



# ICRA'S CORPORATE GOVERNANCE RATING METHODOLOGY

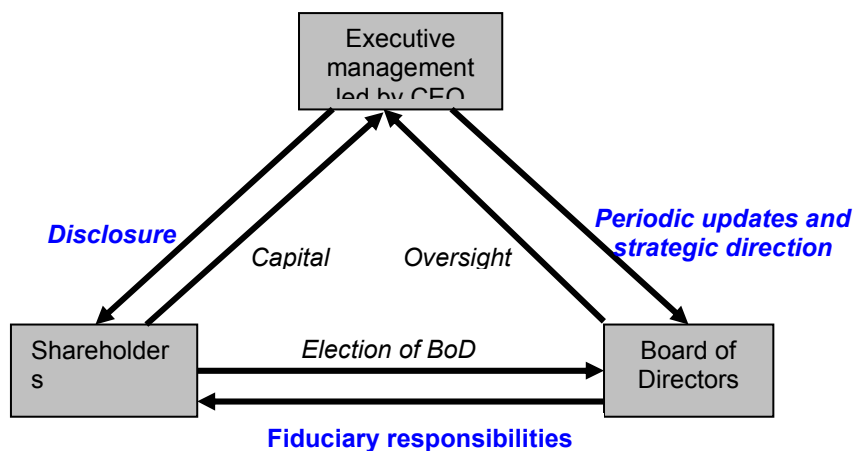
## About ICRA's CGR

ICRA's Corporate Governance Rating (CGR) seeks to evaluate a company's **business conduct and practices** and the **quality** of its **disclosure standards** in terms of **fairness and transparency** from the perspective of its **financial stakeholders**. The corporate governance practices prevalent in an organisation reflect the distribution of rights and responsibilities among its different participants—such as the Board, management, shareholders and other financial stakeholders—and the rules and procedures laid down and followed for making decisions on corporate affairs. The emphasis of ICRA's CGR is on substance over form. ICRA assigns CGRs on a six-point scale of CGR1 through to CGR6. The rating of CGR1 implies that in ICRA's current opinion, the rated company has adopted and follows such practices, conventions and codes as would provide its financial stakeholders the highest assurance on the quality of corporate governance. ICRA's opinion, however, is not a certificate of statutory compliance or a comment on the rated company's future financial performance, credit rating or stock price.

## Conceptual Basis for ICRA's CGR

The Organisation for Economic Co-operation and Development (OECD) has defined Corporate Governance as the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the Board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides a mechanism through which **the company objectives** are set, the **means** of attaining those objectives defined, and the process of **monitoring performance** delineated.

With the OECD definition of Corporate Governance serving as the basis, ICRA's CGR framework seeks to understand the interaction among different participants in the company being rated. The following diagram<sup>1</sup> depicts the typical participants in a corporation, and the interrelationship between them.



<sup>1</sup> Extract from 'The Boards Missing Link' by Cynthia A Montgomery and Rhonda Kaufman *Harvard Business Review*, March 2003

## Analysed

ICRA's framework is designed to analyse the following **key variables** while arriving at the CGR for a corporate entity:

- Ownership Structure
- Governance Structure and Management Processes
- Board Structure and Processes
- Stakeholder Relationship
- Transparency and Disclosures
- Financial Discipline
- Ethical Practices

The following paragraphs highlight the key issues that are analysed for each of the variables.

### **Ownership Structure**

The key issues analysed are:

- ↺ Extent to which dominant shareholders are easily identifiable
- ↺ Extent of cross-holdings that may compromise minority interest
- ↺ Extent of shareholding by promoter group
- ↺ Extent of institutional shareholding
- ↺ Pattern of retail shareholding

A transparent ownership structure where the key shareholders are easily identifiable and the absence of opaque cross-holdings are positives from ICRA's CGR perspective.

### **Governance Structure and Management Processes**

The focus of ICRA's analysis here is on the decision-making process followed within the company being rated, and the quality and nature of information that is presented to its Board. ICRA believes that for a company to be able to respond swiftly to changes in today's dynamic business environment, line managers led by the Chief Executive Officer must be given enough powers to take decisions in the most appropriate manner. However, it needs to be ensured that the powers are exercised in accordance with established procedures and that they are in harmony with the broad policy guidelines and strategic objectives formulated by the Board.

Accordingly, the **key issues** analysed are:

- ↺ Extent to which clearly-defined Governance arrangements are present and followed
- ↺ Appropriateness of the decision-making process
- ↺ Quality of information submitted to the Board

### **Board Structure and Processes**

The key Board functions of any organisation may be summed up as follows:

- Approving, monitoring and reviewing the strategy proposed by the executive management
- Evaluating the performance of the top management
- Ensuring compliance with legal and statutory requirements (that is, the "control" function of the Board)
- Balancing the rights and concerns of shareholders and other stakeholders

A competent Board of Directors, free of conflict of interest, can help protect stakeholders' interests, ensure compliance with the prevailing laws of the land, and provide strategic guidance to the executive management. However, the full Board may not be able to meet very frequently to devote its close attention to the business of the organisation. Some of the Board functions are therefore performed through specially constituted Board Committees consisting mainly or wholly of Independent Directors. The more important among these Committees are the Audit Committee, the Remuneration Committee, the Appointment Committee and the Investment Committee. Through these Board Committees, organisations seek to strengthen the ability of the Non-Executive Directors to discharge their control functions more effectively.

