Standard & Poor’s
Corporate Governance
Scores and Evaluations

Criteria, Methodology
And Definitions

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Standard & Poor’s
Governance Services
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1. WHY MEASURE CORPORATE GOVERNANCE?

Awareness of corporate governance and its role in the global economy has grown steadily in recent years. In developed markets, particularly where there exists an active market for corporate control, governance concerns are increasingly articulated by shareholder value activists, and companies’ governance practices are regularly scrutinized in the public domain. The recent corporate failures of prominent companies in the US, and governance related problems at visible European companies all contribute to greater attention to corporate governance as a stand alone risk factor in developed markets. In the emerging markets, the financial crises in Russia and East Asia in the late 1990s also revealed great gaps in corporate governance practices that many economists attribute to helping to bring about these crises.

Stock exchanges and regulators around the world are increasingly looking to set standards or codes of best practice for corporate governance. Moreover, investors are beginning to review more systematically a company’s corporate governance practices as part of the investment decision-making process. Increasingly, the debate on corporate governance extends beyond a company’s own shareholders to include other stakeholders such as creditors, employees, customers, the environment and the local community.

In the context of this growing interest in corporate governance, there is a role for global benchmarks to help a company’s shareholders, managers, directors or other stakeholders objectively assess and compare corporate governance practices from one firm to another and from one country to another. The concept of corporate governance rating, or scoring, is a way to address this gap, and several firms around the world have either launched governance scoring activities or are actively exploring entry into this area.

Standard & Poor’s began to develop a methodology to benchmark corporate governance in early 1998. Following a pilot project to test this methodology, Standard & Poor’s formed a dedicated unit, Governance Services, and launched a corporate governance scoring service in 2000. In 2004, the unit became a part of the Corporate & Government Services group of Credit Market Services, the division within Standard & Poor’s that provides credit ratings to public and private issuers of debt.

This criteria presents the concept of corporate governance scoring at both the individual company and at the country level. While there are potentially many approaches to assessing corporate governance, this approach takes a financial perspective, namely the perspective of financial stakeholders-- both shareholders and creditors. On that basis, and for purposes of this discussion, corporate governance can be defined as the interaction of managers, directors and shareholders to direct and control the company, and to ensure that all financial stakeholders receive their fair share of a company’s earnings and assets.

Even with this financial focus, the practice of corporate governance scoring is a challenging endeavor, and must be approached with care. Unlike other forms of financial analysis where quantitative measures can provide some “hard” benchmarks to guide more qualitative aspects of analysis, the assessment of corporate governance is largely a qualitative exercise. This chapter will address how the practice of corporate governance at the company level and how corporate governance is influenced at the country level can be broken down into subcomponents for detailed analysis and benchmarking.

The great challenge of establishing a single global benchmark that can legislate meaningfully for the differing cultures of corporate governance around the world must not be underestimated. As these criteria will discuss, overarching principles of fairness, transparency, accountability and responsibility must guide the interpretation of different governance structures and systems at the corporate level. As with many forms of analysis, a global perspective must mesh with local understanding.
While other non-financial stakeholders may find value in this approach to corporate governance benchmarking, this methodology does not directly address broader stakeholder issues unless they in some way affect the economic performance, the market value, or the financial strength of the company. The main beneficiaries of this approach to corporate governance benchmarking are as follows:

--Shareholders (minority and majority)
--Creditors
--Management
--Directors
--Regulators/Exchanges
--Directors and Officers insurance underwriters
--Policymakers
--Financial Intermediaries and Advisors
--Analysts
--Academics

For these constituencies, corporate governance scores can serve as a new tool with varying potential applications, including investment screening, highlighting areas for individual firm improvement, guiding regulation and policy, and helping to price and place issues of new capital. These applications above are outlined in the last section of this chapter in greater detail.

Independence

To be credible, a corporate governance score should represent an independent opinion, based upon transparent criteria and a standardized analytical process. It should not be regarded as an audit, nor as a credit rating, nor as equity analysis. By itself it should not be intended to serve as financial advice, nor as a recommendation for a specific course of action. Its simple purpose is to provide an objective benchmarking of a company’s corporate governance standards in a global context. In this regard, governance scoring can be viewed as a positive complement to traditional equity and credit analysis.

The independence of the corporate governance evaluator is a key issue. As with credit ratings, independence can only be assured if the institution providing the corporate governance analysis has no market exposures which might consciously or subconsciously bias the nature of the governance assessment.

Even firms which promote shareholder activism need to be assessed with regard to independence. The governance debate is comprised of many actors, including financial stakeholders (majority and minority shareholders and creditors), managers, and board directors. If the governance assessor assumes the perspective of one of these constituencies to the exclusion of others, then there is scope for the objectivity of the analysis to be influenced by the perspective of the analyst. In this sense it is arguably the case that the greatest independence derives from individuals or firms that are independent of any of the individual constituencies.

As presented in the chart below, the notion of a “360 degree” perspective is perhaps the most appropriate positioning for the provider of governance scores. In other words, the most robust and independent governance analysis is likely to come from an assessor that objectively engages all parties in the governance debate—but is not a formal member of any one group.

2. CORPORATE GOVERNANCE, the ECONOMY, and FINANCIAL MARKETS

Effective corporate governance is at the core of an efficient market economy. Shareholders and other financial stakeholders must have access to information and have the ability to influence and control management, through both internal governance procedures and external legal and regulatory mechanisms,
in order to ensure that a company's assets are being utilized in the interests of all financial stakeholders. This is important in both developed and developing economies.

At the macro—or country—level, increasing emphasis is being placed on the building of a strong legal and regulatory environment, including the effectiveness and the enforceability of existing laws, as well as the level of transparency and disclosure required by the market. This reflects the premise that countries with higher standards of investor protection are, relatively speaking, better insulated against market turmoil than those countries where investor protection laws are weak.

