National Conference on Corporate Governance Trends in India
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Corporate Governance Assessment – An International Perspective

Ladies and gentlemen,

Thank you for inviting me to participate in this workshop to share some of our experience in assessing companies for corporate governance, and to provide some input on the novel and interesting idea of introducing corporate governance (CG) audits. I shall describe first our experience in assessing CG, my views on the merits and weaknesses of such assessments and then some suggestions on how CG audits could be pursued to provide information of real practical use to investors.

CLSA's corporate governance work

CLSA, is the Asian securities arm of the largest French banking group, Credit Agricole. Our first CG report was printed in year 2000, in response to fund managers pointing to a need for this to be given greater attention in the wake of the Asian financial crisis. The latest of these annual reports on CG came out last month in September.

In these reports we rate both companies and markets for CG. We assess the companies on 60 criteria, under seven key categories viz: discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. Each question has a yes/no binary answer to reduce subjectivity in the scoring by the analyst.

No system of scoring is perfect. There is an inevitable trade-off between scoring companies on the formal structures of CG being in place (board committees, number of independent directors, number of board meetings, reporting results and releasing annual reports within the given time frames etc) as opposed to assessing the actual commitment to CG, which is seen in the track record on treatment of minorities, effective action taken in the past to correct for mismanagement etc. The more objective criteria generally assess for form; an assessment for commitment is more subjective. Trying to move beyond scoring a company on just the objective formal criteria necessarily means incorporating some questions that require an element of judgement, i.e. subjectivity.

I should like to stress the importance of going beyond assessing for form. It is very easy for a company to appoint more so-called independent directors, set up the various committees etc. But that does not mean that the controlling shareholder really does take the interests of minorities seriously. It could all be a façade to give the company some respectability. When the crunch comes, when the controlling shareholder is under duress, the company might still disappoint investors despite having the formal stuff of CG in place. Enron is a classic example of a company that would have scored highly on the objective criteria of CG, but nevertheless had poor checks and balances, highly dangerous off balance-sheet entities that created huge risks for the company and (we all know) it eventually blew up.

In the CLSA company scores for CG, 16 of the 60 questions involve an element of judgement on the part of the analyst. In total, these questions account for 26% of the score.

One major change to the scoring system that we introduced this year is in introducing negative scoring for 15 of the 60 questions. The reason is that under the previous scoring system, a company that transgressed on a major issue does not get the score on a particular question; but typically each question has only 1.7% of the total score. That means a company can make up points on a number of the questions that relate to the form of corporate governance, and that could give it a respectable overall score. Even though on certain key issues its commitment to corporate governance is revealed negatively, its overall score sometimes came in at a level that seemed too high. The scoring system, we felt, was not sensitive enough to transgressions, with some companies tallying up scores that seemed too high given their track record.

Fifteen questions now have a negative score in our ratings on companies, i.e. if a company had a negative answer then instead of just getting a zero, it gets a negative score equal to one-quarter of the total score for that CG category. This has meant a greater dispersion in the scores between companies at the top and the bottom of our rankings.

The findings in the 2004 CLSA CG report

Let me share some of our findings in these reports. In this year's report, which was titled "Spreading the word", we show that over the last five years, markets that we ranked for better CG have significantly outperformed the markets we rank lower for CG in our universe of ten Asian markets. Over the five years to mid-2004, the index that is most commonly used for Asia-Pacific, the MSCI Asia ex-Japan Free Index, is down 16.5%. However the bottom-half markets in our ranking of CG fell much more severely: averaging a decline of 36%. The top five CG markets in our ranking actually managed to give a small positive return, up 3% on average.

As we write in our report "It is noteworthy that India, Malaysia and Korea, the three markets that have seen major improvements in their CG environment over the last few years …. have outperformed the MSCI Asia ex-Japan index over the last three and five years. These are the only markets in our sample that have had positive gains over the last five years, up by 11-24%. Other than Thailand's very small positive return (+2%), the other markets are all down for the five-year period."

India, by the way, is up 24% over the last five years to mid-2004, outperforming the regional index by 40-ppts. For the last three years, MSCI-India is up 43% significantly ahead of the regional index which gained 26%. In our country rankings, India is ranked third for overall CG environment, behind the more developed markets of Singapore and Hong Kong, but ahead of all other developing markets that we cover. Our country score for India has increased from 5.4 out of 10 in 2001, when we first scored the countries, to 6.6 in 2003. This year, we introduced a more rigorous methodology for both country CG determinants (as well as negative scoring for companies). The new country scoring I believe adjusted for some perception biases. The scores for the lower markets came up slightly, but the scores for the three top markets (Singapore, Hong Kong and India) came down an average of 0.4 points compared to 2003; that is exactly the minor decline seen in the India score this year.

