
The stock market reaction to criticism of corporate governance practices of companies listed on the JSE

ABSTRACT

This paper investigates a key aspect of possible reputational damage to a company: the publication of criticism of corporate governance practice in the financial press. To understand the valuation effect associated with such criticism, long-run abnormal returns following the publication date are examined. In addition to the initial negative reaction on publication, the companies in the sample experienced further significant risk-adjusted returns of -15,15% and -22,94% respectively over the next one and two years. A decline in future operating performance appears to be an important reason for the poor stock market performance of the companies. These results underscore the importance of investors fully understanding the disclosure of a company's corporate governance practice.

1. INTRODUCTION

Corporate governance has received much attention especially among very large firms in developed countries. The general consensus seems to be that good governance generates investor goodwill and confidence (Beekes and Brown, 2006). A number of previous studies show that good corporate governance improves profits and increases company valuations. For instance, a study by Gompers, Ishii and Metrick (2003) concluded that companies with strong shareholder rights yielded annual returns that were 8,5% greater than those companies with weak rights. Well governed firms also enjoy higher valuations, higher profits, higher sales growth, and lower capital expenditures. Claessens, Djankov, Fan and Lang (2002) also maintain that better corporate governance frameworks benefit firms through greater access to financing, lower cost of capital, better performance and more favourable treatment of all stakeholders. They argue that weak corporate governance not only leads to poor firm performance and risky financing patterns, but also makes firms susceptible to macroeconomic crises such as the 2008 global stock market crisis and the accompanying economic recession.

Ragothaman and Gollakota (2009) identify a number of reasons for the growing importance of corporate governance. These include the world-wide wave of privatisation of the past two decades, the pension fund reform and the growth of private savings, the takeover wave of the 1980s, the deregulation and integration of capital markets, and the series of recent corporate scandals in the US and elsewhere. Corporate governance has dominated policy agenda in developed market economies for more than a decade, and it is gradually working itself to the top of the policy agenda in the African continent. The Asian crisis and the relative poor performance of the corporate sector

in sub-Saharan Africa have made corporate governance a catch phrase in the development debate (Wanyama, Burton and Helliard, 2009).

In a quest to safeguard the interest of stakeholders in general, and shareholders in particular, most countries have introduced national regulations and codes of conduct defining "best practice" in corporate governance (Fombrun, 2006). Following the King 2 Report, the JSE Securities Exchange (JSE) requires all listed companies to include in their annual report a narrative statement showing how they complied with the corporate governance principles and provide explanations of the extent to which they have deviated from the King 2 Code of Corporate Governance (Vaughn and Ryan, 2006).

Developing countries are now increasingly embracing the concept of good corporate governance, knowing that it leads to sustainable growth and South Africa is no exception in this trend. While much research has been conducted in the field of business ethics in South Africa, the corporate governance influence on firm value remains a largely unexplored empirical issue. This study provides empirical evidence on corporate governance and firm performance from the context of the South African economy. This paper specifically investigates the share market reaction to criticism of corporate governance practices of companies listed on the JSE.

2. LITERATURE REVIEW

There have been a number of studies of possible linkages between corporate governance and firm performance. For instance, Gompers, Ishii and Metrick (2003) suggest that the corporate governance of a firm, more specifically the level of shareholder versus managerial rights, influences stock returns. They create a governance index, the G-index for US companies, awarding one point for each provision that increases managerial rights relative to shareholder rights. A portfolio long in firms with strong shareholder rights and short in firms with strong managerial rights

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would have generated excess returns averaging 8,5% per year during the 1990s. They conclude that weak corporate governance was the major contributor to the portfolio performance.

Evidence from Brown and Caylor (2004) provides additional insight into the association between the G-index and firm performance. They compare the G-index with Gov-score, an index based on firms meeting minimum standards of corporate governance. Their findings suggest a positive association between better governance (as measured by Gov-score) and firm performance which is measured by return on equity, net profit margin and Tobin's Q. This is in contrast to results for the same sample of firms using the G-index, which suggests better governance is positively associated with firm performance for sales growth only. They attribute this difference to the narrow focus of the G-index, which primarily reflects anti-takeover measures.

Several other studies have used the G-index to measure corporate governance and its impact on various characteristics of the firm. Defond, Hann and Hu (2005) report that the appointment of a financial expert to the audit committee is associated with positive abnormal returns when the appointment is announced and where there are strong shareholder rights. Cremers and Nair (2005) investigate the roles of internal and external governance mechanisms and find greater shareholder rights (proxied by vulnerability to takeovers) are associated with greater profitability and positive long-term abnormal returns where there is strong internal corporate governance. Klock, Mansi and Maxwell (2004) observed that corporate governance influences the cost of debt. Firms with greater takeover defences (greater managerial rights) pay less when they borrow. These studies suggest that investors generally reward those companies that make improvements to their corporate governance structures.