Relating this to financial markets, poor corporate governance is often cited as one of the main reasons why investors are reluctant, or unwilling, to invest in companies in certain markets. It can also explain why, in some economies, the shares of many companies trade at a significant discount to their true value. Even better governed companies are 'tarred with the same brush' - almost a case of guilt by association.

If investors are unable to evaluate governance risk, they are likely to be reluctant to invest or will require a significant premium to mitigate uncertainty. In many cases where the investor is unable to evaluate the risks associated with governance practices, equities may be inaccurately assessed. This disadvantages the company and raises the cost of capital. For example, the market capitalization of one major natural resources company in an emerging market suspected of shareholder abuses has been 90% less than that of its Western equivalent although its reserves were six times greater.

In developed markets, large institutional investors pay considerable attention to corporate governance practices. Some US pension funds, such as CalPERS and TIAA/CREFF, actively pursue corporate reform through their positions as major shareholders. Every year, for example, CalPERS publishes a list of the best and worst US corporate boards in an attempt to promote change. In the UK, Hermes plays a similar role of advocating corporate governance reform using its influence as a prominent investor. As institutional investors own more than 50% of the equity of US companies, companies are becoming much more sensitive to the desires of these shareholders.

The market rewards those companies that do change. Some studies have shown that efforts by a company to improve the quality of its board have a significant and positive effect on share price. Similarly, companies that continue to engage in activities that place the interests of management over those of shareholders tend to trade at a discount relative to other companies in their sector.

In emerging economies, the quality of corporate governance can vary enormously. Indeed, poor governance or corrupt governance (“crony capitalism”) negatively affects the returns on investment in many countries and also contributes to larger, systemic problems at national and regional levels. The scarcity and poor quality of publicly available information, as well as limited legal and regulatory recourse, frequently complicate efforts by financial stakeholders to ensure that management is acting in their interests.

Expropriation by insiders and the investors is a major problem of corporate governance. Although expropriation is not exclusive to emerging economies, it is certainly much more prevalent in these markets. Examples of expropriation include, cashflow diversion (transfer pricing), dilution of minority shareholders, asset stripping and delay, or non-payment, of dividends.

In countries where poor governance practices are suspected, a company's share price will often trade well below what should be the real economic value of the enterprise. A June 2000 survey of 200 global institutional investors by the management consulting firm, McKinsey, found that these institutional investors said that they would be willing to pay a significant premium for the shares of companies that they knew to be well governed. In fact, some investors stated that good governance practice was a key determinant of whether they would invest in a particular company or not. Not surprisingly, the average premium differs
from country to country. Companies domiciled in countries with high governance standards could expect to pay significantly less than companies in countries where the reverse is true. This 2000 survey was also repeated by McKinsey in 2001 and 2002, with similar results.

McKinsey’s findings suggest that investors will pay a premium to reduce risk (in this case, risks associated with poor governance practices). Conversely, investors will expect to receive a discount for assuming greater risk.

The linkage between corporate governance and company financial performance and share valuation is a subject of considerable research interest. In addition to the McKinsey study, research projects by academics and practitioners continue to attempt to more rigorously define this linkage. While evidence is beginning to mount to establish a clearer correlation of corporate governance and financial performance, research to date has been inhibited by the lack of global benchmarks that allow for meaningful comparative research on corporate governance. It is hoped that institutionalization of corporate governance scoring can help to promote further research on this important theme.

3. MEASURING CORPORATE GOVERNANCE PRACTICES

3.1 Overview

There is no one model of corporate governance that works in all countries and all companies. Indeed, there exist many different codes of “best practices” that take into account differing legislation, board structures and business practices in individual countries. However, there are standards that can apply across a broad range of legal, political and economic environments. With this in mind, the Business Sector Advisory Group on Corporate Governance to the OECD has articulated a set of core principles of corporate governance practices that are relevant across a range of jurisdictions. These are:

- Fairness
- Transparency
- Accountability
- Responsibility

These same principles can be used as cornerstones in a corporate governance scoring methodology for individual companies. To the extent that these core principles transcend individual country jurisdictions, the process of corporate governance scoring therefore entails the assessment of individual corporate and country practices and structures against these broad principles.

This methodology presents an approach to analyzing corporate governance at both the company and country level. These two dimensions can be assessed jointly or separately.

3.2 Definitions

A company Corporate Governance Score (‘CGS’) reflects Standard & Poor’s assessment of a company’s corporate governance practices and the extent to which these serve the interests of the company’s financial stakeholder, with an emphasis on shareholders’ interests.

These governance practices and policies are measured against Standard & Poor’s corporate governance criteria, which is based on a synthesis of international codes, governance best practices and guidelines of good governance practices.

Standard & Poor’s employs a numeric scale for its corporate governance scores on a 1 to 10 basis (with 10 being the best possible score).

In these definitions, financial stakeholders include both a company’s shareholders and creditors. This reflects the premise that the quality of a company’s governance process can affect its ability both to honor contractual financial obligations to creditors and to maximize the value of a company’s equity and distributions for its shareholders.

Different models of corporate governance around the world reflect the nature of local legal and regulatory systems, as well as
differing approaches to economic management. The Anglo-Saxon system focuses primarily on the shareholder, while others, such as the German or Japanese systems, are often perceived as advocating a greater balance of interests between shareholders and other external stakeholders (including creditors, employees, the community, the environment, etc). By addressing the interests of both creditors and shareholders, this scoring methodology recognizes the importance of stakeholders’ rights beyond the rights of the shareholder. Moreover, this methodology also takes into consideration a company’s relations with key non-financial stakeholders, including its employees, its local community, its customers and other groups that are affected by corporate behavior. Hence, this system can be applied generally in many countries around the world, operating with differing general approaches to corporate governance.

