



**EXTERNAL CORPORATE GOVERNANCE MECHANISMS:
MERGERS AND ACQUISITIONS ON THE BRAZILIAN MARKET**

**MECANISMOS EXTERNOS DE GOVERNANÇA CORPORATIVA:
FUSÕES E AQUISIÇÕES NO MERCADO BRASILEIRO**

**MECANISMOS EXTERNOS DE GOBIERNO CORPORATIVO:
FUSIONES Y ADQUISICIONES EN EL MERCADO BRASILEÑO**

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ABSTRACT

The research aims to answer the following question: What is the effectiveness of mergers and acquisitions in the Brazilian market as external corporate governance mechanism? The main objective of the study is to verify if mergers and acquisitions operations in Brazilian market may act as an external mechanism of corporate governance, replacing managers and, as a

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consequence of changes in management, improving financial performance. The study is exploratory, qualitative in its approach, supported by documentary research on secondary data concerning an intentional sample of Brazilian companies aiming to identify the effect of M&A operations on the corporate governance structure of the acquired firm and on its financial results. Data obtained on the website of the Brazilian Securities and Exchange Commission (CVM), related to Brazilian M&A operations in the period 2005-2010, were analyzed. Although M&A operations in Brazil were found to have disciplinary nature in our sample of firms in the studied period, our results are inconclusive regarding the effectiveness of these transactions and external governance mechanisms.

Key words: mergers and acquisitions; external mechanisms; corporate governance.

RESUMO

A pesquisa busca responder o seguinte questionamento: Qual a efetividade das operações de fusões e aquisições no mercado brasileiro como mecanismo externo de governança corporativa? O objetivo geral do estudo é verificar se as operações de fusões e aquisições no mercado brasileiro funcionam como mecanismo externo de governança corporativa, mudando a gestão das firmas adquiridas impactando positivamente nos seus resultados financeiros. Trata-se de estudo exploratório, de abordagem qualitativa, suportada por pesquisa documental em dados secundários referentes a amostra intencional de empresas brasileiras visando identificar o efeito das operações de fusões e aquisições sobre a estrutura de governança da empresa adquirida e sobre seus resultados financeiros. Foram analisados dados obtidos no *website* da Comissão de Valores Mobiliários (fatos relevantes), referentes a processos de fusões e aquisições de empresas brasileiras realizados no período 2005-2010. Os resultados obtidos apesar de evidenciarem a natureza disciplinadora das aquisições envolvendo empresas brasileiras no período 2005-2010, não são conclusivos no que se refere à efetividade dessas transações como mecanismos externos de governança.

Palavras-chave: Fusões e Aquisições; Mecanismos Externos; Governança Corporativa.

RESUMEN

La investigación trata de responder a la siguiente pregunta: ¿Cuál es la efectividad de las fusiones y adquisiciones en el mercado brasileño como mecanismo de gobierno corporativo externo? El objetivo general del estudio es verificar si las fusiones y adquisiciones en el mercado brasileño función como mecanismo de gobierno corporativo externo y si el cambio de la gestión de las empresas adquiere un impacto positivo en sus resultados financieros. Se trata de un estudio exploratorio con abordaje cualitativo, con el apoyo de la investigación documental en los datos secundarios procedentes de una muestra de conveniencia de las empresas brasileñas para identificar el efecto de las fusiones y adquisiciones en la estructura de gobierno y en los resultados financieros de la sociedad adquirida. Se analizaron los datos obtenidos en el sitio web de la Comisión de Valores (hechos relevantes), relativa a las fusiones y adquisiciones de las empresas brasileñas en el período 2005-2010. Los resultados a pesar de la demostración de la naturaleza disciplinar de adquisiciones de las empresas brasileñas en el período 2005-2010, no son concluyentes respecto a la efectividad de estas operaciones y mecanismos externos de gobernanza.

Palabras clave: Fusiones y Adquisiciones; Mecanismos Externos, Gobierno Corporativo.

1. INTRODUCTION

In capitalist economies the phenomenon of company mergers and acquisitions (M&A) is inherent to the competitive environment and associated with capital market development, especially with regard to corporate financing.