Drobetz, Schillhofer and Zimmermann (2004) investigate whether differences in the quality of corporate governance is able to explain firm performance in a cross-section of German companies. Constructing a broad corporate governance rating (CGR) for German public firms, they document a positive relationship between governance practices and firm valuation. For the median firm, one standard deviation change in governance rating results in about 24% increase in the value of Tobin's Q. An investment strategy that bought high-CGR firms and shorted low-CGR firms earned abnormal returns of around 12% on an annual basis during the 1998 to 2003 sample period. They also show that better governed firms also make more informative disclosures to shareholders.

Giannetti and Simonov (2006) showed that institutional investors regard corporate governance as a primary consideration when selecting shares for investment.

They find that all categories of investors (domestic and foreign, institutional and small individual) who generally enjoy only security benefits are reluctant to invest in companies with weak corporate governance. In contrast, individuals connected with company insiders are more likely to invest in weak corporate governance companies. Their results points to a clear relationship between quality of corporate governance and expanding the shareholder base and raising new capital. It is suggested that firms can use corporate governance to attract shareholders in the same way as they can use dividends to attract certain categories of investors who are less taxed, as in Allen, Bernardo and Welch (2000).

The principal-agent theory is generally considered as crucial for any discussion on corporate governance. It is important to note that agency problems may have two effects on a firm's share price: they can influence (1) expected cash flows accruing to investors and (2) the cost of capital. First, agency problems may lead to lower stock price multiples as investors anticipate that cash flows will be diverted.

La Porta, Lopes-de-Silanes and Shleifer (2002) present a model which predicts that investors pay more because they recognise that, with better legal protection, more of the firm's profits would come back to them as interest and dividends as opposed to being expropriated by the entrepreneur who controls the firm. In addition, because diversion is costly, higher cash flow ownership should lead to higher incentives, lower expropriation and, hence higher valuations. La Porta *et al.* (2002) interpret their empirical results as being consistent with their model. They show that good corporate governance may reduce the expected return on equity to the extent that it reduces shareholders' monitoring and auditing costs.

Lombardo and Pagano (2002) extend the traditional Capital Asset Pricing Model to include compensation for the expected costs induced by the agency relationship between insiders and outside shareholders. They document that the cost of capital is negatively related with measures of protection of shareholder rights and that the cost of implementing enhanced corporate governance measures is rewarded in lowered cost of capital.

Joe, Louis and Robinson (2009) analysed investors' reactions to negative public exposure based on the publication by *Business Week* of companies nominated by institutional investors as "worst corporate boards". They find that the publication of the worst board list has significant economic consequences. In particular, media exposure of board ineffectiveness forces the targeted companies to take corrective actions and enhance shareholder wealth. The researchers also observed that the negative media exposure caused by the publication of the worst board list has an asymmetric effect on institutional and

individual investor behaviour. Individual investors appear to react negatively to adverse media exposure, whereas investment firms trade as if they anticipate the targeted firms' corrective actions.

3. SAMPLE SELECTION AND RESEARCH METHODOLOGY

3.1 Sample selection and hypothesis

Theo Botha is a shareholder activist who regularly attends the annual general meetings of JSE listed companies and raises issues related to their annual reports (Crotty, 2009). His special interest is to ask questions related to the conformity to the King 2 Code of Corporate Governance as reported in the annual reports of companies. Botha's criticism of corporate governance practices at shareholders' meetings gets wide coverage in the business press especially the *Business Day* and *Business Report*. The sample for this investigation is those companies criticised by Theo Botha and the subsequent reporting of his criticism in the *Business Day* and *Business Report*. The period covering the investigation is January 2003 to June 2006.

The review of empirical evidence has shown that investors generally prefer companies that practice good corporate governance and reward them with a superior market rating. This being the case, companies that are criticised for not conforming to best practice in corporate governance should have information content which would exert a downward pressure on their share prices. Based on the above, the following hypothesis has been tested:

H₁: Publication in the financial press of criticisms of corporate governance practice could result in economic damage or loss of reputation to the company or its management. Such publications are regarded by capital markets as having information content and a discernable adverse effect on share prices of the affected companies can be expected.

