company reports sought and expected. The underlying factors were seen as the looseness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business, and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards.’ (Cadbury, 1992, 2.1)

The distinguished Committee established the principles that have been reinforced and securely established in the years since it was published. The governing principles are transparency in reporting and a code of practice based on ‘comply or explain’ rather than legislation. The report concerned the effective operation of the board of directors, the separation of the roles of chief executive and Chairman, the role of non-executives, board committees and the audit process. At the heart of the Committee’s recommendations was a Code of Best Practice designed to achieve the necessary high standards of corporate governance behaviour. The London Stock Exchange required all listed companies registered in the United Kingdom, as a continuing obligation of listing, to state whether they were complying with the Code and to give reasons for any areas of non-compliance.

The recommendations of the Cadbury Committee have been refined and augmented in the intervening years. Continuing concerns about top executive remuneration led to the establishment in 1995 of the Greenbury Committee on the initiative of the CBI. Its purpose was ‘to identify good practice in determining Directors’ remuneration and prepare a Code of such practice’. It

recommended that pay structures should be set to align the interests of directors and shareholders, reinforced the independence of remuneration committees and introduced significant reporting requirements. The guidelines have been reinforced subsequently by reports from the Association of British Insurers (2006) and others.

The Financial Reporting Council in turn set up the Hampel Committee to review the findings and outcomes from the Cadbury and Greenbury Reports (Greenbury (1995), Hampel (1997)). The result was the Combined Code on Corporate Governance published in 1998. In response to this Code, the accounting body, the ICAEW, commissioned the Turnbull Report that examined internal control capabilities and mechanisms (and the guidance that emerged was later revised in 2005). Following the Enron and WorldCom scandals, the Higgs Report of 2003 led to the updating of the Combined Code. Soft regulation and shareholder performance remained at the heart of the reforms.

‘The Combined Code and its philosophy of ‘comply or explain’ is being increasingly emulated outside the UK. It offers flexibility and intelligent discretion and allows for the valid exception to the sound rule. The brittleness and rigidity of legislation cannot dictate the behaviour, or foster the trust, I believe is fundamental to the effective unitary board and to superior corporate performance. ‘ (Higgs, 2003, p. 3)

‘Whereas in the US most governance discussion has focused on corporate malpractice, in the UK sharp loss of shareholder value is more common than fraud or corporate collapse. The fall in stockmarkets in the period 2000-2002 has thrown up some stark examples. In recent cases of corporate under-performance in the UK, the role of the board and of non-executive directors in particular, has understandably been called into question.’ (Higgs, 2003, p. 16)

The revised Code ‘aimed principally to advance and reflect best practice through revisions to the code’ and ‘to focus on the behaviours and relationships, and the need for the best people, which are essential for an effective board’. To this end it gave increased attention to non-executive directors and their recruitment, role and independence.

Throughout this fifteen-year period of development and refinement of the Code the role of institutional shareholders has been tackled quite modestly in each of the reports. Cadbury and the subsequent reports and versions of the Code have made few meaningful suggestions in this area – mainly consisting of

improvements to consultation and information flow. This may be in part due to the orientation of the Code towards aspects of corporate behaviour it is able to directly influence, but it is also due to the requirement to treat all shareholders equally. This ‘equity’ requirement has left these shareholders, who collectively hold over half the shares, with an often indirect influence and involvement with the company. On the other hand there is some evidence that the monitoring role of institutional investors in relation to the implementation of the Code has increased between the publication of the first guidelines by the Institutional Shareholders’ Committee in 1991 and their revisions ISC (2007).

The current version of the Combined Code on Corporate Governance (FRC, 2006) has the following main provisions.

The Role and Composition of the Board

- A single board of appropriate size with members collectively responsible for leading the company and setting its values and standards and taking decisions in the interests of the company.
- A clear division of responsibilities for running the board and running the company with a separate chairman and chief executive.
- A balance of executive and independent non-executive directors - for larger companies at least 50% of the board members should be independent non-executive directors; smaller companies should have at least two independent directors.
- Formal, rigorous and transparent procedures for appointing directors, with all appointments and re-appointments to be ratified by shareholders.
- Regular evaluation of the effectiveness of the board and its committees.

Remuneration

- Formal and transparent procedures for setting executive remuneration, including a remuneration committee made up of independent directors and a vote for shareholders on new long-term incentive schemes.
- Levels of remuneration sufficient to attract, retain and motivate directors of quality.
- A significant proportion of remuneration to be linked to performance.

Accountability and Audit

- The board is responsible for presenting a balanced assessment of the company's position (including through the accounts), and maintaining a sound system of internal control.
- Formal and transparent procedures for carrying out these responsibilities, including an audit committee made up of independent directors and with the necessary experience.

Relations with Shareholders

- The board must maintain contact with shareholders to understand their opinions and concerns.
- Separate resolutions on all substantial issues at general meetings.

The 2006 Code also imposes obligations on Institutional Shareholders as follows:

- Institutional shareholders should enter into a dialogue with companies.
- Institutional shareholders have a responsibility to make a considered use of their votes.

The key questions are whether companies have responded to these changing requirements demanded by successive Codes and, more importantly, has this brought the greater alignment of performance with shareholder interests that was sought.

The Impact on Governance

The first question to be tackled is whether fifteen years of soft regulation has brought significant changes in corporate governance practice and structure in the UK. We will address this question by examining in turn: the role of non-executive directors; the separation of the roles of chief executive and chairman; the level and structure of executive remuneration; and the power and role of institutional investors.

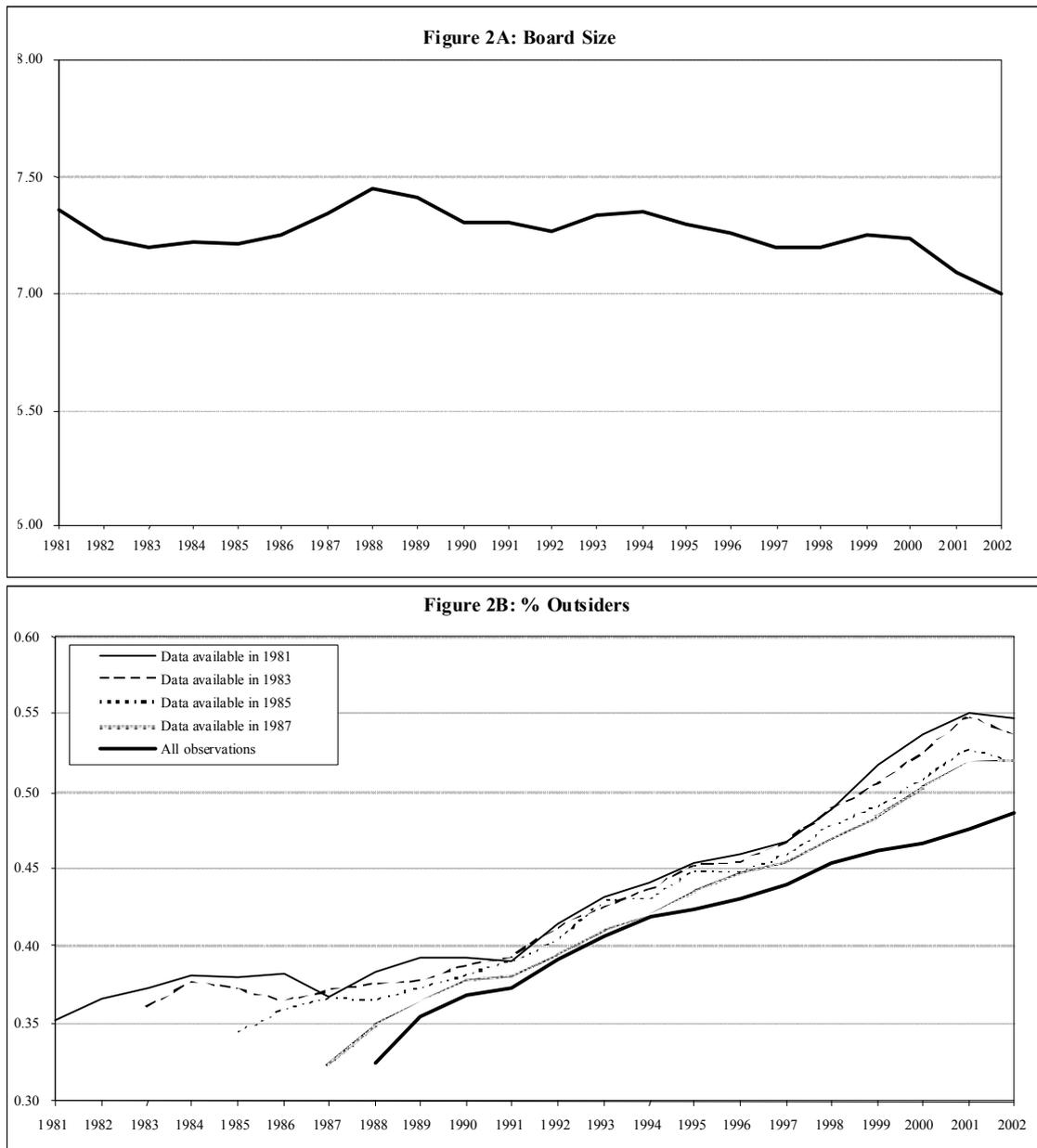
Non-executive Directors

There is overwhelming evidence that the proportion of non-executive directors has increased substantially in the UK in the past two decades. Table 1 shows for a sample of the largest UK companies that the proportion of non-executive

