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# ***Corporate Governance Ratings / Audit***

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**A presentation  
by ICRA Limited**

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**18th October, 2004**

## *Agenda for discussion*

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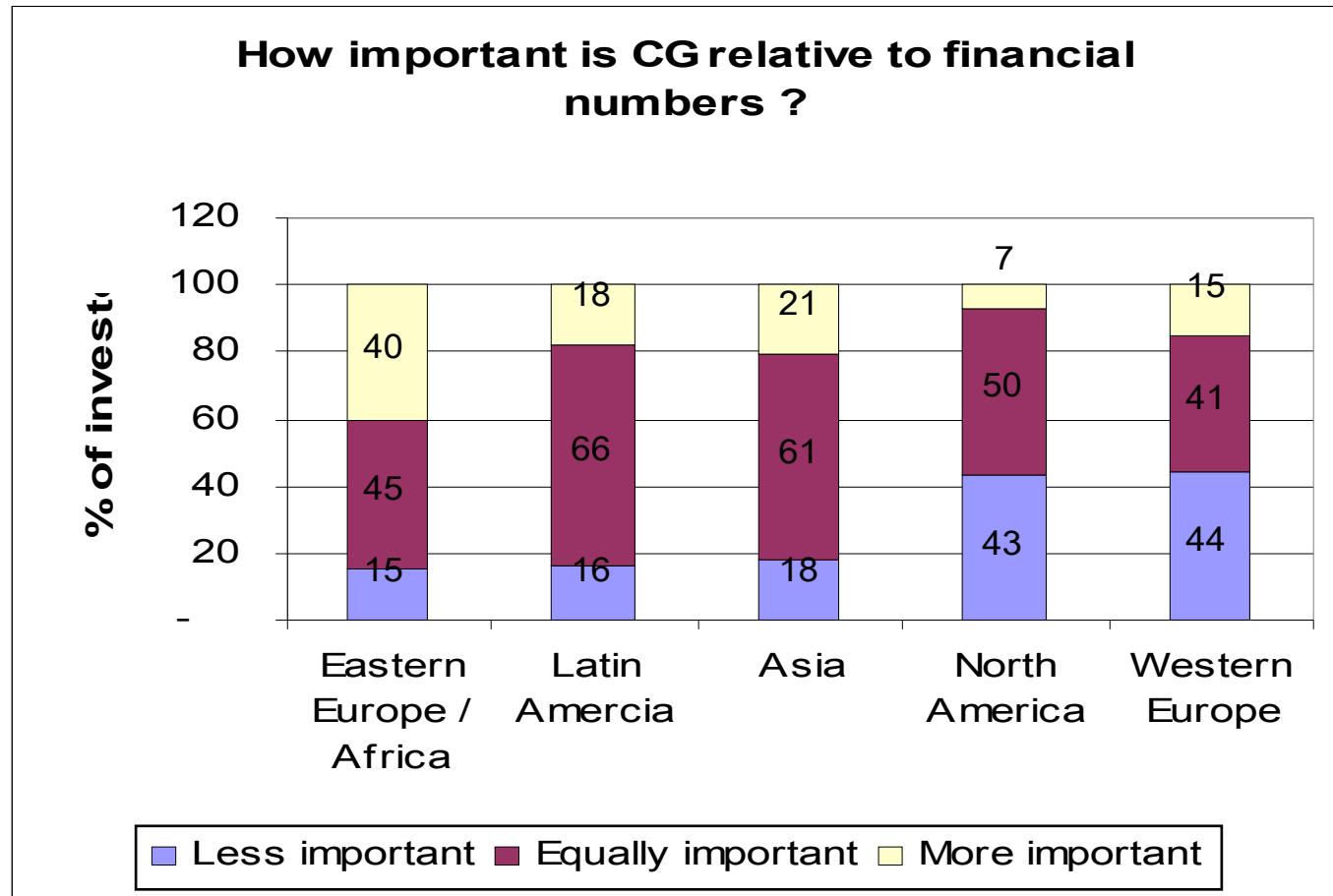
- ◆ **Governance benefits**
- ◆ **Rating framework**
- ◆ **The way forward**

