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**GOVERNANCE AND VALUE CREATION RATINGS  
Vs CORPORATE GOVERNANCE RATINGS:  
WHAT SHOULD INVESTORS USE?**

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## EXECUTIVE SUMMARY

Corporate governance has attracted a good deal of public interest because of its apparent importance for the economic health of corporations and society in general. Investors and other stakeholders are becoming more and more discerning and demanding in the wake of certain major corporate collapses (*Enron, World Com*). This has led to a market for Rating Corporate Governance. Two methods have evolved one that focuses on the process aspects (Corporate Governance Ratings) and the other that includes Value Creation and Management Assessment along with Process Aspects (Governance and Value Creation Ratings). This brings us to the classical dilemma of which ratings to use. These have been studied in light of the following criteria:

- Shareholder Vs Stakeholder (360 Degree Evaluation) Focus
- Extent of Coverage – Legal, Economic and Social
- Sustainability and Profitability – Short Term Vs Long Term Perspective
- Objectivity Vs Subjectivity
- Stability
- Form and Substance: Input Vs Output

Critical analysis of the two ratings reveal that GVC Ratings are much better positioned with regards to providing opinions on the viability of long term investments in an organization. However, these ratings have some limitations and so due consideration must be given to them and other factors before taking the investment decision.

## CORPORATE GOVERNANCE

Corporate Governance is a set of relationships between a company's board, its shareholders and other stakeholders that provide the structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance is determined.<sup>1</sup> It is thus about the understanding the institutional arrangements for relationships among the various economic factors and corporate participants who may have direct or indirect interests in the corporation, such as shareholders, directors/managers, employees, creditors, suppliers, customers, local communities and the general public and their impact on the profitability of the organization.

Everyone is involved with a company in one way or another; either as an investor who seek for returns from investments as part of income; as an employee who spend a good number of hours each day with his employer; as a customer who buy products in a supermarket manufactured by a company; or as a neighbor in the same community. Corporate entities are actually the largest consumers of resources in the present society and also the most important drivers of the economy. ***The accountability, transparency, fairness and responsibility of these companies on legal social and economical,*** as a good corporate citizen is, therefore, crucial for the well being of every civil citizen is in today's economy . This is what is ensured by Good Corporate Governance.

## **RATING CORPORATE GOVERNANCE**

The continuing efforts to develop capital markets and the new ones to bolster investor confidence have created a market for rating corporate governance. The need for validation arises afresh in the context of the failure of to spot the impending collapse of corporate. Cases like Enron could have been avoided, had they been rated on the entire spectrum of Corporate Governance activities. It is thus imperative to have independent standards for judging Corporate Governance in order to save the interests of the investors. Two ratings have emerged over a period of years:

### **Corporate Governance Rating (CG)**

CG Rating is an opinion on relative standing of an entity with regard to adoption of corporate governance practices. It provides information to stakeholders as to the level of corporate governance practices of the entity.

### **Governance and Value Creation (GVC) Ratings**

GVC Ratings are an opinion on relative standing of an entity with regard to its ability to optimize value creation for all its stakeholders in conjunction with corporate governance practices. They are based on the following premises<sup>2</sup>:

- The shareholders have a residual entitlement, while all other stakeholders have contractual entitlement to the value created by the company

- The strength of stakeholder relationships can add to/impede future wealth creation by the corporation
- Governance processes must be such that wealth created is evenly distributed across all classes of stakeholders.
- Management quality must be such that it is able to adapt the above two to match the dynamics of the business environment
- All these impact stability of future wealth creation

The exercise involves assessment of Wealth creation and distribution parameters in addition to the parameters evaluated under CGR. The composite rating is called as Governance and Value Creation (GVC) Ratings.

## **ASSESSMENT OF GVC AND CG RATINGS FOR A LONG TERM INVESTOR**

A series of criteria were developed under which the GVC and CG Ratings have been evaluated.

