# WHAT MAKES BETTER BOARDS?

# A CLOSER LOOK AT DIVERSITY AND OWNERSHIP

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#### ABSTRACT

This study investigates the joint effect of corporate ownership and board of directors' diversity configurations on the success of strategic mergers and acquisitions (M&A) decisions. Board diversity is defined as the extent to which its demographic diversity as measured by the culture, nationality, gender and experience of its directors complements its statutory diversity. A theoretical framework linking ownership, board diversity and M&A strategic decision making is proposed and tested. Based on a sample of 289 M&A decisions undertaken by Canadian firms over the period 2000-2007, demographic diversity is found to have a clear and non linear effect on M&A performance while statutory diversity is of limited influence. Ownership is found to influence the effect of diversity, making the relation finer and more precise.

This has practical implications. First, statutory diversity is not sufficient for well-performing boards. Also, ownership is an important factor. The mostly advocated board diversity aimed at insuring the board's independence is not valid across all ownership configurations. From a public policy perspective, results provide support for the principles-based approach in governance. Governance regimes should encourage the search for a balance between board diversity and the need for cohesion that best serves the firm's purpose and obligations.

**Keywords:** Diversity, Pluralism, Ownership, Corporate Governance, Independence in Governance, Mergers and Acquisitions.

#### 1. Introduction

The general belief that corporate governance contributes to value creation explains why this issue is so widely debated in research and in practice. What is more complex and not completely understood is the nature of the hypothesised contribution. Furthermore, Sur (2009) suggests that it is difficult to understand a firm's governance mechanisms and performance objectives without an analysis of its ownership configuration and Klein et al. (2005) find that the effects of governance do differ by ownership category. This article contributes to the literature on board effectiveness by proposing and testing a theoretical framework describing how the interaction between a firm's ownership configuration and its choice of board diversity or pluralism level may influence the outcome of crucial and complex strategic corporate decisions. Pluralism or heterogeneity in the composition of boards of directors is seen as breeding a higher level of openness and decision-making analytical quality, and despite expected difficulties in reconciling the resulting variety of perspectives, leading to better decisions (Watson et al., 1993; Erhardt et al., 2003). As in McDonald et al. (2008), we focus on merger and acquisition (M&A) decisions as it might reasonably be expected that boards exercise greater influence on acquisition performance than on overall firm performance; the latter being related to a wider array of organisational and environmental factors (Hermalin and Weisbach, 2001).

Board's diversity and its effect on firm performance have been extensively studied and yet it seems that we know little about the issue. Conflicting findings, unclear or unclean methodologies, leave scholars and managers in a quandary. The first important reason for such a situation is the dominant use of agency theory premises that statutory diversity (SD) is all that counts to control management, and provide them with incentives so as to protect shareholder value (Fama and Jensen, 1983). Statutory diversity is mandated by law or best practices, and often reduced to board members' independence from management. The second important issue is the belief that there is a linear relationship between diversity and performance. This is questioned by both logic and extant research (Manzoni et al. 2010; Milliken and Martins, 1996). The third important issue is ownership. It is increasingly believed that

different owners pursue different goals, even when they share the same assets. This may have significant effects on firm governance and ultimately performance (Sur, 2009).

In this study, we believe that we bring to the fore a more convincing theory and finer empirical findings by considering these issues. We recognise that statutory diversity (SD) has an effect, but we consider such effect to be contingent on individual characteristics of actual board members, or demographic diversity (DD), and on the nature of owners. In the second section of the paper, our examination of the literature supports these assertions and is used to build a theoretical model and develop hypotheses. Then, we subject the model and hypotheses to various statistical tests using a sample of 289 M&A decisions undertaken by Canadian firms over the 2000-2007 period. Section 4 describes the findings, and in particular the joint effects, of statutory diversity, demographic diversity and ownership, on firm performance. In the last section, these findings and the methods used are discussed, and a few concluding comments and suggestions for future research, are offered.

#### 2. Theoretical framework and hypotheses development

The question of what impact board characteristics have on firm performance is among the most extensively researched topics in the large body of corporate governance research (McDonald et al., 2008). The first attempt to explain performance, taking into account the interactions among the factors that make up diversity and independence was Molz's (1988 & 1995). He developed a pluralism index to that effect, and classified boards into management dominated and pluralistic. In contrast to what we are proposing in this paper, Molz did not distinguish between demographic and statutory diversity, lumping them together and did not take the firm's ownership structure into account. Furthermore, his model only integrated gender diversity while we also include diversity of culture and experience as measured by the presence of foreign directors and the tenure of directors. These differences may explain why Molz's proposition that performance is related to pluralism was not supported by his

empirical investigations. Neither social (Molz, 1995) nor financial (Molz, 1988) performance was found significantly related to pluralism.

The framework presented in Figure 1 structures and motivates what we do. It underlines the dual but complementary fiduciary and advisory governance roles the board plays in strategic decision making, given the firm's ownership structure. From a fiduciary or statutory perspective, the board is deemed to indirectly influence firm performance by focusing on decision control to minimise agency costs. This monitoring role, where independence and related statutory board characteristics are assumed to ensure better representation and protection of minority shareholders' interests, has been the main proposition of agency theory (Fama and Jensen, 1983) and the focus of most governance research and reforms, such as Sarbanes-Oxley. From such a perspective, board effectiveness is measured in terms of its independence from management or statutory diversity (SD). This means that the diversity of incentives between outsiders and insiders represented on the board should help them meet their fiduciary obligations (Hillman et al., 2008: 441; Fama, 1980; Jensen and Meckling 1976) and keep managerial discretion within proper bounds. However, the results of empirical research on the relation between performance and statutory independence are mixed (Bhagat and Black, 2002). This may not come as a surprise given that in theory, as described in our framework, the main goal of fiduciary governance is to minimise agency costs, thus only indirectly affecting the strategic decision making process. This is the basis of our first hypothesis where we test the relationship between statutory diversity and M&A performance.