# ***What are the benefits of Corporate Governance ?***

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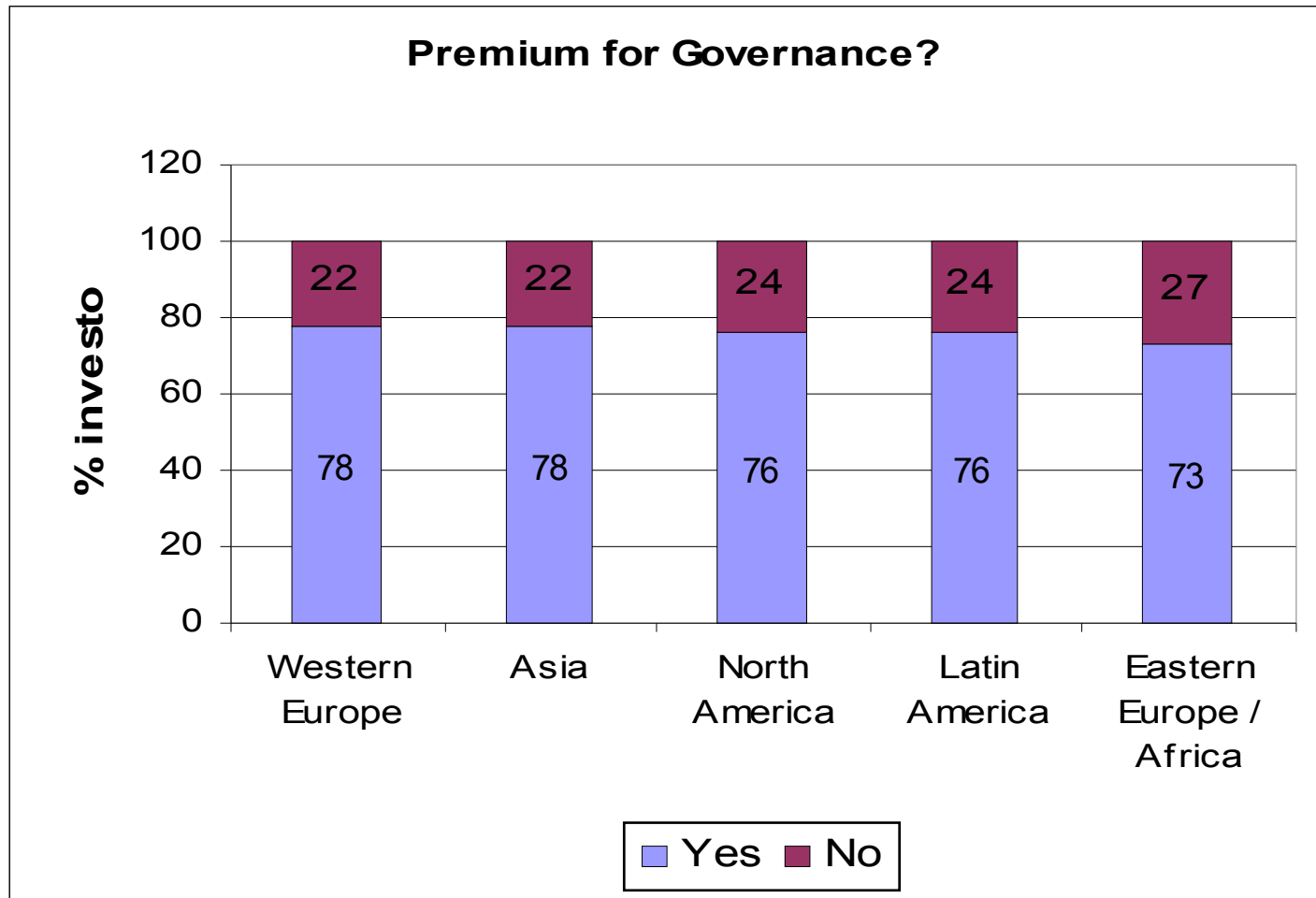
- ◆ Financial theory is yet to establish a linkage
- ◆ Research supports the proposition that ‘good governance enhances value’.
  - Opinion based surveys
  - Research studies linking governance rankings / ratings with performance and value creation
  - CALPERs focus list