directors on the board rose from an average of about one-third in 1980/81 to one-half in 1995/96. By 2006, non-executive directors accounted for 60% of the board on average in the top 100 UK listed companies. Guest (2007b) shows for a much larger sample of UK listed firms that it is not only amongst the largest that this has occurred. Figure 2 shows that much the same process has been under way for the largest fifteen hundred companies, with the proportion of non-executives rising from 35% in the early 1980s to 55% in 2002 – a remarkably similar level as well as pattern to that found for the largest companies. Whilst this growth of the proportion of non-executive towards the typical proportion found in US companies (Cosh and Hughes, 1987) is undoubtedly associated with the reforms discussed in the previous section, Figure 2 shows that the change was already happening prior to the Cadbury Report.

Another feature of changes in board structure is the decline in the average board size shown for the largest companies in Table 1. This finding is supported for the larger sample that includes companies from across a wider size range. Figure 2 shows that this decline started in the late 1980s and is more directly associated with the intense debate about the appropriate size and composition of boards engendered by the various reports. It would appear that somewhat smaller boards could be viewed as more cohesive and effective. An alternative view is that the shortage of top quality candidates for non-executive directorships has forced board size decline as a means of raising the proportion of non-executive directors.

Figure 2 Trends in Board Structure: 1981-2002



Figs. 2A and 2B report the trends in average board size and the proportion of outsiders respectively for UK firms during 1981-2002. The bold line in each figure incorporates all firm year observations. For Fig. 2B this is estimated from 1988 onwards only because of changing sample composition prior to this date. For this figure earlier trends are exhibited by the fainter lines which represent samples available in earlier years (1981, 1983, 1985 and 1987) for which new firms are not added in subsequent years. Source: Guest (2007b).

Table 1 Board Size and Composition 1980-2006 (Large UK Companies)

	1980/81	1995/96	2005/06
All Directors	14	13	11
Executive Directors	9	6	5
Non-executive Directors	5	6	6
Proportion of Non-executives	0.36	0.50	0.60

1980/81 and 1995/96 are drawn from Cosh & Hughes (1997). 2005/06 - authors' calculations for top 100 UK companies.

In some writings the terms ‘non-executive directors’ and ‘independent directors’ are used interchangeably, but this is not necessarily the case. Table 2 examines the background of non-executive directors amongst giant UK companies in 1981 and 1996. It shows that over half of the non-executive directors of these companies are current, or former, executive directors of the company, or of other similar companies; and there is no sign of any change in this proportion in the 1980s and 1990s. Table 3 examines the other directorships held by various types of directors and reinforces the picture of inter-locking directorships. Current executive directors typically hold one other directorship within the Times 1000 companies, but non-executives hold more. Overall, there is a decline in the number of these outside directorships held between 1981 and 1996. This may have declined further since that time. Higgs (2003) reports that of the 3,908 non-executive directors of UK listed companies in 2002, 80% hold only one directorship and only 7% hold both executive and non-executive directorships in UK listed companies. One would expect a higher proportion of the latter amongst the largest companies, but the decline in inter-locking directorships does appear to have continued over the period 1996-2002.

Table 2 Independence of Non-executive Directors (Percentage Distribution - Giant UK Companies)

	1981	1996
Past CEO / executive director of this company	15	10
CEO / executive director of other Times 1000	26	28
Former CEO / executive director of Times 1000	10	14
Executive Director of other non-financial company	4	3
Executive Director of financial company	20	13
Former civil servant or politician	12	12
Overseas	6	14
Other	7	6
	100%	100%
% 'Insider' non-executives (first four rows)	55%	55%

Source: Cosh and Hughes (1997a).

Table 3 Number of Outside Directorships (Median Numbers - Giant UK Companies)

	1981	1996
Executive		
CEO chair	2.3	1.2
CEO not Chair	0.9	1.1
Other executive chair	4.8	2
Other executive	0.6	0.5
Non-executive		
Past CEO / executive director of this company	2.7	2.6
CEO / executive director of other Times 1000	3.3	2.1
Former CEO / executive director of Times 1000	4.2	2.9
Executive Director of other non-financial company	3.9	2.2
Executive Director of financial company	4.1	2.2
Other	2.4	2.4
Summary		
All CEO	1.9	1.2
All executive directors	0.9	0.6
All non-executive directors	3.3	2.4

Source: Cosh and Hughes (1997a).

The above concerns resulted in great emphasis being placed on the importance of the independence of non-executive directors in the Higgs Report published in 2003. It identified the circumstances in which a non-executive director's independence would be called into question; specifically, where the director:

- is a former employee of the company or group until five years after employment (or any other material connection) has ended;
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than ten years.

It is too early to assess the impact of these new recommendations on the independence of non-executive directors in UK companies.

Separation of the CEO and Chairman

A key element of the corporate governance reforms within in the UK from the Cadbury Report onwards has been the separation of the roles of chief executive and chairman.

‘Given the importance and particular nature of the chairman's role, it should in principle be separate from that of the chief executive. If the two roles are combined in one person, it represents a considerable concentration of power. We recommend, therefore, that there should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board.’ (Cadbury, 1992)

There can be little doubt that here too the governance reforms in the UK have had an impact. Cosh and Hughes (1997a) show that, for a sample of the largest UK companies, the proportion of firms combining these roles fell from 74% in 1981 to 50% in 1996. Conyon and Peck (1998a) examine the FT top 100 UK listed companies and find that the proportion with the combined role of chief executive and chairman fell from 52% in 1991 to 36% in 1994. They also show that the proportion with a remuneration committee rose from 78% to 99%, and those with a nomination committee rose from 12% to 72%, over the same period. These findings suggest an instant structural impact of the Cadbury proposals in these areas. Today almost all large UK listed companies have separate audit, remuneration and nomination committees.