#### **Insert Figure 1 here**

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In contrast, the left-hand side of the proposed framework asserts that board members are a key resource and directly contribute to better strategic decision making (Raatikainen, 2002). By questioning, criticising, advising and counselling, they enhance the strategic decision making process.

They also provide "access to channels of information between the firm and environmental contingencies, preferential access to resources, and legitimacy" (Hillman et al., 2009: 1408). So, given that SD may be necessary, but not sufficient to materially influence corporate value, other theories based on the provision of resources, competencies and cultural values (Hillman et al., 2008; Barney, 1991; Selznick, 1990) must be harnessed to complement the insights of agency-based theories and to better understand the governance-performance relation. From this advisory perspective, board effectiveness also requires a diversity of cultures, experiences and genders, henceforth referred to as demographic diversity (DD), in order to guide and contribute to organisational learning and improved management strategic decision making. The emphasis is on the directors' ability to counsel and "mentor" rather than "monitor" management. DD goes beyond SD, which mainly promotes financial literacy and the need for a diversity of incentives between management and shareholders. Although minority investors' protection still matters, under this perspective, a greater consideration is given to all stakeholders and DD is intended to foster greater pluralism on the board.

We define board diversity or pluralism as the extent to which its demographic characteristics complement its statutory characteristics. Demographic diversity (DD) is a broad construct (Hambrick and Mason, 1984) that may include measurable demographics including innate characteristics which are social, racial, cultural diversity, and acquired characteristics related to life experience. In this research, DD refers to the participation of women and foreign directors with diverse cultures on the board as well as to the experience of directors as measured by their tenure<sup>1</sup>. Knowledge and competencies per se are seen as exogenous. In other words, all firms are assumed to select their directors with the objective to optimise the level of knowledge and competence obtained. It is their decision relative to the mix of SD and DD which may make a difference.

Board diversity is expected to be positively related to firm performance, especially in situations of complex decisions, because both DD and SD should enhance the board's overall qualifications and lead

<sup>&</sup>lt;sup>1</sup> Racial diversity on boards was not included in our index as this information was not available in the proxy statements from which we manually collected the data. To the best of our knowledge, this information is not available in any other public database in Canada.

to better debates, thus triggering better M&A decisions (Watson et al., 1993; Erhardt et al., 2003). Our research design distinguishes the effects of "statutory" diversity or highly recommended "best practices," from "voluntary" DD, on firm performance. This leads to our second hypothesis that there is a relationship between a firm's level of DD and the success of its M&A decisions. However, as in Luis-Carnicer et al. (2008) and because heterogeneous groups have to work through their communication problems and conflicts to end up making better decisions, we expect a curvilinear relationship between DD and M&A performance.

Agency theory and recent governance reforms, which are mainly concerned with SD, have been respectively formulated and initiated in the context of the US capital market where corporate ownership is relatively more widely held than elsewhere in the world (La Porta et al, 1999). Furthermore, Sur (2009) and Klein et al. (2005) have shown that governance arrangements and firm performance are related to ownership characteristics. Thus, our last hypothesis concerns the presumed joint effect of ownership and governance configurations on performance.

Referring to the theoretical framework presented in Fig. 1, we shall now first justify why we distinguish board of directors statutory and demographic diversities given the firm's ownership structure, then organise the relevant governance and M&A literatures and finally develop hypotheses on their relative effects on M&A performance.

#### a. Statutory board diversity

"Statutory" board diversity (SD) refers to the regulation-mandated or highly recommended governance '*best practices*' or guidelines put forward in several countries<sup>2</sup>. Statutory diversity recommendations are based on the assumption that a board of directors' independence from management enhances its monitoring function and indirectly improves performance (Fama and Jensen,

<sup>2.</sup> For instance, in the USA, "listed companies must have a majority of independent directors" on their board (NYSE sec. 303A.01). Canada employs a principles-based approach to corporate governance through the implementation in NI 58-101 and NP 58-201 of best practices guidelines. This approach is in combination with a mandatory 'Statement of corporate governance practices' in the firm's annual report or proxy statement as to the extent of compliance with such guidelines.

1983; John and Senbet, 1998). SD includes regulated or recommended governance practices, including in particular a higher proportion of outside directors on the board and the separation of the functions of CEO and chairperson of the board, generally referred to as the leadership structure. These are designed to foster a greater diversity of interests or incentives than if executive directors or dominant shareholders were controlling the board. It also includes such other "best practices," as encouraging share ownership by directors to further align their interests with those of all shareholders.

Theoretical and empirical governance research (Dalton et al., 1998; John and Senbet, 1998) has examined most of agency theory's propositions, in particular that the board of directors monitoring function is an important pillar of a firm's corporate governance system. As described in the right-hand side of Fig. 1, from that fiduciary perspective, SD is assumed to indirectly improve the board's effectiveness in creating value through minimising agency costs. In other words, loss to the principal resulting from interest divergence may be curbed by imposing governance or decision control structures (SD) to the agent. In so doing, agency costs are minimised, which indirectly affects value creation.

To examine statutory diversity, we build a SD index based on four proxies, all widely used in the governance-performance empirical literature to measure the board's independence. These are: the leadership structure, the proportion of outside directors in total board membership and the levels of ownership by inside and outside directors.