3.3 Corporate Governance Scoring Framework

The corporate governance service consists of two parts:

Company Score (CGS): the effectiveness of the interaction among a company’s management, board, shareholders and other stakeholders. This focuses on the internal governance structure and processes at an individual company.

Country Governance Review: the effectiveness of the legal, regulatory informational and market infrastructure. This focuses on how external forces at a macro level can influence the quality of a company’s corporate governance.

Both these micro and macro components are important to the practice of corporate governance. Specific scoring factors can be identified in order to analyze governance practices and facilitate objective and comparative analysis of corporate governance practices at individual companies. Inclusion of the country analysis enables the individual company scores to be placed in a more international context, facilitating a comparison of country governance environments.

Though Standard & Poor’s is not scoring country governance environments at this point in time, the sovereign credit rating can serve in many ways as a proxy for governance risk at the country level. Sovereign credit ratings focus on the financial strength of national governments and do not specifically attempt to measure legal, regulatory and accounting standards in individual countries. However sovereign credit ratings do take into consideration the microeconomic environment in a given country, and it is fair to consider that country governance environments and sovereign credit quality is correlated.

3.4 Relationship to Credit Ratings

Standard & Poor’s Corporate Governance Scores are distinct from Standard & Poor’s credit ratings. The term Corporate Governance Score is used to distinguish corporate governance scoring results from credit ratings. A credit rating is an opinion of the financial ability of an entity to meet its debt obligations in accordance with their terms. A CGS and the accompanying analysis is a composite assessment of various company practices. Its scope is to benchmark the recent and current standards of corporate governance, rather than opine on specific financial or commercial performance.

Linkages between governance and credit quality can be extensive, but often indirect. Indeed, it can be difficult- and sometimes possibly misleading-- to automatically associate a company’s specific corporate governance practices and structures to its fundamental credit quality. While there is likely to be a positive correlation between credit ratings and corporate governance scores, this correlation will not be 1 to 1. In cases where governance features are benign or positive, industry, competitive or financial factors may negatively impact a credit rating. Equally, there can exist situations where governance structures disfavor shareholders, while having a neutral impact from a credit perspective.

However governance is a relevant subject for credit analysts to the extent that corporate governance can be identified as a cause, or as leading to a cause, of weaknesses in a company’s financial
strength. At Standard & Poor’s, governance issues are examined by credit ratings analysts in the context of assessing a company’s management quality, accounting and financial controls. Where appropriate, Corporate Governance Services will assist credit analysts in this examination via detailed reviews. There are times when governance related issues will be a driver in shaping a company’s credit quality; there will also be times when governance is not a key determinant of credit quality. Going forward, the links between corporate governance and credit ratings stand to evolve as more research and case studies bring new issues to light.

In the methodology outlined below, roughly 80 factors can be identified to guide analysts through sets of interrelated observations. These factors have been designed to reveal the quality of corporate governance arrangements and minimize jurisdictional influences to the extent possible.

Each of the four components in the governance criteria contributes to the overall corporate governance score. However, in the case of extremely poor financial transparency and information disclosure, a meaningful assessment of other governance factors may not be possible. So poor transparency by itself can either result in a low overall governance score or it can mean that a governance score is not possible.

Components and their Scoring Guidelines

4.1 Ownership structure and external influences

Understanding the ownership structure of the company is essential, especially when there is a known majority holder or when de facto majority holdings may exist on the basis of collusive shareholding arrangements. Similarly, the existence of a large number of nominee shareholders will make any analysis of the concentration of share ownership difficult.

In cases where the company is widely held, the role of institutional investors is important in overseeing and engaging management.

Whilst the presence of a large, or majority blockholder, is not necessarily a negative governance issue, it is necessary to examine the relationship of any blockholder with the company in order to assess the extent to which that blockholder acts in the interests all shareholders. This is particularly important in economies where ownership is clustered in the hands of the state, financial-industrial groups or families.

An understanding of whether the company has interactions with other companies that may involve transfer pricing on non-market terms, or whether intercompany linkages give rise to intercompany advances, arrears or subsidies is important. This is particularly
true to the extent that management may engage in transactions that may have a detrimental effect on the specific company or corporate structure in which minority shareholders and creditors have a stake. However it is beyond the scope of this methodology to employ techniques of forensic accounting to establish evidence of non-market transfer pricing.

In addition to blockholders, other forms of external stakeholders can exert meaningful influence on a company’s governance process, without holding a significant equity stake—or even without a shareholding at all. These non-financial stakeholders may include a company’s employees, the communities in which it operates, environmental interest groups, regulators and governments. Influences can be both direct and indirect, and need to be interpreted on a case-by-case basis. For many listed companies external stakeholder influences are benign or minimal; in other cases the influence can be more pronounced and can influence a company to act in ways which are not necessarily efficient from at least a short term commercial perspective.

### 4.1.1 Transparency of Ownership

Criteria:

- There should be adequate public information on the company’s ownership structure, including, where relevant, information on beneficial ownership behind corporate nominee holdings.
- The company’s actual ownership structure should be transparent, and should not be obscured by cross-holdings, management controlled corporate holdings, nominee holdings, etc.

Key analytical issues:

- Breakdown of shareholdings
- Identification of substantial / majority holders (including indirect ownership and voting control)
- Director shareholdings
- Evidence of indirect shareholdings
- Management shareholdings

### 4.1.2 Concentration and Influence of Ownership and External Stakeholders

Criteria:

- If large blockholders exist, these should not exert influence that is detrimental to the interests of other stakeholders. Minority shareholders should be protected against loss of value or dilution of their interests (e.g. through capital increases, from which some shareholders are excluded, or through transfer pricing with connected companies).
- Concentration of economic interests and influence of controlling shareholders of the parent/holding company on independent board/management action should not occur through block holdings of key operating subsidiaries and through effective control of key customers and suppliers.
- Shareholders should not be disadvantaged by management and insider shareholders who are shielded from accountability.
- If a company is widely held, it can be healthy for institutional investors to play an active role of engagement and oversight of company management.