We analyse the stock market performance of the companies criticized by Botha for three years after the publication of the criticism. The motivation for examining the long-run market performance has two aspects. First, following the market's negative reaction to the publication of criticised management practice, companies usually respond that this criticism is without merit, that the market's initial negative reaction was excessive, and that a reversal would occur in the long run (Hines, McBride and Page, 1999). Examining the long-run performance allowed us to examine the validity of such claims. If the initial share prices were negative because of Botha's reputation and not because of substantial information in the articles, a close study should observe a reversal in share prices following the initial negative reaction.

The second reason for the interest in a long-run study is that only the in long-term can a full understanding of the magnitude, speed and permanence of the market's adjustment to information contained in Botha's corporate governance analysis be obtained. An examination of the long-run stock market performance is also motivated by empirical evidence in recent years documenting a post-event or post-announcement drift in share prices for a few months following news that moves share prices (Sloan, 1996).

The event study (or market reaction study) is used for this investigation. This is an established methodology used as a means of testing whether a particular class of event, such as announcement of earnings or news of a takeover bid has an impact on the share price of a company (Brown and Warner, 1980). The technique tests for abnormal returns on shares in a "window" of one or more days around the event of interest. Firm, industry and market wide confounding factors are diversified away by performing the test on a portfolio of shares.

The sample was derived from reading all articles published in the *Business Day* and *Business Report* reporting the criticism by Botha of corporate governance practices of JSE listed companies during the period January 2003 to June 2006. The final sample consisted of 44 companies that met the selection criteria. The sample contains no time clustering; the largest number in any given year (2005) is fourteen. No industry clustering occurred - the 44 companies represented an even spread across all sectors of the JSE. The data required in respect to company financial characteristics, share market data, and the operating performance of companies included in the sample were obtained from the McGregor's BFANet database. The companies investigated and their industry classifications are listed in Appendix A.

Table 1 presents summary statistics on company size, ratio of book value to market value (BV/MV) and beta. Using the JSE universe of companies, we also computed the sample companies' size deciles. For a company in the sample in a given year, a decile of 10 implies that the company was among the top 10 percent of all JSE companies (and a decile of 1 implies the bottom 10 percent). These data on average size of companies in terms of market value of share capital and size deciles show that the companies in the sample are large. Thus, these companies are likely to be followed by several analysts. Therefore, one would expect the information asymmetry for these companies to be low and the incremental impact of corporate governance analysis by Botha should be relatively small.

Table 1: Summary statistics for sample companies

Variable	Mean	Median	Standard Deviation
Market value of equity (R bn)	24,17	3,95	0,25
Size decile rank	7,23	7,08	1,64
BV/MV	0,51	0,34	0,48
BV/MV quintile rank	2,94	2,61	1,27
Beta (relative to ALSI)	0,67	0,62	0,28

Note: Market value of equity and BV/MV were measured in December of the previous year relative to the publication month in the financial press. Companies were sorted as of June each year. Sample companies' size decile rankings and BV/MV quintile rankings were based on values in June prior to the publication of the article in the financial press.

The average BV/MV of 0,51 and the corresponding quintile rank of 2,94 suggest that in terms of BV/MV, the companies were not extreme. The median BV/MV ranking, however, indicates that the companies had a somewhat smaller BV/MV than average.

We used the one-factor market model developed by Brown and Warner (1980) to compute beta from Month -60 to Month -13 relative to the publication month and required the availability of a minimum of 12 monthly returns. The average betas of the sample companies based on the JSE All Share Index indicate that the sample consists of companies with above-average betas. Therefore, to the extent that we focus on market-adjusted returns, our results are conservative.

3.2 Research methodology

We define Month 0 as the calendar month in which Botha's criticism appeared in the financial press. Because we examined long-run abnormal returns, we used buy-and-hold or holding period returns in all our analyses. The buy-and-hold return for share *i* for T months was computed as

$$R_{iT} = \prod_{t=1}^T (1 + r_{it}) - 1 \quad \dots (1)$$

where

r_{it} is the raw return (with dividends) for share *i* in month *t*. Similarly, R_{mT} represents the buy-and-hold return for the benchmark market index. We report market-adjusted returns with the JSE All Share Index representing the market. The ALSI is used extensively by researchers because of the convenience of it being readily available. A limitation of the ALSI is that it is skewed towards mining and resource companies. The use of ALSI is a possible limitation in the methodology used.

The main purpose of reporting adjusted returns was to calibrate the level of underperformance. The p-values for statistical significance are based on a bootstrap procedure that controlled for several company-specific

characteristics such as size, industry, and book value to market value ratio.

