CORPORATE GOVERNANCE & VALUE CREATION
- CRISIL’s Perspective

Presentation by
Roopa Kudva
Executive Director and Chief Rating Officer
rkudva@crisil.com
Agenda

- Recent developments in Corporate Governance
  - Well-publicised failures in the US and Europe
  - Areas of failure
  - Governance in India
  - Achievements and shortcomings

- Benchmarking governance practices
  - Conceptual framework: the GVC model
  - Parameters and criteria
Recent Developments

Why has governance become an issue?

Well-publicised failures in the US and Europe
Perspectives on governance in India
Achievements and shortcomings
Well-publicised governance failures

- Governance failures in the US
  - Too numerous to relate

- Governance failures in Europe
  - Royal Dutch Ahold: Accounting irregularities, mainly in its US subsidiary
  - Vivendi: Rapid growth through incautious acquisitions
  - Fimalac: Preferential treatment of favoured Board Member in bonus payments
  - Mannesmann: Preferential treatment of certain executives in bonus payments
  - Parmalat: Accounting irregularities including a forged letter, covering up funds diversion and losses
Areas of failure

- **Accounting**
  - Enron
  - WorldCom
  - Tyco
  - Qwest
  - Merck
  - Mirant
  - AOL
  - FreddieMac
  - Sunbeam
  - Parmalat

- **Compensation**
  - NYSE
  - Vivendi
  - Tyco
  - Fimalac
  - Mannesmann...

- **Control failure**
  - National Century: reckless lending
  - Vivendi: incautious acquisitions

- **Insider trading**
  - ImClone
  - Global Crossing
  - Martha Stewart...
Genesis of Corporate Governance in India

- Voluntary code of Corporate Governance for listed companies - CII - 1998
- Kumar Mangalam Birla committee by SEBI - 2000
- Companies (Amendment Act), 2000 & Clause 49 of listing agreement - 2000
- Naresh Chandra Committee by SEBI - 2002
- Companies (Amendment) Bill of 2003
- N.R. Narayana Murthy Committee - 2003
### Evaluating governance practices - the CRISIL experience

<table>
<thead>
<tr>
<th>Area</th>
<th>Evaluation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equitable Treatment of Shareholders</td>
<td>Moderate</td>
</tr>
<tr>
<td>Transparency and Disclosure</td>
<td>Relatively strong</td>
</tr>
<tr>
<td>Composition of Board</td>
<td>Scope for improvement</td>
</tr>
<tr>
<td>Functioning of Board</td>
<td>Moderate</td>
</tr>
</tbody>
</table>
The CRISIL Experience

- **Shareholder rights and equitable treatment : Moderate**
  - Clearly articulated shareholder rights in public domain
  - Equitable voting rights for all shareholders of a class
  - Advances to group companies
  - 26% shareholding – 50% board nominations
  - PSU Banks – no right to vote on accounts or appoint auditors
The CRISIL Experience

Board Composition: Scope for Improvement

- Independent directors inducted pro-actively, before regulation
- Active Audit Committee in most instances, independently chaired
- Skill set of board members – improving trend
- Definition of Independent directors – Form over substance
  - Ex-employee with 40+ years of service classified as independent
  - Solicitors providing legal services classified as independent
- Long tenures of Board members; no retirement policy/age
- Combined Chairman – CEO position – several instances
- Nominations committee – rarely present
- MNC – empowerment of board in India
The CRISIL Experience

- **Board Functioning**: Moderate
  - Adequate oversight of management
  - Separate strategy session for board – positive trend
  - Independent directors – weak participants
    - Not always able to question related party/group exposures
    - Non-independent stature in reality also affects participation
  - Internal Auditor – not reporting to Audit Committee
  - Performance evaluation of board members – rarely seen
The CRISIL Experience

- Transparency and Disclosure: Relatively Strong
  - Good transparency and disclosure of financial information
  - Good quarterly reporting standards
  - Analyst presentations – Positive trend
  - Related party transactions – regulatory reporting
  - Management discussion and analysis - formality
Evaluating value creation - the CRISIL experience

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Share Holders</td>
<td>High</td>
</tr>
<tr>
<td>Debt Holders</td>
<td>Highest</td>
</tr>
<tr>
<td>Employees</td>
<td>Moderate</td>
</tr>
<tr>
<td>Customers</td>
<td>High</td>
</tr>
<tr>
<td>Suppliers</td>
<td>Scope for improvement</td>
</tr>
<tr>
<td>Society</td>
<td>Scope for improvement</td>
</tr>
</tbody>
</table>
High correlation between shareholder wealth creation and corporate governance

Companies with good governance practices and management quality have favourable credit risk profile

Wealth creation for employees various widely between industries

Customer wealth creation is fairly high while supplier wealth creation needs further improvement

Most companies have a long way to go in wealth creation for society at large
Achievements

- Significant progress in transparency and disclosure by Indian companies
- Revamp of Corporate Boards to induct professionals and non-executive members
- Strong governance practices in companies with listing in overseas markets
- Strong governance practices in companies with high credit quality
Shortcomings

- Governance ..more in form than in content
  - Board structure - role of directors
  - Board functioning - defeats the purpose of structure?
  - Independent directors - are they independent of the company??

