

## Evaluating Corporate Governance

### Issuer-Specific Considerations

#### Cross-Sector Criteria

This report updates and replaces  
*Evaluating Corporate Governance*,  
dated 4 April 2016.

#### Scope

This criteria report outlines India Ratings and Research's (Ind-Ra) approach to assess the impact of governance practices on issuers and identifies which issuer-specific category best reflects issuer-specific characteristics and incorporate these findings into the ratings.

Good governance practices do not, in isolation, positively affect a credit rating. However, poor governance practices, including issuer-specific corporate governance matters, can result in lower ratings than typical quantitative and qualitative credit factors may otherwise imply. The extent to which ratings are affected depends on the extent and pervasiveness of the governance matter(s) identified and the relative strength of an issuer's credit factors within its rating category, balanced against/with the absolute level of its issuer or debt instruments ratings.

#### Key Rating Drivers

**Issuer-Specific Assessment:** In its review of issuer-specific considerations, Ind-Ra focuses on the characteristics shaped by the industry in which the issuer operates, and the relationships between its stakeholders.

**Issuer-Specific Factors:** Ind-Ra focuses on the following issuer-specific governance characteristics: board effectiveness; management effectiveness; transparency of financial information; related-party transactions and corporate structure.

**Creditor Protection Assessment:** Governance characteristics may be evaluated so as to assess how they contribute to protecting the interests of debt-holders and other creditors. Issuer-specific characteristics are each divided into three categories: ratings neutral; those that may put downward pressure on ratings; and ratings negative.

#### Analysts

Arvind Rao  
+91 22 4000 1749  
[arvind.rao@indiaratings.co.in](mailto:arvind.rao@indiaratings.co.in)

Abhishek Bhattacharya  
+91 22 4000 1786  
[abhishek.bhattacharya@indiaratings.co.in](mailto:abhishek.bhattacharya@indiaratings.co.in)

Abhash Sharma  
+91 22 40001778  
[abhash.sharma@indiaratings.co.in](mailto:abhash.sharma@indiaratings.co.in)

## Ratings Analysis

### Issuer-Specific Corporate Governance Characteristics

When looking at issuer-specific governance characteristics, Ind-Ra may focus on board and management effectiveness, transparency of financial information, and related-party transactions.

#### *Board Effectiveness*

Assessing an issuer's governance practices begins with a review of its board of directors. High performing boards are important if executive management is to be challenged. This means that effective boards must include non-executive members with diverse skills, views and professional experience. Members must be prepared to invest sufficient commitment and time into the work of the board. The role of the chairman of the board is particularly important. The board of directors, in its oversight role, plays an integral part in how management is both rewarded and disciplined as it fulfils its fiduciary responsibilities.

A board that is independent, active, knowledgeable and committed generally signals a robust governance framework. A board that is not committed to fulfilling its fiduciary responsibilities can open the door to ineffective, incompetent, and, in some cases, unscrupulous management behaviour.

In evaluating board effectiveness, Ind-Ra looks at the composition of the board, qualifications of board members relative to their assigned committees, and how the board operates. Analysts also focus on the resulting actions and policies set by the board, including selection of management and related succession planning, setting strategic direction, including risk targets, using compensation to reinforce strategic objectives, and oversight of financial reporting.

Board members are evaluated for their areas of expertise and independence from executive management. The board should be comprised of individuals with expertise in related or similar industries, or audit, financial or regulatory experience. Listed companies should also be in compliance with listing or jurisdictional rules related to corporate governance.

The board typically determines incentive compensation and remuneration of executive management. This poses a governance concern to the extent that potential for inappropriate incentives exist, such as a focus on short-term performance criteria that may have a negative influence on the long-term sustainability of the company. Inappropriate remuneration policies may also give rise to conflicts with creditors' interests if the issuer's financial resources are strained as a result.

More fundamentally, poor remuneration policies and incentive structures may be indicative of a lack of financial discipline and accountability operating generally throughout the company. Ind-Ra recognises that incentive and compensation information may not be disclosed in many closely held companies. Ind-Ra analysts may exercise judgement in these cases and determine whether lack of disclosure in itself may be a negative rating factor.

#### *Management Effectiveness*

Management effectiveness is evaluated based on whether the issuer fulfils the objectives set out by the board with regard to strategy, risk tolerance, and policies and controls.

#### *Transparency of Financial Information*

Timely, transparent and accurate accounting statements are critical in ensuring that investors are in a position to assess an issuer's financial condition and fundamental risks. High-quality and timely financial reporting is considered by Ind-Ra to be indicative of robust governance. Likewise, publishing intentionally inaccurate or misleading accounting statements is symptomatic of deeper flaws in an issuer's governance framework. The public exposure of techniques that subvert the spirit of accepted accounting standards or, worse yet, are designed to mask fraudulent activity can undermine investor confidence and destroy value.