The buy-and-hold abnormal return for share *i* was calculated as

$$AR_{iT} = R_{iT} - R_{mT} \quad \dots (2)$$

The portfolio abnormal return is then the average over all *n* shares in the sample:

$$AAR_T = \frac{1}{n} \sum_{i=1}^n AR_{iT} \quad \dots (3)$$

We used several methods to compute the statistical significance levels for portfolio returns. Our procedures are a combination or modification of approaches discussed in Kothari and Warner (1997), Barber and Lyon (1997), Lyon, Barber and Tsai (1999), Daniel, Grinblatt, Titman, and Wermers (1997), and Desai and Jain (1997). We report p-values from the bootstrap procedure used.

In the bootstrap procedure, we matched each company in the sample with a control company that was in the same industry in the month of the publication of the article in the business publications. We then computed the buy-and-hold returns for the portfolio of industry-matched companies in the same manner as for the portfolio companies in the sample. This procedure was repeated 300 times with replacement to generate an empirical distribution of buy-and-hold returns. From this distribution, we computed p-values for the returns on the portfolio of sample companies. The p-values represent the fraction of matched portfolios whose returns were smaller than the corresponding return of the portfolio of sample companies.

We also used the traditional approach to compute the statistical significance of AAR_T by using a parametric t-statistic with *n*-1 degrees of freedom given by

$$t = \frac{AAR_T}{SE_T / \sqrt{n}} \quad \dots (4)$$

where

SE_T is the cross-sectional standard deviation computed from *n* observations of AR_{iT} .

4. EMPIRICAL RESULTS

4.1 Share price performance

We first present evidence on the stock market performance of the companies in the sample before they were criticised by Botha. We then examine the returns around the publication of articles in the

business press and the long-run performance of the sample companies' share prices after publication of Botha's critiques.

An examination of company returns prior to publication of Botha's criticism of corporate governance practice helps explain the nature of the companies singled out by Botha. Table 2 shows returns for the two-year period prior to the publication of the articles. Although Botha did not state directly that the companies were overvalued, his criticism usually suggested that the market might have misinterpreted the company's financial statements, which implies that he considered the shares to be overvalued.

The results in Panel A of Table 2 shows that from Month -25 to Month -13 relative to the publication month, the sample companies earned mean raw returns of 61,66% compared with a return of 22,05% for the market over the same period. The p-value of 0,991 indicates that the sample portfolio outperformed 99, 1% of the 300 control portfolios in a two-tailed test. In the period of Month -12 to Month -2, the sample companies outperformed the market by 22,33%, with a p-value of 0,982. Thus, the results of the

prepublication period suggest that the sample companies were experiencing a large run-up in prices.

We also examined various accounting ratios of the companies in the sample during this period but did not find any strong patterns. We did not locate any traditional fundamental reason for large abnormal returns in the pre-publication period. We conjecture that the lack of fundamental reasons accompanied by share price run-ups may have triggered a shareholder activist such as Botha to take a close look at whether these companies were overvalued.

Table 2 reports the Month 0 results, which are similar to publication-day results because Month 0 includes the publication day. For a three-day window around the publication day (not shown in Table 2), the average market-adjusted return for the sample, with the market represented by ALSI, was -3,94%. The associated t-statistic of -3,62 is statistically significant at better than a 1% level of significance. For a period of Day +2 to Day +30, the average market-adjusted return was -2,39% with a t-statistic of -1,53. Thus, the Day +2 to Day +30 abnormal returns are not statistically significant.

Table 2: Long-run stock market performance

Period (months)	Sample raw return	Market return	Portfolio abnormal return	p-Value
Panel A: Industry-Matched Control Group				
-25 to -13	61,66%	22,05%	39,61%	0,991***
-12 to -2	40,84	18,51	22,33	0,982***
-1	-0,71	1,83	-2,54	0,125
0	-5,86	-0,12	-5,74	1,000***
+1 to 12	-2,43	12,72	-15,15	0,021**
+1 to 24	5,37	26,31	-22,94	0,097*
+1 to 36	24,13	49,82	-25,69	0,228
Panel B: Characteristic-Matched Control Group				
-25 to -13	59,43%	21,84%	37,59%	0,988***
-12 to -2	41,52	15,14	26,38	0,994***
-1	-1,54	1,69	-3,23	0,067*
0	-6,34	-0,27	-6,07	1,000***
+1 to +12	1,13	14,54	-13,41	0,051**
+1 to 24	12,42	31,23	-18,81	0,148
+1 to 36	27,54	55,22	-27,68	0,326

Note: The market was proxied by the ALSI. The p-Value in Panel A and B is the proportion of the control portfolios that had returns lower than that of the portfolio of sample companies.

