Corporate Governance: A Perspective

Amit Tandon
Managing Director
Fitch Ratings India Pvt.Ltd.

OECD Definition of Corporate Governance

"Corporate governance relates to the internal means by which corporations are operated and controlled…[It] involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently."

Corporate governance typically refers to the complete range of systems and processes used in corporate decision making and performance monitoring. Corporate governance should ideally consider the interests of all stakeholders of any organization, and taking into account the interests of both equity and bond holders, without overt priority to one or the other class of investors.

Principal – Agent Conflicts

In the context of corporate governance, the Principal refers to the key stakeholders of an entity or company, while Agent refers to the management team, which is involved in the operations and key decision making of the company, and in the case of good corporate governance, bears in mind the best interests of all stakeholders. Corporate governance procedures are put into place to protect the interests of the stakeholders in instances where the interests of the Agents and the Principals are in conflict. A common example is in the case of management compensation. Corporate governance also becomes important in cases where the interests of various stakeholders are in conflict with each other.

Conflicts between key stakeholders (Equity vs. Bond investors) and their mitigation

In the broadest sense, the interests of both equity and bond investors are similar i.e. ensuring that management must focus on creating long term, sustainable economic value. However, they differ in terms of their typical risk of return and seniority:

- Bond holders have seniority in events of a default, though their returns are capped, though to an extent assured, at the contracted interest rates. As a result bond investors are more concerned with down-side protection, and ensuring that their principle and interest obligations are fully met.
- Equity investors in contrast face substantial fluctuations in returns, with no contractual return assurances, and are the most subordinated of all investor classes. Further equity holders typically seek to maximize their returns on investment, and hence would be likely to support what are perceived as higher risk investments, high leveraging or high dividend payouts, which could generate higher returns, though which could impact the quantum of risk attached to the company's future cash flows.

These conflicts are typically mitigated by the terms of the legal contracts governing the bondholders' interests, and the self correcting market mechanism. In many cases, bondholders are protected by various legal covenants governing their investments, such as a lien on underlying assets against which the bonds are raised in the case of secured debt. Further, in situations where a company does not meet its obligations to the bondholders, it will face severe difficulty when raising additional financing in the instance of future requirements, as well as face a substantial increase in its cost of funds, which could significantly impact the company's long term performance.

Corporate Governance for Bondholders

While the implicit correction mechanisms such as market forces and legal avenues exist, the following corporate governance issues are critical from the bondholders' perspective, to ensure that their interests are protected.

Independence and Effectiveness of the Board

SEBI Listing Clause 49: Independent Directors

Tightening of the definition of independent directors

"*For the purpose of this clause the expression 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the directors."*

- No financial relationship with the company/ subsidiaries/ management / shareholders
- Not related to the promoters or senior management

- Has not been an executive with the company in the immediate preceding three financial years
- Is not a partner or executive of the auditors/ lawyers/ consultants of the company
- Is not a supplier/ service provider to the company
- Does not hold 2 per cent or more of the shares of the company
- Further, a minimum amount of information must be provided to the board of directors prior to any board meeting.

An independent and effective board of directors is critical to ensure good corporate governance. A board which simply serves as a "rubber stamp board" can inadvertently encourage inefficient management which does not work in the best interests of the key stakeholders. An independent board of directors must ensure management accountability. Recent regulations in India suggest that corporate governance is gaining increasing importance (see adjacent box), to ensure the proper conduct of the board's responsibilities. When evaluating the board of a company, the following must be considered:

- Are the board members sufficiently qualified to judge management performance? For example, in a technology company, technical specialists could add significant value in assessing the management's strategy
- Are the independent directors truly independent? A detailed study of the profiles of the independent directors gives a reasonable idea of the nature of relationship between the directors. For instance, in the case where the representative of a major supplier or a consultant with substantial revenues generated from the company is on the board of directors, the relationship is likely to be biased
- Is the board effective in monitoring the performance of the management? The nature of queries raised at board meetings, and the amount of time and commitment demonstrated by the board are some indicators of effectiveness.
- Does the board meet often and regularly? This is important in when the company is undertaking substantial changes in its strategy, business or financial structure.
- What is the selection process in choosing the members of the board? In the instance that the composition of the board is driven by specific parties (usually the majority equity holders), the board is unlikely to function independently. The board must be comprised of members focused on the long term interests of the company, rather than management loyalty

Impact of Equity Ownership

The nature of equity shareholding can substantially impact the level of corporate governance of an organization. In the instance wherein equity holding by directors is encouraged, it could give the board a financial incentive to ensure that the management is running the company effectively. Conversely, it could lead to the board encouraging decisions for short term gains or financial benefits for the directors. This is also applicable in the case of management stock options. Other external events, such as active trading in the company's stock prior to a significant decision taken by the company, or an excessive focus on short term performance metrics, rather than a long term strategy, etc. are also important.