According to Jensen (1988), the observed increase in M&A since the 1980s is the result of several factors: (a) the deregulation of the financial markets; (b) the greater availability of professionals capable of structuring and conducting the sale/purchase of corporations; (c) the loosening of restrictions on mergers; and (d) the demand for greater efficiency associated with a more integrated and competitive economic environment.

The most recent boom in mergers occurred in the US in the year 2000, involving transactions to the tune of USD 1.7 trillion. During such booms, company executives are hard pressed to identify potential target firms, or concerned about the possibility of their own companies being taken over (BREALEY; MYERS; ALLEN, 2008).

The Asian M&A market has also experienced considerable growth. Zou and Simpson, (2008) reported that M&A processes rose from USD 8 million in 1990 to more than USD 11 billion in 2006.

Following the global tendency, the volume of M&A processes has increased in Brazil as well, especially after the economic stabilization achieved with the Plano Real. KPMG (2010) registered over 3,200 M&A-related transactions in Brazil between 2005 and 2010 but, somewhat surprisingly, little research has been published on the subject. According to Kloeckner (1994) and Camargos and Barbosa (2009), the literature on M&A is still under construction. Despite the importance of the phenomenon, few academic and empirical studies have been conducted, and academically the field still lingers in the stage of sustaining theories.

Although M&A operations have profound impacts on the corporate environment and its players (shareholders, staff, suppliers, clients, etc.), the motivations and consequences related to this strategy remain to be more fully explored by scholars.

Studies evaluating the results of M&A strategies have yielded conflicting results, with some observing positive developments (NGUYEN; KLEINER, 2003; MATIAS; PASIN, 2001; CAMARGOS; BARBOSA, 2003; CAMARGOS; BARBOSA, 2009), and others observing negative developments (DICKERSON et al., 1997; ROCHA et al.; 2001).

However, a preliminary analysis of the motivations behind mergers and acquisitions reveals that M&A operations are corporate strategies intended to achieve rapid corporate expansion, penetrate new markets, rationalize production, attain economy of scale and replace inefficient managers, among others.

A good governance structure should make it possible to minimize conflicts of interest between shareholders and executives, thereby reducing agency costs and maximizing company value. One way of achieving this would be to expose the firm to the “corporate control market”, that is, M&A and other forms of control transfer.

Mergers and acquisitions have been associated with corporate governance (CG) since Manne (1965). Over the years, many other scholars have subscribed to this view (SUNDARAM, 2004).

The present study focuses on the replacement of inefficient managers, considering its implications for CG practices, as pointed out by a number of authors, including Grossman and Hart (1980), Jensen (1986b) and Hirshleifer and Thakor (1998).

The research aims to answer the following question: What is the effectiveness of mergers and acquisitions in the Brazilian market as external corporate governance mechanism? The main objective of the study is to verify if mergers and acquisitions operations in Brazilian market may act as an external mechanism of corporate governance,

replacing managers and, as a consequence of changes in management, improving financial performance.

The study is exploratory, qualitative in its approach, supported by documentary research on secondary data concerning an intentional sample of Brazilian companies aiming to identify the effect of M&A operations on the corporate governance structure of the acquired firm and on its financial results.

In the following we present the theoretical framework the methodology adopted, followed by a discussion and analysis of Sections 2, 3 and 4. Finally, in Section 5, we offer our closing remarks and suggestions for further research.

2. THEORETICAL FRAMEWORK

2.1 Company Objectives, Conflicts of Interest and Corporate Governance

According to Jensen (1988), social well-being is maximized when each firm in a given economy maximizes its market value. This view supports the hypothesis that the maximization of shareholder wealth is the policy which produces the greatest social benefit.

Although the assumption that shareholder wealth generates social well-being has been disputed, according to Jensen (1988) it remains valid inasmuch as it is unrealistic to assume that company managers can exclusively favor investors while ignoring the interests of all other stakeholders.