Similarly, if an issuer does not provide timely business and financial updates to the agency and also delays filing regulatory public updates— e.g. to the Ministry of Corporate Affairs website or to stock exchanges or on its own website, Ind-Ra will not be able to provide a credit view on the issuer. The agency may also consider this as symptomatic of a possible disruption / distress in the issuer's business, which may result in any existing rating being constrained to sub-investment grade.

Governance of the internal audit process is an important safeguard for the integrity of an issuer's financial reporting. An independent audit committee is a requirement for listed companies in India. The audit committee plays an important role in governance of the financial reporting and audit processes. It is the responsibility of the audit committee to promote a sound internal financial control environment, to monitor the work of the internal auditors and often to appoint external auditors. It is a desirable feature of good governance to ensure that internal audit reporting is delivered directly to the audit committee and/or to the board rather than to senior management, as this could give rise to conflicts of interest. Similar considerations apply with respect to external auditors.

However, none of these procedures will be effective unless the audit committee, and/or the board, includes independent members with appropriate financial expertise to be able to understand the ramifications of different accounting treatments and any potential risks or vulnerabilities in the issuer's audit process.

Many listed companies are required to publish an evaluation of the internal control environment and procedures. The presence of material weaknesses highlighted in the disclosure could be a negative ratings factor. Other factors that could also be viewed negatively include the late publication of financial statements, frequent changes in independent auditors, multiple restatements of financial data and aggressive accounting positions.

### *Related-Party Transactions*

Transactions between senior executive management, major shareholders or those close to them and the issuer (related-party transactions) merit close review in governance analysis. Related-party transactions give rise to potential conflicts of interest for a rated entity. More specifically, the related party may be faced with a competing set of incentives and not act in the best interests of the issuer. In some cases, the primary motivation of a related-party transaction is to enrich the executive or related-party at the expense of the corporation.

An important safeguard against potential abuse is for the issuer to have mechanisms or policies that ensure such transactions, should they occur, are negotiated at arm's length, are priced on competitive market terms, and serve a viable economic purpose. Some related-party transactions are conducted for legitimate business reasons and are not based on exploitative or fraudulent rationale. Ind-Ra analysts endeavour to understand the nature, purpose, and terms of related-party transactions, particularly when these are large.

The agency's analysis may consider the board's role in reviewing or approving related-party transactions and the level of detail disclosed in public filings. A lack of thorough board review of such transactions can be a sign of inactive or passive board oversight. Similarly, scant or vague disclosure of the facts surrounding the transaction may require examination and Ind-Ra may consult management regarding whether the board was briefed on the key terms of and motivations for the transaction.

### *Corporate Structure*

Companies with a complex corporate structure would involve an in-depth analysis of the corporate hierarchy. An opaque structure or entities with significant cross-holdings may potentially indicate governance risks. The rationale for the presence of multitude of entities operating under the rated entity and/or above as a holding companies and the interplay among them forms an important part of the analysis.

As for systemic characteristics, the issuer-specific characteristics have each been divided into three categories (see Figure 1). Ind-Ra will determine in which category an issuer belongs, based on a “weakest link” approach (i.e. an issuer’s weakest governance characteristic will determine the category).

## Limitations

Corporate governance codes and frameworks are generally applicable only to companies that issue shares, admitted to trading on regulated markets (“listed” companies). In addition, corporate governance principles are not always legally enforceable and often are implemented through recommendations and best practice codes. The applicable principle may be, for example, that companies either comply with broad recommendations or explain, through public discourse, why they are unable to do so. Ind-Ra assigns ratings to listed, non-listed companies and dependent public sector entities of all sizes and recognises that some governance codes may not be applicable across the full spectrum of rated entities,