Key analytical issues:

- Affiliations amongst shareholders
- Commercial arrangements or related party transactions between the company and affiliates or individual managers and directors
- Corporate structure, shareholding and management of key affiliates
- Terms of key contracts and licenses
- Internal financial and operational control system
- Management shareholding / voting control
- Charter provisions regarding change of control
- Contracts with directors / management
- Role of institutional investors

Influence of External Stakeholders

Criteria:
It is important for a company to address and show sensitivity to legitimate non-financial stakeholders, including employees, local communities, environmental interests, regulators, and governments. These are important constituencies in the near term and the maintenance of positive relationships stands to enhance a company’s longer-term sustainability—or lessen vulnerability to legal or operational disruption.

The influence of external stakeholders should not distract or impair an otherwise law-abiding company from realizing its commercial agenda. The influence of non-financial stakeholders must be scrutinized in this context for negative, as well as positive, impact. Regulatory and governmental relationships should be well managed, and for companies with a prominent public profile, analyst attention needs to focus on areas where governmental or political influences could prompt companies to take actions not in the best interest of shareholder value.

Key analytical issues:

- Public reporting in key areas of employee, community and environmental activities to address concerns of non-financial stakeholders
- Evidence of problematic relationships with non-financial stakeholders that could impair longer terms performance
- Proactive programs to address interests of legitimate stakeholder interest groups
- Undue influence from external stakeholders that detract from shareholder value

### 4.2 Shareholder Rights and Stakeholder Relations

Investor rights and relations reflect a company’s treatment of, and relationship with, its financial stakeholders. In a country with weak regulations and laws, a CGS analyses the extent to which a company adopts or exceeds codes and guidelines of good corporate governance practices generally. In a country with stronger regulations and laws, a CGS analyses the extent to which a company meets or exceeds these laws and regulations. In both cases, a CGS reflects what a company does rather than what is the minimum requirement of law, regulation or custom.

#### 4.2.1 Shareholder Meeting and Voting Procedures

Criteria:

- The processes and procedures used for advising shareholders of general meetings should provide for equal access of all shareholders and should ensure that shareholders are furnished with sufficient and timely information
- Shareholders representing at least 10% of the voting rights should be able to call a special meeting and shareholders should have opportunities to ask questions of the board during the meeting and to place items on the agenda beforehand.
- A shareholders’ assembly should be able to control decisions through processes that ensure participation by all shareholders.

Key analytical issues:

- Shareholder meeting procedures:
  - Notices of meeting
  - Documents sent to shareholders
- Charter provisions on calling meeting
- Arrangements for shareholders’ participation in meetings
- Previous meeting minutes
- Shareholder information on voting procedures
- Any deposit agreement for overseas listing
- Proxy arrangements
- Charter provisions on voting thresholds

#### 4.2.2 Ownership Rights and Takeover Defenses

**Ownership Rights**

Criteria:
• There should be secure methods of ownership of shares and full transferability of shares.
• A company’s share structure should be clear and control rights attached to shares of the same class should be uniform and easily understood.
• Voting/control rights should be in proportion to the shareholder’s economic stake in the firm.
• A shareholders’ assembly should be able to exercise decision rights in key areas, ensuring that minority shareholders are protected against dilution or other loss of value (e.g. through related party transactions on non-commercial terms).
• All shareholders should receive equal financial treatment including the receipt of an equitable share of profits.

Key analytical issues:
• Charter provisions
• Arrangements with registrar
• Share structure – classes and rights of common and preferred shares
• Charter provisions – shareholder and board authorities
• Shareholders agreement
• Dividend history
• Examples of share repurchases and swaps

Takeover Defenses

Criteria:
• The company should create a level playing field for corporate control and should be open to changes in management and ownership to the extent this can increase shareholder value.
• Shareholders should have a voice with regard to material takeover bids.
• Takeover defenses should not frustrate legitimate takeover bids.
• Voting/control rights should be in proportion to the shareholder’s economic stake in the firm.
• A shareholders’ assembly should be able to exercise decision rights in key areas, ensuring that minority shareholders are protected against dilution or other loss of value (e.g. through related party transactions on non-commercial terms).
• All shareholders should receive equal financial treatment including the receipt of an equitable share of profits.

4.2.3 Stakeholder Relations

Criteria:
• The company obeys the laws of the jurisdictions where it operates.
• The company should maintain positive relations and engagement with key non-financial stakeholders, including employees, customers, suppliers, local communities, governments and regulators.

Key analytical issues:
• Social and environmental reporting
• Company engagement policies with investor and stakeholder interests
• Evidence of problematic relationships with key non-financial stakeholders and regulators.

4.3 Transparency, Disclosure and Audit

Transparency involves the timely disclosure of adequate information concerning a company’s operating and financial performance and its corporate governance practices. For a well-governed company, standards of timely disclosure and transparency are high. This enables shareholders, creditors and directors to effectively monitor the actions of management and the operating and financial performance of the company. Good transparency means that the financial reporting facilitates a clear understanding of a company’s true underlying financial condition. In part, this means that contingent liabilities and non-arm’s length relationships with other related companies are disclosed.
In certain countries where accounting standards are limited, a commitment to transparency may mean that the company adopts internationally recognized accounting principles in addition to local accounting standards.

Transparency also dictates openness regarding non-financial performance—particularly relating to a company’s business operations and competitive position. Public disclosure of corporate charter, by-laws, and a clearly articulated corporate mission also help to promote high standards of transparency. From a board perspective, it is important to have clear disclosure of who the company directors are, the basis of their remuneration and the extent to which they are independent or insiders.

4.3.1 Content of Public Disclosure

Criteria:

- Reporting and disclosure should be clearly articulated and completed to a high standard. Financial reporting and non-financial reporting are both important for full disclosure.