Empirical tests of the relation between traditional proxies for statutory diversity, and firm performance are generally inconclusive (Dalton et al., 1998). According to Bhagat and Black (2002), "a priori, it is not obvious that independence (without knowledge or incentives) leads to better director performance than knowledge and strong incentives (without independence)." This may not come as a surprise for two reasons. First, according to the stewardship theory, there are "situations where executives as stewards" (including those that are sitting as directors) "are motivated to act in the best interests of their principals" (Davis et al., 1997: 24). Second, as shown in our framework, according to

agency theory, the main goal of fiduciary governance is to minimise agency costs. This only indirectly affects value creation. Nevertheless, we expect agency costs to be particularly important in major strategic decisions such as M&A, which justifies our desire to test the following first hypothesis:

H<sub>1</sub>: There is a positive relationship between a firm's board statutory diversity and the success of its

*M&A strategic decisions.* 

#### b. Demographic Diversity

In the previous section, we have referred to the stream of fiduciary governance research which mainly resorts to agency theory to examine the board of directors' effectiveness. We now turn to advisory governance (left hand side of Fig. 1), which focuses on the board as a provider of key resources. There is substantial evidence (see Hillman et al, 2009 for an overview) that boards of directors play an important advisory role in corporate strategic decisions. From this advisory perspective, demographic diversity (DD) as defined later in this section is assumed to enhance the skills and general competency of boards of directors and directly impact strategic decision making and performance. According to Hillman and Dalziel (2003) and Westphal (1999), directors are in a position to affect strategy by providing advice and social support to the CEO. They can also affect the organisational context within which strategic decisions are made (McNulty & Pettigrew, 1999).

Hambrick & Mason (1984), focusing on the top management team, argue that demographic heterogeneity enhances the ability to deal with strategic change. More recently, building on their work on upper echelons of management, Hambrick (2001), Canella et al. (2008) and Hambrick et al. (2008) extend the theory to address the issue of diversity on the board. Raatikainen (2002) asserts that diverse groups make better decisions, which may lead to better performance. Diversity improves the knowledge base, the creativity and the quality of the decision making and monitoring processes of a group (Watson et al., 1993; Erhardt et al., 2003). Furthermore, Milliken and Martins (1996) suggest that diversity of qualifications engenders favourable board dynamics and fosters innovative solutions to

the strategic issues that the organisation is confronted with. There may however also be an intriguing mediating effect of beliefs in diversity on group performance, as developed by van Knippenberg and Haslam (2003, 2007). According to this psychological perspective, when group value diversity they may be better able to use it fruitfully. In contrast, when diversity is either unexpected or its impact downplayed, its effects may be depressed<sup>3</sup>. Nevertheless, board DD could also produce integration difficulties, result in poorer strategic decisions in contexts that require fast decisions (Milliken and Martins, 1996), and even "backfire on company boards" (Manzoni et al., 2010). In the context of top managers, Hambrick et al. (1996) indicate that heterogeneity is negatively related to the possibility of reaching a consensus in a decision making process<sup>4</sup>. According to them, heterogeneity slows down the process by which strategy is formulated and could considerably impair the decision-making performance of managers and, ultimately, of the firm's board members. Diversity increases creativity (Pelled et al., 1999), but also conflict (Jehn, 1995), and decreases commitment and communication (Tsui et al., 1992).

Prior research on diversity has mostly examined the relation between one factor of demographic diversity at a time and organisational performance. In this research, we test the joint effect of gender, culture or nationality and tenure of board members on M&A performance.

#### Gender diversity

The complexity of board heterogeneity effects may explain that results of extant research on the relationship between board and top management gender diversity, and financial performance, are mixed and inconclusive (Shrader et al., 1997; Daily et al., 1999; Carter et al., 2003; Erhardt et al., 2003; Adams et al., 2009; Haslam et al., 2010). For instance, Adams et al. (2009) find no difference in firms' financial performance around the appointment of a woman or a man as a CEO in the US. Haslam et al. (2010) also report that there is no association between women's board representation and accounting-

<sup>&</sup>lt;sup>3</sup> We gratefully acknowledge that this argument has been suggested and developed by one of this paper's reviewers.

<sup>&</sup>lt;sup>4</sup> One of the reviewers wondered whether consensus was necessary. We believe that in major M&A decisions, it is important for the board to show a united front. A simple majority decision is an ominous signal that may cast a shadow on the value to the firm of the M&A operation.

based performance measures but they find a negative correlation with stock-based performance measures.

In exploring further the relationship, Francoeur et al. (2008) document a positive relation between gender diversity and financial performance in the case of firms operating in riskier environments. The presence of women on boards appears to help deal with more complex strategic issues. Recently, Adams and Ferreira (2009) show that female directors have a significant impact on board inputs and governance. More specifically, gender diverse boards allocate more effort to monitoring management, but the true relation between gender diversity and firm performance is complex. For instance, these authors find that the relation between gender diversity has a positive impact on performance in firms that otherwise have weak governance, as measured by their abilities to resist takeovers. In firms with strong governance, however, enforcing gender quotas in the boardroom could ultimately decrease shareholder value" (Adams and Ferreira 2009: 308). Overall, empirically, gender diversity is found to be either positive or neutral vis-à-vis performance.

#### Culture or nationality diversity

Oxelheim and Randøy (2003), Choi et al. (2007) and Ruigrok et al. (2007) have explored the effect of foreign directors' representation on the board's processes and dynamics and ultimately on firm performance. Their findings confirm the dialectic mentioned earlier. On the one hand, in agreement with the resource dependence perspective, foreign directors' cultural knowledge and expertise in foreign markets is beneficial (Ruigrok et al., 2007). In particular, foreign directors extend board international exposure and its network of contacts, an important source of competitive advantage in international acquisition strategies. On the other hand, diversity of nationalities on the board may create communication and integration problems. In particular, misunderstandings and conflicts among board members can affect the time value and the accuracy of decisions (Ruigrok et al., 2007).

Empirical tests generally confirm the positive effect of foreign directors on firm performance. Oxelheim and Randøy (2003) document that Swedish and Norwegian firms with Anglo-American outside directors have higher valuations than comparable firms without foreign outside directors. Choi et al. (2007) also report a positive effect of foreign directors on firm performance in the Korean context. So in general, international diversity among board members can be expected to have a positive effect on performance.