ICRA's CGR process evaluates the **Board Structure and Processes** in relation to the following:

- **Structural Aspects**
  - ↺ Size of the Board
  - ↺ Proportion of "Independent" Directors
  - ↺ Other Directorships held by the Independent Director(s)
  - ↺ The mix of skill sets which the "Independent" Directors bring to the Board

- **Effectiveness of the Board**

- ↳ Frequency of Board meetings
- ↳ Attendance track record of Directors
- ↳ Quality of agenda papers and extent to which they are circulated in advance
- ↳ Quality of presentations made to the Board
- ↳ Board's role in approving strategy proposed by the executive management
- ↳ Deliberations related to major investments, capital expenditure, and related party transactions
- ↳ Board's role in determining executive compensation

- **Functioning of Board Committees**

Among the Board Committees, the Audit Committee is clearly the most important in terms of scope of activities. A properly functioning Audit Committee has the potential to improve the quality of financial reporting, strengthen the position of auditors, and ensure that effective internal audit and internal control/risk management systems are in place. The key aspects relating to the effectiveness of Audit Committees as reviewed by ICRA are:

- ↳ Composition of the Audit Committee
- ↳ Background, expertise, experience and independence of its members
- ↳ Deliberations at Audit Committee meetings with respect to:
  - ↳ compliance with Accounting Standards
  - ↳ qualifications in published accounts
  - ↳ major issues involving the financial reporting process, systems and control, and internal audit coverage
- ↳ Audit Committee's role in the appointment of statutory auditors, and its policy on rotation of lead partners and on "non-Audit" services provided by the auditors

**Internal Auditors** and **Audit Committees** are mutually supportive; it is essential for the Audit Committee to consider the work of internal auditors so as to gain an understanding of the organisation's risk management processes and control systems, and of the areas that need strengthening. Thus, ICRA's assessment covers, among others:

- ↳ Strength and quality of the Internal Audit team
- ↳ Internal Audit coverage plan
- ↳ Extent of Internal Audit's interaction with the Audit Committee
- ↳ Management's responsiveness to issues highlighted by Internal Audit

Clause 49 of the Listing Agreement does not make it mandatory for a company to set up other Board-level committees like the **Remuneration Committee** and the **Nomination Committee**. However, ICRA believes that issues like established and transparent criteria for selecting Independent Directors, determining Directors' remuneration, and ensuring that Directors' and senior management's remuneration is aligned with the company's performance are important indicators of a company's Corporate Governance process.

The feedback from the Independent Directors on the effectiveness of a company's Board is an important input in ICRA's CGR process since Minutes of Board meetings may not record the actual deliberations preceding a decision.

### **Stakeholder Relationship**

An organisation's shareholders are its owners, and their basic rights include: the right to have their shares transferred and registered smoothly; the right to access timely information; the right to participate in, and vote at, shareholders' meetings; the right to elect members on the Board; and the right to share the organisation's profits through dividends. Shareholders also have a say on issues such as amendments to the organisation's Memorandum and Articles of Association, reduction or augmentation of share capital, and sale/lease/disposal of any undertaking. Most importantly, all shareholders need to be treated equitably. Also, an organisation must have appropriate systems in place to enable its shareholders participate effectively in shareholders' meetings and cast their votes.

The emphasis of ICRA's analysis is on evaluating the extent to which a company goes beyond what is mandatory under law to serve the rights and interests of its shareholders. The issues analysed include:

- ↳ Conduct of Annual/Extraordinary General Meetings (AGMs/EGMs) and the extent of disclosures at such meetings
- ↳ Procedures for transfer and registration of shares and payment of dividend
- ↳ Company's responsiveness to investor complaints
- ↳ Timeliness of release of any market sensitive information
- ↳ History of penalties levied by regulators for violations of statutory provisions, if any

Moreover, ICRA evaluates the functioning of the company's in-house Investor Services Centre or the Share Register & Transfer Agent, as the case may be. Besides, ICRA also evaluates the track record of the company in servicing other financial stakeholders like banks, financial institutions and fixed deposit holders.

### **Transparency and Disclosures**

Listed companies have to meet several statutory requirements on disclosures, financial results, and information that must be part of their published accounts. However, with the depth of the capital markets increasing and institutional activity in the markets picking up, organisations are making voluntary disclosures that go beyond the minimum disclosure requirements. Shareholders and potential investors require access to regular, reliable and comparable information in sufficient detail to assess the quality of the management, the organisation's growth prospects, and the associated risk factors. At the same time, organisations are not expected to disclose information that may endanger their competitive position. In ICRA's opinion, the information disclosed by organisations should be material and must shed light on their plans/expectations as well the foreseeable risks.