As shown by Jensen and Meckling (1976), Fama (1980), Fama and Jensen (1983), Jensen (1986a) the lack of convergence between the interests of principal and agent is a predominant theme in the literature. The organization must develop mechanisms capable of harmonizing these interests to the benefit of the whole. By maximizing the market value of the firm, managers maximize shareholders' investments and, by the same token, minimize agency costs.

When, by way of contract, company owners entrust a manager with the responsibility of conducting the business of the firm, they expect him/her to pursue the goals established for the organization, namely to maximize shareholder wealth.

According to Jensen and Meckling (1976), the relation between owner and manager is one of agency and may be defined as a contract in which one or more individuals (the principal) hire an individual (the agent) to perform a service for which the delegation of certain powers of decision is necessary.

In modern firms, this principal-agent relationship gives rise to two types of ownership: active and passive. According to Kloeckner (1994), passive ownership is that exercised by the shareholders who, despite being the rightful owners of the firm and the net income, waive their right to management by transferring the power of decision to a third party (manager). Active ownership is that exercised by managers hired by the owners to conduct the business and maximize their wealth.

Ideally, the interests of principal and agent should converge towards a common end, assuming that the prosperity of the one is the prosperity of the other. This, however, is rarely the case in real life. In a review of the literature, Rogers and Ribeiro (2006) identified three major factors responsible for the conflicts between owners and agents: separation between control and ownership, the inexistence of a complete and perfect contract, and the inexistence of a perfect agent.

The separation between control and ownership creates a situation in which managers are easily tempted to act in their own interest, in detriment to the shareholders (BERLE; MEANS, 1932).

The inexistence of a complete and perfect contract is at the heart of Klein's tenet (1983). It goes without saying that no contract can anticipate all possible contingencies and

responses to changes and challenges in the business environment due to their indefinite variability and frequency. Thus, managers have not only the power to take predictable actions but also, ultimately, the residual right to control the firm.

On the other hand, the inexistence of the perfect agent is explained by the fact that, as a result the utilitarianism and rationality of human nature, managers tend to maximize their own interests in detriment to the company's investors (tenet of JENSEN; MECKLING, 1976).

Grossman and Hart (1980) believe that over time the contract between principal (owner/shareholder) and agent (manager) becomes obsolete and unable to ensure managers will maximize the owners' interests, thereby creating a principal-agent conflict. In addition, as pointed out by Jensen (1986b), managers are often affected with "managerial myopia", meaning they prioritize short-term results in detriment to the creation of long-term shareholder wealth.

According to Jensen (1986a), the allocation of free cash flow is a source of conflict between managers and owners, as for example when a choice has to be made between the distribution of a large part of the cash flow to shareholders and the acquisition of a new firm, especially when the latter does not result in the creation of value for the owners of the acquiring firm.

However, in modern corporations another type of agency conflict may be observed involving majority and minority shareholders. As explained by La Porta *et al.* (1998), the concentration of ownership in the hands of a small number of individuals can cause wealth to be further transferred from minority to majority shareholders. The authors base their claim on a study involving 49 countries, the results of which show that ownership concentration is negatively related to the protection of shareholder rights and that firms in countries in which the legal system protects the rights of minority shareholders tend to display a greater dispersion of ownership and greater market value. They also found that the quality of the CG systems and the level of legal investor protection influence ownership structure, dividend policies, share prices and the availability of external resources.

Similar conclusions about the relation between ownership concentration, the nature of the legal environment and corporate mechanisms of investor protection, regardless of size, were reached by Shleifer and Wolfenzon (2000) and by John and Kedia (2002).

The existence of principal-agent conflicts, whether it be between owners and managers or between majority and minority shareholders, leads to suboptimal corporate arrangements marked by loss of efficiency or high agency costs.

Agency costs correspond to the sum of (a) the costs of monitoring the conduct of managers and (b) loss of efficiency due to the impossibility of a complete solution to the conflicts between owners and managers (JENSEN; MECKLING, 1976; JENSEN, 1988).