Among companies, Infosys, with a score of 87 out of 100, comes out ahead of all the companies in our coverage in Asia. Wipro, HDFC, Hindustan Lever and Bharti are also among the bigger market cap companies in our top thirty across the entire region.

What strikes me about India is the drive for reform on the part of the authorities and also some of the large companies. Some of the initiatives here are truly remarkable, for instance SEBI setting up a committee on CG, chaired by Infosys's CEO Narayana Murthy, to examine best-practices and come up with practical suggestions of what can be implemented. Many of the recommendations of the committee, if implemented, would really set India apart from the rest of Asia on the CG front.

The proposal for CG audits

Another remarkable initiative in India is the discussion on this concept of a CG Audit, which has not been considered anywhere else, certainly not in the Asian markets that CLSA covers. I think it has the potential for giving investors' some useful information on which to make their investment decisions, information relevant to determining the quality and risk of the companies they are investing in, which they would otherwise not be able to get readily. However, as we have tried to do in our company questionnaire, I think it is important that the CG audit should move away from just assessing for form, but also to reflect to some extent what can be seen about the company's commitment to CG.

First, the easier sorts of information or data that would be relevant to investors, which it would be useful to assess companies on:

1) The composition of the audit committee – whether it has an independent director with financial expertise, whether it is chaired by an independent director;
2) How often have audit committee members met during the year and what has been the attendance rate of committee members;
3) What, if any, are the related party transactions the company engages with related companies of the controlling shareholder, in particular sourcing of materials and/or distribution channels for the products, and including details of fees paid to other related companies of the controlling shareholder outside the given listed company;
4) If there are any transactions with off balance-sheet entities, e.g. special purpose vehicles, which the listed company has contingent liabilities to cover;

5) The size of the board, the number of INEDS, whether the INEDs have financial expertise/experience, and if the INEDs also have other professional positions (i.e. reputations to protect;
6) Attendance record of directors overall and INEDs at board meetings;
7) How long the INEDS have been on the board;
8) Whether the chairman is non-executive;
9) Whether risk management reports are tabled and discussed annually at board level;
10) The amount of non-audit fees paid to auditors and how much these are compared to audit fees paid;
11) Whether the auditor, or the audit partner, is rotated every 3 or 5 years;
12) How often the company has issued dilutive instruments in recent years e.g. convertibles, warrants and options and details on these.

The list could go on to be much longer, but I believe it shouldn't be allowed to be too long. When too many criteria get included, the weight of any given criterion gets diluted. It is important to cover the key issues that matter, and leave out the more peripheral CG matters.

Who should engage in the CG audit? To be frank, I do not think that so-called specialists will provide much greater value-add in the audit exercise as opposed to officials of the exchange. The companies can be asked to provide the information, to self-answer these questions. If they participate, then it should be made clear that any deliberate false information will mean penalties on the persons providing such information. These penalties should be quite severe, like recommending the person who has knowingly provided false information (or information that he should have known was false) pay a penalty personally, be removed from holding any such position where he signs public documents for a listed company and be barred, by the securities regulator, from holding a similar position or directorships in any listed company.

However, to offset, there should be a suitable incentive for companies to participate in this exercise. One suggestion is that the exchange compiles the information from the listed companies that participate, and based on this information, have a scoring system to rank the companies that participate into three tiers for CG. The companies that do not participate would then be shown as companies that are unclassified for CG. Investors will then soon get the message that to provide the information is itself an act of transparency which puts a company higher than companies that do not provide the information.

Of course, if only a small number of companies participate in the exercise, then to be one of the many that does not participate will not carry much stigma. To encourage most companies to participate, the exchange could consider lower listing fees for companies that participate. And the funds that invest on behalf of domestic institutions could be instructed that they can only invest in companies that participate in providing this information and thus get a CG ranking by the Exchange.

To provide information of relevance to investors

The issues that I have mentioned above are fairly standard in assessing CG. Partly for this reason, providing this information will not really create much of a stir within the investment community. For this effort to really provide information that is especially relevant to investors and be noticed, I would suggest two criteria that are usually not in CG checklists. The first, is:

A) What are the other business interests of the controlling shareholder, and what other companies is he a director of other than the subsidiaries of the given listed company?

This I believe to be one of the most important questions regarding the risk in investing in Asian companies. In the developed world, the main CG issues arise in checking management to make sure they are not hijacking control and economic value at the expense of shareholders. However, in the Asian context, controlling shareholders tend also to be active in management and generally are able to check management from abusing shareholders overall. The main CG issue in our region is balancing the interest of controlling shareholder versus minority shareholders.