# Mckinsey Investor Opinion Survey- June 2002 .... board practices are at least as important as financial performance

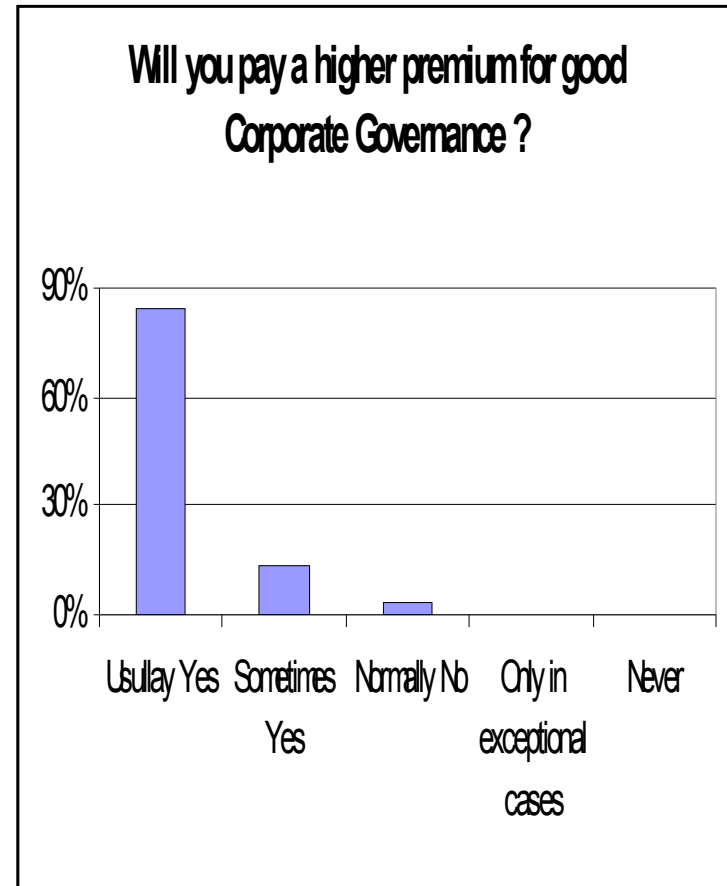
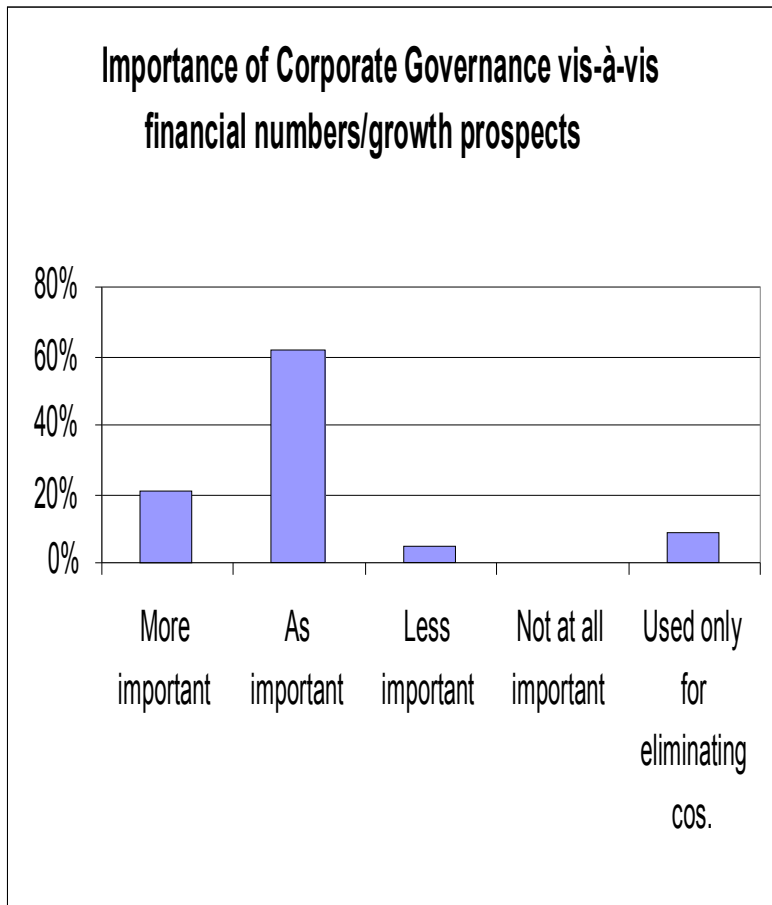


