Assessing Corporate Governance: a Quantitative Perspective

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The reality behind corporate governance assessments get highlighted only when failure becomes too big to hide. For instance, the deteriorating financial condition of IL&FS, which during the period 2011 and 2019, saw five rating agencies assign a total of 429 ratings, remained largely unknown to the regulators and indeed to the market at large, until 2018. Later, as a forensic audit done at the behest of the new board, revealed, the erstwhile management manipulated some of the ratings agencies to give them favourable ratings, ensuring that the truth was not reported. Rating agencies often rely significantly on qualitative and indicative data on governance to adhere to legal standards of governance, accept financial statements as they appear and rarely take insights from persons outside of the management e.g. auditors, bankers, proxy advisors etc. Hence, the information is often linear and rigour that public markets expect is missing. The company's auditors too allegedly failed in their responsibilities to report. Regulators and courts are judging the quality of audit work and the full jury on that is not out yet.

It is not just rating agencies or auditors as gatekeepers who have failed. Governance failures are the result of a whole host of participants and failures rarely happen without the consent or negligence of the board. The failure of the board including the audit committee to flag conflict of interest concerns in transactions entered into by a private bank highlight the concerns of relying solely on company disclosures. It also highlights the fact that having a board comprising of qualified and experienced directors may not always be a sufficient deterrence to bad governance.

Intermediaries such as rating agencies, auditors, independent directors, regulators also called "the gatekeepers", are key to maintain a check on the corporate power imbalance which is otherwise tilted disproportionately in favour of company managements. Recent instances of failures such as in the case of IL&FS highlighted the failure of these agencies to report or detect what would otherwise been obvious weaknesses.

Assessing the corporate governance levels of companies is not easy. The failure of companies previously rated highly for its good governance raises doubts on the effectiveness of either models used by rating agencies or subjective assessment of governance processes adopted by companies.

This raises the fundamental question of looking beyond the regular compliance which companies are mandatorily required to fulfil. The much-touted spirit of corporate governance is illusive and seldom realised. The committee on corporate governance chaired by banker Uday Kotak in its report, in 2017, said that Indian companies were failing the spirit of corporate governance even as they would largely comply in letter with the law. Elsewhere, on various occasions, the role of the board, the independent directors, audit committees of companies have been questioned, raising one to wonder where are we in terms of corporate governance.

The need for a quantitative indicators for corporate governance

The need to understand the state of corporate governance is long felt. But efforts to measure corporate governance has been limited to aspects of the board strength, the presence of independent directors, meetings held in a year and similar qualitative parameters. Most of the efforts in India, on building a corporate governance index, is either not reliable because of its dependence on qualitative disclosures by the companies themselves, or relying on factors which are not reliable.

Examining a company's board strength, the quality of its board, the number of independent directors, meetings held, disclosures made, are factors which provide an understanding of a company's compliance culture. But the elusive spirit is ignored in such an assessment. Events of frauds reported in companies with highly experienced and qualified directors raise the question on the efficacy of building an index based on such subjective factors.

Changes in the company law and listing regulations have mandated many of these governance parameters: the level of compliance increasing in recent years. That leads us to the question of a right measure of corporate

governance in India. One of the foremost difficultly in this is to define what are the measure of good governance. OECD defines corporate governance as: “procedures and processes according to which an organisation is directed and controlled. The structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders and other stakeholders – and lays down the rules and procedures for decision-making.” Hence, the structure and processes of management that determines the outcome of their actions defines the concept.

In India, according to the PwC India Family Business Survey 2019, over 73% businesses are family owned and nearly all are run by the families and in 2020, NIFTY 50 has 16 companies, which are family owned. Hence, the ownership concentration and agency problem , the low gap between management and owners in India is one of the constructs around which measures of governance need to be woven. High concentration of ownership and its consequent reflection in management creates discretion in the hands of owners which determines the quality, manner and the quantification of financial and operating results. On the other hand such powers do create opportunities of diversion of financial resources of the company for personal use or keeping onerous liabilities off the books.