Figure 1  
**Structure Diagram**

1. Issuer-Specific characteristics neutral to ratings	2. Issuer-Specific characteristics that may constrain ratings	3. Issuer-Specific characteristics that are likely to have a negative impact on ratings
<p><b>Board effectiveness</b></p> <ul style="list-style-type: none"> <li>The board has selected a strong management team.</li> <li>The board has a well-thought-out succession plan and a deep bench of talent.</li> <li>The board is perceived to be setting a proper strategic direction:               <ul style="list-style-type: none"> <li>sets appropriate risk management targets;</li> <li>balances short-term and long-term perspectives through compensation and management direction.</li> </ul> </li> <li>Proper oversight of the financial reporting function exists.</li> </ul>	<p><b>Board effectiveness</b></p> <ul style="list-style-type: none"> <li>Board members are not familiar with the business of the company and/or background information is unavailable.</li> <li>Board members are stretched, with multiple board memberships and unable to attend to oversight risk.</li> <li>The board has set compensation targets to reward short-term behaviour over a long term focus.</li> <li>Succession planning is not transparent, or key man risk is not addressed by the board.</li> </ul>	<p><b>Board effectiveness</b></p> <ul style="list-style-type: none"> <li>The board has not created a strategic plan.</li> <li>The board has no independent members.</li> <li>The board has no independent audit committee.</li> <li>The board has not developed a succession plan.</li> </ul>
<p><b>Management effectiveness</b></p> <ul style="list-style-type: none"> <li>Management is perceived to be implementing well the strategic direction set by the board.</li> <li>Risk appetites are consistent with board directives.</li> </ul>	<p><b>Management effectiveness</b></p> <ul style="list-style-type: none"> <li>Management compensation is considered excessive in relation to peers.</li> <li>Local management in a single instance has been found in violation of anti-bribery and/or corruption statutes or subject to criminal or civil proceedings in connection with work-related actions.</li> <li>Key man risk has been identified; overreliance on one or a few individuals for the success of the issuer.</li> <li>Management's stock holdings may encourage shareholder-friendly actions that run counter to creditor interests, such as issuing debt for stock repurchases.</li> <li>Management has overridden board directives or risk targets.</li> </ul>	<p><b>Management Effectiveness</b></p> <ul style="list-style-type: none"> <li>The management team is perceived as weak or ineffective.</li> <li>There is management team infighting.</li> <li>Local management in multiple jurisdictions and/or senior management has been found in violation of anti-bribery and corruption statutes or found guilty in criminal or civil proceedings in connection with work-related actions.</li> <li>Management poorly manages risk or has overridden the board's risk tolerance on multiple occasions.</li> </ul>
<p><b>Issuer-Specific factors for financial information transparency</b></p> <ul style="list-style-type: none"> <li>Financial statements are prepared on a timely basis.</li> <li>Financial statements are audited annually and interim results are available.</li> <li>External auditors are selected by an independent audit committee.</li> <li>External auditors are considered experts in the company's industry.</li> <li>Disclosures are informative, robust, and not boilerplate.</li> <li>Information provided by management is consistent with financial statements and third-party sources.</li> <li>No weakness has been identified in internal controls.</li> <li>Willingness to share required information and participate with the agency in management discussion periodically.</li> </ul>	<p><b>Issuer-Specific factors for financial information transparency</b></p> <ul style="list-style-type: none"> <li>Auditors have identified material weakness(es) in the internal control environment, or no audit of the internal control environment has been performed.</li> <li>There have been multiple changes to audit providers over a short period of time.</li> <li>Financial statements are late (based on regulatory or covenant requirements).</li> <li>A restatement of financial data is required.</li> <li>The auditor was not selected by an independent audit committee, or the audit committee appears to lack a "financial expert".</li> <li>Aggressive accounting positions exist.</li> </ul>	<p><b>Issuer-Specific factors for financial information transparency</b></p> <ul style="list-style-type: none"> <li>Auditors have identified multiple material weakness(es) in the internal control environment.</li> <li>Auditors are unable to express opinion or have an unfavourable opinion on financial statements.</li> <li>There is a change of auditor due to a disagreement in accounting treatment.</li> <li>Financial statements are consistently late.</li> <li>There are multiple restatements of financial data.</li> <li>Is irregular or may not share relevant information and participate with the agency in management discussions.</li> </ul>
<p><b>Related-Party transactions</b></p> <ul style="list-style-type: none"> <li>There is very limited related-party transaction activity.</li> </ul> <p>Any related-party transactions are transparent, arm's length, and receive proper oversight by the board.</p>	<p><b>Related-Party transactions</b></p> <ul style="list-style-type: none"> <li>There is a lack of transparency on related-party transactions.</li> </ul> <p>There is ineffective board oversight for related-party transactions.</p>	<p><b>Related-Party transactions</b></p> <ul style="list-style-type: none"> <li>Related-party transactions are considered excessive.</li> <li>The extent of related-party transactions is unable to be determined.</li> </ul> <p>There is no oversight by the board for related-party transactions.</p>

Source: Ind-Ra

ALL CREDIT RATINGS ASSIGNED BY INDIA RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTPS://WWW.INDIARATINGS.CO.IN/RATING-DEFINITIONS](https://www.indiaratings.co.in/rating-definitions) IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEBSITE [WWW.INDIARATINGS.CO.IN](http://WWW.INDIARATINGS.CO.IN). PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. INDIA RATINGS' CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE.

Copyright © 2020 by Fitch Ratings, Inc., Fitch Ratings, Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, India Ratings and Research (Ind-Ra) relies on factual information it receives from issuers and underwriters and from other sources Ind-Ra believes to be credible. Ind-Ra conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Ind-Ra's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Ind-Ra's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Ind-Ra relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Ind-Ra and to the market in offering documents and other reports. In issuing its ratings Ind-Ra must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. An Ind-Ra rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Ind-Ra is continuously evaluating and updating. Therefore, ratings are the collective work product of Ind-Ra and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Ind-Ra is not engaged in the offer or sale of any security. All Ind-Ra reports have shared authorship. Individuals identified in a Ind-Ra report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Ind-Ra rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Ind-Ra. Ind-Ra does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Ind-Ra receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Ind-Ra will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Ind-Ra shall not constitute a consent by Ind-Ra to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Ind-Ra research may be available to electronic subscribers up to three days earlier than to print subscribers.