

Should corporate governance ratings be banned?

While they help investors form opinions about a company, ratings should address the process and not the result

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“An interesting debate is ensuing in India on the importance of corporate governance ratings, which can be of great relevance for the international investor community. G N Bajpai, chairman of the Stock Exchange Board of India is bullish on corporate governance ratings. Two rating organisations in India — ICRA and Crisil — have developed well-thought-out criteria for measuring corporate governance practices and value creation for all stakeholders. These take into account ratings on wealth creation, wealth management and wealth sharing, and are based not only on data published in the public domain, but also detailed interviews with management and stakeholders.

Recently, M Damodaran — accredited with the turnaround of the Unit Trust of India — has criticised the idea of corporate governance rating and asked for a ban on the ratings by credit-rating agencies until companies implement corporate governance more in content rather than as a check list compliance merely to satisfy the stock market.

If there is one lesson that can be learnt from the corporate scandals at Enron, Worldcom, Global Crossing, Marconi, Equitable Life, Parmalat, Skandia, Vivendi and now Shell, it is to move away from the box-ticking approach to corporate governance. Enron had ticked every box. More than 50 per cent of its directors were independent. The chairman of its audit committee was a person of irreproachable reputation as Dean of Stanford Business School. It was declared “the most innovative company” by *Fortune* for five successive years. McKinsey was consultant to Enron and collected fees of \$ 10 million a year. It had top ratings from every rating agency until days before filing for chapter 11. The story repeats itself verbatim in almost all the subsequent investigations. Lynn Turner, chief accountant of SEC from 1998-2001, who was earlier a partner of Cooper & Lybrand, admitted in a TV interview, “All Big Five accounting firms helped Wall Street investment banking firms to engineer hypothetical transactions to make companies look better than they actually were.”

There is a further danger in the

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Indian scenario. Unlike the UK, India is still grappling with reform on the appointment of independent directors. A report submitted by Naresh Chandra Committee has been scuttled. The report that recommended at least 50 per cent directors to be independent, created the same storm as in the UK, but India did not have Patricia Hewitt to stem the revolt. The government has capitulated to these corporations and the report is collecting dust. Independent directors are the cornerstone of good corporate governance.

The current rating systems are based on the results available in the public domain. There is no system of

checking the veracity of the claims. To be meaningful, ratings have to address the process and not the result. This is difficult to measure

when we do not even have well-defined criteria to measure them. Besides, wealth creation, as measured by the market capitalisation, may be due to market effect and have nothing to do with corporate governance practices. A case in point is the profits generated by steel companies worldwide because of unusually high demand by China. Another example is that of Antofagasta, a Chilean company that outperformed the market by 58 per cent over the past year on the back of rising copper prices. On the other hand, BHP Billiton, the London-listed Australian-African mining group believed to be following best practices in corporate governance, has outperformed only by 24 per cent.

The real issues that determine the quality of corporate governance are the issues of heart. No law, rule or rating can be an effective measure. It is naïve to think that the ratings can truly measure transparency, equity, accountability, integrity and responsibility — the five pillars of good corporate governance.

Stock markets work on a short-term basis. Every CEO is in the mortal fear of quarterly results and lives from quarter to quarter. We have to educate investors that in an economy based on innovation there is no way companies can give a double-digit growth every quarter, unless CEOs manage expectations and resort to earning manipulation. Markets have to learn to reward good tries and not just successes, which may simply be flukes.

There is no doubt that the effort to popularise corporate governance rating has good intentions, but these intentions will be better served by directing all efforts on strengthening the fundamentals of corporate governance in India by getting the two important reports — Narayana Murthy's and Naresh Chandra committee's — implemented. Corporate governance ratings until then can be counter-productive.