* Significant at the 10% Level in a two-tailed test

** Significant at the 5% Level in a two-tailed test

***Significant at the 1% Level in a two-tailed test

The last three rows in Panel A, of Table 2 present the long-term buy-and-hold results for the sample companies; the p-values were based on the bootstrap procedure (industry matching). In the first year following publication of the article (Months +1 to +12), we found that the sample companies, on average, continued to perform poorly. For the Months +1 to +12, the p-value of 0,021 indicates that only 2,1% of the 300 industry matched portfolios over the same period had raw returns that were smaller than -2,43% for the sample companies. Keep in mind that the bootstrap

procedure is based on the industry-matching methodology, not the traditional t-tests based on market-adjusted or risk-adjusted abnormal returns. However, the conclusions were similar when we used the traditional approach.

For the time horizon of two years (Months +1 to +24), Panel A shows the sample companies underperforming the market by 22,94%. The corresponding p-value of 0,097 suggests that 9,7% of the randomly selected portfolios of companies from the

same industry performed as poorly as or worse than the -22,94%. For the 36-month holding period, the abnormal return deteriorated to -25,69%, but with a p-value, that is not statistically significant.

Daniel *et al.* (1997) have documented strong relationships among size, BV/MV, and future returns for companies listed on the NYSE. We followed the procedure recommended by Daniel *et al.* to control for the potential impact of these characteristics on future returns. We replicated the analysis with a set of matching companies that were close to the sample companies in terms of size and BV/MV. Then a control company was randomly selected for each sample company such that the control company was of the same size and BV/MV as the sample company. The buy-and-hold return of this control portfolio was then computed. This procedure was then repeated 300 times with the replacement to generate an empirical distribution of buy-and-hold returns.

The results for the sample of Botha criticised companies measured against the characteristics-matched control group are reported in Panel B, of Table 2. The results are similar to those reported in Panel A representing industry matched control group. The one-year abnormal returns of the sample companies were -13,41% with a p-value of 0,051. The two-year results are not as significant as those in Panel A.

Overall, the results show that the valuation effect of Botha's criticism of corporate governance practice is not restricted to the time period immediately surrounding the day of publication in the financial press. The market continues to adjust to the information at least for one year and possibly for two years after publication of the articles. Because the significant negative abnormal returns continue for two post-publication years, we conclude that the initial negative reaction at the time of the article's publication was an under-reaction.

It is not suggested that Botha was the cause of the downward effect on the share prices. His criticisms of the companies concerned seem to have triggered a re-evaluation by the market, and his analysis apparently helped move prices towards the fundamentals. If Botha had not criticised these companies, someone or something else would in time have brought about a revaluation of these shares. However, without Botha's criticism, it would have apparently taken longer for the information to be impounded in the share prices.

4.2 Operating performance

In an effort to understand the source of the abnormal share price performance of the companies in our sample, we investigated their operating performance around the time of publication of the articles. In effect, we examined the possibility that Botha could foresee a

decline in profitability arising from his criticism of the companies concerned. We first report results from an examination of operating performance. We then briefly present changes in Altman's Z-scores that corroborate the operating performance findings.

A problem in examining operating performance is the identification of an appropriate metric. In some instances, such as pooling-of-interest accounting, excessive write-offs related to acquired in-process research and development, and so forth, can allow companies to report higher net income numbers after mergers or acquisitions. Also, the use of varying accounting treatment for similar transactions that result in vastly different reported income (e.g., capitalising versus expensing) limits the usefulness of net income as a performance metric. Therefore, we used the ratio of operating income before depreciation and amortisation to total assets as the measure of operating performance of the companies. This ratio provides a relatively clean measure of operating performance and is less likely than net income to be affected by accounting issues to measure the performance of the sample of companies criticized by Botha.

Table 3 presents an analysis of the operating performance of the companies in the sample around the period of the publication in the financial press in response to criticism by Botha. We defined operating performance as return on assets (ROA), computed as the ratio of operating earnings to total assets. To abstract from economy-wide or industry-wide effects, we also used industry-adjusted numbers. The industry benchmark was defined as the median operating performance of all companies operating in the same industry as the sample company.

Panel A, of Table 3 shows raw and industry-adjusted mean and median ROAs for each year up to Year +3 relative to the publication year. Year -1 is the last year for which data were available prior to publication of the article, and Year +1 is the first year for which data were available after the publication of the article. The results in Panel A (raw and industry-adjusted means and medians) show that, on average, the companies' operating performance declined from pre-to-post publication years. The mean operating performance of the sample companies declined from 14,27% in Year -3 to 8,73% in Year +3.

