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## **A Survey of Corporate Governance Practices of Indian Companies Gone for Mergers and Acquisitions**

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### **Abstract**

*In the present paper, we construct a corporate governance index for a sample of 93 Indian companies listed on Bombay Stock Exchange and National Stock Exchange. The index is based on a comprehensive set of 64 governance attributes for these sample companies, the companies, then, have been classified into four governance portfolios using their corporate governance ranking. Furthermore, we have calculated average of 3 years post - mergers and acquisitions (M&A) financial performance and valuation ratios for each governance portfolio. Our findings suggest good governance appears to be of much value as we found significant higher post mergers and acquisitions rate of return ratios for companies in top quartiles. We also report significant higher valuation ratios for companies in top governance portfolio. The present study concludes that companies with higher rank for corporate governance score are good performers which are revealed from better financial ratios. Their post M&A better financial performance and valuation shows that good governed companies bring positive synergies from their M& A activities which is recognized by market reflected in higher valuation ratios.*

*Key words: Merger, Acquisition, Agency problems, Synergy, Corporate Governance, Hubris, Managerialism, Abnormal Returns*

## **I Introduction**

The motives for acquirers engaging in merger and acquisitions are well documented in the literature with the synergy motive associated with positive wealth effects for acquirers while zero/negative wealth effects said to be driven by hubris and/or managerialism (Berkovitch and Narayanan, 1993). Synergy results when the value of the combined firm is greater than the sum of the acquirer and target as individual firms and can be achieved from combining firms in the same industry sector (operational synergy), when firms have different financial resources (financial synergy) or different managerial resources (managerial synergy). Hubris occurs when management in the acquiring firm makes a mistake in over-estimating the value of the target leading it to overpay and a wealth transfer from acquiring to target shareholders as a result. Managerialism arises when managers use acquisitions for their own motives of empire building at the cost of their own shareholders wealth. Managers can be viewed as agents for the shareholders of public corporations.

Corporate governance has evolved as a response to the agency problems that arise from the separation of ownership and control in a corporation. A firm's governance structure can be used to reduce the total agency costs of a firm through the monitoring of management of action by aligning the managers' self-interests with those of shareholders. In much of finance and strategic management literature, the definition of corporate governance has been viewed through the lens of an "agency problem" arising out of separation of ownership and control between firm and its providers. (Jensen and Meckling, 1976) An agency relationship exists when one or more persons (the principal or principals) hire another person (the agent or agents) as decision -making specialists to perform a service.

The agency problems arise when agent makes decision that result in the pursuit of goals that conflict with those of principals, or because shareholders lack direct control of largely publicly traded corporations. Thus, principals establish governance and control mechanisms to prevent agents from acting opportunistically. Agency problems exist any time when managers serve their own interests at the expense of their shareholders (Williamson, 1984). Agency problems create need for effective corporate governance to align the interest of managers and shareholders (Baysinger and Hoskisson, 1990).

Ever since Manne (1965) and Marris (1964) framed the phrase "the market for corporate control", the phenomenon of mergers and acquisitions has been closely associated with corporate governance. Market for capital control is external mechanism to control agency problems. If the managers are inefficient at maximizing shareholder wealth and the board fails to replace them, then an outside group may be able to takeover the company and replace the firm's management. The primary purpose of takeovers is in disciplining inefficient management and the threat of takeover helps to align the managers' interests with shareholders. A great deal of theory and evidence supports that takeovers address the governance problems. In view of the above, Mergers and acquisitions are well suited events to conduct an empirical study of the effects of corporate governance on financial performance and valuation.

The present paper has several objectives. Firstly, it constructs a corporate governance index based on the scores to a questionnaire scheduled with a personal interview of the directors and executive directors, chief finance officers, company secretaries of Indian companies who have undertaken mergers and acquisitions from 2003-2007. Secondly, it investigates the difference between the post mergers and

acquisitions financial performance and valuation of companies ranked on the basis of the corporate governance score. For better exposition, the remainder of the paper has been organized in 4 sections. Section II reviews some of the relevant existing empirical work. Section III delineates with the sources of data and research methodology; section IV presents the empirical results. Finally section V presents concluding observations.

## **II Literature Review**

The present section presents review of select major empirical works that focus on the relationship between corporate governance rating and firm performance.