### **Shareholder Vs Stakeholder (360 Degree Evaluation) Focus**

*A Longitudinal Study of British Managerial Mindsets indicates that between 1980 and 2000, there was 20 percent increase in emphasis on stakeholder interests. Most of the Managers (nearly 80 percent on average) attach importance to stakeholders in 2000, compared with only 50% in 1980<sup>3</sup>*

*In between 1997 and 2000, 25 states of the USA have amended their General corporation Laws to incorporate stakeholder concept, while most of the states had expressly permitted directors to take into account the interests of stakeholders in Decision Making<sup>4</sup>*

The above illustrations indicate the rising importance of stakeholders in the Corporate Decision Making Process. This is because of the realization that stakeholding is an effective means to improve efficiency, profitability, competitive position and economic success. This in turn can be explained as below:

- **Shareholders** are the **residual interest holders** in the corporate entity, after meeting obligations to other contractual stakeholders such as employees, customers, suppliers and indeed the society in which it operates. Therefore, the corporate has to **create enough value to meet all of these obligations**

before meeting its promise of returns to shareholders. It can do all of these in a sustainable manner only if it enjoys an **enduring relationship with these constituencies**. Therefore the **value creation is critically dependent on and directly linked** to the governance practices adopted by the corporate vis-à-vis all of the constituencies that are critical to its operations.

- The evaluation of the corporate governance issues requires a good understanding of the corporate's behaviour vis-à-vis each of its stakeholders. Issues like Corporate Social Responsibility, Labour Laws, and Environment Protection are no longer behavioral, but are being looked at as means of survival and growth in the long run. This is because of factors like **increased costs** due to additional efforts by the organization to take care of these issues or **disruptions in normal operations** which in turn reduce profitability.

GVC ratings provide a complete 360 degree evaluation of the stakeholders; their relationships with the corporate as well with each other. On the other hand the Governance Ratings are only concerned with the rights of the shareholders. Hence, for a long term investor GVC provide a better, clearer and most importantly a complete picture of the organization.

### **Extent of Coverage – Legal, Economic and Social**

CG is a social, economic as well as a legal process which cannot be isolated from social and other non economic conditions such as power, legislation social relationships and institutional contexts. The entire liability and risk of an organization is shared by many stakeholders including shareholders and in this sense all organizations have some public charter

GVC covers the entire gamut of governance issues, from the input side practices to the outside wealth creation performance. It therefore looks at the tangible measures of results and the intangible factors that influence the decision making process. It explores the structural issues, philosophy of management, robustness of processes, strategies, tactics and capabilities across the spectrum of activities undertaken by the entity. In this sense, it covers both the ***internal and external issues associated with the three factors***

Corporate Governance Ratings on the other hand cover mainly the ***internal issues*** associated with the functioning of the corporate and some external issues concerning the shareholders. These ratings are ***mainly economic in nature*** and ***completely ignore the legal and social relationships*** that exist with the organization.

### **Sustainability and Profitability – Short Term Vs Long Term Perspective**

In order to invest in an organization, it is extremely important to know the future of the organization. This involves understanding the current situation, with respect to ***practices and wealth creation*** and provide an opinion on the future sustainability.

***Example of General Electric Company***<sup>5</sup>: During 1930's Depression, General Electric promoted stakeholders' interests in order to survive the economic crisis. It had followed it ever since through and not only has the organization survived; it has grown to be one of the largest and most respected organizations worldwide.

**GVC** ratings arrive at the core of the value creation capability of a corporate entity by capturing embedded risks and exploring the connected governance for all the activities carried out by the organization with respect to the various stakeholders. They negatively mark inappropriate practices as possible sustainability issues for a particular stakeholder which lowers the overall wealth creation for that stakeholder. This is because in the long run, this might be disrupted due to new policies, public intervention etc. Hence ***they provide an idea about the sustainability of the organization in the long run***

CG Ratings on the other hand, have a historical perspective and focus on the conformity of the processes to governance standards. It is more of an ***audit exercise that evaluates the "as is" situation and provides the gaps with respects to the standards***. This does give some insight into the sustainability of the organization but then it is **incomplete** (as it does not include all the stakeholders) and more importantly is **short term**.