The key parameters used to assess a company's transparency and disclosure standards are:

- ✎ Accounting quality, including compliance with accepted accounting standards and comparison with industry best practices
- ✎ Changes in accounting policies
- ✎ Notes to accounts of a materially significant nature
- ✎ Quality and level of detail in accounts, especially with respect to item likes Loans and Advances, Inter-Corporate Advances and Contingent Liabilities
- ✎ Disclosures on transactions with subsidiaries, associates and other related parties
- ✎ Additional information to shareholders
- ✎ Quality of disclosures in Management Discussion and Analysis (MDA)

While assessing the MDA and Directors' report, ICRA evaluates the extent to which information is available on areas<sup>2</sup> like:

- ✎ Competitive position of the company's product portfolio and trends in the same
- ✎ Key drivers of the company's operating performance, including sustainability of margins
- ✎ The rate and success of product innovations
- ✎ Risk factors that could have a bearing on the prospects of each business line

The trends in share price movements around major corporate announcements are also looked at to evaluate whether price sensitive information is disseminated in a timely manner to all stakeholders.

### **Financial Discipline**

The ultimate objective of Corporate Governance is to create and maximise shareholder value. While the actual shareholder value generated by a company may be dependent on a number of factors that are beyond the control of its management, ICRA believes that maintenance of a certain level of discipline in the conduct of business operations also has an important role to play. ICRA's analysis therefore focuses on factors that are within the company's control, and which, in ICRA's opinion, impact the shareholder value that a company is able to generate in the long run. Such factors include:

- ✎ Business segments in which the company operates
- ✎ Rationale for presence in multiple businesses, if any
- ✎ Return on capital employed in each business compared with the industry average
- ✎ History of equity dilution
- ✎ Extent of reliance on debt funding
- ✎ Dividend policy
- ✎ Number of subsidiaries/associates and rationale for the same
- ✎ Nature of transactions with subsidiaries

It must be emphasised that ICRA does not view a company's presence in multiple businesses or the existence of subsidiaries/associates as a negative factor per se. ICRA only tries to evaluate the rationale for the same and determine whether the parent holds its subsidiaries/associates at "arm's-length" in its transactions with them and whether the business decisions are based on commercial prudence.

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<sup>2</sup> This actually varies depending on the industry to which the company belongs. The items highlighted would apply to a typical consumer products company.

### **Ethical Practices**

Corporate Governance, ultimately, is about promoting corporate fairness and transparency. Therefore, a cornerstone of Corporate Governance is a company's commitment to maintain the highest standards of ethical practices in all its transactions. ICRA's analysis thus covers:

- ↗ Comprehensiveness of code of ethics and integrity
- ↗ Steps taken to effectively communicate the principles of corporate ethics
- ↗ Extent to which compliance with the codes and guidelines is monitored
- ↗ Extent to which feedback systems have been established to encourage whistle-blowing.

### **Miscellaneous Practices**

Although the focus of ICRA's CGR exercise is primarily on a company's financial stakeholders, ICRA also evaluates the company's conduct in relation to its other key stakeholders like employees, customers, suppliers and society at large. Any demonstrated evidence of unsatisfactory relationship with any of these major stakeholders is factored in negatively.

### **Statutory Compliance**

As mentioned, the focus of ICRA's CGR exercise is on the spirit in which a corporate entity is governed rather than mere statutory compliance, i.e. on substance over form. In ICRA's view, statutory compliance is only a necessary but not sufficient condition for a high CGR. Still, ICRA's CGR exercise does involve a check on the company's compliance with various statutory provisions that are important from the Corporate Governance perspective. The following is an indicative list of such statutory provisions:

- ↗ Clauses 49, 47, 41 and 31 of the Listing Agreement
- ↗ Sections 292, 292A, 293, 297, 299, 301, 308 and 372A of The Companies Act, 1956, as amended
- ↗ Regulations 7, 8 and 10 of the SEBI3 Takeover Code
- ↗ SEBI Insider Trading Regulations

However, it needs to be emphasised that ICRA does not carry out a compliance audit and CGR is not to be interpreted as an indicator of statutory compliance by the rated company.

### **Conclusion**

ICRA believes that this rating service would assist the corporates to project an objective and credible opinion on the quality of their corporate governance practices and on their responsiveness in addressing the interests of all financial stakeholders. Empirical research shows that corporate governance is one of the important factors influencing corporate valuations. Besides, superior governance practices may also facilitate access to fresh capital, thus having a favourable impact on the cost of capital. Although ICRA's CGR is not an indicator of statutory compliance, a higher CGR may improve the comfort that statutory authorities/regulators may have with the rated company. Also, a CGR may enable a company benchmark itself against the best practices prevalent, thus providing a possible opportunity for improvement.

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<sup>3</sup> Securities and Exchange Board of India



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