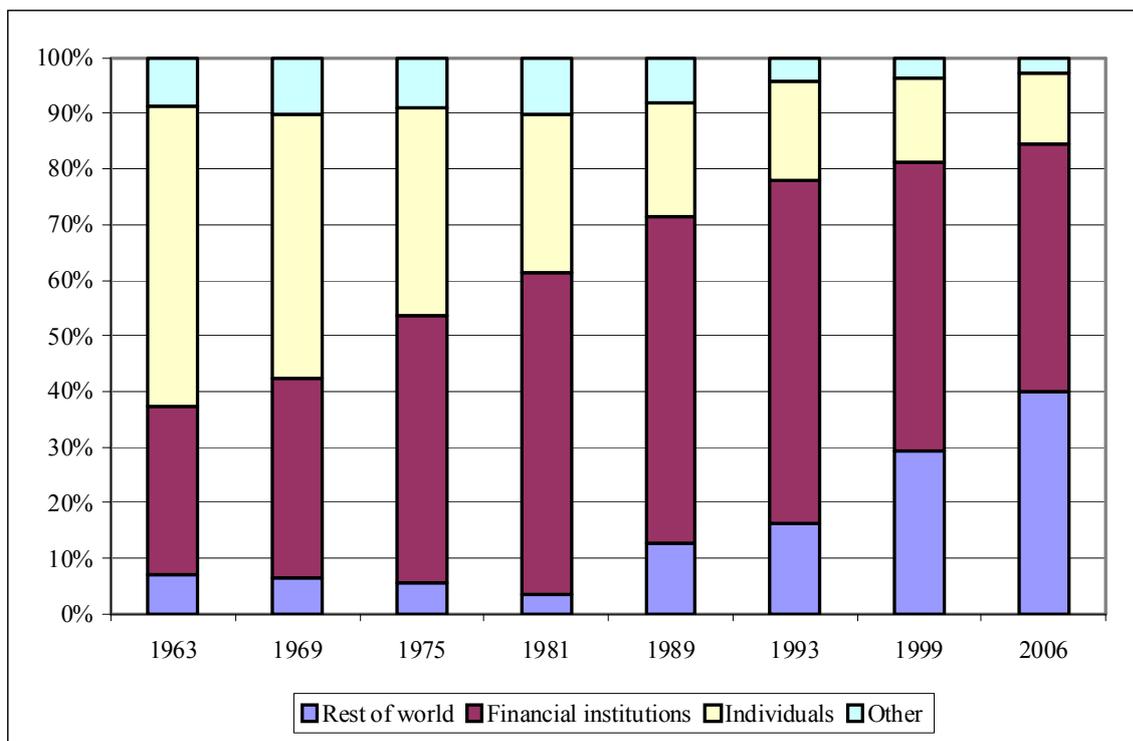
Executive Remuneration

The Combined Code on Corporate Governance recommends that executive remuneration should be at a level sufficient to attract and retain executive talent and that a significant proportion should be directly related to corporate performance. It also seeks transparency in the reporting of executive pay to shareholders and, as a consequence, UK company reports today generally contain lengthy and detailed reports from the Remuneration Committee. However, these still fail to give a simple overall picture of the total remuneration package and its composition. In addition, it is perhaps ironic that public concern about the level of top executive pay that led to these reforms has not resulted in lower levels of executive pay on average. In fact, quite the opposite has occurred. Cosh and Hughes (1997a) show that the median level of CEO remuneration rose from £222,000 in 1981 to £827,000 in 1996 for a sample of large UK companies (in 2006 prices). The bonus element of this pay rose from a negligible proportion to 21% by 1996. Amongst the top 100 UK listed companies in 2006, the median level of CEO remuneration was £1,017,000 and the bonus element had risen to over 35% of this part of the remuneration package. This rise in executive pay levels, particularly in the past decade, has been reinforced by the award of stock option and long-term incentive plans that were rare in the early 1980s (Cosh and Hughes, 1987, 1997; and Main et al., 1996). By 2006 the inclusion of these elements raises the average pay package of CEOs of FTSE 100 companies to £3.3m and the performance related element of the whole package has increased to about 80% (Financial Times, 15 May 2006). Despite this rise in the level and structure of top executive pay, the debate continues to rage about whether it has had the intended effects in terms of performance (e.g., Bebchuk and Fried, 2004; and Kay and Putten, 2007).

Institutional Shareholdings

The rising dominance of financial institutions as holders of UK listed company shares is well documented. Figure 3 shows that the proportion of ordinary shares held by financial institutions more than doubled from 30% in 1963 to 62% in 1993. The figure also shows that overseas holdings have risen dramatically from 4% in 1981 to 40% in 2006. Most of these holdings appear to be with overseas financial institutions and so it is reasonable to allocate the overseas holdings across the other categories in the proportions they are found for domestic holdings. If overseas holdings are allocated in this way, the holdings of financial institutions have risen from about 30% in 1963 to above 70% since 1990s.

Figure 3 The Ownership of the Ordinary Shares of UK Listed Companies 1963-2006



This picture of rising dominance is calculated by summing all the holdings of financial institutions, but this may give a false picture if the holdings are so dispersed that effective action is prevented. This is not the case. In a random sample of fifty of the FTSE 100 companies we found that the median number of holdings above 3% of the voting stock was 3 and that the median % of the stock held by such holdings was 17.9% (the mean figures were 3.5 holdings with 21.8%). These holdings are in general dominated by the holdings of financial institutions, about half of which are foreign. This suggests a much greater dominance by institutional holders than that reported by Cosh and Hughes (1997a) for 1981 and 1996. It would appear that this type of holder clearly has the ability to directly influence management behaviour.

In conclusion, we can see that there have been many changes to these key structural aspects of corporate governance over the last two decades, at least partly in response to the evolving Code. The question remains whether this closer tie of executive pay to performance and the supposed greater scrutiny of their decisions by the board of directors have led to changed takeover behaviour. It is apparent from Figure 1 that despite all of these changes there has been no abatement in takeover activity. In fact, it has grown in scale and become more international in nature. In recent years the UK market has seen the rise in importance of private equity transactions.

“Our inquiry was undertaken in response to the growing significance of the private equity industry in the UK, and particularly the rising number of takeovers of very large companies by private equity firms. These are a new phenomenon; the recent £11 billion purchase of Alliance Boots was the first takeover of a FTSE 100 company by a private equity firm. The increasing size of private equity deals raises a range of issues, relating for example to the impact of private equity on jobs, pensions, financial stability, transparency and accountability and tax revenues.... Currently 8% of the UK’s workforce (1.2 million workers) is employed in private equity owned companies and 19% work in companies which have at some stage been in private equity ownership.” (Treasury Select Committee, 2007)

This phenomenon is beyond the scope of this review, but we do speculate below whether it has introduced something new into the market for corporate control. We now turn to examine whether we can observe an improved takeover performance in recent years.

UK Takeover Performance since the 1980s

Have these corporate governance changes been associated with better acquisition performance? There are different ways of addressing this question. We can examine the apparent impact on performance of individual aspects of corporate governance. We do this below but, first, in this section we ask whether the large and pervasive changes in corporate governance have been associated with overall improvements in acquisition performance. A number of UK studies have examined the performance of takeovers since 1980 in terms of both shareholder returns and accounting profitability.

These studies have shown that share returns at announcement are negative for acquirer shareholders. For example, Cosh et al. (2006) for a sample of 363 acquirers (between 1985 and 1996) acquiring UK listed targets find that the mean announcement abnormal return is -1.13 percent, which is statistically significant. Therefore, over the three days surrounding the acquisition announcement, the stock market overall assessment is that the average acquisition will result in a small but significantly negative effect on acquirer value. This finding is consistent with other UK studies for the time period that also report significantly negative abnormal announcement returns to acquirers (e.g. Sudarsanam and Mahate, 2003). Share returns for acquiring firms over the long run post-acquisition period are also significantly negative for samples since 1980. For example, Cosh et al. (2006) find that the 36-month post-acquisition mean return is -16.26 percent which is statistically significant. This result is consistent with other long run studies of UK acquirers over this sample time period such as Gregory (1997), and Sudarsanam and Mahate (2003).¹ Therefore, overall, the impact on the share price performance of acquiring firms is similar to earlier periods.

The impact of takeovers on profitability since the 1980s is somewhat more positive than in earlier periods, although it depends very much on the specific profitability measure employed. Powell and Stark (2005) and Cosh et al. (2006) use a range of measures and find consistent results. Specifically, when comparing post- and pre-takeover performance, measures based on accrual profit report a significantly positive increase in operating performance. The improvement ranges from 1.08 in the case of profit to book assets, to 1.65 in the case of profit to market value of assets. In contrast, when cash flow, rather than accrual, measures are used the impacts are positive, but smaller and statistically indistinguishable from zero. Therefore, there is some evidence that takeovers improve profitability, but this does not hold across all profitability measures.

To summarize, results post-1980 show that UK takeovers result in significant share price losses over both the short and long run period surrounding the acquisition. Acquiring shareholders are unambiguously worse off. The effect on operating performance ranges from mildly positive for the cash flow measures, to economically and statistically significantly positive for the accrual operating performance measures. There is therefore some evidence that the considerable changes in corporate governance described above have resulted in improved takeover performance in the aggregate.ⁱⁱ The fact that this result is measurement specific suggests that caution should be exercised in placing too much weight on the accounting results. However, within the average effect it could be that those firms with ‘effective’ governance structures do better for their shareholders than those with less effective structures. In order to control for such factors, it is necessary to directly examine the impact of the specific corporate governance features on acquisition performance itself.

Governance and Merger Performance Review

There is a large UK empirical literature on the impact of firm specific corporate governance mechanisms on both overall firm performance as well as firm specific actions. However, despite the importance of acquisitions within firm strategy and the market for corporate control, only one published study to date in the UK has examined the impact of internal corporate governance measures on acquisition performance. Cosh et al. (2006) examine the impact of a wide range of corporate governance variables on takeover performance. They examine a sample of 363 domestic UK takeovers which occurred in the period 1985-96, and assess performance in terms of announcement returns, long run share returns and a portfolio of accounting measures. In this section, we review the Cosh et al. (2006) findings, a summary of which is reported in Table 4. We also review the literature that examines the impact of these particular governance factors on firm performance in general.