Discretionary Accruals and Earnings Management

The manifestation of powers that a promoter has gets reflected in what is called “earnings management“ of results of a company which ranges from ‘manipulation to opportunism’. Earnings management refers to adjustment of financial reporting numbers for managerial self-interests. Technically speaking, earnings management is not illegal as the accounting principle that allows the management to use their discretion and judgment in financial reporting. The research on accrual management focuses on separating managed accruals from normal accruals. It is not easy to identify the managed accruals. The part of the accrual normal to an industry is called non-discretionary component of accrual. Discretionary accrual refers to the difference of actual accrual and nondiscretionary accrual i.e. the extent to which earnings have been manipulated through management’s intervention. The use of discretionary accrual as a measure of earnings quality is widespread in the literature. Non-discretionary accrual is calculated by taking average of total-accrual in estimation period and then discretionary accrual for a year is calculated by subtracting the nondiscretionary component from total accrual. One implicit assumption of this model is that the discretionary accrual sums up to zero in the long-run.

While the research on earnings management focuses on accrual-based earnings management, recently another means of earnings management- real earnings management- has been brought into attention. Real earnings management refers to real activities’ manipulation such as acceleration of sales, delaying of R&D and maintenance expenditure. Some researchers have found that as the change in market value of an asset is realized in the year of sale, management could manipulate earnings by manoeuvring the timing of asset sales. In some cases, managers cut R&D expenditure to report higher earnings during the end of their tenure. Roy Chowdhury (2006) studies about real activities manipulation, which he defines as management practices deviating from normal business practices to meet earnings forecasts and expectation. He emphasized on three types of management practices in real earnings manipulation. These are – i) Reduction of COGS by means of overproduction, ii) reduction in discretionary expenditures and iii) sales manipulation through channel stuffing and lenient credit terms.

This pervasive use of earnings management or active interventions to produce or project profits which are in part synthetic is a quantitative measure of the quality of corporate governance. The quantitative models that measure the intention of management measure the preponderance of discretionary earnings/ expenses in the income statement as compared to the firm and peers over a time series to determine the extent of such infractions.

Related party transactions- in guise of arms’ length?

In the past, governance failures have often resulted not from non-compliance with the law, but circumventing the regulatory objective driven by mala fide intent. Majority of corporate frauds reported in the past one decade have been perpetrated by companies undertaking related party transactions which went unchecked. Such transactions often go unreported, as the so-called gatekeepers of corporate governance, such as the company board, auditors, rating agencies etc fail to oversee mala fide corporate intent. Such actions are often found common in companies which have a large concentration of ownership with the company’ promoters or through its related entities.

A study by Thought Arbitrage Research Institute, a public policy research outfit, in 2018, sponsored by the Ministry of Corporate Affairs, analysed more than 150 financial statement frauds in India between the years 2012-2018, and found certain common patterns by which related party transactions—by far, the dominant method by which frauds take place, took place. These patterns are in many ways unique to the years leading up to the fraud getting reported, and hence represents the period when the illegalities were being carried on.

The study found the following patters to be commonly used: Investments in related parties, (2) Sales to related parties, (3) Loans to related parties, (4) Loans from related parties, (5) Purchases from related parties. For instance, with respect to sales to related parties, a common pattern in companies indicted for fraud is that they have reported sales to related parties at below market price.

Research and regulations have one basic tenet that related party transactions are not on arm's length unless otherwise proved. Hence the intensity and pervasiveness of such transactions entered by a company with entities that are not subsidiaries but are owned or connected by promoters is another pillar on which measures of corporate governance stands. Often such vehicles are used for creating sales, purchases, diversion of funds and even resting liabilities off the balance sheet.

Disclosures and transparency: to show or to hide?

Corporate disclosures form the basis for governance assessments. Often a company with a poor governance record would not disclose on time, and not disclose adequately. Despite improvements in the disclosure requirements, with the need for continuous disclosure obligations on material events and information, it is not uncommon for companies to not disclose key financial aspects. The areas of conflict are not disclosed effectively, say in ICICI Bank relating to loans approved by the CEO for companies where her husband has an interest or the manner of dealing with whistle blower complaints are not adequately disclosed, when they concern a promoter or KMP.

Our analysis of the companies indicted for financial statement fraud during 2012-2018 revealed that the in most occasions the companies for many years could get away with financial misappropriation as they would not report, for instance, obligations for loans and borrowings to and from related parties. At least 10% of the cases identified for fraud had no disclosure on related parties at all.

The lack of a proper deterrence for companies which fail to make timely and adequate disclosures often allows the failures to go unchecked. It is important that governance assessments consider specific aspects of disclosure and not generic submissions of a report without substantive details and depth. Other relevant aspects which needs consideration include the company's outreach to shareholders on contentious issues, number of shareholders participating in e-meetings, timing of AGM., concerns raised by proxy advisors, etc.