*Gompers, Ishii and Metrick (2003)* examine the relationship between corporate governance and firm value in large sample of 1500 U.S. companies for a period 1990-1999. They have constructed a “Governance Index” to serve as proxy for the level of shareholder rights using the incidence of 24 governance factors provided by Investor Responsibility Research Center (IRRC). The index is based on the factors that influence shareholders right by adding one point for every provision that restricts shareholders’ rights. Their contention is that every provision that restricts shareholders’ right increases managerial power. They found a positive relationship between corporate governance and stock returns; empirical evidence has also been observed between performance and corporate governance. They measured performance through Tobin’s Q. They have concluded that an investment strategy which focused on buying a portfolio of shares with strong shareholders rights which represents strong governance structure and selling shares with weak shareholder rights a proxy for weak governance structure would have realized annualized abnormal returns of 8.5 per cent from 1990 to 1999.

*Bebchuk, Cohen, and Ferrell (2009)* extended the work of Gompers, Ishii and Metrick (2003) by investigating the relative importance of 24 governance provisions included in the index. They constructed an Entrenchment Index (E Index) based on the six provisions and found that the index based on these provisions is negatively correlated with the abnormal return and firm’s value, as measured by Tobin's Q during the period 1990-2003.

*Cremers and Nair (2005)* examined the relationship between abnormal return and governance proxies for a period from 1999 to 2001. They have considered the percentage of share ownership by institutional block-holders, and the percentage of share of ownership by pension funds as proxies for internal governance. For proxy of external governance they have constructed a Takeover Protection Index based on presence of staggered boards, presence of poison pill and restriction on shareholder voting right to call special meetings. They demonstrated an investment strategy that focused on buying a portfolio of shares of firms with high takeover vulnerability and high public pension fund (block- holder) ownership and selling shares of firms with low takeover vulnerability and high public pension fund (block- holder) ownership generates an annualized abnormal return of 10-15 per cent, depending on which proxy is used for internal governance.

*Aggarwal and Williamson (2006)* constructed a comprehensive corporate governance index based on 64 corporate governance attributes provided by Institutional Shareholder Services (ISS). They studied a composite set of governance provisions that specifically focus on the ones targeted by new regulations of Sarbanes Oxley Legislation (SOX 2002). They examined the relationship between governance

and valuation for the period 2001-2005 using a sample of 5,259 firms. They find a positive and significant relation between governance and firm value after controlling for size and industry. They find that new regulations are associated with higher firm value in firms that adopted the regulations prior to these regulations being mandated.

*Durnev and Kim (2005)* have developed a model which identifies investment opportunities, external financing and ownership structure are related to quality of governance and disclosure practices. They used the Credit Securities Lyonnais Agency (CSLA) corporate governance ratings to test the model. The CLSA ratings cover 24 emerging countries and newly-emerging countries for 2000 and provide ratings for 494 companies. They have also used Standards and Poor (S&P) disclosures data as robust checks. They demonstrated that firm with higher governance and transparency rankings are valued higher in stock market. The study also reveals that the relations are stronger in weaker legal regimes/ less investor friendly legal environment. Klapper and Love (2003) also document a positive relationship between market valuation and corporate governance by using similar CLSA data. They also find that better corporate governance is highly correlated with better operating performance.

*Dahya, Dimitrov, and McConnell (2006)* complemented *Durnev and Kim (2005)* *Klapper and Love (2003)* by focusing on the board composition as a central building block of a firm's corporate governance structure. They investigate the relation between corporate value and the proportion of the board made up of independent directors in 799 firms with a dominant shareholder across 22 countries. The study presents evidence that firm value is positively related to board independence for a sample of firms (with a controlling shareholder) in countries with weak legal protection for shareholders.

While corporate governance has received more attention in recent years, the role that such governance plays in merger and acquisition strategy has not attracted such attention particularly in India. Much of the recent academic attention on corporate governance has been focused on corporate accounting scandals and their prevention. Corporate governance and merger strategy, however, has not been the focus. Literature survey indicates that there is very little empirical work, if any, on the relationship between mergers and acquisition and a comprehensive framework of corporate governance as far as India is concerned. The present research work is an attempt to fill this gap by conducting an empirical research by investigating the impact of corporate governance in a comprehensive framework by constructing a corporate governance Index for the companies undertaking mergers and acquisitions in India.

### **III Research Methodology**

**Research Design:** The study is based on a sample of 93 companies having completed mergers and acquisitions deals announced between January 2003 to December 2006. The rationale of the period of study emanates from the fact the major development and changes in SEBI clause 49 has been incorporated in year 2003 itself. The sample consists of 58 manufacturing and 35 service companies.

**Table 1: Distribution of Sample, Year-wise (2003-06)**

year	Number of companies
2003	20
2004	21
2005	33
2006	19
total	93

**Data Collection:** The present study is based on the primary as well as secondary data. The secondary data is collected in two parts. In first part, acquisitions of Indian companies are identified from Center for Monitoring Indian Economy (CMIE) data base related to Monthly Review on Mergers and Acquisitions, Deal Tracker in Business World and NEWS Papers.

