Corporate Governance, Fair Value Reporting and Fairness Opinions

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Corporate governance is an oft-used, but ill-understood term. Broadly speaking, it is a set of rules, practices and policies that dictates corporate behavior.

The Narayana Murthy Committee on Corporate Governance 2003 defines corporate governance as "*acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, ethical business conduct and making a distinction between personal and corporate funds in the management of a company.*"

Board of directors, shareholders and management act as the three pillars of the corporate governance framework with the board acting as the custodian. While it is difficult to put forth a simple yardstick of what constitutes good corporate governance, the lack of corporate governance often sticks out like a sore thumb, or manifests itself in the form of disastrous corporate failures resulting in substantial losses to investors.

In India, while the regulatory framework of corporate governance was introduced in the Companies Act 1956, it has received much greater attention in the last few decades. As shown below, various committees and regulatory bodies have contributed to strengthening the framework over the years.

1996	First special initiative by the Confederation of Indian Industry (CII) in introducing the corporate governance code
1999	Kumar Mangalam Birla Committee appointed to promote the standards of corporate governance
2000	SEBI introduces mandatory corporate governance code through Clause 49 of
2002	Naresh Chandra Committee appointed by the Department of Corporate Affairs. Lays down strict guidelines defining the relationship between auditors and clients.
2003	Narayana Murthy Committee set up by SEBI. Introduces recommendations focusing on strengthening the responsibility of audit committee, quality of financial
2004	SEBI announces revised Clause 49 making major changes in the definition of independent directors, strengthening the responsibilities of audit committees, improving the quality of financial disclosures, etc.
2009	After the Satyam scandal broke in early 2009, the Ministry of Corporate Affairs (MCA), inspired by industry recommendations, releases a set of voluntary
2013	The Companies Act 2013 introduces some progressive and transparent processes, which benefit stakeholders, directors and company management.
2017	SEBI appoints Kotak Committee to advise on issues relating to corporate
2018	SEBI notified the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2018.

- **Impact of good Corporate Governance on Firm Value**

  Corporate Governance primarily addresses the "agency problem" ensuring the "agents", i.e., the management acts in the best interests of the "principals", i.e., the shareholders. In the Indian context, where promoters typically don the hat of management, protecting minority shareholders' interest is key to a good corporate governance framework. It bridges the information asymmetry between promoters and other shareholders, while instilling confidence among minority shareholders that they will not be taken for a ride.

  Not only is it intuitive, but also various researchers across the world have found positive correlation between good corporate governance and superior market returns. It has also been established that there is a causal link between good corporate governance and lower cost of capital, effective capital allocation and risk management, among other benefits.

  The following table captures the annualized return (%) of the MSCI India ESG Leaders Index[1], which can be considered a proxy for good governance.

Index	3 Year	5 Year	10 Year
MSCI India ESG Leaders	11.37%	8.74%	10.16%
MSCI India	10.52%	5.43%	7.53%

  Source: MSCI

  As seen above, companies with a higher ESG index have delivered consistently superior returns in the medium term as well as in the long term. While it will be simplistic to attribute the above superior returns entirely to good governance, the correlation is hard to ignore.

- **Fair Valuation and Corporate Governance**

  Transparency and disclosure are the key ingredients of good corporate governance, which comes from a company's willingness to disclose the critical details that can help an investor make an informed decision. In financial reporting, the new Indian Accounting Standards (Ind AS) have emphasized the value of disclosure as well as recognition of assets and liabilities at fair value.

  As per Ind AS, "Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." As fair value represents a realizable value in a hypothetical transaction scenario as of a specific date, it gives a truer picture of assets and liabilities compared to historical cost.

  Corporate governance and fair value complement each other. While fair value ensures that assets and liabilities presented on the balance sheet are not disconnected to their market value, it is also dependent on the control environment. Estimation of fair value is contingent on certain forward-looking management assumptions, which can be abused in the absence of the right control environment and good corporate governance.

  Apart from financial reporting, "fairness" has significance in transactions as well. In case of any corporate actions such as mergers, acquisitions, capital reduction, etc., resulting in changes in shareholding patterns, it is the fiduciary responsibility of the board of directors to protect shareholders' interest by ensuring fairness of the transaction.

- **Fairness Opinions**

  While a fairness opinion at its core protects the minority shareholders from a raw deal, it also insulates board of directors from potential litigation. As per the Companies Act 2013,
  - A director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment.
  - A director of a company shall exercise his duties with due and reasonable care, skill and diligence, and shall exercise independent judgment.

  In most common law countries, the "business judgment" rule is a legal business principle, which confirms that the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that business decisions were made in the best interests of the company. A fairness opinion by a third-party, independent and

qualified advisor provides protection to the board of directors under the "business judgment" rule.
A recent article discussing the increasing requirement of a fairness opinion in today's legal environment, focuses on board accountability and shareholder activism. As per the article, globally 98% of public companies that were acquisition targets from 1996 to 2011, obtained at least one fairness opinion. The desire for fairness opinions for a transaction stems from the high likelihood of litigation. In 2017, 73% of M&A deals involving public company targets and valued over US$100 million, witnessed lawsuits by shareholders[2].

Types of Transactions that may need Fairness Opinions

While all M&A transactions may not need or have a regulatory requirement of a fairness opinion, it's highly recommended to obtain a fairness opinion in certain cases. Some of the potential triggers are enumerated below:

- Merger between public companies
- Going-private transactions
- Acquisition by a public company involving share consideration
- Public company as an acquisition target
- Potential conflicts of interest for buyer and/or seller
- Significant divestiture or recapitalization
- Selling company with an unsolicited offer and lack of an investment banking process
- ESOP transaction
- Venture capital-backed or private equity-backed selling companies with different classes of equity
- Reverse stock splits
- Deals with multiple bids of varying forms of purchase price consideration (cash, stock, notes, etc.)
- Deals in which directors' and shareholders' interests are not identically aligned

Given the current litigious business environment, it is important for any board to be able to document its process in evaluating the merits of any significant corporate action. Effectively using fairness opinions issued by outside advisors will ease the strain on board members to demonstrate their careful consideration of different shareholder groups' varying points of view.

- **Fairness Opinions Providers**

  As mentioned earlier, it is critical that the board exercises due care while choosing the issuer of the opinion which is not only independent, but also possesses expertise and a track record. As per the Thomson Reuters Mergers & Acquisitions Review – Full Year 2018 rankings for worldwide providers of fairness opinions, the top five providers (based on the number of transactions) of announced fairness opinions rendered globally are presented below:

  1. Duff & Phelps
  2. CITIC
  3. Huatai Securities Co. Ltd
  4. J.P. Morgan
  5. Stout

- **Parting Thoughts**

  In an increasingly globalized world, where money and corporate operations constantly cross borders, creating an environment of trust by protecting investors' interest is critical for financial stability and sustainable economic growth for an emerging country like India. Corporate governance, aided by the application of fair value-based financial reporting, tax planning, transactions and other corporate decision making, will play a key role in that endeavor.

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[1] The MSCI India ESG Leaders Index is a capitalization weighted index that provides exposure to companies with high Environmental, Social and Governance (ESG) performance relative to their sector peers. MSCI India ESG Leaders Index consists of large and mid-cap companies in Indian markets.

[2] Four critical questions when obtaining a fairness opinion, EY, March 2019.