Table 4 Summary of the Findings of Cosh et al. (2006) on the Impact of Corporate Governance Characteristics on UK Takeover Performance

Corporate governance measure	Takeover performance measure		
	Announcement share returns	Long run share returns	Profitability
Board structure			
%non-executives	-	-	+
Board size	-	+	+
Chairman-CEO	-	-	+
Impact of Cadbury			
Post-Cadbury	+	+ *	+
Chairman-CEO post-Cadbury	- *	+	-
Ownership structure			
Board ownership (%)	+	+ *	+
Board ownership (%) squared	+	-	-
CEO ownership (%)	-	+ *	+ *
CEO ownership (%) squared	+	-	-
Executive ownership (%)	+	+	+
Executive ownership (%) squared	-	+	-
Non-executive ownership (%)	-	-	+
Non-executive ownership (%) squared	+	+	+
Largest institutional shareholder (%)	-	+	-
Largest corporate shareholder (%)	+	+	-
Largest personal shareholder (%)	-	+	-
Incentive shares & relative pay			
CEO incentive shares (%)	-	+	+
Executive incentive shares (%)	- *	- *	-
Non-executive incentive shares (%)	+	+	-
High CEO relative pay	+	-	+

This table summarises the results from Cosh et al. (2006), who examine the impact of various firm specific governance characteristics on the performance of 363 domestic acquisitions made by UK public firms for UK public firms between January 1985 and December 1996. %non-executives is the number of non-executive directors on the board divided by board size. Board size refers to the entire board of all executive and non-executive directors. Chairman-CEO is a dummy variable that is set equal to one if the Chairman is also the CEO, zero otherwise. Post-Cadbury is a dummy variable that is set equal to one if the year of completion is 1993 or afterwards, zero otherwise. Chairman-CEO post-Cadbury is a dummy variable that is set equal to Chairman-CEO if the acquisition year is 1993 or afterwards, zero otherwise. Board ownership (%) is the number of beneficial and non-beneficial shares owned by the entire board, divided by total shares in issue. CEO ownership (%) is the number of beneficial and non-beneficial shares owned by the CEO, divided by total shares

in issue. Executive ownership (%) is the number of beneficial and non-beneficial shares owned by all executive directors except the CEO, divided by total shares in issue. Non-executive ownership (%) is the number of beneficial and non-beneficial shares owned by all non-executive directors, divided by total shares in issue. Largest institutional shareholder (%) is the largest external shareholding held by a financial institution. Largest corporate shareholder (%) is the largest external shareholding held by another firm that is not a financial institution. Largest personal shareholder (%) is the largest external shareholding held by a private individual. CEO incentive shares (%) is the number of incentive shares owned by the CEO, divided by the total number of shares in issue. Executive incentive shares (%) is the number of incentive shares owned by all executive directors except the CEO, divided by the total number of shares in issue. Non-executive incentive shares (%) is the number of incentive shares owned by all non-executive directors, divided by the total number of shares in issue. High CEO relative pay is the highest paid director's salary divided by the board total remuneration divided by board size. Pay refers to salary, plus pensions and bonuses. Announcement share returns are the mean cumulative abnormal share return for acquirers calculated from day -1 to day +1 (where day 0 is the announcement day), relative to the Market Index. Long run share returns are the mean buy-and-hold abnormal returns for acquirers over the 36-month period following the completion month, relative to control firms. Profitability is the post-takeover abnormal profitability (median operating profitability of the acquirer in years +1 to +3 relative to control firms) regressed on pre-takeover profitability (median operating profitability of the weighted average acquirer and target in years -1 to -3 relative to control firms). Six measures of profitability are employed (profit/total assets, profit/sales, profit/market value, cash flow/total assets, cash flow/sales, cash flow/market value), where profit is operating profit before depreciation, cash flow is operating profit before depreciation adjusted for short term accruals, and market value is the market value of equity and book value of long and short term debt. The profitability column here reflects the average impact on all six measures. Control firms, for both long run returns and profitability, are non-merging firms matched on industry and pre-acquisition profitability. The results for CEO ownership, executive ownership, non-executive ownership, and incentive shares, are for a reduced sample of 178 acquisitions for which data is available. * indicates statistical significance at the 10 percent level or higher. For the profitability measure, significance is measured according to the average *t*-statistic across the six profitability measures.

The Impact of Cadbury

We argued above that average takeover performance and acquiring company shareholder returns do not appear to differ in the period prior to and following the 1980s. Although pressure for corporate governance change can be traced to at least the early 1980s, formal corporate governance reforms could arguably be said to commence with the Cadbury Code in 1992. Since the sample takeovers in Cosh et al. (2006) straddle the Code, the authors include a dummy variable to reflect pre and post the implementation of the Cadbury Report. Table 4 shows that acquisitions carried out after Cadbury have more positive announcement and long run returns, significantly so for the latter. In terms of operating performance, this is more positive following Cadbury but not significantly so. Acquisitions are more profitable following Cadbury for four of the six operating performance measures, significantly so for one of these measures. There is therefore some evidence that takeover performance improves following Cadbury.

Board Composition

A small number of UK studies examine the impact of board composition on overall firm performance. The results provide little support for the hypothesis that a greater number, or proportion, of non-executive directors is associated with enhanced performance. Vafeas and Theodorou (1998), using a cross section of 250 UK firms in 1994, find that the proportion of non-executives has an insignificant impact on Tobin's Q. Weir and Laing (2000) examine 200 UK firms in both 1992 and 1995, finding that the number of non-executives has a negative impact on profitability, but an insignificant impact on share price performance. Weir et al. (2002) find that the proportion of non-executives has an insignificant effect on Tobin's Q for 311 firms over 1994-96. These results are broadly consistent with the results for outside the UK.ⁱⁱⁱ In terms of firm specific decisions, there is evidence that a higher proportion of non-executives leads to less earnings manipulation (Peasnell et al., 2005), but little evidence it leads to more efficient decisions in terms of CEO dismissals (Cosh and Hughes, 1997b; and Franks et al., 2001) or executive compensation (Cosh and Hughes, 1997b). This is in contrast to the US, where there is stronger evidence that the proportion of outside directors is associated with better specific decisions such as acquisitions, executive compensation and CEO turnover (Hermalin and Weisbach, 2003). In terms of the impact on takeover performance, Cosh et al. (2006) find that the proportion of non-executives has an insignificantly negative impact on announcement and long run returns, and an insignificantly positive impact on five of their six operating performance measures. Therefore the impact is inconsistent across the measures and is insignificant.

Board Size

A large number of empirical studies for the US have documented a negative association between board size and firm performance (Hermalin and Weisbach, 2003).^{iv} In addition to these general performance effects, there is also evidence that smaller boards are more effective at specific decisions.^v The only UK study to date is Conyon and Peck (1998b). They examine 481 listed UK firms for 1992-95 and find a significantly negative effect of board size on both market to book value and profitability. However, there is no evidence that the negative impact of board size extends to takeover performance. Cosh et al. (2006) find that board size has a statistically insignificant effect on takeover performance. Although the impact is negative for announcement returns, it is positive for long run returns and profitability.

Separation of the CEO and Chairman

There is a relatively small body of empirical research examining the impact of whether firms have a combined CEO-Chairman or not on performance. The evidence that does exist suggests that this factor has no significant impact on performance. For the UK, studies such as Vafeas and Theodorou (1998), Weir and Laing (2000) and Weir et al. (2002) find little impact. Similar results hold elsewhere.^{vi} Cosh et al. (2006) find that when the chairman and CEO roles are combined, there is a negative impact on announcement and long run returns, yet a positive effect on five of the size operating performance measures, none of which are statistically significant. The authors hypothesize that any negative impact of the combined role will be weaker following Cadbury since the Code required a transparent and specific public justification where they continued to be combined. Therefore Cosh et al. (2006) interact the CEO-Chairman dummy variable with the post-Cadbury dummy. As Table 4 shows, this interactive variable is significantly negative for announcement share returns, but positive for long run returns and insignificantly negative for profitability effects. Thus in the long run, acquiring company shareholders may be better off as a result of this governance change.

