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Editorial

'Prising' out good corporate governance

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The recent worldwide accounting scandals, have underscored the role of corporate governance in protecting the interests of investors. However, the growing awareness of corporate governance has also made it more difficult to define good governance. The complexities behind corporate governance arise on account of two reasons. First, it is the multi-disciplinary nature of the subject. Among other disciplines, Accounting, Financial economics, Law, Philosophy and Political Science have linkages with corporate governance. The diversity of disciplines involved makes it difficult to arrive at one single measure of corporate governance. The second factor is cultural diversity. Anglo-Saxon countries such as the US and the UK equate corporate governance with firms pursuing the interests of shareholders. Whereas in countries like Japan, Germany, and France, corporate governance is concerned with the interests of a wider set of stakeholders, including employees, customers and shareholders.

We need a reasonably accurate way to measure corporate governance if we want to improve the standards of corporate governance in the country. We feel that in today's market economy, notwithstanding some limitations, it is market reactions which provide the best measure of corporate governance. The way markets react to information about the company tells a lot about corporate governance. Market reactions, to put it short, depend on the quality & timeliness of disclosures.

Even from a larger societal point of view, companies must make timely disclosures to the investing public, to facilitate reasonably quick if not immediate adjustment of share prices. Otherwise, there will be mispricing of shares. Mispricing is bad for society because it leads to sub-optimal capital structures resulting in inefficient usage of scarce resources. Consequently, there is lower social welfare. Thus, a company with overpriced shares, attracts more equity capital than that requires from investors, while one whose shares are underpriced, attracts less than it needs. In both cases, the economic resources are being diverted to less optimal uses.

We believe that regulators, market structure/ design and market participants have an equally important role to play in ensuring instantaneous adjustment of stock prices to information. If we assume that most of the mispricing is due to poor corporate governance, the following hypotheses must hold good.

1. Good governance companies should have less mispricing compared to bad governance

companies.

2. Good governance companies should have less private information, information that only they have but not the general investing public, before events than bad governance companies.

3. Good governance companies should have lower volatility compared to bad governance companies. Such companies should be making timely disclosures thereby ensuring that the stock price does not overshoot or undershoot the intrinsic value significantly.

We decided to test these hypotheses in case of some leading Indian companies. We used Standard and Poor's (S&P) corporate transparency rating of Indian companies as the basis for identifying good and bad governance companies. S&P ranking which covers around 50 Indian companies, takes into account, corporate structure and investor relations, transparency and information disclosure and management structure and processes.

While companies make announcements about various events, we have selected four such events which vary with respect to the nature of information, private or public: (1) Dividends, (2) Merger/takeovers, (3) Preferential allotment and (4) Sale of assets.

Dividends have a higher degree of public information than private information. This is because analysts follow dividend announcements closely and information on historical trends is easily available. Mergers / takeover events due to their price sensitivity have more private information. But some analysts may come across signals prior to merger / takeover announcements by tracking prospective companies' interactions. The remaining two events namely, preferential allotment and sale of assets, due to their very nature, have the highest degree of private information.

According to theory, bad governance companies should exhibit more mispricing than good governance companies during these four events. The mispricing should be more if the event has a higher degree of private information than public information. Good governance companies should not exhibit any abnormalities in case of both events.

We tested these hypotheses by examining the reaction of the markets when companies make announcements about important events. We found that in India, the average mispricing is low for good governance companies compared to bad governance companies. However, we also found that good (bad) governance companies are heavily overpriced (underpriced) during event announcements. We also found that over pricing in good governance companies is significantly high if the nature of information is more private than public. Whereas bad governance companies experience significant underpricing if the nature of information is more public than private.

Our research reveals that good governance companies are highly overpriced during the sale of assets and preferential allotment events. On the other hand, bad governance companies are highly underpriced for the same events. The level of over/under pricing is not that high for merger/takeover and dividend announcements. In support of this evidence, we find that there is more private information before the announcement of sale of assets and preferential allotment events for good governance companies.

All this goes to show that despite the efforts made by many leading Indian companies to improve corporate governance, we have still a long way to go. Even our best governed

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companies need to improve their disclosures. They have to do much more to minimize private information, by making disclosures on a timely basis. Only then will mispricing be minimized, if not eliminated. Regulators and market analysts, by constantly monitoring how the markets are responding to announcements of events by companies, can create the necessary pressure for improving disclosures and consequently corporate governance. Indeed, this may be as if not more effective, than the numerous committees which have been set up to streamline corporate governance practices in India .

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