Good CG practices can reduce the risk of principal-agent conflicts and attenuate the negative effects of already existing conflicts. The view of CG as a set of values, principles and internal and external mechanisms designed to minimize agency costs and, consequently, maximize shareholder returns, is shared by several scholars, including Jensen and Meckling (1976).

In view of this definition of CG, it is possible to understand the importance of the CG mechanisms designed to harmonize the interests of executives and shareholders.

Morck, Shleifer and Vishny (1988) indicated three CG mechanisms intended to monitor and control the performance of managers (therefore, indirectly, company results): internally precipitated management turnover, hostile takeover and friendly takeover.

CG systems feature certain internal and external mechanisms, the purpose of which is to minimize agency conflicts. In an empirical study, Agrawal and Knoeber (1996) evaluated the performance of firms and the way they deal with agency problems between managers and

shareholders. The authors identified three such external mechanisms (debt policy, the external managerial labor market, the corporate control market) and four internal mechanisms (insider shareholding, institutional shareholding, blockholding, use of outside directors).

In their analysis of the determinants and effects of internal CG mechanisms in 81 US firms on the list of Fortune 500, Rediker and Seth (1995) used the following categories: a) threat of takeover, b) external labor market, c) ownership structure, d) board of directors, e) organizational structure, and f) mutual monitoring. The authors found that in large corporations CG standards are maintained regardless of performance, whereas standards are often changed in smaller firms when results are negative. Many different combinations of mechanisms may be used to harmonize the interests of agents and shareholders, for example combinations between monitoring by outside directors, incentive stock options for managers, and mutual monitoring by inside directors and owners.

Hart (1995) proposed five types of control mechanisms: board of directors, proxy fights, large shareholders, hostile takeovers and financial structure. The board is important in that it appoints the agent and monitors the relations between the shareholders and other stakeholders, thereby exercising both endogenous and exogenous functions. A proxy fight is a situation when dissident shareholders are persuaded to join forces to win a corporate vote (it may also be used to correct a situation of reckless management or simply to maintain the status). Larger shareholders have greater influence on major corporate decisions. Hostile takeovers allow investors to obtain a large reward by buying all the shares of an underperforming company and installing new management. The management of the firm's capital structure adds visibility to the company value and the shareholders can define the level of monitored debt.

The purpose of control mechanisms is to protect shareholders and minimize potential conflicts of interest. Denis and McConnell (2003) classified CG mechanisms into internal mechanisms (the board of directors and ownership structure) and external mechanisms (M&A market and legal environment).

According to Morck, Shleifer and Vishny (1988), a takeover is hostile when the acquirer bypasses the board and makes the initial bid directly to the shareholders, or when the bid is not accepted by the board and the acquirer engages in proxy fighting to get it approved. In contrast, takeovers are friendly when discussed in the absence of an external threat and accepted by the board.

Monitored debt and the M&A market are considered external CG mechanisms by other authors as well, including Jensen (1988) and John and Kedia (2002).

In the opinion of Sundaram (2004), corporate governance is much more than the relationship between the firm and its capital providers, and CEOs and boards are involved in a much wider range of issues.

2.2 Acquisition as a Corporate Governance Mechanism

The role of the capital market as CG mechanism, especially by way of the acquisition of corporate control, has been investigated by several authors. Thus, Weisbach (1993) made two seminal propositions relating CG to M&A: a) one of the reasons for hostile takeovers is the replacement of managers who are not prioritizing the maximization of shareholder wealth, and b) certain CG structures lead to better business results than others, the difference being related to specific variables (board composition, remuneration policies, etc.).

The probability of a company becoming the target of an acquisition is inversely proportional to its business performance. The latter is to a large degree influenced by the CG practices adopted. In other words, based on Weisbach's propositions (WEISBACH, 1993), acquisitions are prone to occur when the internal CG mechanisms fail to ensure the maximization of shareholder wealth.

Other authors, including Fama and Jensen (1983) and Coughlam and Schmidt (1985), believe the effectiveness of this CG mechanism is associated with two major factors: the nature of the problems faced by the firm and the level of influence and power of the company directors.