# Mckinsey Investor Opinion Survey- June 2002

----- investors would be willing to pay more for the shares of a well-governed company



# A similar survey carried out by ICRA among domestic fund managers



# ***Research linking governance ranking with stock performance***

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## ◆ CLSA study

- ❑ The April 2003 study showed that over the past five years, high CG stocks (ranked in the 1st quartile) outperformed the Sensex by 169%
- ❑ The out-performance was at over 40% even if one excluded the Software stocks

## ◆ CG and Equity Prices - A Study by Paul Gompers of Harvard Business School and others

- ❑ A 'Governance Index' was calculated for 1500 large firms during the 1990s
- ❑ An investment strategy that bought firms in the decile with strongest CG and sold firms in the decile with lowest CG would have outperformed the index by 8.5% during the period .

# ***Research linking governance ranking with stock performance***

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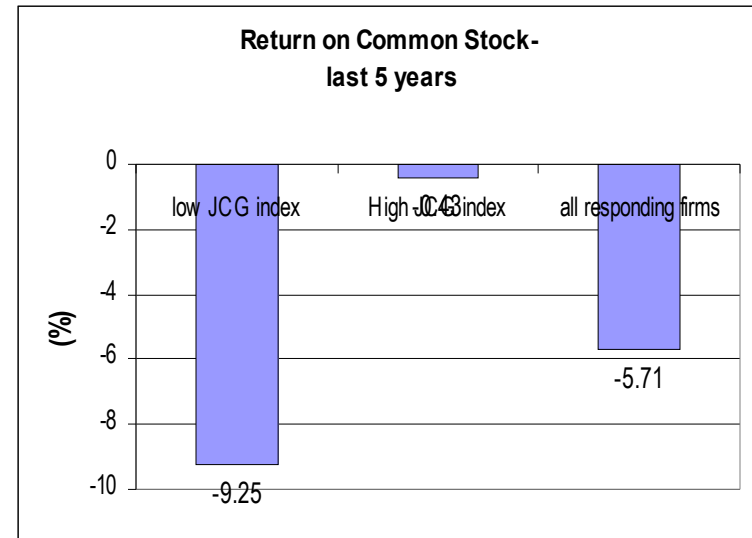
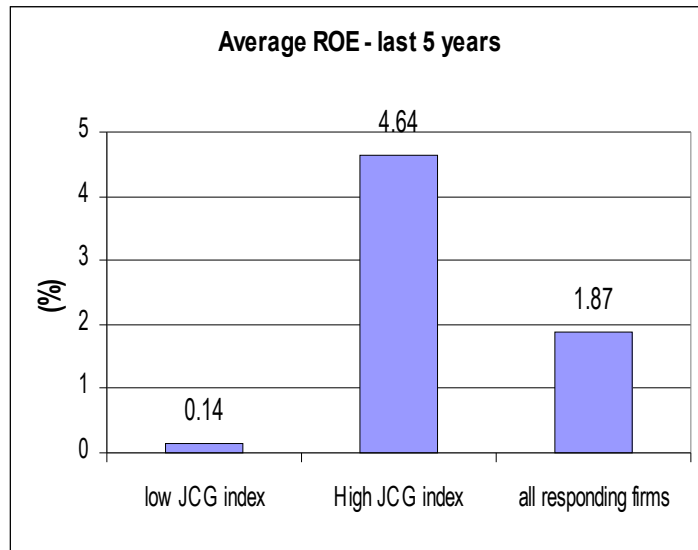
- ◆ **CG and Expected Stock Returns - A Study by Wolfgang Dorbetz , University of Basel**
  - An investment strategy that bought high-CGR firms and shorted low CGR firms would have earned excess returns of 12% compared to the DAX 100 during 1998-2000.
  
