Rating of Corporate Governance Practices of India Incorporations: Methodological Issues

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The concept of corporate governance, which emerged as a response to corporate failures and widespread dissatisfaction with the way many corporate function, has become one of the wide and deep discussions across the globe recently. While the recent high-profile governance failures have brought the subject to media attention, the issue has always been central to the economists and business and academicians.

Corporate governance generally refers to the set of mechanisms that influence the decisions made by managers when there is a separation of ownership and control. Some of these monitoring mechanisms are the board of directors, institutional shareholders, and operation of the market for corporate control. The importance of this topic is obvious from an examination of the considerable growth in the empirical literature on corporate governance across accounting, economics, finance, management, and corporate strategy literature. Typical research studies examine whether different corporate governance ratings impact on organization's financial performance.

The core principles of corporate governance as laid down by the Organization for Economic Cooperation and Development (OECD) Advisory Group are the four pillars on which the edifice of Corporate Governance is built. These are: fairness; transparency; accountability; and responsibility. Without doubt, these are essentially qualitative and subjective issues, and therefore, may not be easily amenable to clear-cut objective analysis.

The scope and significance of corporate governance in India increased sizably in the recent period, particularly following the financial sector reforms. As Indian corporate are finding new space in domestic and global markets for business growth, their interaction with the financial markets and investing community too witnessed significant surge. In this process, corporate governance came as an effective instrument for companies to communicate with the various types of stakeholders in general and investors in particular.

What began as an industry initiative of CII, corporate governance today became an essential part of the culture that defines better run companies and those held in esteem by the investors and stakeholders. India has advanced significantly in adopting better governance standards and its standing in the world is quite high in regard to designing effective policies and procedures. Several companies go beyond the mandatory requirements in fulfilling the corporate governance objectives. Companies have developed philosophies governing the governance practices that were introduced in their respective companies and the outcome that is being expected from these initiatives. Some of the modern governance practices such as separation of the Chair and the CEO, constitution of boards, representation of independent directors, meetings of the board and audit committees, discussion on the corporate governance practices in the annual reports, disclosure through a wide range of media and company sources etc., have greatly enhanced the image of the quality of corporate governance in India. India currently is ranked third in Asia for the overall quality of corporate governance.

While great progress has been made in improving the governance standards, concerns about quality of enforcement, companies routinely fulfilling the requirements as a form of box ticking, deviating from the spirit of some of the important aspects of the compliance code etc., are a few of the issues that engage the attention of the policy makers and the regulatory agencies. Similarly, self evaluation processes for the board and audit committees are not yet formalized in many companies. Family ownership continues to dominate the corporate landscape thus providing a scope for inadequate disclosures in regard to subsidiary companies operations and related party

There are certain specific statutory and regulatory requirements governing the economic management of corporate entities, which also define the codes and standards with particular orientation towards protecting the interests of diverse stakeholders. The Cadbury Committee's recommendations, the OECD principles, the Confederation of Indian Industry (CII) Code, the Securities and Exchange Board of India directive through Clause 49 of the Listing Agreement, and the recent changes in the Companies Act provide the guiding principles of corporate governance. These could be excellent starting points for developing an analytical framework within which a corporate entity's quality of Corporate Governance may be assessed.

When talking about stakeholders, the question that arises is: "Which stakeholder?" Stakeholders range from internal ones like equity investors, lenders, creditors, and employees to external ones such as sovereign authorities and social environments. Accordingly, the stakes could be financial and non-financial. Moreover, there could even be some conflict between the interests of the different categories of stakeholders. Defining the scope of corporate governance rating is thus essential.

ICRA's corporate governance rating, for instance, limits its scope primarily to the interests of financial stakeholders. The basic parameters are built around the shareholding structure, governance structure and management processes, including board-level issues, inter-relationship of stakeholders, and quality of financial discipline, reporting, transparency and disclosures. Also, issues related to creation

and distribution of corporate wealth are captured in the process, albeit indirectly.