- Transparency & Disclosure - more regulatory and less voluntary

- Compliance with corporate governance code - treated as a structure and not as a way of life

- Lack of explicit focus on all stakeholders
How can the shortcomings be overcome?

- Legislation
- Stock Exchanges
- Institutional activism
- Market as a disciplining factor
- Self-regulation
Benchmarking Governance and Value Creation

Using the CRISIL GVC® Methodology

The corporate value chain
Twin foci of benchmarking
The corporate value chain

Each Stakeholder relationship represents:

• A potential opportunity to be leveraged
• A potential threat to sustainable performance
Twin foci of benchmarking

Two foci for analysis of relationships, stakeholder-wise:

- **Value creation and management**
  An analysis of the company’s capabilities in creating, maintaining and managing value, while balancing stakeholder interests

- **Fairness and transparency in dealings**
  Processes in place to ensure fair and equitable treatment of all stakeholders, prevent abuse of power, enable transparent reporting
Measuring value creation and management (1)

Value creation, stakeholder-wise:

- **Shareholders**
  
  Return on invested capital compared to weighted average cost of capital, payout ratio etc.

- **Debt Holders**
  
  High debt protection measures – credit rating; upgrades in ratings etc.

- **Customers**
  
  Market Share; Assessment of Customer satisfaction; Cost savings passed on to customers etc.

(Contd...)
Measuring value creation and management (2)

Value creation, stakeholder-wise: (contd...)

- **Employees**
  Absolute Salary levels, adjusted growth in average annual salaries; ESOPs; Attrition rates; Intangibles etc.

- **Suppliers**
  Relative change in credit terms; Support/Intangibles to suppliers, etc.

- **Society**
  Total direct taxes paid; Employment generated; Expenditure on social infrastructure; Environmental/Social impact cost; Fair practices followed etc.
Measuring value creation and management (3)

Quality of management:
- Success of strategies
- Track record of innovation
- Reputation of management
- Experience of management
- Process Quality
Twin foci of benchmarking

Two foci for analysis of relationships, stakeholder-wise:

- Value creation and management
  An analysis of the company’s capabilities in creating, maintaining and managing value, while balancing stakeholder interests

- Fairness and transparency in dealings
  Processes in place to ensure fair and equitable treatment of all stakeholders, prevent abuse of power, enable transparent reporting
Fairness & Transparency (1)

- Board performance
  - A. Functioning of Board
    - Contribution of independent directors and independence from management
    - Adequate discharge of role by Board
  - B. Composition of Board
    - Independence of board, adequacy of representation of all shareholders
    - Relevant competencies and board compensation
    - Succession policy of board, Nomination committee
    - Processes for induction of board members

- Process – related parameters
  - Ownership concentration and equal treatment of shareholders of each class
  - Adequacy of audit procedures and independence of auditors
  - Impediments to market forces on corporate control
Fairness & Transparency (2)

- Process-related parameters (contd...)
  - Anti-insider trading mechanisms
  - Process for addressing investor grievances
  - Shareholder participation at meetings - ease and effectiveness

- Disclosure – related parameters
  - Extent of disclosure: Quality, timeliness and ease of access to information for all stakeholders
  - Disclosure of disproportionate control provisions and shareholding pattern
  - Disclosures to facilitate shareholder participation at meetings
  - Basic shareholder rights - articulation and documentation
CRISIL GVC Ratings Assigned

<table>
<thead>
<tr>
<th>Company</th>
<th>CRISIL GVC Level</th>
</tr>
</thead>
<tbody>
<tr>
<td>HDFC</td>
<td>Level 1</td>
</tr>
<tr>
<td>HDFC Bank</td>
<td>Level 1</td>
</tr>
<tr>
<td>Hero Honda</td>
<td>Level 1</td>
</tr>
<tr>
<td>Bharati Televentures</td>
<td>Level 1</td>
</tr>
<tr>
<td>Infosys</td>
<td>Level 1</td>
</tr>
<tr>
<td>Dabur India</td>
<td>Level 2</td>
</tr>
<tr>
<td>Kanoria Chemicals</td>
<td>Level 3</td>
</tr>
</tbody>
</table>
Conclusion

- Significant progress in corporate governance in the past 3 years
- However, substantial scope exists in certain areas to reach to the level of global best practices
- Voluntary compliance and self regulation will be the most important tools for achieving excellence
- Companies should assess their strengths and weaknesses and set up a road map to achieve best governance standards
Thank You