#### Directors' Tenure

According to organisational demography research, tenure in a group has an effect on firms' performance (Kosnik, 1990), strategic actions, and strategic change (Golden and Zajac, 2001). As their association with a board lasts, directors' experience and familiarity with the corporation's specific governance issues and problems increase (Kesner, 1988). Directors with longer board experience also better understand the ongoing management team practices and can carry their oversight responsibilities with greater skills. Experienced directors can also contribute to company strategy (Bilimoria & Piderit, 1994), and have a better understanding of the firm's resources and operations (Alderfer, 1986). In contrast, newly appointed directors, may be captured by the incumbent CEO (Finkelstein and Hambrick, 1988). However, tenure diversity may have negative consequences as well. Katz (1982) suggests that longer tenure is associated with greater rigidity, increased commitment to established practices and procedures, and increased insulation from new ideas. According to the management friendliness hypothesis (Vafeas, 2003), directors with long board tenure are less effective at monitoring management, which increases the chances of CEO entrenchment. Vafeas (2003) argues that extended tenure may reduce intra-group communications and lower the quality of firms' decisions. This study shows that the participation of senior directors in the compensation committee is associated with higher compensation payments to the firm's CEO.

In summary, long tenure is useful and leads to better performance, but pushed to the extreme, it leads to groupthink and the tendency to suppress conflict, even at the expense of good decisions.

12

Overall, demographic diversity is seen as having a positive effect. But there are situations where negatives are also observed. This mixed evidence suggests a non linear relationship with performance. First, diversity has to be significant before it can be domesticated and made acceptable to all board members (van Knippenberg and Haslam, 2007). When it does, it improves performance. On the other hand, diversity might have positive effects at low levels but, beyond a certain stage, it may overwhelm the board's ability to converge. This leads to our second hypothesis:

*H*<sub>2</sub>: There is a non linear relationship between a firm's board demographic diversity and the success of its M&A strategic decisions.

#### c. The ownership factor in governance

In the SD section, we have indicated that it is important to take into account the incentive effect of board ownership on performance. To contribute to the debate on the presumed relation between governance and performance, our framework of Fig. 1 also indicates that the interaction between the firm's ownership structure as a whole and both demographic and statutory diversity cannot be ignored when trying to explain performance. Indeed, agency theory is based on Berle and Means' (1932) premise of diffused ownership. Therefore, dispersed outside investors are seen as the rightful principal, whose only concern is the quality of SD to ensure that managers' opportunism is kept in check. Yet, ownership is often not dispersed as reported in recent international studies (Holderness, 2009; Denis and McConnell 2003; Faccio and Lang 2002; La Porta *et al.* 1999). On this basis, Sur (2009) uses a large sample from the USA to show that board composition, strategic decisions and performance are all related to ownership. He proposes three owner types: institutional, family and corporate blockholder. Institutional ownership behaviour is geared at maximising shareholders' value; corporate blockholder behaviour is guided by the strategy of the dominant owner, and family ownership is dominated by ideological or value considerations. So, Sur demonstrates that ownership configuration must be considered to help understand actual firm behaviour. In addition, his findings show that board composition and behaviour are also related to ownership.

Sur's findings and previous related contributions (Klein et al., 2005) lead us to consider that board characteristics are influenced by ownership. Owner identity is deemed to influence both statutory and demographic diversity levels within the board of directors, which in turn will ultimately affect M&A performance. Thus, in our model, ownership matters and we introduce an interaction variable to represent it, which leads to our last hypothesis:

# $H_3$ : There is a joint effect of ownership and diversity configurations (SD and DD) on the success of

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*M&A strategic decisions.* 

#### d. Control variables

Prior research identifies several variables that are deemed to affect M&A success. A high relative size of the target company to the acquirer (Asquith et al. 1983; Kohers and Kohers, 2000) and paying in cash (Travlos, 1987; Huang and Walking, 1987) are factors that are generally viewed as favourable by the market. On the contrary, acquiring public targets, as compared to private ones, is generally associated with lower performance (Fuller et al, 2002; Faccio et al. 2006). Cross-border transactions create value for the acquiring firm by exploiting market imperfections in outside markets (Eun et al. 1996). However, integration costs and cultural problems could undermine these gains. Empirical results have been somewhat mixed (Eun et al., 1996; Cakici et al. 1991; Faccio et al., 2006). Technology-based industries are characterised by high growth potential and high risk due to the uncertainty associated with the complexity of their activities and the unproven nature of technology used within these companies (Kohers and Kohers, 2000; 2001). Finally Datta et al. (1992) note that the relatedness, among the acquiring and target firms' activities, is a key determinant of the level of value creation in their merger. Synergies are indeed easier to achieve when the merged firms operate in the same type of business (Rumelt, 1982).

#### 3. Data and methodology

In this section, we first explain why we selected a sample of mergers and acquisitions (M&A) conducted by Canadian firms to examine the joint effect of ownership and diversity on the success of M&A strategic decisions. We then present the dependent and independent variables of our empirical model.

#### Institutional setting and sampling procedure

The Canadian institutional setting constitutes a particularly good "laboratory" to study ownership and diversity configurations and their joint relation with performance. With regards to ownership, its mix of closely and widely held firms is representative of corporate ownership around the world (Denis and McConnell 2003; Faccio and Lang 2002; La Porta *et al.* 1999). Yet, its mostly voluntary principles-based approach to corporate governance is significantly different from the US mostly rulesbased approach (Broshko and Li, 2006) and the resulting managerial latitude may thus be more conducive to a broader diversity. Our final sample consists of 289 observations covering 206 acquiring firms. Table 1 summarises the sample selection process.