Board Ownership

There is an extensive empirical literature on the impact of ownership structure on overall company performance. Until the mid 1980's, the literature in this area tested for differences between usually dichotomous groups of firms characterised as owner or manager controlled. Control status depended upon the proportion of shares owned by the board. Most such studies were concerned with testing specific predictions of the managerial theory of the firm that manager-controlled firms would have higher growth rates but lower and more volatile profit rates or return on shares than owner controlled firms (Marris, 1964). However, this particular trade off was rarely supported by the data. For the UK, Radice (1971) shows that significant board ownership is associated with superior shareholder performance whilst Holl (1975), using a much larger sample and controlling for market power, finds insignificant differences. The US results are equally mixed.^{vii}

Later studies for both the UK and the USA have moved away from the dichotomous approach as more refined ownership data has become available, and attention has switched to testing for entrenchment-based non-linear effects. Empirical studies attempting to identify the impact of these effects in the US and UK have found evidence of a non-monotonic relation between board

ownership and company performance. For the USA, Morck et al. (1988) find that the value of Tobin's Q at first increases with board share ownership in the range 0 to 5 percent, decreases between 5 and 25 percent and then increases again above 25 percent. They argue that the entrenchment effect takes root once certain shareholding levels are reached and increases as shareholdings rise up to a further point beyond which no further entrenchment is necessary. Once the conditions necessary for entrenchment are reached, further ownership bestows no further entrenchment and no further adverse effects in terms of shareholder welfare. The convergence-of-interests effect it is argued, in contrast, operates throughout the whole range of ownership. Therefore once entrenchment is reached, further ownership will result in an increase in company performance. McConnell and Servaes (1991 and 1995), and Hermalin and Weisbach (1991), find an inverted U-shaped relationship that is consistent with entrenchment, but do not find a second turning point beyond which alignment effects reappear. The former, for instance, report positive effects between 0 and 40-50 percent and negative effects thereafter with no subsequent upturn. Kole (1995) argues that the difference between the first turning point in these results and those of Morck et al. (1988) may be due to the exclusion of small companies from Morck et al.'s sample. The inclusion of large numbers of smaller companies, she contends, raises the point up to which the positive effects of alignment persist because 'the positive relationship between Tobin's Q and managerial ownership is sustained at higher levels of ownership for small firms than it is for large firms' (Kole, 1995, p. 426).

For the UK, Cubbin and Leech (1986) develop a continuous variable of shareholder power based on the size and location of shareholdings and the dispersion of remaining shares. In a sample of 43 large companies in the early 1970's they find no evidence of significant performance effects arising from board shareholder power. However, Short and Keasey (1999) use a random sample of 221 large UK companies for the period 1988-1992 and report similar results to Morck et al. (1988) linking board ownership to performance. They report higher turning points at around 12-15 percent and then 41 percent depending on the performance measure used. Although these are similar to the turning points in some of the other US studies they interpret this as showing that board entrenchment becomes effective at higher levels of ownership in the UK compared to the US and that the entrenchment effect dominates up to much higher share ownership levels. Faccio and Lasfer (1999) analyse a much larger UK sample of all UK non-financial listed companies in 1996 and find no relationship between firm value and board ownership in general, although they report that a non-linear relationship with two turning points exists for the subset of firms with high growth prospects (proxied by high P/E ratios). They

speculate that their general lack of robust findings of any entrenchment effects of board ownership on firm value performance may reflect the effectiveness of external governance pressures in the UK. Finally, Weir et al., (2002) analyse 311 companies from the 1996 *Times1000* list, and find evidence for an entrenchment effect in terms an inverted U shaped relationship between Tobin's Q and CEO share ownership. They do not report the estimated turning point in this relationship.^{viii ix}

Cosh et al. (2006), in keeping with the existing literature on entrenchment and alignment, test the hypothesis that there will be a significant but non-linear relationship between board ownership and takeover performance. They experiment with various functional forms. They find no evidence of a relation between board ownership and announcement period share returns, strong evidence of a positive linear relation between board ownership and long run share returns, and weak evidence of a positive linear relation between board ownership and operating performance. They find no evidence of negative entrenchment effects although they do find that the effect of board ownership is more acute at low (less than five percent) levels of holdings, and some evidence of diminishing effects at higher levels of ownership.

The scope for entrenchment and the exercise of discretionary power to pursue non-shareholder welfare strategies may be imperfectly measured by focussing on board ownership in aggregate and by focussing on board ownership alone. Aggregate board ownership is one component of the anatomy of corporate control and should be disaggregated and located in a wider range of factors which will condition its impact (Cosh and Hughes, 1987 and 1997a; Deakin and Hughes, 1997; Vafeas, 1999; and Weir et al., 2002). Where a substantial aggregate board holding is made up of several smaller holdings, entrenchment requires coordination of action and a clear community of interests between the holders. This may weaken the power of the entrenchment effect, and at the same time strengthen the incentive effect because ownership is dispersed across more board members. Conversely, where board ownership in aggregate is dominated by one, or a few, large holdings the entrenchment effect will be more likely to emerge and the incentive effect will be more muted because fewer directors are involved.

Stronger entrenchment effects for CEO and executive shareholdings are predicted than for board ownership as a whole and for non-executive shareholdings. In a US study focussing on CEO ownership, Griffith (1999) reports results similar to Morck et al. (1988) in having two turning points. He shows that Tobin's Q rises with CEO ownership between 0 and 15 percent,

declines for values between 15 and 50 percent, and rises again when the CEO has over 50 percent of the stock. For the UK, Weir et al. (2002) find that Tobin's Q initially rises with CEO ownership and then declines. It is also important to distinguish between non-executive and executive directors shareholdings. The former, in principle, play a key role in monitoring executive directors and are expected to have objectives aligned with shareholder interests. We would therefore expect entrenchment effects based on ownership to be weaker for this group compared to executive shareholdings.

Cosh et al. (2006) also take a disaggregated view of board shareholdings paying particular attention to the composition of board shareholdings as well as their size. They analyse the separate impact of CEO shareholdings and the pattern of non-executive and executive holdings within the board. Much stronger effects are found when the overall board measure is split into CEO, executive, and non-executive directors. They find strong evidence of a positive relation between CEO ownership and both the long run return and operating performance impact of takeover on acquiring firms. The positive effect declines as CEO ownership increases to high levels of about 20 percent. These findings are consistent with the existence of discretion to pursue non-shareholder welfare maximisation takeovers, and with an incentive impact of CEO shareholdings that prevents it from occurring when substantial CEO holdings are present. This 'corrective' power appears to be subject to diminishing returns. It is not however subverted by potential entrenchment effects at higher CEO shareholding levels. In contrast, shareholdings of other executive directors, non-executive directors, and non-board holdings are found to have no significant effect on takeover performance.

The intra-board emphasis is in keeping with a more general interest in the governance and agency literature, of conflicts of interest within corporate elites and the potential role of CEO power and hubris in driving corporate strategic decision taking (Allen 1981; Baysinger and Hoskisson, 1990; Hayward and Hambrick, 1997; and Jensen and Zajac, 2004). Cosh et al. (2006) investigate the impact that CEO dominance may have in affecting takeover outcomes where dominance is proxied by the ratio of CEO to other directors' remuneration. The authors predict a negative relationship between takeover performance and the ratio of CEO to average board pay. However, the coefficient for the CEO pay over average pay measure is of indeterminate sign and statistically insignificant. This is consistent with corporate governance restrictions on CEO discretion.

As noted above, incentive shares increased dramatically in the bull markets of the 1990s and potentially increase the incentive alignment effects of share ownership since in principle the shares should yield gains conditional on meeting specified shareholder welfare creating activities. The extent to which this is the case clearly depends upon the design of the contracts and the extent to which executives can manipulate them in their favour. Cosh et al. (2006) consider the impact of incentive shares on takeover performance, by examining the number of incentive shares as a proportion of number of shares in issue. The hypothesis is that takeover performance will be enhanced in the presence of CEO, executive and non-executive incentive shares. They find that neither CEO nor non-executive director incentive shares have a consistent or significant effect on takeover performance. However, they do find that executive director incentive shares have a consistently negative impact, significantly so in the case of announcement returns, long returns, and for two of the six operating performance measures. This is a curious finding which is inconsistent with expectations.

Institutional Shareholdings

As noted above, takeover performance is hypothesised to be more closely aligned with shareholder interests where substantial off-board holdings by financial institutions exist. Filatotchev et al., (2007) review the literature on large external shareholders and overall firm performance and conclude that there is no robust link between more concentrated external holdings and better firm performance. The only previous UK study examining the impact of financial institutions on merger performance is Cosh et al. (1989). They examine two U.K. merger samples. In the first sample drawn from the low merger period 1981–1983, pre- and post-merger differences are found between merging companies with, and without a significant institutional presence. However, in the takeover boom year of 1986, from which the second sample is drawn, all such distinctions become blurred. Cosh et al. (2006) also assess the impact of non-board holdings by financial institutions, as well as by corporations and persons. The effect of these external shareholders is indeterminate and rarely significant. For example, the largest institutional shareholder has an insignificantly positive impact on announcement and long run returns, yet a negative impact for three (significantly so in one case) of the operating performance measures, and a positive impact for the other three of these measures.