Morck, Shleifer and Vishny (1988) suggest that when performance is poor due to a crisis in the industry or sector to which a firm belongs, an external element or power must take on the task of implementing the changes required to maximize shareholder wealth. The authors also believe that the ability of the board to effectively monitor and control management is inversely proportional to the influence and power exercised by the directors and that only complete changes in management have a disciplining effect (partial changes are perceived as part of the ordinary process of managerial succession). Acquisitions related to wealth maximization is rewarding for managers as well, not only for pecuniary reasons, but also due to the perspective of increased power and status (MORCK; SHLEIFER; VISHNY, 1988).

In an analysis of the relation between CG and M&A, Shivdasani (1993) found hostile takeovers to be less likely the more independent outside directors are and the more stock is owned by affiliated blockholders. Also, hostile takeovers tend to be disciplining, while friendly takeovers are primarily intended to capture synergies and economies of scale and scope.

Scharfstein (1988) and John and Kedia (2002) looked into how the M&A market works to discipline the conduct of managers and identified a number of determinants, especially shareholder concentration (the more diffuse, the more effective) and statutory provisions raising share prices in the case of a takeover (limiting the effectiveness of the M&A market as an external CG mechanism).

Kloeckner (1994) proposed to classify the motivations behind M&A operations into four categories: (a) general issues, (b) horizontal and vertical mergers, (c) conglomerate mergers, and (d) managerial issues. The author classifies the substitution of inefficient managers in the category of managerial issues, in support of the disciplining effect of M&A operations (KLOECKNER, 1994).

Based on the studies reviewed up to this point, the relation between M&A and CG may be summed up as follows:

- Firms with poor financial performance are more likely to undergo a complete substitution of managers (especially if they belong to sectors not affected by economic crisis);
- Hostile takeovers tend to occur in firms in problematic sectors, with poor financial performance;
- Friendly takeovers do not appear to be associated with poor financial performance or specific sectors, but rather with factors like the capture of synergies;
- The board of directors cannot ensure the maximization of shareholder wealth if, when faced with poor performance due to sector problems, it is unable to replace the managers. In such situations, hostile takeovers, acting like an external CG mechanism, are more efficient at disciplining corporate managers;
- Defensive attitudes and measures taken by managers against takeovers are detrimental to the interests of the owners of the target firm.

An analysis of the M&A literature reveals a set of non-systematized explanations based on firm and agency theory, in an attempt to provide a theoretical-conceptual framework for understanding the phenomenon. However, studies are mostly focused on the identification and measurement of the effects of M&A operations on corporate performance, while the discussion on the disciplining role of acquisitions has been given very little attention, especially in Brazil.

In order to contextualize the present study within the body of research on M&A, especially with regard to M&A as a CG mechanism, we will now briefly go over eight studies relevant to the Brazilian corporate market:

- According to Jensen and Ruback (1983), in most cases target firms raise share prices by 16-30 % when a bid is announced. Usually, target firms obtain a 10% average return from merger negotiations. The return is not always positive for the acquirer at the time the bid is announced, but varies considerably over time.
- Kloeckner (1994) analyzed the factors motivating M&A operations, describing several categories of factors and indicating literature references and theories associated with each, along with a summary of studies by other authors regarding the effect of takeovers on the prices of both acquirer and target firm. Most of these studies found that share prices in target firms increase, supporting the hypothesis that acquisitions help discipline the managers of poorly performing firms.
- Matias and Pasin (2001) also analyzed the factors motivating acquisitions, and evaluated the performance of 25 firms acquired between 1995 and 1997 in order to detect M&A-related improvements in performance, especially in terms of cost/expense reduction. The study found positive effects attributed by the authors to operational synergies.
- Camargos and Barbosa (2005) discussed the theoretical aspects, principles and motivating factors of M&A operations. Based on the economic-financial literature, the authors formulated empirically testable hypotheses and reviewed studies in the field. In conclusion, the observed M&A processes yielded contradictory empirical results, making it impossible to confirm the hypotheses. According to the authors, this indicates the need for further studies, especially covering the Brazilian capital market due to its lack of tradition and information on M&A operations.
- Rogers and Ribeiro (2006) analyzed CG mechanisms in Brazil, with focus on the M&A market, and reviewed a number of comparative analyses of corporate performance in firms adopting best CG practices. Despite the relevance of the stated objectives, the authors did not discuss the disciplining function of the M&A market, focusing instead on the performance of firms listed in special CG segments.
- Rocha, Iooty and Ferraz (2001) analyzed the effect of the M&A process on the performance of Brazilian industrial firms acquired in the period 1990-1997. Based on the balance sheets of 120 acquired firms, the authors found no evidence of increased profitability during the two years following the acquisition. However, the fact that the sample contained both private and publicly traded firms constitutes a limitation in the analysis of M&A as a CG mechanism.
- Camargos and Barbosa (2009) looked into 72 M&A operations involving Brazilian firms in the period 1996-2004 to determine whether the transactions resulted in operational synergies and value creation for the shareholders of both parties, and tested for correlations between three measures of value creation to evaluate their relevance as alternative measures of corporate performance. The M&A operations evaluated were found to contribute to the maximization of corporate market value and, consequently, shareholder wealth.
- Nunes and Vieira (2008) reviewed the literature on M&A, contextualized M&A operations within the universe of different corporate strategies and analyzed the main modes of M&A, the steps in the process and the key factors associated with successful and unsuccessful transactions in order to show how results are influenced by M&A-related cultural shock management.

The studies above found positive results associated with M&A operations, especially in terms of value creation (improved efficiency and/or reduced costs and expenses). On the

whole, however, none of the authors explored the question of why certain companies become targeted for acquisition. Little or no attention was given to the role played by inefficient management, that is, to the role of M&A as an external CG mechanism.

In some cases, the managers of the acquiring firm may favor mergers or acquisitions based on erroneous estimates of benefits (ROLL, 1986; MALMENDIER; TATE, 2008).

The association between M&A, CG and corporate performance has been studied internationally, especially in the fields of finance and strategy (JENSEN; RUBACK, 1983, JARRELL; BRICKLEY; NETTER, 1988, ANDRADE; MITCHELL; STAFFORD, 2001). For a summary of U.S. evidence from a managerial perspective, see Bruner (2001); for a summary of the strategic management literature, see Datta, Pinches and Narayanan (1992); for non-U.S. evidence, see Denis and McConnell (2003).

3. METHODOLOGY

The present study was exploratory in that ideas were refined and propositions were made for subsequent research, underpinned by theoretical arguments derived from a careful review of the literature on M&A. According to the procedures adopted it was a documental research supported by secondary data concerning an intentional sample of Brazilian companies aiming to identify the effect of M&A operations on the corporate governance structure of the acquired firm and on its financial results.

For the purposes of this study, we set forth two propositions:

- Acquisitions act as an external CG mechanism, disciplining management and resulting in substantial replacement of the directors of the acquired firms.
- Acquisitions act as an external CG mechanism, leading to improved financial results in the form of greater return on assets as a consequence of changes in management.

Information on acquisitions was retrieved from an online database of the CVM (Brazilian equivalent of the Securities and Exchange Commission) covering the period 2005-2010. The sample did not include acquisitions of companies that were not listed for trading on stock exchanges, nor acquisitions of public companies of which the capital was subsequently closed, since this would not characterize M&A as an external CG mechanism for the reduction of agency problems in the acquired firms. Takeovers of financial institutions were also excluded from the sample since such operations are usually undertaken for prudential reasons related to the maintenance of solvency and creditworthiness of the financial system as a whole.

Control transfer processes were analyzed for a sample of non-financial corporations traded on the BMF&BOVESPA stock market before and after takeover. The listing of the companies incorporated by the purchaser was assumed to be equivalent to the listing of the acquiring firms.

The sampled firms were distributed in two groups: one with firms listed in differentiated BMF&BOVESPA segments of corporate governance (“New Market”, “Level 1” and “Level 2”), and one with firms not listed in any special segment.