Quality and type of investors: the company you keep?

Ownership and investments by outside investors who make long term investments and changes in their interest is an indicators of lowering faith in the management and the operations. Unrelated substantial investors, guided by their professional advisors make reasoned choices and some measures that guide of their level of interest include changes in FI and MF's investments, change in investments by investors who sold after holding for 2-3 years, change in shares mortgaged by the owners, changes in overseas investors, who are unrelated to large funds or FIIs.

Quality of audit, internal audit and results of tests of internal financial controls

Regulators have in recent years turned on their scrutiny on auditors, with recent changes in law empowering them to look into matters of audit quality, concerns over independence and engagement, resignation etc. The need for auditors to report instances of fraud including suspicion of fraud, in addition to greater accountability for inaction, makes auditors important in assessing the quality of governance in companies. Some key aspects which can be quantitatively processed to score the governance quality for audited companies include errors reported and corrected, high level of discretionary entries and accounting treatment of key elements in variance with peer groups, etc. Other aspects which are also important include change of auditors before completion of their term, resignation of an auditor before term or not offering for a reappointment, type of audit qualifications, among others.

The opportunity to measure better

Corporate governance is critical in times of distress which demand efficient management of resources, plugging of leakages and transparency in dealings. In this regard, the current economic condition driven by COVID-19 is an opportunity to improve the state of corporate governance in companies, with an objective to safeguard the interests of shareholders. The depressed economic conditions that we are currently facing is likely to negatively impact the financial position of firms. With a majority of companies dependent on bank loans, there is an incentive to manipulate the financial position as it reflects high compliance of bank covenants.

Corporate governance assessments offer one of the many policy tools which could help improve the reputation of our corporate institutions, safeguard investor wealth and promote economic prosperity. The law recognises that the business decisions may not always go as planned and makes an important distinction between mala fide intent and genuine business failure. While stressed economic conditions is likely to lead to companies. The need for a quantitative assessment is important to help identify genuine failures from those which may have committed a fraud.

It is important that governance assessments go beyond what is reported as past instances have repeatedly shown otherwise. Prior attempts to analyse the impact of corporate governance, by academics and commercial providers, have either used individual variables (such as board independence and ownership structure) or have attempted to construct composite measures. Despite the efforts and considerable sophistication of measures and methods, the results so far are surprisingly ambiguous and contradictory.

Governance assessment in India is passing through an important phase where regulators are active and market expectations are high. On August 3, 2020, SEBI released the "Procedural Guidelines for Proxy Advisors", which among other things, asked proxy advisors to disclose the methodologies and processes followed in the development of their research and corresponding recommendations, and also to review its policies at least once annually.

A quantitative approach to building a corporate governance index could help not just differentiate the good from the bad, but provide an insight on the true state of the corporate governance in India. It could help mitigate some of the regulatory concerns over the failing spirit of corporate governance.

In governance assessments, it is often found that the assessment is biased, using subjective reasoning. The use of financial indicators could help manage this critical concern. Indian companies, particularly those which have been indicated of fraud in recent years, have been found to have poor disclosure record. This often is the result of lax enforcement and limited deterrence. Any quantitative analysis platform needs robust data support. With company data management fast moving towards sophisticated data platforms such as XBRL, analysis of complex nature of transactions can help decipher tendencies which are contrary to good governance practices and even could help predict financial frauds of the future.

The report of the Uday Kotak Committee on Corporate Governance (2017) categorised two broad styles of running companies in India—the "Raja" (Monarch) model – typical of promoter-led companies, and the "Custodian" (Trusteeship) model. As the report said, there are instances of promoters carrying out actions that are favourable to them but detrimental to the interests of the minority shareholders. It said that corporate India needs to move in the direction of the trusteeship model, relevant for both promoter-led and professionally managed entities, which places interest of all stakeholders over self-interest of the few.

A corporate governance index based on quantitative parameters is a way forward in this regard that puts qualitative variables in a measurable framework

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Kaushik Dutta and Souvik Sanyal work for Thought Arbitrage Research Institute, a not for profit independent think tank working in areas of corporate governance, public policy and economics. They have co-written Hand book of Independent Directors- upholding a moral compass, sections of CR Datta on Company Law, Hand book for Audit Committee – Beyond Numbers