Summary

Our review of the literature on the relationship between internal corporate governance mechanisms and the performance of UK companies in both a general sense and in terms of takeover performance shows that there is a weak relationship between internal governance mechanisms and performance. The exception is board and more specifically CEO ownership. Acquirers whose CEOs own a larger proportion of equity, consequently carry out acquisitions which perform significantly better in terms of both long run returns and operating performance, and these impacts are stronger at lower levels of board ownership reflecting diminishing returns to alignment at higher ownership levels. There is no evidence of entrenchment effects within the levels of board ownership examined. Furthermore, acquisition performance is not only better, but significantly positive for such acquirers. This key finding on CEO ownership in the context of acquisitions is robust to a number of potential biases. Firstly, a potentially serious problem with many corporate governance studies is that of reverse causality, whereby governance changes because of past or expected performance, not the other way round. One possibility in the context of acquisitions is that at low levels of ownership, CEOs purchase stock in anticipation of good takeover performance. Cosh et al. (2006) carry out two-stage least squares regressions but find that this approach yields results that are very similar. They therefore conclude that the positive effect of CEO ownership on takeover performance is the result of higher CEO shareholdings leading to improved takeover performance rather than CEOs buying shares in anticipation of good takeover performance. The finding is also robust to controlling for other factors that determine takeover performance (acquirer performance, relative size, means of payment, hostility, industrial direction) and a variety of other constraints which may influence director behaviour arising from debt related lender power and the product market. The fact that CEO ownership leads to higher acquisition performance potentially has important implications for the effect of acquisitions involving private equity firms. In particular, given that such acquisitions frequently result in CEOs taking a large ownership stake, they may *ceteris paribus*, perform better than other types of acquisition.

Conclusion

We have shown that waves of takeover activity have occurred with increasing intensity in recent decades in the UK, unabated by the significant changes to share ownership and corporate governance. Initially, the poor average outcomes for shareholders of these bouts of takeover activity could be argued to follow from the separation of ownership from control, the lack of alignment of management with shareholder interests, and the inability of boards of directors to monitor and control the strategies of their management teams. We have shown the massive structural changes in each of these features over the last forty years and yet, takeover performance for the acquiring shareholders shows little sign of improving and positive profitability performance effects depend upon the choice of particular performance measures. In addition, the specific changes to board structures and executive pay cannot be shown to have had much impact on takeover outcomes. It still appears to be the case that, as Dennis Mueller argued in 1969, the directors of large corporations invest in acquisitions beyond the point at which the welfare of their shareholders will be maximised. It may be the case that both management and shareholder representatives are overly optimistic about the gains they can make from acquisitions and about the premiums they can afford to pay. We have pointed out above that it is possible that private equity firms bring a new type of player on to the market for corporate control, one for whom the rewards for effective takeovers are greater and more direct. It would be ironic if this turned out to be the means for improved takeover performance given the conglomerate nature of private equity acquisitions and their rather poor record on corporate governance.

Notes

ⁱ It is important to note that studies which examine the impact of acquisitions of private targets (e.g., Conn et al., 2005) do not find evidence of negative returns. Earlier studies (i.e., pre-1980) do not examine this type of acquisition.

ⁱⁱ Despite the overall performance of acquisitions over the period, Guest (2007a) shows that acquisitions on average have a significantly positive impact on executive pay. Therefore acquiring firm directors benefit in terms of higher pay, even if their shareholders do not.

ⁱⁱⁱ For the US, most studies (e.g., Hermalin and Weisbach, 1991; Yermack, 1996; Dalton et al., 1998; and Klein, 1998) find no association, whilst a smaller number (e.g., Agrawal and Knoeber, 1996; Bhagat and Black, 2002; and Coles et al., 2007) find a negative relation. Outside the US, Hossain et al. (2001) and Choi et al. (2007) find a positive relation for New Zealand and Korea respectively, Beiner et al. (2004; 2006), and Haniffa and Hudaib (2006) find no relation for Swiss and Malaysian firms respectively, whilst Bozec (2005) finds a negative relation for Canadian firms.

^{iv} For the US, see Yermack (1996), Huther (1997), and Coles et al. (2007). Evidence from other countries is broadly consistent but less robust. Eisenberg et al. (1998) provide similar evidence for small private firms in Finland, whilst Mak and Kusnadi (2005) and Haniffa and Hudaib (2006) do so for Malaysian firms. For Belgium, Dehaene et al. (2001) find that board size has an insignificantly negative impact on profitability. For Switzerland, Loderer and Peyer (2002) find a significantly negative impact on Tobin's Q (although not on profitability) whilst Beiner et al. (2004 and 2006) find no negative impact. Bozec (2005) finds a significantly negative effect on sales margin but not profitability for Canadian firms.

^v For example, Yermack (1996) finds that firms with smaller boards have a stronger relationship between firm performance and CEO turnover, and higher sensitivity of CEO cash compensation to stock returns.

^{vi} See e.g., Daily and Dalton (1992; 1994), Beatty and Zajac (1994), Boyd (1994), and Ocasio (1994). In their meta-analysis of 31 studies of links between separation and financial performance, Dalton et al. (1998) do not establish any significant causal relationship.

^{vii} Profit and share price performance differences alone proved equally elusive, although studies which corrected returns for risk, controlled for market power constraints and allowed for some disaggregation between board and non-board holdings produced more robust results. For the USA, Kamerschen (1968), Lerner (1970), Sorensen (1974), Qualls (1976), Kania and McKean (1976), Zeitlin and Norich (1979), and Herman (1981) find insignificant shareholder

performance differences between high board shareholder (owner controlled) and low board shareholder (manager controlled) groups. In contrast, Mosen et al. (1968), Boudreaux (1973), Palmer (1973 and 1975), Stano (1975 and 1976), McEachern (1975 and 1978) do find superior shareholder welfare performance. Palmer (1973 and 1975), in particular, shows the importance of market power in allowing managerial discretion and performance differences to emerge.

^{viii} A number of studies have related ownership characteristics not to overall performance, but to specific observable firm actions. These include US papers analysing the impact of board ownership on the premiums paid in takeover bids, the method of takeover payment and post-acquisition executive job retention (Martin, 1996; Hayward and Hambrick, 1997; and Ghosh and Ruland, 1998), executive pay around acquisitions (Wright et al., 2002), and the likelihood of paying greenmail or excessive bid premia (Kosnik, 1987 and 1990). These studies provide mixed evidence in identifying significant ownership impacts. For the UK, Guest (2007a) finds that ownership structure has no impact on executive pay awards following acquisition.

^{ix} There are also some direct estimates of the impact of board ownership on takeover performance outcomes for the acquiring company shareholders. These have focussed on announcement effects, and relate only to the USA. Conn (1980) using a dichotomous approach finds no differences in merger pricing or share returns between owner and manager controlled groups. However, Slutsky and Caves (1991) show that as acquiring board holdings increase, a lower premium is paid for the target. Lewellen et al. (1985), Loderer and Martin, (1998), and Shinn (1999) using a more continuous approach report a positive linear relationship between board ownership and announcement returns. These latter three studies suggest that the detrimental effects of entrenched management observed with company performance in general do not apply in the case of corporate takeovers. Hubbard and Palia, (1995) however provide evidence of a U shaped relationship. They argue that at sufficiently high levels of managerial ownership, managers hold a large non-diversified financial portfolio in the firm. Such management will pay a premium for risk reducing acquisitions, even if the value of the acquiring firm decreases.

References

- ABI. 2006. *Executive Remuneration – ABI Guidelines on Policies and Practices*. Association of British Insurers, London.
- Agrawal, A., Knoeber, C.R., 1996. Firm performance and mechanisms to control agency problems between managers and shareholders. *Journal of Financial and Quantitative Analysis* 31, 377-97.
- Allen, M.P., 1981. Managerial power and tenure in the large corporation, *Social Forces* 60, 482-494.
- Asquith, P., Bruner, R.F., Mullins, D.W., 1983. The gains to bidding firms from merger. *Journal of Financial Economics* April, 121-139.
- Barber, B.M., Lyon, J.D., 1997. Detecting long run abnormal stock returns: The empirical power and specification of test statistics, *Journal of Financial Economics* 43, 341-372.
- Baysinger, B., Hoskisson, R.E., 1990. The composition of boards of directors and strategic control: Effects on corporate strategy. *Academy of Management Review* 15, 72-87.
- Beiner, S., Drobetz, W., Schmid, M.M., Zimmermann, H., 2004. Is board size an independent corporate governance mechanism? *Kyklos* 57, 327-356.
- Beiner, S., Drobetz, W., Schmid, M.M., Zimmermann, H., 2006. An integrated framework of corporate governance and firm valuation. *European Financial Management* 12, 249-283.
- Berle, A.A., Means, G.C., 1932. *The Modern Corporation and Private Property*. Macmillan, New York.
- Bhagat, S., Black, B.S., 2002. The non-correlation between board independence and long-term firm performance. *Journal of Corporation Law* 27, 231-273.
- Beatty, R.P., Zajac, E.J., 1994. Managerial incentives, monitoring and risk bearing: a study of executive compensation, ownership, and board structure in initial public offerings. *Administrative Science Quarterly* 39, 313-335.
- Bebchuk, L., Fried J., *Pay without Performance: The Unfulfilled Promise of Executive Compensation*. Harvard University Press, Cambridge.
- Boudreaux, K.J., 1973. Managerialism and risk-return performance. *Southern Economic Journal* 29, 366-372.
- Boyd, B.K., 1994. Board control and CEO compensation. *Strategic Management Journal* 15, 335-344.

