ENACTMENT OF CORPORATE GOVERNANCE GUIDELINES: ADVANTAGES FOR LATE ADOPTERS?

Michael J. Rubach, College of Business Administration, University of Central Arkansas, Conway, Arkansas 72035. 501 450-5348, mrubach@uca.edu
Armand Picou. College of Business Administration, University of Central Arkansas, Conway, Arkansas 72035. 501 450-5355, ArmandP@uca.edu

ABSTRACT

Corporate governance guidelines are practices used by firms to align the interests of boards with their shareholders. The transparency of guideline enactment should have a positive effect. The results indicate the absence of a first-mover advantage from the announcement of guideline adoption. The presence of a bandwagon effect dissipates any value added from the transparency of this board practice. Board interlocks were identified as a possible cause for the spread of guideline adoption transparency.

INTRODUCTION

Corporate governance guidelines are a set of rules or practices that firms can adopt to reduce agency costs. The guidelines are generally lists of practices of how the board of directors will oversee the management of the firm and carry out its responsibilities. The guidelines can be viewed as a proactive mechanism demonstrative of good governance. Investors, especially institutional investors, are willing to pay a premium for companies that demonstrate good governance practices.

Good governance starts with transparency and public disclosure. A major corporate governance issue is the construction of rules, practices, and incentives by firms themselves to effectively align the interests of the boards with shareholders. This exploratory study examines whether the announcement of the enactment of corporate governance guidelines increases value. The diffusion literature of corporate best practices may provide an explanation for why firms adopt guidelines. The results indicate that first movers did not experience greater stock price increases. The findings suggest a bandwagon effect dissipated any advantages from the announcements. Further, board interlocks provided opportunities for the diffusion of innovative best practices and the results provide evidence of first-order imitation, the act of imitating the content of other boards' policy decisions. Due to the bandwagon effects, the results fail to provide evidence that good governance matters.

THEORY AND HYPOTHESES

The trend of developing corporate governance guidelines and codes of best practices began in the US in the early 1990's. This led to the issuance of numerous guidelines for corporate governance by corporations, institutional investors, and associations of directors and corporate managers.

First-mover theory applies generally to product innovation: the firms that first introduce a product into the marketplace will gain an advantage due to the lag time for any imitators. However, first-mover advantages are not limited to product innovations, but can be gained through process or policy initiatives. It has been suggested that firms, which enact good governance practices, may enjoy first-mover advantages. However, not every innovation experiences a first-mover advantage. If the innovation is easily imitated, no monopoly is created. Rapid diffusion counters first-mover advantages. We hypothesize that the imitability of guidelines negates first-mover advantages from their adoption and announcement. Quick responses by others reduce any potential first-mover benefits and can often create superior results for late movers.

Firms often adopt strategic processes or policies despite the lack of evidence that the processes will lead to better performance. Diffusion theory provides an explanation for why firms adopt corporate governance guidelines despite the lack of evidence that the adoption will improve a firm's performance. Success is not a prerequisite; under bandwagon effects, adopters choose an innovation because of the sheer number of previous adoptions. Bandwagons are often self-reinforcing; the bigger the bandwagon, the greater the number of adopters. Bandwagon effects also cause the returns from the innovation to dissipate; once the asset is imitated, the increasing rate of adoption leads to value dissipation. During the study's time frame, the number of announcements of enactments of corporate governance guidelines increased each year. We hypothesize that the adoption of corporate governance guidelines underwent bandwagon effects and late adopters of guidelines will not exhibit strong stock price reactions.

Innovations can spread through organizational fields via mimetic processes. Previous research has established that the diffusion of policies and strategies of boards of directors occurs through the social networks created by board interlocks. Board interlocks research has demonstrated how overlapping board memberships have facilitated the imitation of particular board policy decisions. The research has shown that board interlocks facilitate first-order imitation, the act of imitating the content of a specific policy. We hypothesize that board interlocks led to the diffusion of the enactment and announcement of enactments of corporate governance guidelines.