The analysis used two main variables: (a) board composition (b) return on assets (total assets/net operating income before interest and taxes).

Information on board composition was obtained from annual reports (IAN) submitted to the CVM by the acquired firms or by the acquiring firms (in the case of incorporation) one year prior to and two years after the acquisition. The acquisition was assumed to be an effective CG mechanism when the CEO and at least 80% of the board members in firms acquired were replaced.

Differences in return on assets between the year prior to the acquisition and the two subsequent years were taken to indicate a relation between the substitution of managers and

improvement of financial results. Improvement was defined as a higher return on equity in the second year after acquisition than in the year prior to acquisition and/or a higher average return on equity for all three years than for the year prior to acquisition.

With the procedures explained above, we intend to verify the effectiveness of M&A operations in Brazil in the period 2005-2010 as an external corporate governance mechanism.

4. RESULTS AND DISCUSSION

Initially, 116 CVM publications containing “relevant facts” regarding M&A operations involving Brazilian firms in the period 2005-2010 were analyzed. Then operations were excluded in which (a) the transaction did not result in control transfer, (b) the transaction involved private firms or firms not traded on BMF&BOVESPA or other securities markets; (c) the transaction led to the closing of the capital of the target firm, or (d) the transaction involved financial institutions.

The adopted criteria for exclusion resulted in the final sample of seven firms of which the control had been acquired (Table 1).

Table 1: Sampled firms.

| Firm | Year of acquisition |
|--------------------|---------------------|
| Brasil Telecom | 2008 |
| Calçados Azaléia | 2007 |
| Globex | 2009 |
| João Fortes | 2007 |
| Light | 2006 |
| Magnesita | 2007 |
| Refinaria Ipiranga | 2007 |

Source: the authors.

The relatively small number of eligible firms may be explained by the characteristics of the Brazilian capital market, especially with regard to ownership composition. Most firms are still controlled by a single individual/family or by a small group of majority shareholders. As argued by John and Kedia (2002), external CG mechanisms are more effective when ownership is dispersed.

In all seven firms, the acquisition process entailed the substitution of the CEO, the most important director of the firm, suggesting that M&A operations do in fact act as an external CG mechanism.

Likewise, a comparison between the directors serving on the board before and after the acquisition shows that board composition was substantially changed as a result of the transaction (by the end of the study period, there were more new than old directors on the boards of all 7 companies), supporting the proposition that M&A operations act as external corporate governance mechanism.

On the whole, the observed changes in board composition of the seven studied companies support our proposition that acquisitions act as an external CG mechanism by disciplining management and this result of our study is supported by authors cited in the literature review such as Fama and Jensen (1983) and Coughlam and Schmidt (1985), which believe the effectiveness of this CG mechanism is associated with the level of influence and power of the company directors; Morck, Shleifer and Vishny (1988) which suggest that only complete changes in management have a disciplining effect.

Table 2 provides information on board composition before and after the acquisition (in accordance with the criteria established in the Methodology section).

Table 2: Acquisitions and board composition in acquired firms.

| Firm | Was the CEO replaced? | Number of directors before acquisition | Number of directors after acquisition | Number of directors replaced/excluded after acquisition | Number of new directors after acquisition | Are there currently more new than old directors? | Did the acquisition have a disciplining effect? (defined as change of CEO + more new than old directors) |
|--------------------|-----------------------|--|---------------------------------------|---|---|--|--|
| Brasil Telecom | Yes | 6 | 5 | 5 | 4 | Yes | Yes |
| João Fortes | Yes | 3 | 5 | 3 | 5 | Yes | Yes |
| Calçados Azaléia | Yes | 7 | 8 | 6 | 6 | Yes | Yes |
| Globex | Yes | 4 | 5 | 3 | 4 | Yes | Yes |
| Light S/A | Yes | 8 | 7 | 7 | 6 | Yes | Yes |
| Magnesita | Yes | 7 | 7 | 7 | 7 | Yes | Yes |
| Ipiranga/ Ultrapar | Yes | 10 | 5 | 9 | 4 | Yes | Yes |

Source: the authors.

