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Corporate Governance Ratings

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The article focuses on the principles of corporate governance and how rating services affect the companies and the investors regarding the subject. Corporate governance is the concept of applying transparency, shareholder rights and accountability to the entities. In the near future, several rating services were born, influencing investors and companies by grading them on the degree of how well they apply corporate governance principles. Recent studies concluded that performance is directly related to the rating a company receives on corporate governance practices.

"Corporate Governance looks at the institutional and policy framework for corporations - from their very beginnings, in entrepreneurship, through their governance structures, company law, privatization, to market exit and insolvency. The integrity of corporations, financial institutions and markets is particularly central to the health of our economies and their stability."

OECD

In 1997, The East Asian Crisis saw the economies of many countries severely affected by the exit of foreign capital after property assets collapsed. The lack of corporate governance mechanisms in these countries highlighted the weaknesses of the institutions in their economies. The following event was the US corporate crises of which saw the collapse of two big corporations: Enron and WorldCom, and the ensuing scandals and collapses in other organizations such as Arthur Andersen, Global Crossing and Tyco.

In the aftermath of these events, the concept of corporate governance was born. The term can be defined as the set of processes, customs, policies, laws and institutions affecting the way in which a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many players involved and the goals for which the corporation is governed. The principal players of the concept are the shareholders, stakeholders, management and the board of directors.

The key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization. Rights and equitable treatment of shareholders, interests of other stakeholders, roles and responsibilities of the board, disclosure and transparency are the main principles to be followed in adopting effective corporate governance strategies for the companies.

In the near future, the rising importance of corporate governance principles have led to the birth of rating systems and services which have various effects on the rated companies and investors. Beyond influencing the related parties, these ratings also

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impact the value of corporate reputations and the cost of capital for public companies.

Some of the corporate governance rating services are as follows:

- Institutional Shareholders Services (ISS)
- Governance Metrics International (GMI)
- The Corporate Library
- Standard & Poor's (S&P)

Rating services have different scoring systems, grading the companies on scales of 1 to 10 or 100 and the research is performed on a systematic, objective and market oriented process. The rating processes include a review of both public and confidential information and cover key areas such as:

- Ownership structure and external influence
- Shareholder rights and stakeholder relations
- Transparency, disclosure and audit
- Board structure and effectiveness

A company "*Corporate Governance Score*" expresses the rating firm's opinion about the extent to which a company adopts and conforms to codes and guidelines of good corporate governance practices that clearly serve the interests of its financial stakeholders.

A corporate governance service consists of two parts:

Company Score: The effectiveness of the interaction among a company's management, board, shareholders and other stakeholders. This focuses on the *internal* governance structure and processes at an individual company.

Country Governance Classification: The effectiveness of the legal, regulatory informational and market infrastructure. This focuses on how *external* forces at a macro level can influence the quality of a company's corporate governance.

Both these micro and macro components are important to the practice of corporate governance. Specific scoring factors can be identified in order to analyze governance practices and facilitate objective and comparative analysis of corporate governance practices at individual companies. Inclusion of the country analysis enables the individual company scores to be placed in a more international context, facilitating a comparison of country governance environments.

A corporate governance score represents an independent opinion, based upon transparent criteria and a standardized analytical process. It is not an audit, financial advice, nor a recommendation for a specific course of action.

The process involves analysts from the above mentioned firms' governance services and may also include analysts from the firms' affiliates, local law firms and other professionals in corporate governance where appropriate.

In the process of rating, analysts will meet with the management and other officials (including outside/independent directors, shareholders and the company secretary) of the company to be evaluated to discuss the company's corporate governance process based on predetermined criteria. The company will be provided with questions in advance, drafted to reflect their specific environment.

In the end, the company will receive a *Corporate Governance Score* which reflects the opinion of the extent to which a company adopts and conforms to codes and guidelines of good practices of corporate governance overall. A scale of 10 (highest)

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to 1 (lowest) is used, but in contrast, several other rating firms use scales of 1 to 100 for the same purposes.

A deeper look at the analysis and rating process will reveal four main components, and their sub-categories, to evaluate the corporate governance standards of individual companies.