Panel B of Table 3 reports the change in post-publication ROA relative to Year -1. The results for raw as well as industry-adjusted ROA show both the mean and the median ROAs in the post-publication years to be significantly lower than ROAs in the year prior to publication. Overall, the decline in operating performance is large (economically meaningful) and statistically significant.

Table 3: Operating performance

	Raw company ROA		Industry-Adjusted ROA	
	Mean	Median	Mean	Median
Panel A: Performance				
Year relative to Criticism				
-3	14,27%	13,63%	1,06%	0,73%
-2	13,45	14,17	0,81	-0,15
-1	13,64	12,39	1,31	0,19
+1	10,68%	10,96%	-1,33%	-0,96%
+2	9,25	11,12	-2,22	-0,79
+3	8,73	10,42	-2,56	-0,73
Panel B: Change in Post-publication ROA				
Difference in performance from year-1 to year-				
+1	-2,96%***	-1,43%***	-2,64%**	-1,15%**
+2	-4,39***	-1,27***	-3,52**	-0,97***
+3	-4,92***	-1,97***	-3,87	-0,91

Note: The significance of the mean was determined by using a t-test, and the significance of the median was determined by using the Wilcoxon signed rank-sum test.

** Significant at the 5% level in a two-tailed test

***Significant at the 1% level in a two-tailed test

The results for the stock market performance and operating performance show that the sample companies, on average, performed poorly following the publication of Botha's criticism. To corroborate these results, we examined changes in risk and distress probabilities for the sample companies. We used changes in Altman's Z-score as the proxy for measuring such changes (Altman, 1968). Altman's Z-score captures the risk of the company to the extent that the accounting data are reliable. If Botha's criticism of corporate governance were well founded and if the accounting numbers did indeed capture the company's performance properly, Altman's Z-scores should deteriorate over the three years after Year -1.

We found strong support for the deterioration in the companies' performance, on average. The Z-scores declined sharply following the publication of a Botha criticism. The median Z-score in the year prior to publication was 4,74. The median Z-scores in Years +1, +2, and +3 following the publication of the criticism were, respectively, 4,52, 4,23 and 3,69. The median decreases in Z-score relative to Year -1 were -0,95, -1,27 and -1,89 for respectively, Years +1, +2, and +3, and each is significant at the 5% level. This result is consistent with and validates the post-publication stock market performance and operating performance of the sample companies, both of which showed sharp declines following Botha's critique.

5. DISCUSSION

The results provide clear evidence of adverse share price reaction to the publication of criticism of corporate governance practices of companies listed on the JSE during the period 2003-2006. The results support the hypothesis tested and suggests that the stock market does consider the publication of

corporate governance criticism to contain information. This implies that: either the details of the specific corporate governance problems are not known to all market participants, or that this new information is considered sufficiently significant to cause a reappraisal of share prices. Furthermore, any criticism of the quality of management implicit in the financial press publications is also considered sufficiently significant to impact on share prices.

Given that the financial press is reacting to criticism by Botha of corporate governance practices published in the annual reports, it is expected that these issues should already be in the public domain. The significant share market reaction to publication of Botha's criticism published in the financial press appears to contradict the semi-strong form of the efficient market hypothesis which predicts that any new information contained in the financial statements should be rapidly impounded in the share prices (Fama, 1970).

The King 3 Code on Corporate Governance is now applicable to all JSE listed companies. However, the King 2 Code had only been recently introduced during the 2003-2004 evaluation period and its full ramifications may not have been fully understood by investors at the time. It could also be argued that publication of Botha's critique in the financial press might be seen by capital markets as an implicit criticism of company management, which in itself has information content. Therefore, such disclosure in narrative form in the financial statements may not be fully reflected in the share price. Instead, it appears that subsequent dissemination of corporate governance information in the financial press has a significant impact on the market price. However, the findings of this study are not necessarily at variance with the notion of an efficient market – publication of

corporate governance criticism in the financial press makes the market more efficient by passing on new information to a large group of investors.

Including the publication period abnormal returns, the sample companies experienced significant abnormal returns of -20,89% over one year and -28,68% over two years (see Table 2). Thus, the magnitude of abnormal returns is large and economically significant. An interesting question is how these abnormal returns compare with the abnormal returns associated with recommendations of other analysts. The "Botha effect" we have analysed can be compared with other sell recommendations.

Because we analysed only negative criticisms by Botha, a comparison with the performance of "sell recommendations" of other analysts is most appropriate. Supporting this view, prior research examining sell recommendations found that the impact on share prices of sell recommendations is much greater than the impact of the much more frequent buy recommendations.