Key analytical issues:

- Accounting standards
- Financial statements and reports (including data on key affiliates) disclosed to shareholders and investment community
- Minority, interfirm and related party transactions
- Operating disclosure
- Governance related disclosure
- Company legal documentation (articles of association, by-laws, etc)
- Social and environmental reporting

4.3.2 Timing of, and Access to, Public Disclosure

Criteria:

- All publicly disclosable information should be promptly available and freely accessible to the investment community and shareholders. Public disclosure is a function of internal transparency and effective internal control policies.
- The company’s by-laws, statutes and/or articles should be clearly articulated and readily accessible to all shareholders.
- The company should maintain a policy of free and continuous disclosure
- The company should maintain a website and make company reports, summary reports and / or other investor relevant information available in both local language and English.

Key analytical issues:

- Filing record
- Access to public information
- Procedures for disclosure of corporate actions and market sensitive information
- Frequency of reporting
- Continuous and fair disclosure
- Briefing materials for investment community presentations
- Records available to all shareholders at the company’s headquarters
- Reports to shareholders
- Website and web – based reporting.

4.3.3 The Audit Process

Criteria:

- Auditors should be independent of the board and management and the company’s performance, and objectives. They should also be reputable.
- The audit committee should provide oversight with regard to both the company’s financial statements and its internal control and risk management functions.

Key analytical issues:

- Auditor selection
- Non audit services
- Auditor rotation policy
- Audit committee independence
- Audit committee resources and training
- Audit committee charter
- Audit committee engagement
- Audit committee accountability
- Internal controls
- Risk management
**4.4 Board Structure and Effectiveness**

Board Structure and Effectiveness addresses the role of the corporate board and its ability to provide independent oversight of management performance and hold management accountable to shareholders and other relevant stakeholders.

Separation of authority at the board level is important. Boards with high accountability include a strong base of independent outside directors, looking after the interests of all shareholders—both majority and minority holders. Conversely, companies with a strong majority shareholder—or dominated by a few shareholders—may have boards with limited accountability to all shareholders. This is particularly the case when the company’s management is heavily represented on the corporate board. Boards often have key subcommittees, and the composition of these committees—particularly the balance between independent and non-independent directors—can be significant. In particular as the methodology is used to differentiate companies whose governance is at a high level, it is anticipated that further calibration will be possible with a greater understanding of how corporate boards actively and effectively employ risk management tools in their stewardship of the company.

Another significant board governance factor is how management is remunerated and what other benefits managers may enjoy. With regard to the selection of management and board members and other voting matters, a cumulative voting structure can allow for board representation for minority shareholders. The board selection process is best when non-staggered to ensure the possibility of change.

The process by which outside directors are nominated and elected to the board, and the methods by which they are compensated for their board duties, are important considerations relevant to an assessment of the board’s accountability and practice.

**4.4.1 Board Structure and Independence**

Criteria:

- A board should be structured in such a way as to ensure that the interests of all the shareholders may be represented fairly and objectively. Key functional areas, including audit, nomination and compensation are addressed either through formal committee structures or other structural mechanisms.

Key analytical issues:

- Board size and composition
- Skill mix
- CEO/Chair split
- Board leadership and committees
- Director selection
- Director shareholdings
- Independence
- Director tenure

**4.4.2 Role and effectiveness of the Board**

Criteria:

- The board should bear overall accountability for the performance of the company. The board should play a meaningful role in directing the articulation and implementation of the company’s strategy, in overseeing the performance of the CEO and other senior managers and in ensuring that appropriate financial and operational controls and risk management systems are in place. Effective boards are active and engaged, and demonstrate true “independence of mind” vis-à-vis company management.

Key analytical issues:

- Definitions of board role
- Board access to information: committee meeting’s agenda and papers
- Articulation of mission and strategy
- Ethical boundaries
- Internal controls
- External stakeholder relationships
- Self evaluations
- Succession policies
- Attendance rates
- Other external directorships
- Meeting frequency
- Training
- Nominations process
- Board change
4.3.3 Senior Executive and Director Compensation

Criteria:

- Directors and executives should be fairly remunerated and motivated to ensure the success of the company.
- There should be clearly articulated performance evaluation and succession policies/plans for employed directors of the company.
- The company should link pay to performance.
- Executive management should not set their own pay.

Key analytical issues:

- Performance based pay
- Independence of executive compensation setting
- Relationship with compensation consultants
- Form of compensation
- Performance evaluation criteria
- Compensation setting process
- Usage of stock options
- Compensation disclosure
- Executive contracts
- Compensation plan dilution

4.3 Corporate Governance Scoring Committee

The Scoring Committee includes the analytical team and other senior personnel from Standard & Poor’s Corporate Governance Services. It may also include other individuals, including credit rating analysts, local legal counsel and affiliate services staff.

Standard & Poor’s affiliates may also participate in committees in accordance with agreed affiliate operating guidelines.

4.4 Surveillance

The surveillance of a CGS will depend on the nature of the scoring assignment. If the project is a simple point-in-time governance assessment, no subsequent follow-up may be required. Longer-term surveillance may be required depending on the nature of the engagement or the ongoing needs of an information service. This will entail ongoing dialogue with the company and probably at least one annual review visit.

4.5 GovernanceWatch and Outlooks

A “GovernanceWatch” designation may be used to highlight the fact that identifiable governance events and short-term trends have caused a CGS to be placed on review. GovernanceWatch does not mean that a change to the CGS is inevitable. GovernanceWatch is not intended to include all CGS’s in the context of their normal review cycle, and changes to the CGS may occur without the CGS first having appeared on GovernanceWatch. GovernanceWatch designations can be “positive”, “negative” or “developing”—with the latter designation indicating potential for both upwards or downwards revision.

Outlooks may also be assigned to governance scores, indicating trends over time. These may be “stable”, “positive” or “negative”.