These four components, and the sub-categories, are as follows:

Component 1 - Ownership Structure

Sub-categories:

Transparency of ownership structure:

Criteria:

- There should be adequate public information on the company's ownership structure, including, where relevant, information on beneficial ownership behind corporate nominee holdings.
- The company's actual ownership structure should be transparent, and should not be obscured by cross-holdings; management controlled corporate holdings, nominee holdings, etc.

Concentration and influence of ownership:

Criteria:

- If large blockholders exist, these should not exert influence that is detrimental to the interests of other stakeholders. Minority shareholders should be protected against loss of value or dilution of their interests (e.g. through capital increases, from which some shareholders are excluded, or through transfer pricing with connected companies).
- Concentration of economic interests and influence of controlling shareholders of the parent/holding company on independent board/management action should not occur through block holdings of key operating subsidiaries and through effective control of key customers and suppliers.
- Shareholders should not be disadvantaged by management and insider shareholders who are shielded from accountability.

Component 2 - Financial Stakeholder Relations

Sub-categories:

Regularity of, access to, and information on shareholder meetings:

Criteria:

- The processes and procedures used for advising shareholders of general meetings should provide for equal access of all shareholders and should ensure that shareholders are furnished with sufficient and timely information.

Voting and shareholder meeting procedures:

Criteria:

- Shareholders representing at least 10% of the voting rights should be able to call a special meeting and shareholders should have opportunities to ask questions of the board during the meeting and to place items on the agenda beforehand.
- A shareholders' assembly should be able to control decisions through processes that ensure participation by all shareholders.

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Ownership rights:
Criteria:

- There should be secure methods of ownership of shares and full transferability of shares.
- A company's share structure should be clear and control rights attached to shares of the same class should be uniform and easily understood.
- A shareholders' assembly should be able to exercise decision rights in key areas, ensuring that minority shareholders are protected against dilution or other loss of value (e.g. through related party transactions on non-commercial terms)
- All shareholders should receive equal financial treatment including the receipt of an equitable share of profits.

Component 3 - Financial Transparency and Information Disclosure
Sub-categories:
Quality and content of public disclosure:
Criteria:

- Financial reporting and disclosure should be clearly articulated and completed to a high standard.

Timing of, and access to, public disclosure:
Criteria:

- All publicly disclosable information should be promptly available and freely accessible to the investment community and shareholders. Public disclosure is a function of internal transparency and effective internal control policies.
- The company's by-laws, statutes and/or articles should be clearly articulated and readily accessible to all shareholders.
- The company should maintain a website and make company reports, summary reports and/or other investor relevant information available in both local the language and English.

Independence and standing of the company's auditor:
Criteria:
Auditors should be independent of the board, management, the company's performance, and objectives. They should also be reputable.
Component 4 - Board Structure & Process
Sub-categories:
Board structure and composition:
Criteria:
A board should be structured in such a way as to ensure that the interests of all the shareholders may be represented fairly and objectively.
Role and effectiveness of the board:
Criteria:

- The board should bear overall accountability for the performance of the company.
- The board should be ultimately responsible for the system of internal risk control at a company.

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Role and independence of outside directors:
Criteria:

- A significant proportion of the non-employed directors should be truly independent and act as such. Independent or outside directors should ensure that the long-term interests of all shareholders are represented and that the interests of other stakeholders are duly taken into account.
- Directors should be elected under a transparent system in which they are not able to participate.

Directors and executive compensation, evaluation and succession policies:
Criteria:

- Directors and executives should be fairly remunerated and motivated to ensure the success of the company.
- There should be a clearly articulated performance evaluation and succession policies/plans for employed directors of the company.

After the ratings have been given and through the various levels of reporting, clients can assess, position, compare and study corporate governance in depth. The most significant uses of the reports are to advise investors on matters being voted on, effect corporate change by recommending improved governance standards, and to serve as an evaluation tool for prospective investors so that future financial returns can be improved. Adversely, low ratings can increase the cost of capital by reducing the share price and encourage shareholder activism.

External studies have also conducted that there is a link between well governed companies and long term performance, a reduced cost of capital and equity risk. According to a global investor opinion survey conducted by McKinsey, an overwhelming majority of investors have been willing to pay a premium for well governed companies. This premium differs between countries and regions.