This issue comes up as a particular risk when the controlling shareholder has various other interests, some through other listed vehicles and some under private companies. Then the risk is that a given listed company might be doing well by itself, but because some other business of the controlling shareholder is suffering, the healthy listed company is used to rescue the weaker business that was originally outside the listed company.

In my view the risk of conflict of interest of the controlling shareholder becoming real and affecting minority shareholders, is the biggest CG risk for investors in this region. Sometimes, that risk comes also from listed companies that are controlled by the government – when the government's other interests may come into conflict with value-creation for the listed company.

If one is invited to invest in a small partnership where one of the partners is going to manage the business, one would naturally want to know a bit about the person who runs the business. Not only will that background knowledge cover his expertise in the area of business, but also what his other commitments are. How many would be comfortable investing in a venture where the person running the business and controlling the finances might have many other businesses, some of which might be used to siphon off funds from the company in question?

Yet when investors buy shares in the public market, this key information, on other business interests of the controlling shareholder is missing. It is not provided in IPO documents, nor in annual reports. Certainly, we find high risks of negative surprises where groups have entangled corporate relationships, for instance the *chaebols* of Korea, when one listed company is sometimes used to bail out another.

Most often, the most important information that one should be aware of, before deciding to become involved as a shareholder in Asian companies, is the other businesses of the controlling shareholder. Hence I would include this as a criterion for information to be provided and where possible verified by those undertaking the audit. This is usually not one of the factors that is generally considered part of good corporate governance. That to me is a myopic view of CG, looking only at formalities within a firm, rather than key issues related to the firm that bear on the risk of investing in it. I strongly recommend that a CG audit, if it is to have relevance to CG issues in our markets, should also seek to provide this information.

The second issue I believe important to provide information that investors do not generally get, but information that is quite crucial, is:

B) An assessment of the competence of independent directors and the extent to which they have played the role expected of them.

This assessment should determine, through interviews of the independent directors, their financial expertise (what they claim their knowledge to be and whether they understand and are able to answer correctly a random selection of fairly basic accounting/finance questions); their understanding of the risks involved in the business (based on what they state these to be), how many days ahead of board meetings they reveal they get the agenda and supporting documents; what in their view are the major decisions made by the board in the recent years and the extent of briefing that they obtained from management pertaining to those decisions; and an assessment of the minutes of board meetings, as well as minutes of the key committees under the board, in particular the audit committee, to determine to what extent was there discussion in which the independent directors participated and asked relevant questions.

Investors are not able to determine the extent to which independent directors are competent and are playing their role diligently. Just as a financial audit checks on certain key areas to see if the accounts are accurate, similarly those undertaking the CG audit should discuss with the independent directors and look at the minutes of the board and committee meetings, to assess whether the independent directors have appeared to act independently, have been diligent in assessing the information provided by management and have acted in the best interests of the company.

This idea clearly needs to be considered more thoughtfully, for instance, how some reasonably objective criteria can be drawn up to determine whether the independent directors are playing the role expected of them. But in my view, it would provide information that investors would find extremely illuminating, for instance if the CG audit stated that independent directors did not ask probing questions of information provided to them, rather than mere clarifications; if the audit could not find any independent director who had financial knowledge; or if the independent director is not able to provide much information on what were the supporting information and documents that management had provided the board for the most important board decisions in recent years.

Making the exercise worth the effort

Providing information regarding (A) the other business interests of the controlling shareholder, and (B) the extent that independent directors are seen to be competent and playing the role expected of them, would, in my view, make all the difference in determining whether international investors pay heed to the results of the CG audit – and whether it might become a model for other markets to adopt. (A) and (B) give investors key information that they would not otherwise have. These go beyond just the form of CG. The information that would be provided would reflect the real level of diligence by independent directors and the companies where controlling shareholders have a wide range of other business interests that could conflict with the company in question.

If this idea of a CG audit is to be put into practice, it should move away from mere box-ticking, ie assessing for just the objective criteria in most lists of CG assessments. If it does also give some assessment of the real commitment to CG, information that investors otherwise can't get, it will be worth the effort of all the parties. Otherwise, it might be something that could be used to guide the investments in equities of domestic funds, but it will not provide information that would not already be available to investors who bother to check. International investors may then give these assessments little attention. My recommendation is to pursue this idea, but like financial audits, seek to provide a check and information of what is going on inside a company which makes it of real use to both domestic and international investors assessing the company from outside. This, I believe, is crucial to make the exercise worth the effort.

Thank you.

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