4.6 Company Report Format

Following meetings with a company, a detailed report will be prepared covering the main elements of the analysis and will also articulate the CGS and individual scores for each of the four components.

In the scoring report the analyst presents the logic underlying the individual scores and variables.

The report will be in the following format:

1. Executive Summary Rationale. This will present the aggregate governance score with a rationale together with summaries of key features of component scores and identify the main strengths and weaknesses for each.
2. Company Description: Basic operating, financial, management and ownership information.
3. Methodology: Scores and analysis for each of:
5. COUNTRY GOVERNANCE REVIEW

The country governance review assesses the extent to which the external environment in a given country either supports or inhibits healthy governance practices at the corporate or micro level. It addresses a country’s legal, regulatory, informational or market infrastructure and the extent to which these support governance at the company level.

The primary focus of this analysis is at the country or national level. When the external environment is affected by the policies and actions of local and regional governments, and the economic infrastructure at this level, the focus of this analysis can be modified to consider relevant influences.

The external environment can be important in motivating good or bad internal governance practices by individual companies. It is also of importance in defining:

- The rights of financial stakeholders: how do these impact the company’s relations with its financial stakeholders?

- How effectively the relevant infrastructure in a given country encourages and protects these rights?

The first question attempts to clarify what stakeholder rights exist as defined by legislation and regulatory practice. The second question addresses the relevance of these rights in practice.

In addition to an assessment of pertinent laws and regulation, the analytical process may involve discussions with investors, company directors, lawyers, accountants, regulators, stock exchange officials, economists and relevant trade associations.

The four main areas of focus in this analysis are:

- Market infrastructure
- Legal infrastructure
- Regulatory infrastructure
- Informational infrastructure

The country analysis includes assessments of each factor.

5.1 Market infrastructure

Country-specific aspects of how markets function can influence the practice of corporate governance. These need not be designated as factors that are intrinsically positive or negative; they simply should be understood for a clear appreciation of the environment for corporate governance. For example, ownership structures can play an important role in shaping the governance environment. A prominent example of ownership concentration lies in large family stakes held in listed companies in many jurisdictions. Asia, in particular, is noted for the prevalence of these large family ownership concentrations. In other countries this has led to concentration of ownership and cross-ownership between banks and industrial enterprises. In transition countries, it is important to understand how the process of privatization has proceeded.

The functioning of public capital markets is important in this regard because it reflects the extent to which companies are publicly listed, as well as the liquidity/transferability of shares and ownership rights. Differing approaches to public versus private capital markets can be important in understanding the role of banks in the corporate sector. In particular, the existence or not of a robust market for corporate control can have an important influence on a country’s overall corporate governance climate. It can also help the understanding of how bank influence or ownership can affect public transparency and disclosure. This is particularly the case when financial-industrial groups play an important role in the functioning of the market. The presence of one versus two tiered board structures must be appreciated in the context of local norms. While either structure can be
acceptable for a healthy governance process, the structure should be understood to assess how the board acts to promote the interests of financial stakeholders.

Factors to be when evaluating a country's market infrastructure:

- Are there significant ownership blocks/concentrations:
  - State ownership
  - Financial-industrial groups
  - Family/private blocks
- Are most major firms listed on public stock exchanges?
- Is there ease of access to public exchanges?
- What role do institutional investors play?
- For transition economies and other countries with state-owned enterprises: what methods of privatization exist and what impact do these have on ownership structures?
- What is the importance of institutional investors (mutual funds, pension funds, insurance companies, etc.)?
- Is there a universal banking system versus separation between commercial and investment banking?
- Do banks commonly hold significant equity stakes in industrial companies?
- Are financial-industrial groups prevalent? What is the degree of transparency in their intercompany relationships?
- Do market distortions exist in the form of uncompetitive industry structures or government protection of individual companies or sectors?
- Are there signs of macroeconomic stability or stress?
- What is the nature of the political environment? Is this relevant to the practice of corporate governance in the country?

5.2 Legal infrastructure

An effective legal environment is essential to good corporate governance. Shareholders' legal rights should be clearly defined. The judicial process should allow for consistent and effective law enforcement in the event that stakeholder rights are abused. In a broader context, the general rule of law and order is also important.

Of the various types of law, company law is perhaps the most important. Company law covers fundamental issues, including how companies are formed, what rights exist for shareholders and other stakeholders, how shares are registered, and the responsibilities of board directors and management. In cases where majority and minority shareholders exist, it is important to understand how minority shareholder rights are defined and protected. Securities law ranks prominently with company law in assessing a country’s legal infrastructure in the context of corporate governance.

Other important areas of law include bankruptcy and pledge law. While these are less central, per se, to the practice of corporate governance than company law, they nonetheless form an important part of the commercial legal infrastructure. Particularly in the case of bankruptcy law, it is important that creditors and shareholders are in a position to reach settlement on whether to liquidate or restructure an insolvent company.

The effectiveness of law enforcement will affect the extent to which financial stakeholder legal rights are relevant in a practical sense. This analysis addresses the fairness and consistency with which laws and regulations are administered. Again, the effectiveness of enforcement for minority shareholders and creditors is a particular focus. The degree of effectiveness of a country’s legal system will be broadly addressed through positive and negative examples of governance cited in discussions with lawyers and investors.

Factors to be considered when evaluating a country’s legal infrastructure:

- What are the relevant laws that address corporate governance in the country and its various jurisdictions?
- How are shareholder and other stakeholder rights defined?
- What laws exist that govern:
  - Insider trading
  - Reporting and disclosure
  - Duties and composition of boards of directors
• Shareholder registry and share depository
• Proxy rights at shareholder meetings
• Voting procedures (cumulative)
• Minority shareholder rights
• Rights of foreign creditors and shareholders
• How extensive are these laws?
• Is a shareholder registry necessary to prove ownership?
• Are outside directors required?
• Does a licensed registrar keep the shareholder registry?
• What is the nature of the judicial system in law enforcement?
• Is violation of the law a common occurrence?
• Do examples exist that point to judicial success in promoting and enforcing corporate governance?
• Are there examples of poor corporate governance where the law is not effective in principle or in practice?
• How many investor lawsuits exist relating to corporate governance related disputes?
• What is the track record of these legal processes? What is the timeframe?
• How does the legal system operate in practice?