The data collection in second part mainly focuses on data pertaining to financial performance and valuation as a measure of corporate governance. To collect data related to corporate governance measures, annual reports of the acquirers are examined from website of companies, the PROWESS data base of CMIE, Capitaline data base, Website of Ministry of Corporate Affairs and Security Exchange Board of India (SEBI) website and Electronic Data Information Filing and Retrieval System (EDIFAR) website of SEBI.

Primary data is used to prepare a Corporate Governance Index (CGI). Primary data is collected through a questionnaire supplemented with interviews of senior management, directors, CFOs, company secretaries, compliance officers, investor relation officers and board members. The questionnaire is designed on the basis of major standard qualities relevant to measure the corporate governance.

**Table 2: Respondents Profile**

Respondents Designation	Number
Chairman, Executive Directors ( Finance) and Chief Financial Officers	35 (37.7 %)
Vice Presidents, Head and Chief Legal Officers	20 (21.5%)
Company Secretary and Deputy General Manager	23(24.7%)
General Manager ( Finance, Investor Relations)	15(16.1%)
Total	93(100%)

The survey is based on the 64 broad attributes of corporate governance arranged into following seven sub-categories. Corporate Governance Score (CGS) is based on the responses of the 64 issues included in the questionnaire.

1. Management Discipline (MDIS)
2. Transparency (TRA)
3. Independence (IND)
4. Accountability (ACC)
5. Responsibility (RES)
6. Fairness (FAI)
7. Social Responsibility & Recognition (SRR)

CGS has been assigned a value of 1 to governance attribute if the company meets minimally acceptable standard on that attribute and 0 otherwise. The answers to these questions are also cross-checked from the information available in public domain. Primary data is used to prepare a Corporate Governance Index (CGI). Corporate Governance Index (CGI) is constructed on the basis of total scores obtained for these qualities.

There are several minimum accepted standards that are met by all companies in the sample. These minimum standards are the mandatory requirements of SEBI Clause 49 on Corporate Governance. Our questionnaire contains 18 such questions and the minimum average score for such minimum accepted standards is 28.1 % (this confirms to SEBI's requirement). On the basis of these scores companies are classified in four quartiles. Companies in top quartile are the companies having score above 80%. These are the companies which have gone beyond the mandatory requirements and moved ahead in pursuit of excellence in corporate governance. Companies in the bottom quartiles are the companies complying with the minimum mandatory standards of corporate governance.

**Hypotheses:** The study tests the following hypotheses to measure the impact of corporate governance on financial performance and valuation. Financial performance has been measured in terms of the important profitability ratios which measure how efficiently financial resources are deployed by the management.

***H<sub>1</sub>: The financial performance of the companies with higher corporate governance score is higher than the financial performance of the companies with lower corporate governance score.***

***H<sub>2</sub>: The financial valuation of the companies with higher corporate governance score is higher than the financial valuation of the companies with lower corporate governance score.***

The financial performance has been judged on the basis of profitability ratios related to investments namely assets, capital employed and equity funds. Accordingly the following three ratios have been computed for three years subsequent to mergers and acquisitions:

ROTA (return on total assets), ROCE (return on capital employed) and ROE (return on shareholders' equity). While ROTA is useful as an overall measure of performance in respect of operating efficiency, return on capital employed (ROCE) manifests how efficiently long-term funds of owners and lenders are used. Return on

ordinary shareholders' equity (ROE) indicates the return provided to the common shareholders.

We have calculated ROTA, ROCE, and ROE as per equations 1 to 3 respectively.

ROTA=

$$\frac{\text{Earning After Taxes (EAT)} + \text{Interest} - \text{Tax Advantage on Interest}}{\text{Average Total Assets}} \dots (1)$$

ROCE=

$$\frac{\text{EAT} + \text{Interest} - \text{Tax Advantage on Interest} - (\text{Interest} / \text{dividends received} - \text{Taxes paid})}{\text{Average Capital Employed}} \dots (2)$$

$$\frac{\text{EAT} - \text{Preference Dividend}}{\text{Average Total Shareholders' Fund}} \dots (3)$$

Shareholders fund comprises shareholders capital plus reserves and surplus minus accumulated losses; Capital employed is the sum of shareholders funds and long term liabilities.

To test the relationship between corporate governance score and financial valuation, we have measured Price to book ratio (PB) and Price earning ratio (PE)

We have also checked the significance of difference of these ratios for the top and bottom quartiles.