METHODOLOGY

Filings made from January 1, 1994 until December 31, 2000 with the Securities and Exchange Commission (SEC) (the EDGAR database) were examined to determine the first time that firms announced whether they had enacted corporate governance guidelines or principles. 141 US-based firms with complete stock performance data announced the enactment of guidelines during this time frame. For the board interlock analysis, a smaller sample was used, where firms that had confounding public announcements in major newspapers during the 14-day trading window were excluded. We conducted an event study analysis associated with the release of the SEC filings with model parameters estimated over a 220-day period: from 222 days to 2 days before the SEC filing date. Using these parameters, we estimated the abnormal returns (ARs) over a 9-day period from -1 day before the filing date to 7 days after the filing. The filing date (day t=0) in our sample represents the SEC determined date of the filing. Average cumulative abnormal returns (CARs) for each day from day t to day t + 7 are computed. To test for the presence of first-order imitation, the proxy statements for the smaller sample companies were reviewed. The descriptions of the current board members identified any board interlocks. These interlocks were compared for an early adopters (1994-1998) and late adopters (1997-2000).

RESULTS AND DISCUSSION

As Table 1 indicates, the number of companies that announced the enactment of corporate governance guidelines grew each year before leveling off in 1999 and 2000. The results support the argument that there was a bandwagon effect. However, as to stock price reactions, there are no significant daily or cumulative reactions for any year. Our hypotheses, that first- and late-mover advantages would not be present, were supported. The results support the argument that bandwagon effects dissipated any potential advantages for late movers. While there were a number of firms in each year of the study that exhibited significant ARs, their reactions were offset by the other group members causing the group returns to be insignificant. Given the lack of evidence that announcing the adoption of guidelines improved stock values, why did companies continue to follow a policy of transparency? The results provide some evidence that the first-order imitation may be associated with board interlocks. A number of board interlocks existed from the early adopters and later adopters.

	Table 1						
Year	Firms Announcing Enactments	Firms with a Significant Reactions	ARs & CARs	Firms with Interlocking Boards	Total # of Interlocks	# of Interlocks with a company which later adopted guidelines	Firms with any prior board interlocks
1994	2	0	NS	1	39	4	0
1995	6	0	NS	5	165	22	0
1996	23	4	NS	21	323	18	0
1997	21	4	NS	17	329	20	7
1998	35	6	NS	32	711		12
1999	30	4	NS	28	646		21
2000	24	10	NS	19	359		18
Totals	141	28					

This research is unique in its application of first-mover theory to corporate governance. Corporate governance guidelines, like many other corporate governance mechanisms, are not unique. Imitation fails to provide the adopter with a sustainable competitive advantage. It appears that the adoption and announcement of corporate governance guidelines experienced a bandwagon effect. The number of announcements increased substantially from years 1994 until 1998, and continued until the year 2000. However, there were no significant stock price reactions following the announcements. This supports the theory that bandwagon effects cause the returns from the innovative action to dissipate. While the evidence is not preponderant, there is an indication that first-order imitation occurred with regards to the adoption and transparency of corporate governance guidelines.

Corporate governance guidelines are only one of numerous mechanisms that boards of directors can adopt to improve governance. Future research should address the cumulative effects of the numerous mechanisms that can enhance governance. This may be especially true following the governance scandals that have occurred. Numerous firms faced with calls for better governance have enacted or adopted numerous rules, practices, and incentives other than corporate governance guidelines. Additional research is necessary to discover if early- or late-mover advantages exist from the adoption of these different governance programs.

Good governance should matter. The transparency of corporate governance guideline adoption should have created an advantage for the adopters. Bandwagon effects negated any advantages for subsequent adopters. In reviewing the proxy filings for firms disclosing the adoption of guidelines after the year 2000, we found that few US based firms that made new disclosures. The failure of companies to receive a benefit from the transparency may explain why more firms have stopped announcing guideline adoption. However, the adoption of different governance mechanism continues, and future research should continue to look for any advantages. The innovation diffusion literature provides a lens for this future research.

References will be provided upon request from Michael J. Rubach