5.3 Regulatory Infrastructure

The legal and regulatory environments are closely interlinked, with regulatory bodies often being charged with regulating markets to conform to existing laws. Regulatory bodies also attempt to ensure orderly and efficient market environments, and can play a key role in setting and enforcing standards for public disclosure. Regulatory regimes differ on a country-to-country basis, and the system in each country should be understood and evaluated. Regulatory bodies governing specific industries and markets may exist within individual government ministries, a central bank or may have a more autonomous structure. For investors, the role of securities regulators in supporting effective corporate governance is highly important. Other important regulators may focus on specific interests of financial institutions, insurance, pensions and on general competitive practices. In many countries, Self-Regulatory Organizations (SROs) exist to complement the regulatory process established by formal government bodies.

Factors to be considered when evaluating a country’s regulatory infrastructure:

• What regulatory bodies exist and what is their purview?
• Are there regulatory gaps or areas in which regulatory responsibility overlaps among bodies?
• Do the different regulatory bodies work in co-operation or conflict with one another?
• Are specific regulations viewed by market participants as inappropriate?
• Do SROs play a role that is relevant from the perspective of corporate governance?
• What new legislation is on the regulatory agenda?
• What are the information and timing requirements for public disclosure?
• How effectively are securities and disclosure regulations followed and enforced?
• Do regulators have sufficient resources and practical enforcement tools to achieve their mission?
• Is there a securities regulator? How long has it been in place?
• What is the relationship of securities and other regulators to stock exchanges?
• Examples of regulatory successes and failures.

5.4 Informational infrastructure

Accounting principles differ from country to country, with differences often reflecting varying business practices, reporting practices (managerial versus tax) and disclosure preferences.

For corporate governance to be effective, official regulation of public disclosure should produce company information which is accurate, complete and timely. Public information should be useful enough to enable existing and potential financial stakeholders to monitor a company’s governance, as well as its operating and financial performance. Where information standards are poor, proper corporate monitoring can be either difficult or
impossible, leaving open possibilities for corporate governance abuses.

It is not necessary to endorse one particular accounting system over another, but rather to assess the degree to which standards in individual countries provide meaningful and timely disclosure. In some countries, however, and particularly in emerging economies, accounting standards may be incomplete. In such cases, the use of International Accounting Standards, US GAAP, or other internationally recognized standards of accounting, can be regarded as a positive feature.

Factors to be considered when evaluating a country’s informational infrastructure:

- Number, quality and independence of public auditors
- Is there a requirement for independent financial audit?
- Local accounting standards versus international accounting standards:
  - Basis of consolidation
  - Operating data in addition to financial data
  - Financial position of subsidiaries whose health is material to the interests of the company and individual shareholders.
  - Segment data: financial performance of individual business or business units.
  - Methods of asset valuation.
  - Definitions of revenues, expenses, profits and losses.
  - Cash flow: sources and uses of funds.
  - All real and contingent liabilities
  - Related party transactions
- Evidence of transfer pricing, hidden transfers or subsidies.
- Arrears with related companies.
- Disclosure on management and board structure requirements
- Social and environmental reporting requirements
- What is the required timing of disclosure?
- Is there ease of access to independently audited financial statements?

6. HOW COMPANY SCORES AND COUNTRY REVIEWS FIT TOGETHER

The Country Governance evaluation reflects the degree to which the macro legal, regulatory, and informational and market environments provide a supportive infrastructure for effective corporate governance.

A “strong” country support environment will not mean that an individual company from that country will automatically be highly scored itself. There is no “floor”: an individual company in a positively assessed country can receive a low CGS if so warranted.

Conversely, because the analysis focuses on what a company does, rather than what is required by law, regulation etc. and benchmarks a company’s corporate governance standards to codes and guidelines of good corporate governance practices, there is no sovereign constraint. A “weak” support environment will not necessarily mean that a company will receive a low CGS. A well-governed company in a negatively assessed country may receive a high CGS.

As noted earlier, in the absence of specific scores for the country governance environment, the sovereign credit rating of a given country can be used as a proxy for the country governance environment.

Corporate Governance Scores allow the comparison of individual companies within a national context as well as comparisons of companies in different jurisdictions. This concept is reflected in the graphic below which isolates country and individual firm governance standards on a two dimensional matrix. While Firm A and Firm B may have a similar level of overall governance standards, the fact that Firm A is in a more protective country environment than Firm B suggests that the greatest investor protection is for Firm A given that it is domiciled in a country with a more robust supportive environment for good governance practice.
At this point in time there is limited empirical evidence linking individual company scores with the country environment. However it is reasonable to assume that the two are positively correlated. In other words, one would expect to see high governance standards in countries that reflect strong legal, regulatory and informational infrastructures; the opposite would be the case in countries that score lowly in this macro assessment. This is reflected in the “hypothetical distribution” reflected below. This hypothetical distribution is broadly consistent with Standard & Poor’s own experience in corporate governance scoring.

However it is important to note that it is also reasonable to expect “outliers”—i.e. cases of strong firm governance in weak country environments, and vice versa. In many ways these “outliers” are the most interesting situations to assess, and need to be properly identified.

In this context this two dimensional matrix can be further subdivided into 4 quadrants, as reflected in the diagram below.