- ◆ **Lipper-GMI Mutual Fund Report**
  - The two firms compared the performance and portfolio of 725 large-cap funds against GMI's corporate governance ratings
  - Conclusion : Mutual funds that invest in companies with higher CG ratings have been rewarded with superior returns

# Research linking governance ranking with stock performance

- ◆ Study by Japan Corporate Governance Research Institute. (Data from 2003 report)

The Institute has developed the JCG Index , which measures corporate governance in Japanese firms

Their study found that high JCG Index firms achieved superior performance , as measured by ROA, ROE, Stock Returns etc.



# ***Shareholders Wealth Effect of CALPERS focus list***

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- ◆ California Public Employees Retirement Systems identifies and publishes a Focus list annually ----companies with poor Governance and financial performance
- ◆ CALPERS study showed that there is a significantly positive shareholder impact from the release of CALPERS focus list over the period 1992-2001
  - At 95% confidence, the study found that inclusion in the focus list results in a 5.37% additional return over a 6 month period.

# *Agenda for discussion*

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- ◆ **Governance benefits**
- ◆ **Rating framework**
- ◆ **The way forward**

# What are we trying to do ?

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- ◆ Objectively and independently evaluate the Corporate Governance practices of a company and rank it on a relative rating scale that would facilitate comparison.
- ◆ Overriding emphasis is on ‘Substance’ over ‘Form’
- ◆ The ICRA rating is meant to indicate
  - the extent to which a company adopts and follows such practices and conventions that would provide
  - its stakeholders an assurance on the quality of Corporate Governance practices

# Ratings Approach

- ◆ Primary focus on the **business processes**
  - Strength and integrity of structures , processes, risk management and disclosure standards from a stakeholders perspective
- ◆ The measurable **outcome is also** evaluated
  - No established input-output relation, however consistently poor performance needs to be factored in
- ◆ Emphasis on **substance** over **form** , not a ‘Checkbox’ exercise
- ◆ Involves detailed perusal of documents like Board Notes and Agenda Papers not available in the public domain

# *Key Variables in the Rating Process*

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- ◆ Ownership structure
- ◆ Governance Structure and Management Processes
- ◆ Board Structure and Processes
  - Audit Committee and Risk Management
- ◆ Stakeholder Relations
- ◆ Transparency & Disclosures
- ◆ Financial discipline

***Feedback from Independent Directors a key part of the exercise***

# Accepted ratings so far

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◆ Bank of Baroda	CGR2
◆ Infosys Technologies Limited	CGR1
◆ Wipro Limited	SVG1
◆ ITC Limited	CGR2
◆ Godrej Consumer Products Limited	CGR2
◆ Godrej Consumer Products Limited	SVG2
◆ PNB Gilts Limited	CGR3+
◆ Esab India Limited <i>(Since Withdrawn)</i>	CGR4

# ***Some observations from rating experience....***

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- ◆ Extent of involvement of Independent Directors in evaluating strategic issues vary widely
  - Administrative , routine details are invariably sent to Board
- ◆ Audit Committee seems to be effective and functional
  - However, quality of Risk Management Systems differ greatly
- ◆ Nomination and Compensation Committee role is still evolving
- ◆ Rigorous and structured performance evaluation in some cases ; however linkage between performance evaluation and remuneration is tenuous

# ***Some observations from rating experience....***

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- ◆ Innovative practices seen in some Boards :
  - Evaluation of Board members
  - Board Committees comprised entirely of Independent Directors
  - Independent Directors meeting without executive presence
  - Feedback from Directors on quality of Agenda Papers
- ◆ By and large, companies have adhered to Indian GAAP
- ◆ Disclosure practices range from ‘exemplary’ to ‘complying with statutory minimum’

# *Agenda for discussion*

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- ◆ **Governance benefits**
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# *Some thoughts ....*

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- ◆ The basic essence , ‘**Evaluating Substance over Form**’ needs to be maintained while devising alternative frameworks.
  
- ◆ Key challenge is in evaluating issues like :
  - ❑ Board effectiveness (from outside the board room !)
  - ❑ ‘Independence’ and ‘ competence’ of outside directors
  - ❑ Extent of guidance provided by the board on key challenges facing the company
  - ❑ Focus on ethical practices

# *Some thoughts ....*

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- ◆ Unlike credit ratings, there is no ‘quantitative’ measures for peer comparison
- ◆ A judgmental call, arrived at with sufficient rigour and due diligence, may ,therefore, be unavoidable in some areas



***Thank You***