- Bozec, R., 2005. Boards of directors, market discipline and firm performance. *Journal of Business Finance & Accounting* 32, 1921-1960.
- Brown, S.J., Warner, J.B., 1985. Using daily stock returns, the case of event studies. *Journal of Financial Economics* 14, 3-31.
- Cadbury, Sir A., 1992. *The Financial Aspects of Corporate Governance*. Financial Reporting Council, London
- Chatterjee, R., Meeks, G., 1996. The financial effects of takeover: Accounting rates of return and accounting regulation. *Journal of Business Finance & Accounting* 23, 851-868.
- Choi, J.J., Park, S.W., Yoo, S.S., 2007. The value of outside directors: Evidence from corporate governance reform in Korea. *Journal of Financial and Quantitative Analysis*, forthcoming.
- Coles, J.L., Naveen D.D., Naveen, L., 2007. Does One Size Fit All? *Journal of Financial Economics*, forthcoming.
- Conn, R.L., 1980. Merger pricing policy by owner-controlled versus manager-controlled firms. *Journal of Industrial Economics* XXVIII, 427-438.
- Conn, R.L., Cosh, A., Guest, P.M., Hughes, A., 2004. Why must all good things come to an end? The performance of multiple acquirers. In Nagao, D.H. (ed.), *Proceedings of the Sixty-third Annual Meeting of the Academy of Management*.
- Conn, R.L., Cosh, A., Guest, P.M., Hughes, A., 2005. The impact on UK acquirers of domestic, cross-border, public and private acquisitions. *Journal of Business Finance & Accounting* 32, 815-870.
- Conyon, M.J., Peck, S.I., 1998a. Board control, remuneration committees and top management compensation. *Academy of Management Review* 41, 146-157.
- Conyon, M.J., Peck, S.I., 1998b. Board size and corporate performance: Evidence from European countries. *The European Journal of Finance* 4, 291-304.
- Cosh, A., Guest, P.M., Hughes, A., 2006. Board share ownership and takeover performance. *Journal of Business Finance & Accounting* 33, 459-510.
- Cosh, A., Hughes, A., 1987. The anatomy of corporate control: Directors, shareholders and executive remuneration in giant US and UK corporations. *Cambridge Journal of Economics* 11, 285-313.
- Cosh, A., Hughes, A., 1997a. The changing anatomy of corporate control and the market for executives in the United Kingdom. *Journal of Law and Society* 24, 104-123.

- Cosh, A., Hughes, A., 1997b. Executive remuneration, executive dismissal and institutional shareholdings. *International Journal of Industrial Organisation* 15, 469–492.
- Cosh, A., Hughes, A., Lee, K., Singh, A., 1989. Institutional investment, mergers and the market for corporate control. *International Journal of Industrial Economics*, 73-100.
- Cosh, A., Hughes, A., Singh, A., 1980. The causes and effects of takeovers in the United Kingdom: An empirical investigation for the late 1960s at the microeconomic level. In Mueller, D.C. (ed.), *The Determinants and Effects of Mergers: An International Comparison*. Oelgeschlager, Gunn & Hain, Cambridge MA.
- Cubbin, J., Leech, D., 1986. Growth versus profit – maximisation: A simultaneous equation approach to testing the Marris model. *Managerial and Decision Economics* 7, 123-131.
- Daily, C.M., Dalton, D.R., 1992. The relationship between governance structure 201 and corporate performance in entrepreneurial firms. *Journal of Business Venturing* 7, 375-386.
- Daily, C.M., Dalton, D.R., 1994. Bankruptcy and corporate governance: The impact of board composition and structure. *Academy of Management Journal* 37, 1603-1617.
- Dalton, D.R., Daily, C.M., Ellstrand, A.E., Johnson, J.L., 1998. Meta-analytic reviews of board composition, leadership structure and financial performance. *Strategic Management Journal* 19, 269-90.
- Deakin, S., Hughes, A., 1997. Comparative corporate governance: An interdisciplinary research agenda, *Journal of Law and Society* 24, 1-9.
- Dehaene, A., De Vuyst, V., Ooghe, H., 2001. Corporate performance and board structure in Belgian companies. *Long Range Planning* 34, 383-398.
- Dickerson, A., Gibson, H., Tsakalotos, E., 1997. The impact of acquisitions on company performance: Evidence from a large panel of UK firms. *Oxford Economic Papers* 49, 344–361.
- Eisenberg, T., Sundgren, S., Wells, M.T., 1998. Larger board size and decreasing firm value in small firms. *Journal of Financial Economics* 48, 35-54.
- Faccio, M., Lasfer, M., 1999. Managerial ownership, board structure and firm value: The UK evidence. Working Paper City University.
- Fama, E.F., 1998. Market efficiency, long-run returns, and behavioral finance. *Journal of Financial Economics* 49, 283-306.

- Filatotchev, I., Jackson G., Gospel, H., Allcock, D., 2007. Key drivers of 'good' corporate governance and the appropriateness of UK policy responses. DTI, London.
- Franks, J., Harris, R.S., 1989. Shareholder wealth effects of corporate takeovers: the U.K. experience 1955–1985. *Journal of Financial Economics* 23, 225–249.
- Franks, J., Mayer, C., Renneboog, L., 2001. Who disciplines management in poorly performing companies? *Journal of Financial Intermediation* 10, 209–248.
- FRC. 2006. *The Combined Code on Corporate Governance*. Financial Reporting Council, London.
- Ghosh, A., Ruland, W., 1998. Managerial ownership, the method of payment for acquisitions and executive job retention. *Journal of Finance* LIII, 785-798
- Greenbury, Sir R., 1995. *Directors' Remuneration*. CBI, London
- Gregory, A., 1997. An examination of the long run performance of UK acquiring firms. *Journal of Business Finance and Accounting* 24, 971-1002.
- Griffith, J.M., 1999. CEO ownership and firm value. *Managerial and Decision Economics* 20, 1-8
- Guest, P.M., 2007a. The impact of mergers and acquisitions on executive pay in the United Kingdom. *Economica*, forthcoming.
- Guest, P.M., 2007b. The determinants of board size and composition: Evidence from the UK. *Journal of Corporate Finance*, forthcoming.
- Gugler, K., Mueller, D.C., Yurtoglu, B.B., Zulehner, C., 2003. The effects of mergers: An international comparison. *International Journal of Industrial Organisation* 21, 625–653.
- Hampel R., 1997. *Committee on Corporate Governance, Final Report*. Gee Publishing Ltd, London.
- Haniffa, R., Hudaib, M., 2006. Corporate governance structure and performance of Malaysian listed companies. *Journal of Business Finance & Accounting* 33, 1034-1062.
- Hayward, M.L.A., Hambrick, D.C., 1997. Explaining the premiums paid for large acquisitions: Evidence of CEO hubris. *Administrative Science Quarterly* 42, 103-127.
- Hermalin, B., Weisbach, M., 1991. The effects of board composition and direct

- incentives on firm performance. *Financial Management*, 101-112.
- Hermalin, B.E., Weisbach, M.S., 2003. Boards of directors as an endogenously determined institution: A survey of the economic evidence. *Economic Policy Review* 9, 7-26.
- Herman, E.S., 1981. *Corporate Control, Corporate Power*. William Morrow, New York.
- Higgs, D., 2003. *Review of the role and effectiveness of non-executive directors*. Department of Trade and Industry, London.
- Hossain, M., Prevost, A.K., Rao, R.P., 2001. Corporate governance in New Zealand: The effect of the 1993 Companies Act on the relation between board composition and firm performance. *Pacific-Basin Finance Journal* 9, 119-145.
- Holl, P., 1975. Effect of control type on the performance of the firms in the U.K. *Journal of Industrial Economics* 23, 257-271.
- Hubbard, R., Palia, D., 1995. Benefits of control, managerial ownership, and the stock returns of acquiring firms. *Rand Journal of Economics* 26, 782-792.
- Hughes, A., 1993. Mergers and economic performance in the UK: A survey of the empirical evidence 1950-90. In Bishop, M. and Kay, J. (eds.), *European Mergers and Merger Policy*. Oxford University Press, Oxford.
- Huther, J., 1997. An empirical test of the effect of board size on firm efficiency. *Economics Letters* 54, 259–264.
- ISC, 2007. The Responsibilities of Institutional Shareholders and Agents – Statement of Principles. Institutional Shareholders Committee, June <http://institutionalshareholderscommittee.org.uk/library.html>
- Jaffe, J.F., 1974. Special information and insider trading. *Journal of Business* 47, 305-360.
- Jensen, M.C., 1986. Agency costs of free cash flow, corporate finance and takeovers. *American Economic Review* 76, 323–329
- Jensen, M., Ruback, R., 1983. The market for corporate control: The scientific evidence. *Journal of Financial Economics*, 5-50.
- Jensen, M.C., Zajac, E.J. 2004. Corporate elites and corporate strategy: How demographic preferences and structural position shape the scope of the firm. *Strategic Management Journal* 25, 507-524.
- Kamerschen, D.R., 1968. The influence of ownership and control on profit rates. *American Economic Review* 58, 432-447.