- “Underachievers”: companies in strong country environments whose own governance standards have not met high standards (For example Enron, WorldCom, HealthSouth in the US)
- “Overachievers”: companies in weak country environments whose own governance standards can be viewed as high relative to the country of domicile. (For example Infosys in India)

In this schema, clearly the “underachievers” will have little or no incentive to have their governance standards publicly scored. However the “overachievers” — mostly from emerging economies—are likely to have the greatest interest in receiving a governance score so as to differentiate positively their firm from local peers with lower governance standards.

7. Applications of Corporate Governance Scores and Benchmarks
With corporate governance scoring still in a relative infancy, the practical uses of this tool remain to be determined. However it is possible to isolate different user groups to explore potential applications of this tool. While it is to be expected that the primary use of this tool will be for investors, these investors can run a broad range to include majority shareholders, minority shareholders and creditors. But there are also meaningful applications for other groups, including board directors, managers, regulators, policymakers, financial intermediaries, analysts and academics.

Potential applications of governance scores reflecting the specific interests of these groups are outlined below.

**Shareholders (Majority and Minority)**

- To understand how management is promoting the interests of the shareholders.
- To understand the relative degree of transparency at a firm
- To guide existing and new investments: both strategic and portfolio investment

**Minority Shareholders specifically**

- To appreciate how management treats minority shareholders vis-à-vis majority shareholders or other significant blockholders

**Creditors (Lenders, Investors, Counterparties)**

- To use as a guide or as conditionality for lending decisions
- To understand how management promotes the interests of financial stakeholders
- To guide rollover or new lending decisions

**Board Directors**

- To understand the relative standing of existing governance practices as a form of self assessment
- To use as benchmarks for improvement
- To reduce directors’ liability insurance premia
- To provide additional information to attract new directors to join the board
- To help orient new directors about a company’s governance processes

**Managers**

- To understand the relative standing of existing governance practices
- To use as benchmarks for improvement
- To communicate governance standards as an investor relations tool (annual reports, websites, advertising, etc)

**Regulators/Exchanges**

- To assist in market regulation (shares and fixed income)
- To promote governance and high transparency standards
- To include in exchange listing requirements

**Director and Officer Insurance Underwriters**

- To screen companies for D&O underwriting purposes
- To help for a basis for risk-adjusted D&O insurance premiums

**Policymakers**
To identify key gaps in governance standards at the country and private sector level to guide policy formation and new legislation

Financial Intermediaries and Advisors

To facilitate pricing and placement of new debt and equity issues: IPOs, secondary offerings, syndicated loans, bond issues, fairness opinions for M&A transactions

Credit Rating/Equity Analysis

To include as part of broader management assessment

Academics

To use as units of measurement in research linking corporate governance to company performance

8 Methodology Development

This methodology has been under development since early 1998, and its drafting has drawn from a wide range of sources. This includes literature from multilateral banks, academics, law firms, brokerages, regulators and exchanges. In particular, many codes of best practice were reviewed, reflecting a variety of country and individual company perspectives from around the world. In the development stage, this methodology was shared for feedback with various specialists in corporate governance, including investors, lawyers, economists and bankers. Further refinement came through a pilot project in which this methodology was tested on a range of companies, from large listed companies to closely held small and medium sized enterprises.

The spirit of the methodology is to synthesize the key elements of corporate governance on a global basis, and not to impose the standards of any particular country or jurisdiction. As mentioned earlier, the approach is to understand individual governance practices and structures through the lens of overarching principles, such as those emphasized in the OECD corporate governance guidelines. The key is to ensure sufficient flexibility to accommodate different governance structures in the scoring process without compromising the assessment of the ultimate substance of a company’s governance standards as reflected in the broader principles of fairness, transparency, accountability and responsibility.

This methodology provides a way to objectify the process of corporate governance scoring. Its application in individual companies inevitably combines objective benchmarks with subjective assessments on the part of the analyst. Hence, the process of governance scoring is as much of an art as a science. This is not a foolproof process, particularly in that it cannot legislate for fraud. Moreover, it also cannot purport to the same level of insider knowledge that would come through active participation in the governance process as a manager or director. That notwithstanding, the methodology that is presented here provides a robust basis for assessing corporate governance at the firm and country levels. Inevitably the methodology will evolve over time to reflect improvements in both process and in thinking about corporate governance.

Appendix

I. INFORMATION REQUIRED PRIOR TO A CORPORATE GOVERNANCE SCORING MEETING

Typically, Standard & Poor’s analysts will visit the company to make an inspection of relevant documentation prior to meeting with officers of the company and other relevant individuals. Analysts will examine a number of company documents including the following:

- Company annual and intra year reports.
- Proxy statements
- Company Charter/By-laws.
- Filings with Government Regulatory Agencies.
- Records of recent shareholder meetings (past three years), general and extraordinary.
II. TYPICAL INTERVIEWEES FOR THE SCORING PROCESS

Following examination of the documents described above, Standard & Poor's analysts will meet with officers of the company and other relevant individuals, among whom the following is a representative list of typical interviewees:

- Chief Executive
- Finance Director
- Company Secretary/Corporate Counsel
- Board of Directors (in particular the Chairman and independent directors)
- Investor relations personnel
- Key shareholders and creditors (if relevant)
- Company's auditor

III. Scoring Definitions

A CGS is articulated on a scale of CGS 1 (lowest) to CGS 10 (highest).

**CGS 8 and CGS 7**—a company that, in Standard & Poor's opinion, has **strong** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, some weaknesses in certain of the major areas of governance analysis.

**CGS 6 and CGS 5**—a company that, in Standard & Poor's opinion, has **moderate** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, weaknesses in several of the major areas of governance analysis.

**CGS 4 and CGS 3**—a company that, in Standard & Poor's opinion, has **weak** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in a number of the major areas of governance analysis.

**CGS 2 and CGS 1**—a company that, in Standard & Poor's opinion, has **very weak** corporate governance processes and practices overall. A company in these scoring categories has, in Standard & Poor's opinion, significant weaknesses in most of the major areas of analysis.