For example, Womack (1996) shows that over the 1989-91 period, sell recommendations from 14 major brokerage companies in the US yielded six-month size-adjusted abnormal returns of -9,15% (industry-adjusted abnormal returns were -5,65%). For the longer 1985-96 period, Barber, Lehavy, McNichols and Trueman (2001) reported that the annualised abnormal returns for a portfolio of the least favourably recommended shares was -4,91%. Desai and Jain (1995) examined the sell recommendations of the most well known money managers in the US during the period 1968-1991. They found the one-year abnormal returns for the sell recommendations to be -8,28%. Perhaps the most interesting comparison is a study by Bhana (1990) who investigated the sell recommendations by South African investment advisory services to their clients during 1979-1988. A one-year abnormal return of -12,54% was observed. Thus, the impact of Botha's criticism is much stronger than that of a typical sell recommendation.

Furthermore, for the most part, the companies criticised by Botha are large companies. Typically, share prices of large companies do not yield large abnormal returns (either positive or negative) because they are followed by a large number of analysts and are heavily traded. Thus, the level of information asymmetry is low for large companies and the opportunity to identify mispriced shares is limited. The fact that Botha was able to identify such valuation inefficiencies in large companies is impressive.

There are potential parallels with a study carried out by Foster (1987) on the impact of a series of press articles written by Abraham Briloff in which the accounting practices of a number of companies are criticised. Foster showed that companies whose

accounting practices are criticised suffer, on average, a share price decline of about 8% on the day the article is published. This is the so called "Briloff sting". The Briloff effect is difficult to explain because only information in the public domain is used in his articles, and therefore according to the semi-strong form of the efficient market hypothesis, should already be impounded into share prices. One of Foster's favoured explanations for this anomaly was that Briloff possessed superior analytical skills which could earn abnormal returns. A parallel of this argument could be applied to Botha who uses his specialised knowledge for investigating breaches of corporate governance practices to identify overvalued shares. This would enable investors to earn superior returns by following a strategy of selling short those companies that are criticised by him.

6. SUMMARY AND CONCLUSIONS

We examined abnormal returns for three years following the publication of Theo Botha's corporate governance criticism between 2003 and 2006. Our results strongly vindicate Botha's criticism of corporate governance practice. Companies criticised by him experienced large negative and significant abnormal returns following the publication of his criticisms. The share prices of the companies continued to perform negatively for a period of two years. The two-year buy-and-hold abnormal return following the month of publication is a statistically significant -22,94%. Including the initial announcement period of Month 0, the overall effect from Botha's critiques is an abnormal return of -28,68% for the two years. This can be described as the "Botha sting" which could be used by astute investors to earn superior returns by following a trading strategy of selling short those companies whose corporate governance policies are criticised by him.

We also examined operating performance of the sample companies. Our results showed a significant decline in operating performance following the publication of Botha's criticisms. Furthermore, the sample companies experienced a significant increase in their risk and distress probability as measured by Altman's Z-score. Overall, the operating performance results are consistent with the stock market results.

Our results indicate that Botha, through his criticisms, was, on average, better able to foresee the coming decline in performance than the market. Does Botha identify some red flags that the market has overlooked? There has been much financial press coverage highlighting his role as a shareholder activist. It could be suggested that corporate governance and its disclosure is a relatively new concept and that many investors may not be fully aware of its impact on company performance (Merkl-Davies and Brennan, 2007). The professional investment analysts by tradition and training concentrate on analysing the data

contained in the main section of the financial statements. It would seem that they do not give sufficient attention to corporate governance disclosure that is required to be presented in narrative form. This is consistent with evidence that narrative reports are free style and open to confusion and manipulation (Balata and Breton, 2005). Botha specialises in corporate governance issues and it appears that his skill lies in probing the issues to generate incisive and coherent analysis of possible deficiencies (Rose, 2007).

The impact of Botha's analysis may be related to at least three noticeable differences between him and other financial analysts. First, Botha is staunchly independent. He does not work for a company in the investment industry and does not accept compensation for research. His research is not published by a partisan firm. Thus, the chance of a leak of information prior to publication is small. Second, he is a shareholder activist who regularly scrutinises the annual reports of companies to find discrepancies and inconsistencies on corporate governance issues and raises his concerns at annual general meetings. Third, most professional analysts investigate a limited number of companies in clearly defined industries and report on areas of their expertise. They may not have much discretion in reporting on company issues that fall outside their chosen area of expertise. Botha, however, does not face such constraints.