Confirmance by a corporate entity to the requirements of rules, procedures and codes as prescribed by the appropriate statutory and/or regulatory authorities is the minimum in the benchmarking process that is part of ICRA's corporate governance rating exercise. Thus, the coverage of the analytical framework extends beyond mere compliance-compliance being only the starting point. The focus is predominantly on the substance over the form. It is more the spirit than the letter of the relevant rules, procedures and codes that is important. The sets of variables that have been identified are drawn from different guidelines, codes of governance and committee recommendations on the subject. These variables reflect the distribution of rights and responsibilities among the constituents of the corporate management including the shareholders, the board of directors, the executive management, and, of course, the committees constituted for specific purposes.

There is a possibility that the corporate governance rating and the conventional credit rating for the same corporate entity would not converge. But they may not necessarily do so in all cases. The parameters, methodologies, target audiences and objectives of the two rating exercises are not identical, although they share certain common features. It is possible that a corporate entity following excellent corporate governance practices is unable to generate the kind of cash flows that would merit a high level of credit rating. Thus, credit rating and corporate governance rating are not necessarily co-directional. A corporate entity does not carry on its business perpetually to demonstrate excellence in corporate governance. Good corporate governance is the means and not an end by itself. Ultimately, the business has to create wealth and distribute it fairly and equitably among its diverse groups of stakeholders.

Given the recent importance of corporate governance in academic research and policy, we ask a very straightforward question: “do companies in emerging markets that practice better corporate governance receives higher valuations in the market?” That is, do investors care, via valuations, if a firm practices better governance?

Accordingly, timely and accurate disclosure of information regarding the financial performance, ownership and governance of the company is an important part of corporate governance. This improves public understanding about the structure, activities and policies of the organization. Consequently, the organization is able to attract investors and enhance the trust and confidence of the stakeholders. This is the system by which companies are run and the means by which they are responsive to their shareholders, employees and society.

To find out the impact of corporate governance rating on corporate financial performance, if the data consists of yearly-level governance ratings for major industries and the relevant financial performance of selected industries in BSE Index for almost five years, and these ratings allow us to conduct a study to examine the effects of Corporate Governance Rating on Corporate Financial Performance for a given period of time.

In other words, we can examine firms on a time-series basis and see what happens to market valuations before and after corporate governance improves or declines. Finally, besides examining the changes in corporate governance ratings, it is also possible to investigate other issues, using data, if better governance implies higher valuations by investigating the levels of governance and valuation rather than the changes. Second, since if the study has yearly time-series data on firm-level governance, it is possible to examine the link between firm-level governance and financial performance via time-series regressions on industry basis. It is required to calculate various scores in the area of financial performance and Corporate Governance.

The Corporate governance score will be calculated as per ICRA rating model by considering the parameter which has been defined by ICRA for better Corporate Governance Scoring. To evaluate the financial performance of selected companies under each Industry, some of the accounting ratios have been selected to measure the financial performance as follows:

I) EBT / Sales

ii) Sales / Total Assets

iii) Earnings Per Share

iv) P/E Multiple

After analysis of governance structure, process and disclosures made on corporate governance, the question comes to mind is what is the standard and quality of governance that has been achieved by various companies? Then the companies under each category of Industry will be ranked accordingly the Corporate Governance Rating Index obtained. Thereafter, it is possible to find out the correlation between the parameters of Corporate governance and the accounting parameters of selected companies under each Industry whether a good corporate governance rating influence the financial performance or not.

Conclusion:

This paper highlights the methodology of ICRA'S model for evaluating the Corporate Governance Rating and its impact on financial performance of Indian companies. ■

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Rules of the Garage

- Believe you can change the world.
- Work quickly, keep the tools unlocked, work whenever.
- Know when to work alone and when to work together
- Share – tools, ideas. Trust your colleagues..
- No politics. No bureaucracy. (These are ridiculous in a garage)
- The customer defines a job well done.
- Radical ideas are not bad ideas.
- Invent different ways of working.
- Make a contribution everyday. If it doesn't contribute, it doesn't leave the garage.
- Believe that together we can do anything.
- Invent

If you carry these rules with you on your journey, If you create an environment where people's hearts and minds are fully engaged, where strategy is ennobling, where great aspirations are powered by the desires of people to do something worthwhile, then you will have touched others you encounter on your journey. ■