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#### **Insert Table 1 here**

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#### **Empirical model**

The resulting model is described in more details later, but can be summarised as follows:

$$CAR_{it} = Constant + \beta_{1 it} STATUTORY_DIVERSITY + \beta_{2 it} DEMOGRAPHIC_DIVERSITY + \beta_{3 it} OWNERSHIP + \beta_{4 it} RELSIZE + \beta_{5 it} CASH + \beta_{6 it} TARGETPUB + \beta_{7 it} CROSSBORDER + \beta_{8 it} HIGH_TECH + \beta_{9 it} RELATED$$

Where CAR<sub>it</sub> is the cumulative abnormal return around the announcement date. Dependent and control variables are described in Table 2. We now turn to discussing both the dependent and the independent variables.

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Insert Table 2

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#### M&A performance (dependent variable)

M&A offer the right context, within which to test the contribution of diversity in governance to enhanced decision making. M&A decisions are strategic, complex, and fraught with uncertainty. Also, complex strategies and decisions of M&A are typically under the responsibility of top management and the board of directors. Given the uncertainties related to both the transaction itself and to the future integration of the firms involved, M&A are likely to reveal disagreements among, and a greater involvement of board members.

In line with research on the impact of M&A on shareholder's wealth, we use the Brown and Warner (1985) event study methodology to assess the success of M&A strategic decisions<sup>5</sup>.

#### **Diversity configuration**

If individual director characteristics interact to produce the board's behaviour, their diversity may constitute either a stimulus or a challenge (or both) to the board's effectiveness and innovativeness. Therefore, rather than only examining the relationship between directors' individual characteristics, and performance, we combine all dimensions of diversity or pluralism discussed earlier into two indices, statutory and demographic diversity, to examine their interaction and effect on the success of M&A strategic decisions. The construction of our diversity indices is straightforward. As in prior

<sup>&</sup>lt;sup>5</sup> This short-window event study methodology is widely used in prior M&A studies (McWilliams & Siegel,1997; Bruner, 2002; Tuch & O'Sullivan, 2007). It produces the most statistically reliable evidence on whether M&A create value for shareholders (Andrade et al., 2001).

research that calculated governance indices (e.g. Gompers et al. 2003, Black et al. 2006) we compute our index scores by adding points for every characteristic that enhances the level of diversity of the board. Dichotomous variables are given values of 0 and 1. As in Dittmar & Mahrt-Smith (2007) and Francoeur et al. (2008) we split the sample into terciles for continuous variables to rank firm's board diversity levels. These groups then take values of 0, 1 and  $2^6$ . The procedure is summarized in Table 2.

#### **Ownership configuration**

To take ownership into consideration, we rely on the same methodology as La Porta et al. (1999) and Faccio and Lang (2002) to measure the ultimate voting and ownership rights held by the firm's largest blockholder. Sample firms are classified in three groups of owners: widely held, when there is no dominant owner at the 10% threshold level; institutional investor, when the largest shareholder at the 10% threshold level is a financial institution (e.g., mutual fund, pension fund, etc.), and family firms, again when the largest shareholder at the 10% threshold level is a family.

#### **Control variables**

The model controls for factors that are identified in the literature as potentially affecting stock market returns at the announcement date of M&A transactions. These factors have been mentioned earlier, and their expected relationships with performance are summarised in Table 2.

#### 4. Results and analyses

<sup>&</sup>lt;sup>6</sup> For robustness check, we divided our sample by the median or in quartiles and obtained similar results.

#### Descriptive statistics and univariate analyses

Table 3 provides descriptive statistics. First, the mean cumulative market model abnormal returns (car\_mm) obtained in the three-day window around the announcement date (-1,0,+1) is positive and significant (1.4%, p.value 0.01). The average statutory diversity score is 3.75 and the median is 4.00. Board demographic diversity measures its gender diversity, its cultural and international exposure and its directors' experience within the firm. The average demographic diversity score is 1.93 while the median is 2.00. Results also show that 42.2 % of the firms in our sample are widely held, 25.3% are controlled by an institutional investor and 25.3% are controlled by a family blockholder. The proportion of family firms in our sample is comparable to what it is in prior Canadian studies.

The average relative deal size to the bidder market value is 28.1% and 58.8% of the transactions are paid exclusively in cash. Moreover, 28% of the transactions involve publicly held targets while 54% involve foreign targets. Table 3 also shows that 17.0% of the acquired companies belong to the high-tech industry and 57.4% of the transactions involve an acquirer and a target from related industries (same 3 digits SIC code). Table 4 presents the distribution of the statutory and demographic diversity indices.

**Insert Tables 3 and 4 here** 

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Table 5 presents the distribution of statutory and demographic diversities by type of ownership. Panel A shows that firms controlled by institutional investors exhibit the highest level of statutory diversity (average of 4.14) among the firms of our sample, followed by widely held firms (average of 3.68) and family controlled firms (average level of 3.52). Panel B of Table 5 also shows that the difference between SD scores of firms controlled by institutional investors and the two other groups is statistically significant. In contrast, family firms do not seem to differ from widely held firms in the level of statutory diversity. These results suggest that institutional investors promote more intensely the adoption of best-practices governance guidelines.

Panel C of Table 5 compares the level of demographic diversity between the three groups of owners. Widely held firms exhibit the highest average DD score (2.14), followed by family firms (1.74) and institutional investors firms (1.71). The results of Panel D shows that the demographic diversity level observed in widely held firms is statistically higher than the level achieved by family and institutional investors firms (at the 10% level). Taken together, the results presented in Table 5 show that owner identity has a significant effect on the diversity configuration of firms.

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Table 6 presents a matrix of correlations between independent and explanatory variables. The highest correlation coefficient is -0.338 (correlation between family and institutional dummies). These results indicate that multicollinearity is not a serious threat in our following multivariate analyses.