Majority or Family owned Companies

When management and equity control is in the hands of a few individuals, the key risk is that fewer checks and balances are likely to be put in place to protect the interests of minority stakeholders, as interests are likely to be aligned towards the interests of the majority holders. However, this does not necessarily imply a failure of corporate governance, as in many cases, the nature of investment ensures that the stakeholders are focused on creating long term value for the company.

An important class of companies to consider is the family owned businesses. While many family owned companies have professionalized their management team, thereby separating ownership and management, a large number of family businesses continue to be run by family members. The following aspects are critical for good corporate governance:

- Is there an excessive focus on rewarding majority equity holders? E.g. declaration of high dividends despite poor performance, or granting family members high compensation above market benchmarks.
- Are there sufficient disclosure norms? While private companies have traditionally not focused on ensuring appropriate disclosure, as the companies broaden their stakeholder base (usually by accessing the capital markets) the levels of corporate governance and disclosure norms are likely to improve, with the interests of the new stakeholders becoming an important consideration in management decision making
- Is there a clear delineation between personal and corporate finances? For instance, a high quantum of interest-free loans to key directors or management personal is a clear cause for concern.
- Does the board continue to support management in the face of poor performance? In many cases, family owned companies face the problem of lack of accountability of management to the board, due to the quantum of shareholding, which could be against the best interests of the company.
- Are there significant conflicts of interest arising on account of the equity holders' other interests? For instance, in the case when the majority stakeholders have significant interests in other companies, which take a significant proportion of management time, it could subvert the best interests of the company. Further, in instances where other concerns

managed by the stakeholders require substantial investments or liquidity support, this could result in uneconomical decisions being taken by the management, thereby subverting the best interests of the company at hand. These aspects are discussed in the section on Holding Structures and Related Party Transactions, below.

Holding Structure and Related Party Transactions

Key Regulations Governing Related Party Transactions

- Section 301(b) of the Companies Act: maintaining a full record of all related parties
- AS 18: related party disclosures
- Section 239 of the Companies Act: defines the power of inspectors to investigate into the affairs of related parties

In studying the corporate governance of an organization, the quantum and nature of related party transactions must be clearly evaluated. Typically, good corporate governance must ensure that all transactions with related parties must be undertaken on an arms' length basis, and in the best interests of the company. These transactions could either be with the management, key equity holders, or other concerns controlled by the majority shareholders. This aspect becomes increasingly important in the case of transactions between companies controlled by the management or key stakeholders.

In many cases, transactions take place where the benefits are clearly to the related party and at the cost of the company, indicating a clear failure of corporate governance, and a failure on the part of the board of directors. Some examples of such transactions include loans and advances granted to related parties on a preferential basis to finance liquidity requirements, or investments in new ventures established by the management or the majority equity holders, or, in the worst case, to extract finances from the company. A lack of transparency on the part of the management in disclosing the details and clear purpose of these transactions is a significant cause for concern. A study of related party transactions must consider the following

- Have the transactions served a tangible economic benefit to the company commensurate with the quantum of investment?
- Has the board taken an active role in analyzing and evaluating the transaction?
- Has management provided sufficient information to the stakeholders and received their approvals?
- Have related parties had an important role in determining the nature and terms of the transaction?

The above considerations are especially critical in the case of complex holding structures of a group of companies. A careful analysis of the relationship (legal or otherwise) between group concerns, especially where there exist a significant quantum of transactions between group concerns, and appear intended to transfer resources from one entity to another, without a clear economic benefit. A different auditor evaluating the various parties between whom such transactions have taken place is a significant cause for concern, as it does not allow for the requisite degree of control and evaluation. In evaluating these transactions, a careful look at the legal and holding structure of the group, and incorporating the impact of these related parties (as appropriate), must be undertaken to ensure that the company's corporate governance process has the requisite checks and balances to fully protect the interests of the bondholders.

Reliable Audit Process

The quality of financial reporting and internal audit mechanisms are critical in evaluating the level of corporate governance of a company. An understanding of the Company's auditing and financial accounting policies i.e. whether aggressive or conservative is critical in this regard. Companies found to have violated the applicable GAAPs typically suffer on account of reduced investor confidence. Further, such violations are symptoms of a deeper issue, and in many cases, are a result of management attempts to conceal material impacts of various decisions. The strength and composition of the audit committee as well as the quality of the external auditor becomes critical in evaluating the reliability and integrity of the audit process. The composition of the audit committee, and the experience and qualifications of the members must be studied, to ensure that the committee understands the risk impact of various accounting decisions. Further, the stature and reputation of the auditor becomes critical in ensuring auditor independence. An external auditor may not act conservatively in instances where the audit firm stands to lose substantial consulting or other revenues on account of their audit decisions. This is also applicable in cases where the company is critical to the firm, and comprises a substantial proportion of its revenues.

A combination of discussions with the management team and auditors is used to assess a company's corporate governance. However, in these evaluations, no generalizations should be made based on the above principles, and must be undertaken on a case to case basis, considering various company-specific factors.

Note: The above article draws extensively on the Fitch Ratings report titled "Evaluating Corporate Governance: A Bondholders' Perspective" dated April 12, 2004.