It remains to be evaluated whether the acquisitions affected the financial performance of the firms in the sample, using return on assets as proxy. Based on total assets and net operating income before interest and taxes values retrieved from financial statements (DFP) made available online by the CVM, return rates were calculated for shares in the 7 firms covering one year prior to and two years after the acquisition.

As shown in Table 3, acquisitions were only associated with improved financial performance (greater return on assets) in 3 out of 7 firms.

Table 3: Acquisitions and financial performance of acquired firms.

| Firm | Return On Assets (ROA) | | | | Did the acquisition result in better ROA? |
|------------------|------------------------|-------|-------|---------|---|
| | Y-1 | Y1 | Y2 | Average | |
| Brasil Telecom | 10,0% | -4,4% | 10,4% | 5,3% | No |
| João Fortes | 15,9% | 1,9% | 6,0% | 8,0% | No |
| Calçados Azaléia | 18,6% | 37,2% | 36,3% | 30,7% | Yes |
| Globex | 3,3% | 2,8% | 1,6% | 2,5% | No |
| Light S/A | 12,8% | 9,7% | 5,1% | 9,0% | No |
| Magnesita | 4,4% | -0,4% | 13,1% | 5,7% | Yes |
| Ipiranga/ | 8,7% | 4,8% | 8,6% | 7,4% | Yes |

| | | | | | |
|----------|--|--|--|--|--|
| Ultrapar | | | | | |
|----------|--|--|--|--|--|

Source: the authors, based on data retrieved from financial statements (DFP) made available online by the CVM.
Y-1: year before the acquisition;
Y 1: first year after the acquisition;
Y 2: second year after the acquisition.

The information given in Tables 2 and 3 may be combined to analyze the proposition that M&A operations are positively associated with financial performance in the form of return on assets as a consequence of substantial changes in board composition. However, the conflicting findings regarding the financial performance of the acquired firms provided no support for this proposition. Thus, since the effectiveness of CG mechanisms is per definition associated with the maximization of shareholder wealth, the ability of M&A operations to act as an external CG mechanism cannot be conclusively demonstrated.

This result conflicts with that of Camargos and Barbosa (2009) in which the Brazilian M&A operations evaluated were found to contribute to the maximization of corporate market value and, consequently, shareholder wealth.

Despite indicating a disciplining effect on management, the results found for the acquisitions of seven Brazilian public firms in the period 2005-2010 are not conclusive with regard to the ability of M&A operations to act as an external CG mechanism since acquisitions were not invariably associated with improved financial performance. Further studies are necessary to clarify the role of M&A in corporate governance, especially in the M&A-poor Brazilian capital market.

5. CONCLUSIONS

The present study sheds light on a little-explored aspect of acquisitions, namely the role of M&A operations as an external CG mechanism on the Brazilian capital market.

Based on the literature, we reviewed relevant mechanisms of corporate governance, especially external mechanisms, along with the factors associated with their effectiveness, and made two propositions regarding the relation between Brazilian M&A operations registered in the period 2005-2010 and external CG mechanisms.

Very few cases of acquisitions involving firms traded on BMF&BOVESPA or equivalent securities markets were eligible for the study. This suggests that the M&A market is at an early stage of development in Brazil and that, consequently, M&A operations do not currently play as important a role in corporate governance as external CG mechanisms.

The results lend support to one of our propositions: although M&A operations were found to act as an external CG mechanism disciplining management, with replacement of most of the directors, it was not possible to demonstrate a positive association between M&A operations and financial performance (greater return on assets) of the acquired firms.

The present study is not conclusive but makes a contribution towards identifying aspects and issues for further research on the relation between M&A operations and corporate governance. These include the potential association between the level of performance of the sector and the occurrence of acquisitions (testing the applicability to the Brazilian corporate environment of Morck, Shleifer and Vishny's propositions (1988)), the profile of managers of firms targeted for acquisition (testing whether specific manager characteristics increase the likelihood of a takeover), the nature of internal CG mechanisms adopted by Brazilian firms, and several others.

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