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#### **Multivariate analyses**

Table 7 presents the results of three OLS regressions testing the three hypotheses of our theoretical framework of Fig. 1 and including the control variables. In regression 1, we test for a linear relationship between statutory and demographic diversity (hyp. 1), and M&A financial performance. In regression 2, we consider that the tested relationships between performance and board statutory and especially demographic diversity (hyp. 2) may not be linear. Thus, we include the squared values for

board diversity variables to test for the existence of an inflexion point. Finally, in regression 3, we introduce ownership dummies to test our third hypothesis of a joint interactive effect of board diversity variables and owners' identity on M&A performance.

As suggested by Aiken and West (1991), the independent variables (statutory and demographic diversity) are mean-centered to attenuate the threat of multicollinearity in our regression models when introducing quadratic terms. We also tested for multicollinearity among our explanatory variables by computing the variance inflation factors (VIF) for each of the regression coefficients. As presented in Table 7, the highest VIF value in our models is 2.13, which is well below the cut-off value of 10 suggested by Neter et al. (1985).

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Results of the first regression indicate that the levels of statutory or demographic diversity of the board of directors are not statistically related to the financial success of M&A. We then use two quadratic regressions to test the possibility of a non linear relationship between board diversity and M&A performance. The results of regression 2 show a non linear relationship between the demographic diversity of the board members and CAR at the time of M&A announcement which is in line with our second hypothesis. The coefficient of the demographic diversity variable (DD) is negative and statistically significant whereas the coefficient of its squared value (DD<sup>2</sup>) is positive, and significant, which is consistent with an asymmetric U-shaped curve. Figure 2 represents graphically the relationship between demographic diversity and M&A performance. These results suggest that introducing demographic diversity on the board of directors has at first a negative effect on the success of acquisition decisions, probably because the benefits of DD are counterbalanced by problems related

to integration difficulties. But beyond a certain level<sup>7</sup>, DD starts enhancing the board's knowledge base and ability to deal with complex strategic decisions and results in better M&A decisions. In total, these results confirm our second hypothesis.

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#### **Insert Figure 2 here**

Regression 3 where ownership is introduced shows the same relation between demographic diversity and M&A success. Institutional and family ownership also have a significant positive impact on the dependent variable over and above the widely held firms. Table 8 summarises table 7's results relative to the joint influence of diversity and ownership on M&A success. In general, for firms whose largest shareholder is an institutional investor, high levels of statutory diversity seems to be detrimental to the success of M&A decisions and the effect increases as SD increases. The effect is the same and perhaps a little more pronounced in family firms.

On the contrary, both ownership configurations benefit from low levels of demographic diversity. Diversifying the boards at low levels may bring new ideas and perspectives to the directors in place or to the family members. However, higher levels may affect family firms negatively. The recognised advantages of family governance, i.e. the coherence, trust and long term orientation of the board members (Eddleston et al. 2010; Le Breton-Miller and Miller, 2006; Steier 2001), could be lessened when higher levels of statutory or demographic diversity are in place.

#### **Insert Table 8 here**

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Looking at control variables, several of the extant literature traditional findings are confirmed. In particular, the public status of the target firm produces a negative impact on the dependent variable

<sup>&</sup>lt;sup>7</sup> Technically, this level corresponds to the inflexion point of the U-shaped curve, a value of 1.1.

consistently across all the regression models. In agreement with the limited competition hypothesis (Chang, 1998), our results suggest that acquiring companies are likely to pay lower premiums and earn higher returns for deals involving private targets than in the case of publicly listed ones. Table 7 also shows a positive association between the target size, relative to the bidder, and CARs around announcement date. These results are consistent with the literature findings.

#### 5. Discussion and conclusion

The effect of board diversity on performance has been the topic of a large number of studies. Most research has however focused on the effect of a few statutory diversity variables aimed at having the differences in incentives between outsiders and insiders represented on the board. Our research has three important distinctive features. First, we distinguish statutory diversity, either mandated or normatively recommended to monitor management, from demographic diversity which is related to the resource provision function of board members and refers to their individual background characteristics (in this case: gender, experience, nationality and culture). We propose indices to capture the effects of either statutory or demographic diversity.

The second important feature is the investigation of the effect of ownership. Multivariate analyses are first conducted without including the ownership variables. In this first model, the influence of board diversity is barely noticeable, and more generally not significant. When including the ownership variables, the picture is completely different. Ownership does definitely make a difference. In our analyses, we show that diversity can have a generalised effect and a more specific effect depending on the type of ownership.

The third feature is that we examine decisions of M&A that are clearly board responsibility. Therefore, we believe that the validity of the findings is much greater than when general firm performance is considered.

22

We developed a theoretical framework summarized in Fig. 1 and generated three hypotheses. The first hypothesis concerning the effect of SD on M&A success was not confirmed. We explain this result by the fact that statutory diversity is becoming a must, and no longer discriminates among firms. There are also nuances to take into account. We can state unambiguously that, in the case of Canadian M&A performance, there is no generalised board statutory diversity effect, which appears to go against generally accepted corporate governance "best" practices. Moreover, statutory diversity is less favourable to institutional and family-owned firms than to widely held firms. This would imply that it is appropriate to insist on statutory diversity or fiduciary governance when mostly dealing with widely held firms as in the USA, but that SD appears to have a limited effect when shareholding is more concentrated. This is an important finding both for practical and academic reasons. It confirms that one has to give attention to the premises of agency theory and ensure that they apply, before considering their generally accepted consequences.

Hypotheses 2 and 3 have been confirmed. Demographic diversity has a general negative effect at lower levels and the effect reverses at higher levels. This suggests that there is a threshold level beyond which the effect becomes positive. There is also a more specific effect of demographic diversity depending on the ownership configuration. At lower levels, it is positive for institutional owners and families, but at higher levels, family firms are affected adversely. The coherence, trust and long term vision of these close-knit boards (Eddleston et al. 2010; Le Breton-Miller and Miller, 2006; Steier 2001) is lessened when subjected to higher levels of demographic diversity. Family firms are founded on a belief in the value of a homogenous management structures. These firms tend to perform best under conditions of low demographic diversity as they do not value diversity (van Knippenberg, 2007)<sup>8</sup>.