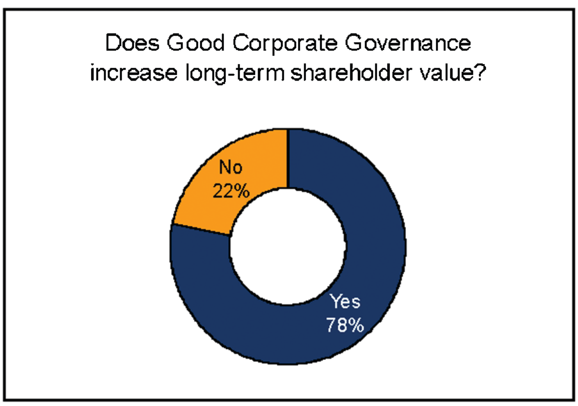
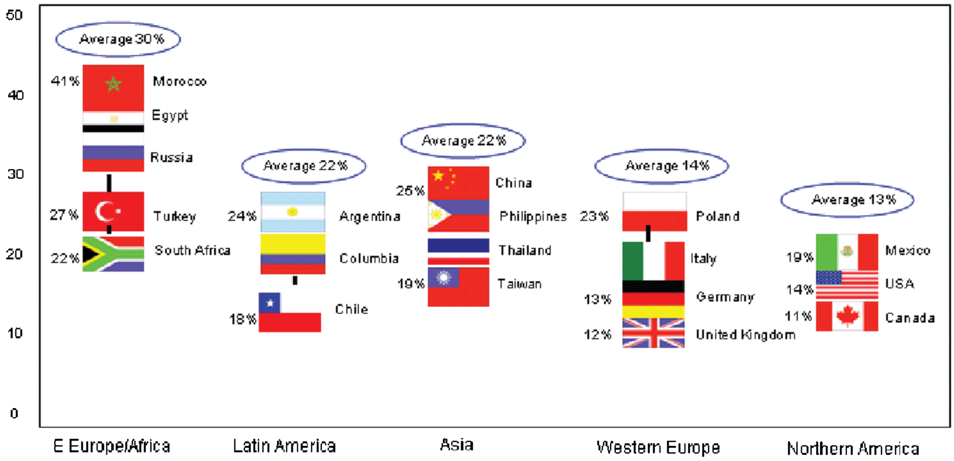


Figure 1

In countries such as Morocco, Egypt, Russia, Turkey and South Africa, investors are willing to pay an average premium of 30% whereas in countries such as USA, United Kingdom, Germany and Italy an average of 13–14%.



Source: ISS

Figure 2

Another important outcome of the survey was that 56% of the attendees stated governance practices are equally important when compared to financials in selecting companies in which to invest.

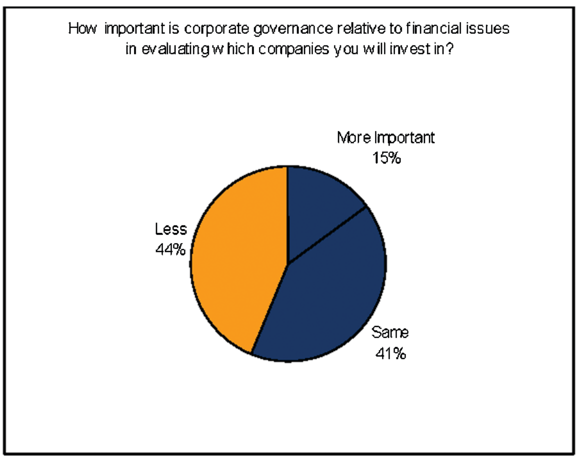


Figure 3

As a result, corporate governance ratings may provide significant advantages to investors such as:

(1) **Assess Governance Risk**

a) Avoid investing in poorly structured companies
b) Reduce the risk of investing in the next governance failure
c) Examine and compare corporate governance practices

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(2) **Improve Financial Return**

a) Profit from the valuation gap between well-governed and poorly governed companies
b) Consider active shareholder fund strategy engaging in and leading to improved shareholder return
c) Companies with high governance standards are expected to have better performance than poorly governed companies.

(3) **Complement Voting Research**

a) Become familiar with voting procedures and prepare for an informed and coherent active voting policy.
b) Understand governance related legal and procedural issues

(4) **Complement SRI (Social Responsibility Investment)**

a) Add a strong governance risk assessment layer to your social responsible investment approach
b) Extend your SRI Research into the ethics of good governance and proper conduct on the management and board level

(5) **Prepare for Relationship Investment**

a) Use the ratings as a benchmark to review governance practices

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