## Objectivity Vs Subjectivity

Any investor planning to invest would like to have an as objective opinion as possible about the current and future state of a potential organization and minimize the subjectivity involved. The more the mathematics and the number of factors involved, the higher the objectivity of the source of information. The more the qualitative factors, the higher would be the individual judgment and higher the subjectivity. The following facts compare the GVC and CG ratings with respects to this criterion:

- **Qualitative and Quantitative Parameter Balance:** Extent of compliance to standards of corporate governance as well as the relationships between the various stakeholders is more often than not a checklist arrangement that tends to be subjective in nature .The **value assessment parameters** like Return on Capital Employed (ROCE), Return on Net Worth (RONW), Dividends, Economic Value Added (EVA) and Market Value Added (MVA) etc. on the other hand are mainly **quantitative in nature**.

**GVC ratings** have a **good balance** of the two as they include the gamut of factors stated above, and hence have a **high degree of objectivity**. In contrast the **CG ratings** appear to be nearly qualitative, focusing only on the standards and rights of shareholders and hence are **more subjective**.

- **Stakeholder Evaluation** in Corporate Governance can generate more accurate and unbiased information for business operations and management and thus improve governing efficiency and effectiveness <sup>6</sup>. Here again it is seen that the GVC ratings are much better positioned than CG ratings to provide objective opinions.

## Stability

Stability implies constancy over a period of time as well as immunity to changes in the external environment. Also, the same ratings model can be repeatedly used to examine and factors like Organization Life Cycle, stakeholder relationships, sudden economic shocks etc would not affect them. This lends credibility to organizations and gives investors sufficient time to take decisions.

CG ratings are determined mainly by comparing the corporate's practices against the well laid out Corporate Governance Principals. These principals are not open to sudden or immediate changes and remain stationary over years. The **CG ratings then naturally would be pretty much stable over a period.**

However, GVC ratings on the other hand are subject to dynamic changes .This is because of the fact that the relationships with stakeholders are very dynamic and change almost instantaneously with slight change in company's orientations. Also the relative strength of stakeholders to satisfy critical organizational needs varies with market conditions and with organizational life cycles <sup>7</sup>.Also, at times the relationships might not be specified correctly. In this respect **GVC ratings are relatively unstable and extremely prone to changes.**

**Example:** An In the Wake of September 11 attacks, the airline industry in the US as well as outside, which was doing so well before went down drastically. Though the Governance Structure of the organizations did not change, the long term value creation ability did get affected which would have definitely caused a drop in the GVC ratings post September 11 as compared to pre September 11 Scenario, although the CG ratings for the same organization would have been constant .

### **Form and Substance: Input Vs Output**

Evaluating Corporate Governance Practices and Wealth Creation and management are two aspects of the Corporate Governance Exercise. An analysis of the former provides insights into the way the activities are being carried out vis a vis the best practices in an environment. This essentially measures the **form** part of the exercise. This is incomplete without an evaluation of the Wealth management and Creation which helps in understanding the effectiveness of these policies. This is the **substance** part of the exercise. In other words ***corporate governance practices of an organization are inputs (form) that lead to effective outputs (substance) of long term sustainability and profitability.***

***GVC ratings address the substantive impact*** of the governance policies. They help in differentiating two equally well governed companies on value creation as well as on the stakeholder types that they address. ***CG Ratings on the other hand focus on form*** and provide insights into governance practices of the organizations.

## CONCLUSIONS

The relative merits of GVC and CG ratings for long term investors, with regards to the criteria discussed above can be summed up in the table given below:

Factors	GVC Ratings	CG Ratings	Long Term Investor
Stakeholder Vs Shareholder	Stakeholders	Shareholders	GVC
Extent of Coverage	Wide	Narrow	GVC
Sustainability And Profitability Indication	Long Term	Short Term	GVC
Objectivity Vs Subjectivity	Objective	Subjective	GVC
Stability	Low	High	CG
Form Vs Substance	Substance	Form	GVC

As the above table indicates, ***the GVC ratings are much better placed to provide an opinion on the viability of a Long Term Investment in an organization***

Rating corporate governance is serious business Institutional investors, financial institutions, employees and small investors will get guided by it even if the intention is probably only to serve as a guide. Obviously rating is mere opinion than surety. With no permanent principle which covers all societies, cultures and business situations being in place for Corporate Governance, the ratings come with loads of caveats. These should be taken into account and the institutional investors should use them only as guidelines to assist them in their decision making<sup>8</sup>

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