<sup>&</sup>lt;sup>8</sup> We thank one of the anonymous reviewers for pointing this out.

To sum up, what do these findings mean? The effect of diversity on firm's performance is multi factorial. Several aspects have to be considered to get a clear picture. Board diversity does not have either an overall positive or negative effect. Its effect depends on contextual factors and in particular on ownership configurations. Furthermore, it does not have a linear effect. Diversity at lower levels can be favourable for some types of firms and unfavourable for others. At higher levels, effects change. The general picture that comes out is that a balance should be struck between control and freedom when time comes to select board members. Good governance is probably more about the building of such a balance than the simple implementation of pre-specified rules of statutory independence.

Our findings apply to the Canadian context. Nevertheless, they may have a more general value, from a public policy perspective. In particular, the complex and non linear relationship between board diversity and M&A performance provides some support for the principles-based approach in governance used in several other countries like for instance Great-Britain and Australia. Rather than providing strict rules, regulatory authorities should allow companies to design the composition of the board, according to their organisational and financial characteristics, and reach an 'optimal level' of diversity.

This study has limitations. First, we use an index to assess diversity on the board. Lumping together several variables in a single index may have unexpected drawbacks. When variables work at cross-purpose, we may end up with effects being hidden rather than revealed. Nevertheless, we took comfort in the theoretical belief that all the DD variables considered are believed to have positive effects on the quality of board decisions. Second, although our short-term window (i.e. three days around the announcement date) has often been used in prior research (e.g., Bruner et al., 2002; McWilliams & Siegel, 1997) it may not fully reflect total value creation from M&A. Future research should investigate the relationship between board diversity and the long term success of strategic decisions such as M&A.

### Figure 1





# Figure 2





# TABLE 1

# Sample selection

Raw Data from Thomson-SDC	941
Less : Income Trusts	(294)
Less : Overlapped transactions in estimation period	(110)
Less : Missing returns in CFMRC database	(168)
Less : Missing predictor variables in SEDAR	(80)
Final sample	289

# TABLE 2Variable description and hypothesized relationship<br/>Panel A

Dependent variable					
Cumulative abnormal returns for a three-day window around the M&A announcement date (-1, 0, +1) CAR					
Independent variables of interest					
Statutory Diversity Index (SD)	Construction of the index				
CEO is not chairperson - Binary variable	0 if CEO is also Chairperson; 1 if not				
Percentage of independent directors	First tercile : 0 mark Second tercile : 1 mark Third tercile : 2 marks				
Percentage of outside directors ownership (voting rights)	First tercile : 0 mark Second tercile : 1 mark Third tercile : 2 marks				
Percentage of inside directors ownership (voting rights)	First tercile : 0 mark Second tercile : 1 mark Third tercile : 2 marks				
Demographic diversity Index (DD)	Construction of the index				
Percentage of women on the board	First tercile : 0 mark Second tercile : 1 mark Third tercile : 2 marks				
CEO is a woman - Binary variable	0 if the firm's CEO is not a woman; 1 otherwise				
Percentage of foreign directors (residence is outside Canada)	First tercile : 0 mark Second tercile : 1 mark Third tercile : 2 marks				
Directors' tenure (number of years) within the firm	First tercile : 2 marks Second tercile : 1 mark Third tercile : 0 mark				

### Panel B

Ownership variables	Hypothesized relationship			
Widely held firms : Dummy variable that equals 1 when there is no dominant shareholder at the 10% threshold or when the largest shareholder is a widely held corporation	?			
Institutional blockholder : Dummy variable that equals 1 when the largest shareholder at the 10% threshold is an institutional shareholder (for instance, pension funds and mutual fund managers) (INST)	+			
Family firms : Dummy variable that equals 1 when the largest shareholder at the 10% threshold is an individual or a family (FAM)				
Control variables	Hypothesized relationship			
Relative size of the transaction to the acquiring firm market value prior to the deal announcement - RELSIZE	+			

Method of payment - Binary variable - CASH			
Public status of the target (public or private) - Binary variable - TARGETPUB	-		
Cross-border transactions - Binary variable - CROSSBORDER	?		
Target operating in the high technology sector - Binary variable – HIGH-TECH	?		
Relatedness of the activities acquirer/target - Binary variable - RELATED	+		

# TABLE 3Descriptive statistics

	Mean	Median	Std deviation	
Inde	ependent vari	able		
CAR_mm	0.014 ***	0.012	0.078	
CAR_mm = Cumulative m	narket model a	bnormal retur	n	
	Diversity			
Statutory	3.758	4	1.423	
Demographic	1.931	2	1.276	
	Ownership			
Widely held	0.494	0	0.495	
Institutional	0.253	0	0.435	
Family	0.253	0	0.435	
C	ontrol variable	es		
Relsize	0.281	0.113	0.469	
Cash	0.588	1	0.493	
Targetpub	0.28	0	0.45	
Crossborder	0.54	1	0.499	
High-tech	0.17	0	0.376	
Related	0.574	1	0.495	
Ν	289			

\* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

# TABLE 4Distribution of observations by diversity score

	Statutory diversity	Ν	Demographic diversity	Ν
	0	2	0	42
	1	11	1	67
	2	39	2	87
	3	85	3	67
	4	58	4	16
	5	61	5	8
	6	26	6	2
	7	7		
Total		289		289
Mean	3.8		1.9	
Median	4.0		2.0	
Std dev	1.4		1.3	