The criticism of corporate governance practice by Botha and its subsequent publication in the financial press clearly has information content which results in a significant decline in the share prices of the companies concerned. Conformity to corporate governance practice is highly valued by market participants and there is a severe share price penalty for non-compliant companies. Shareholder awareness has been raised since regulatory authorities increasingly emphasise the issues of corporate governance and social responsibility.

This underscores the importance of investors fully understanding the disclosure of a company's corporate governance practice. While regulators have long been interested in improving corporate governance (Gompers, Ishii and Metrick, 2003), the widespread allegations of accounting fraud, and the staggering impact of the recent corporate scandals have brought corporate governance to centre stage, making it one of the most critical issues in business today, as evidenced by the 2002 Sarbanes-Oxley Act's heightened emphasis on corporate governance.

Joe *et al.* (2009) have shown that negative media reports published in *Finance Week* related to companies rated as "worst company boards" have significant economic consequences. It can be posited that given the extent of *Business Day's* and *Business*

Report's circulation and readership, the negative publicity associated with the corporate governance criticism by Botha in these publications will also have significant economic effects. In particular, we expect corporate governance offenders singled out in these publications to take corrective actions. Not only is the negative media spotlight likely to lead the corporate governance offenders to improve the quality of their governance, it is also likely to force the board members and the managers of these firms to fulfil their fiduciary responsibilities with more diligence. These observations are in line with the findings of Monks and Minow (2004) who illustrated, that by shaming directors and managers, negative media exposure might accomplish what shareholder action cannot.

To date, there is no evidence for the South African market as to whether institutional shareholder activism is associated with any short- or long-term wealth effects. However with corporate governance becoming a more popular topic in the field of management, we believe that professional investors will become more involved in shareholder activism programmes such as companies complying with corporate governance best practice. Once a critical mass of investors pursue corporate governance best practice, this will ultimately lead to higher cost of capital and lower valuations for those firms with governance defects. The capital market appears to reward good corporate governance practices and punish bad ones. Accordingly, corporate governance should be understood as an opportunity and not an obligation from the perspective of a firm's decision makers.

This study covers a short time period and a limited number of companies have been investigated. A follow-up study may be worth undertaking when a larger population of cases covering a much longer period is available.

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Appendix A: Companies investigated and their industry classifications.

Name of Company	JSE Industry Sector
Absa Group Ltd.	Banks
Alexander Forbes Ltd.	Insurance Brokers
Allied Electronics Corporation Ltd.	Electrical Components & Equipment
Allied Technologies Ltd.	Mobile Telecommunications
Anglogold Ashanti Ltd.	Gold Mining
Barloworld Ltd.	Diversified Industrials
Dorbyl Ltd.	Auto Parts
Ellerine Holdings Ltd.	Home Improvement Retailers
Gold Reef Resorts Ltd.	Gambling
Harmony Gold Mining Company Ltd.	Gold Mining
Hosken Consolidated Investments Ltd.	Equity Investment Instruments
Illovo Sugar Ltd.	Food Products
JCI Ltd.	Gold Mining
JD Group Ltd.	Home Improvement Retailers
Johnnic Communications Ltd.	Publishing
KWV Beleggings Beperk	Distillers & Vintners
Labat Africa Ltd.	Business Support Services
Liberty Group Ltd.	Life Insurance
Metrofile Holdings Ltd.	Business Support Services
Mittal Steel South Africa Ltd.	Steel
Mvelaphanda Resources Ltd.	General Mining
Nampak Ltd.	Containers & Packaging
Nedbank Group Ltd.	Banks
New Africa Investment Ltd.	Publishing
Pretoria Portland Cement Company Ltd.	Building Materials & Fixtures
Primedia Ltd.	Broadcasting & Entertainment
Rainbow Chicken Ltd.	Farming & Fishing
Remgro Ltd.	Diversified Industries
Reunert Ltd.	Electrical Components & Equipment
Rex Trueform Clothing Company Ltd.	Apparel Retailers
Richemont Securities AG	Clothing & Accessories
SABMiller PLC	Brewers
Sanlam Ltd.	Life Insurance
Sappi Ltd.	Paper
Shoprite Holdings Ltd.	Food Retailers & Wholesalers
Sovereign Food Investments Ltd.	Farming & Fishing
Steinhoff International Holdings	Furnishings
Sun International Ltd.	Gambling
Super Group Ltd.	Transportation Services
Telkom SA Ltd.	Fixed Line Telecommunications
Tiger Brands Ltd.	Food Products
Tiger Wheels Ltd.	Auto Parts
Venter Leisure and Commercial Trailers Ltd.	Commercial Vehicles & Trucks
Wesco Investments Ltd.	Automobiles