#### **IV Empirical Results**

A survey of 93 companies was conducted to construct a corporate governance index. Corporate governance score has been calculated for each attribute individually and this score has been used to rank the companies. We then classify companies, using quartiles based on their corporate governance score, into four governance portfolios. Mean average score for the sample is 57.1 per cent. Table 3 shows that nearly 25 per cent companies in the sample had scores below 50 per cent. Mean average score for the sample is 56.9 per cent.

**Table 3: Mean Corporate Governance Score of Sample Companies (Quartiles-wise)**

Quartile	Mean Corporate Governance Score(CGS)	Number of Companies (N)
Top Quartile( Q <sub>1</sub> )	73.5%	23(24.7%)
Q <sub>2</sub>	62.9%	24(25.8%)
Q <sub>3</sub>	53.7%	22(23.7%)
Bottom Quartile (Q <sub>4</sub> )	37.9%	24(25.8%)
Sample	56.9%	93(100%)

Table 4 describes the average of three year post mergers and acquisition performance and valuation ratios for four quartile based on corporate governance scores.

**Table 4: Corporate Governance Ranking and Financial Performance**

Quartile Corporate Governance Ranking	Percentages			Ratios	
	ROCE	ROE	ROTA	PB	PE
Top Quartile( Q <sub>1</sub> )	39.7	28.9	15.9	6.57	25.34
Q <sub>2</sub>	26.75	23.16	13.68	4.23	21.20
Q <sub>3</sub>	17.67	14.17	9.03	2.66	19.55
Bottom Quartile (Q <sub>4</sub> )	8.4	3.09	5.36	1.71	6.66
Average of sample	23.34	17.47	11.06	3.78	18.71

**Post M&A Return on Capital Employed (ROCE):** The three year Post M & A average return on the capital employed for the sample companies is 23.34 percent while the companies in upper quartile have an average return of 39.7 percent which is significantly higher than the average ROCE of companies in lower quartile. Companies in the lower quartile have average ROCE of 8.4 percent.

**Post M&A Return on Equity (ROE):** The three years Post M & A average ROE for the sample companies is found to be 17.47 percent whereas the ROE for the top quartile companies is 28.9 percent but in the lower quartile ROE is 3.09 percent.

**Post M&A Return on Total Assets (ROTA):** The three year Post M & A average return on the total assets for the sample companies is 11.06 percent while the companies in upper quartile have an average return of 15.9 percent which is

significantly higher than the average ROTA of companies in lower quartile. Companies in the lower quartile have average ROCE of 5.36 percent.

To test the hypothesis  $H_1$  i.e. *the financial performance of the Companies with higher corporate governance score is higher than the financial performance of the Companies with lower corporate governance score*. We have conducted T test for the difference of mean for ROCE, ROE and ROTA for top quartile ( $Q_1$ ) and bottom quartile ( $Q_4$ ). Table 5 reveals the results.

**Table 5: Test Statistic Difference of Means for Performance Ratios**

Ratio	Mean difference	T	Standard error difference	Degree of freedom	95 % confidence interval of difference	
					Lower	Upper
ROCE	31.2	6.4*	4.8	45	21.5	41.1
ROTA	10.1	4.27*	2.5	45	5.6	15.6
ROE	25.9	4.8*	5.3	45	15.1	36.5

\* Significant at 1 per cent level

T statistics for difference of means rejects the null hypothesis of no difference between the financial performance of companies in top quartile and companies in bottom quartile. We can conclude that companies having higher corporate governance score shows better financial performance on the basis of all measures of rate of return.

**Table 5: Test Statistic Difference of Means for Valuation Ratios**

Ratio	Mean difference	T	Standard error difference	Degree of freedom	95 % confidence interval of difference	
					Lower	Upper
PE	17.9	4.7*	3.7	45	10.3	25.5
PB	4.7	4.5*	1.04	45	2.6	6.8

\* significant at 1 per cent level

Companies with higher CG score enjoy premium valuations as revealed by higher PB and PE ratios which may be due to their better financial performance. Table 5 presents the ‘t’ statistics for valuation ratios. On the basis of the results we reject the null hypothesis and accept the alternative hypothesis  $H_2$  that financial valuation of the Companies with higher corporate governance score is higher than the financial valuation of the Companies with lower corporate governance score. We may conclude that companies with higher corporate governance score shows better valuations.

## Concluding observations

The present study concludes that companies with higher rank for corporate governance score are good performers which are revealed from better financial ratios. Their post M& A better financial performance and valuation shows that good governed companies bring positive synergies from their M& A activities which is recognized by market as evidenced by higher valuation ratios.

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