#### TABLE 5

#### Descriptive statistics and comparisons of group means by type of ownership Panel A - One way ANOVA

	Statutory diversity				
Ownership	Mean	Std. Dev.	Freq.		
Widely held	3.6853	1.4013	143		
Institutional	4.1370	1.2618	73		
Family	3.5205	1.5555	73		
Total	3.7578	1.4228	289		
P value	3.87**				

### Panel B – Scheffe multiple group comparisons

	Statutory diversity Row mean - Col mean (p value)				
	Widely held	Institutional			
Institutional	0.4517				
	(0.085)*				
Fomily	-0.1648	-0.6164			
ranny	(0.719)	(0.032)**			

#### Panel C- One way ANOVA

	Demographic diversity					
Ownership	Mean Std. Dev. Freq.					
Widely held	2.1399	1.1903	143			
Institutional	1.7123	1.1605	73			
Family	1.7397	1.4816	73			
Total	1.9308	1.2756	289			
P value	3.89**					

# Panel D– Scheffe multiple group comparisons

	Demographic diversity Row mean - Col mean (p value)						
	Widely held	Institutional					
Institutional	-0.4275						
	(0.064)*						
Family	-0.4001	-0.4001 0.0274					

(0.090)*	(0.991)

\* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

# TABLE 6Correlations

This table presents pairwise correlations between the study's variables. All correlations are based on the full sample of 289 observations. SD = statutory diversity index, this variable is mean-centered (statutory diversity index – mean of statutory diversity index) in regressions 2 and 3; SD<sup>2</sup> = SD squared; DD = demographic diversity index, this variable is mean-centered (demographic diversity index – mean of demographic diversity index) in regressions 2 and 3; DD<sup>2</sup> = DD squared; inst = dummy variable that equals 1 when the largest shareholder at the 10% threshold is an institutional shareholder; fam = dummy variable that equals 1 when the largest shareholder at the 10% threshold is an individual or a family; variables with underscores represent interactions; relsize = value of transaction / acquirer's market value ; cash = 1 if method of payment is cash only, 0 otherwise; targetpub = 1 if target is publicly traded, 0 if target is private; crossborder = 1 if target nation is not Canada, 0 if it is; high-tech = 1 if target is operating in the high tech industry; related = if 3 digit SIC code of acquirer and target are the same, 0 if not.

	Car_mm	SD	DD	Inst	Fam	Relsize	Cash	Targetpub	Crossborder	High-tech
SD	0.030									
DD	-0.083	-0.120 **								
Inst	0.076	0.155 ***	-0.100 *							
Fam	0.131 **	-0.097	-0.087	-0.338 ***						
Relsize	0.121 **	0.027	0.022	0.130 **	-0.045					
Cash	0.038	-0.138 **	-0.046	-0.145 **	0.179 ***	-0.243 ***				
Targetpub	-0.218 ***	0.068	0.040	-0.044	-0.150 **	0.064	-0.308 ***			
Crossborder	0.123 **	-0.167 ***	0.086	-0.118 **	0.010	-0.059	0.187 ***	-0.212 ***		
High-tech	0.084	0.032	0.017	-0.029	-0.008	-0.023	-0.072	-0.056	0.158 ***	
Related	0.012	0.090	0.052	0.049	-0.128 **	0.088	0.034	0.148 **	0.020	0.072

\* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

g Ч J Dependent variable = Market model cumulative abnormal returns over the (-1,+1) window Reg1 Reg2 Reg3 0.0022 0.0023 0.0013 SD(0.483) (0.486) (0.784)-0.0004 0.0044  $SD^2$ (0.763)(0.119)-0.0051 -0.0066 -0.0177 DD (0.008)\*\*\* (0.180)  $(0.090)^*$ DD<sup>2</sup> 0.0030 0.0056  $(0.072)^*$  $(0.049)^{**}$ INST 0.0277 (0.046)\*\* FAM 0.0600 (0.002)\*\*\* SD\_INST -0.0056 (0.439) SD<sup>2</sup>\_INST -0.0072 (0.060)\* DD INST 0.0225  $(0.014)^{**}$ DD <sup>2</sup>\_INST 0.0046 (0.345)SD\_FAM 0.0051 (0.523) SD <sup>2</sup>\_FAM -0.0083  $(0.024)^{**}$ DD\_FAM 0.0242 (0.022)\*\* DD <sup>2</sup>\_FAM -0.0090 (0.029)\*\* 0.0224 0.0222 RELSIZE 0.0230  $(0.082)^*$  $(0.073)^*$  $(0.082)^*$ -0.0007-0.0008 0.0028CASH (0.952) (0.942)(0.806)-0.0360 -0.0343 -0.0256 TARGETPUB (0.002)\*\*\*  $(0.002)^{***}$  $(0.032)^{**}$ 0.0143 0.0135 0.0157 CROSSBORDER (0.114)(0.134)  $(0.089)^*$ 

0.0121

(0.436)

0.0040

(0.664)

0.0069

(0.685)

0.004\*\*\*

0.087

289

1.11

0.0128

(0.412)

0.0053

(0.562)

0.0008

(0.950)

0.005\*\*\*

0.094

289

1.11

0.0101

(0.491)

0.0024

(0.788)

-0.0239

(0.122)

 $0.000^{***}$ 

0.166

289

2.13

	TABLE 7
Regressions of the acquiring firms'	CAR around M&A announcement on their diversity index

*p*-values in parentheses: p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

HIGH-TECH

RELATED

CONSTANT

Prob > F

 $R^2$ 

N Mean VIF

### TABLE 8

Level of diversity	Institutional ownership	Family ownership
Low statutory diversity	None	None
High statutory diversity	Negative	Negative
Low demographic diversity	Positive	Positive
High demographic diversity	None	Negative

# Joint influence of diversity and ownership on M&A success

Note: these results are relative to widely-held firms

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