- Kania, J.J., McKean, J.R. 1976. Ownership, control and the contemporary corporation: A general behavioural analysis. *Kyklos* 29, 272-91.
- Kay I., Van Putten, S., *Myths and Realities of Executive Pay*. Cambridge University Press, Cambridge.
- Klein, A., 1998. Firm performance and board committee structure. *Journal of Law and Economics* 41, 275-303.
- Kole, S.R., 1995. Measuring managerial equity ownership: A comparison of sources of ownership data. *Journal of Corporate Finance* 1, 413-435.
- Kosnik, R.D., 1987. Greenmail: A study of board performance in corporate governance. *Administrative Science Quarterly* 32, 163-185.
- Kosnik, R.D., 1990. Effects of board demography and directors incentives on corporate greenmail decisions. *Academy of Management Journal* 33, 129-150.
- Larner, R.J., 1970. *Management Control and the Large Corporation*. Dunellen, New York.
- Lewellen, W., Loderer, C., Rosenfeld, A., 1985. Merger decisions and executive stock ownership in acquiring firms. *Journal of Accounting and Economics* 7, 209-231.
- Limmack, R.J., 1991. Corporate mergers and wealth effects: 1977–86. *Accounting and Business Research*, 21, 239–251.
- Loderer, C., Martin, K., 1998. Executive stock ownership and performance: Tracking faint changes. *Journal of Financial Economics* 45, 223-255.
- Loderer, C., Peyer, U., 2002. Board overlap, seat accumulation and share prices. *European Financial Management* 8, 165-192.
- Lyon J.D., Barber, B.M., Tsai, C., 1999. Improved methods for tests of long-run abnormal stock returns. *Journal of Finance* 54, 165-201.
- Main, B., Bruce A., Buck T., 1996. Total board remuneration and company performance. *Economic Journal* 106, 1627-1644.
- Magenheim E.B., Mueller D.C., 1988. Are acquiring-firm shareholders better off after an acquisition? In Coffee Jr. J.C., Lowenstein, L., Rose-Ackerman, S. (eds.), *Knights, Raiders and Targets..* Oxford University Press, Oxford.
- Mak, Y.T., Kusnadi, Y., 2005. Size really matters: Further evidence on the negative relationship between board size and firm value. *Pacific-Basin Finance Journal* 13, 301-318.

- Mandelker, G., 1974. Risk and return: The case of merging firms, *Journal of Financial Economics* 1, 303-335.
- Manne, H., 1965. Mergers and the market for corporate control. *Journal of Political Economy* 73, 110–120.
- Marris, R.L., 1964. *The Economic Theory of Managerial Capitalism*. Macmillan, London.
- Martin, K.J., 1996. The method of payment in corporate acquisitions, investment opportunities, and management ownership. *Journal of Finance*, 1227-1246.
- McConnell, J., Servaes, H., 1991. Additional evidence on equity ownership and corporate value. *Journal of Financial Economics* 27, 595-612.
- McConnell, J., Servaes, H., 1995. Equity ownership and the two faces of debt. *Journal of Financial Economics* 39, 131-157.
- McEachern, W.A., 1975. *Managerial Control and Performance*. Lexington, MA.
- McEachern, W.A. 1978. Corporate control and growth: An alternative approach. *Journal of Industrial Economics* 26, 257-66
- Meeks, G., 1977. *Disappointing Marriage: Gains from Mergers*. Cambridge University Press, Cambridge.
- Monsen, R.J., Chiu, J.S., Cooley, D.E., 1968. The effects of separation of ownership and control on the performance of the large firm. *Quarterly Journal of Economics* 82, 435-451.
- Morck, R., Shleifer, A., Vishny, R., 1988. Management ownership and market valuation: An empirical analysis. *Journal of Financial Economics* 20, 293-315.
- Mueller, D.C., 1969. A theory of conglomerate mergers. *Quarterly Journal of Economics* 83, 643-659
- Mueller, D.C., (ed.) 1980. *The determinants and effects of mergers: An international comparison*. Oelgeschlager, Gunn & Hain, Cambridge MA.
- Ocasio, W., 1994. Political dynamics and the circulation of power: CEO succession in U.S. industrial corporations 1960-1990. *Administrative Science Quarterly* 39, 285-312.
- Palmer, J., 1973. The profit performance effects of the separation of ownership from control in larger US industrial corporations. *Bell Journal of Economic and Management Science* Spring, 293-303.

- Palmer, J., 1975. A further analysis of profitability and managerialism. *Economic Training* 13, 127-30.
- Peasnell, K.V., Pope P.F., Young, S., 2005. Board monitoring and earnings management: Do outside directors influence abnormal accruals? *Journal of Business Finance & Accounting* 32, 1311-1346.
- Powell, R., Stark, A., 2005. Does operating performance increase post-takeover for UK takeovers? A comparison of performance measures and benchmarks. *Journal of Corporate Finance* 11, 293-317.
- Qualls, D.P., 1976. Market structure and managerial behaviour, in R.T. Masson and D.P. Qualls (eds.) *Essays on Industrial Organisation in Honour of J.S. Bain*. Ballinger, Cambridge MA,.
- Radice, H.K., 1971. Control type, profitability and growth in large firms: An empirical study. *Economic Journal* 81, 547-562.
- Shinn, E., 1999. Returns to acquiring firms: the role of managerial ownership, managerial wealth, and outside owners. *Journal of Economics and Finance* 23, 78-89.
- Short, H., Keasey, K., 1999. Managerial ownership and the performance of firms: Evidence from the UK. *Journal of Corporate Finance* 5, 79-101.
- Singh A., 1971. *Take-overs: Their Relevance to the Stock Market and the Theory of the Firm*. Cambridge University Press, Cambridge.
- Slutsky, A., Caves, R., 1991. Synergy, agency, and the determinants of premia paid in mergers. *Journal of Industrial Economics* 39, 277-96.
- Sorensen, R., 1974. The separation of ownership and control and firm performance: An empirical analysis. *Southern Economic Journal* 41, 145-148.
- Stano, M., 1975. Executive ownership interests and corporate performance. *Southern Economic Journal* 42, 272-278.
- Stano, M., 1976. Monopoly power, ownership control, and corporate performance. *Bell Journal of Economics* 7, 672-679.
- Sudarsanam, S., Mahate, A.A., 2003. Glamour acquirers, method of payment and post-acquisition performance: The UK evidence. *Journal of Business Finance & Accounting* 30, 299-341.
- Treasury Select Committee (2007). *Private equity*, House of Commons Treasury Committee
Tenth Report of Session 2006–07, The Stationery Office, London, July.

- Tuch, C., O'Sullivan, N., 2007. The impact of acquisitions on firm performance: A review of the evidence. *International Journal of Management Reviews* 9, 141-170.
- Turnbull, 1999. *Internal Control: Guidance for Directors on the Combined Code*. Financial Reporting Council, London
- Vafeas, N., 1999. Board meeting frequency and firm performance. *Journal of Financial Economics* 53, 113-142.
- Vafeas, N., Theodorou, E., 1998. The relationship between board structure and firm performance in the UK. *British Accounting Review* 30, 383-407.
- Weir, C., Laing, D., 2000. The performance-governance relationship: The effects of Cadbury compliance on UK quoted companies, *Journal of Management and Governance* 4, 265-281.
- Weir, C., Laing, D., McKnight, P.J., 2002. Internal and external governance mechanisms: their impact on the performance of large UK public companies. *Journal of Business Finance & Accounting* 29, 579-611.
- Wright, P., Kroll, M., Elenkov, D., 2002. Acquisition returns, increase in firm size and chief executive officer compensation: The moderating role of monitoring. *Academy of Management Journal* 45, 599-608.
- Yermack, D., 1996. Higher market valuation of companies with a small board of directors. *Journal of Financial Economics* 40, 185-221.
- Zeitlin, M., Norich, S., 1979. Management control, exploitation, and profit maximization in the large corporation: an empirical confrontation of managerialism and class theory. *Research in Political Economy*.