الوكالة الإسلامية الدولية للتصنيف
Islamic International Rating Agency

CORPORATE GOVERNANCE METHODOLOGY

Islamic International Rating Agency's (IIRA) Corporate Governance Rating evaluates an entity's governance practices with respect to the relationships between management and the stakeholders and the extent to which they conform to the regulations and global 'best practices'. IIRA's Corporate Governance Rating (CGR) is an independent opinion on an organization's commitment to excellence in its managerial practices.

Here is the definition of Corporate Governance by the Organization for Economic Co-operation and Development (OECD) and as adopted by the Basel Committee:

> "Corporate Governance involves a set of relationships between an entity's management, its board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the entity are set, and the means of attaining those objectives and monitoring performance. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the entity and shareholders and should facilitate effective monitoring, thereby encouraging firms to use resources more efficiently."

Generally, Corporate Governance involves the procedures for directing and controlling the organization, the processes for making corporate decisions, disclosing entity's financial and operational information, and the framework for monitoring management performance.

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. The aim is to ensure sufficient flexibility to accommodate different governance structures in the scoring process without compromising the assessment of the entity's governance standards on the touchstones of fairness, transparency, accountability and responsibility.

THE ORIGINS OF CORPORATE GOVERNANCE EVALUATION

The preliminary developments took place in the late 1980s in the wake of corporate scandals like Polly Peck and Maxwell in the UK. A corporate governance committee, led by Sir Adrian Cadbury, came up with numerous recommendations with the publication of the Cadbury Report in 1992. The suggested measures included:

- Separate roles of Chief Executive and Chairman
- Balanced composition of the board
- Strong internal controls
- Efficient processes for the selection of non-executive directors
- Increased transparency in financial reporting

In 1995, as a response to the concerns about directors' pay and share options, the Greenbury Report suggested extensive disclosure in annual reports on remuneration and recommended the establishment of a remuneration committee comprised of non-executive directors. Again, the majority of the recommendations were endorsed by the Listing Rules.

Six years later another committee published the 'Combined Code of Corporate Governance'. The code addressed

- The structure and operations of the board
- Directors' remuneration
- Accountability and audit
- Relations with shareholders, and
- Responsibilities of shareholders

In 2004, in-line with the developments in Islamic financial markets, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) also issued Governance Standards. The ethical values emphasized by AAOIFI in its Code of Ethics include:

- Faith-driven conduct
- Professional competence and diligence
- Trustworthiness
- Religious legitimacy
- Objectivity
- Professional conduct and technical standards

In an attempt to create a Corporate Governance framework in the Middle East, the Bahrain Monetary Agency (BMA) outlined a number of rules with which Islamic Financial Institutions (IFIs) must comply. In the rulebook for IFIs, the regulator of the Bahraini financial system requires:

- Separation of the roles of chairman and chief executive
- Development of a code of conduct by the organization and its approval by the board
- The board members to be independent and non-executive

- Mandatory setup of audit and Shari'a committees
- Compulsory setup of independent functions of internal audit and risk management
- Prior notification to BMA in case of major changes in the strategy and corporate plan of the entity

THE IMPACT OF CORPORATE GOVERNANCE ON PERFORMANCE

Corporate Governance holds vital importance for the credit analysis process since the financial health of the entity is dependent to a large extent on the governance practices of the entity.

A number of studies published in recent years have exhibited a strong link between high Corporate Governance standards and a healthy earning stream. For example, Brown, Lawrence D., and Caylor, Marcus, "Corporate Governance Study in 2004: The Correlation between Corporate Governance and Company Performance," found that the best-governed companies had higher returns on investment and equity than those of poorly governed companies.

A single model of Corporate Governance cannot be applied to all organizations. The Business Sector Advisory Group on Corporate Governance to the OECD has articulated a set of principles of corporate governance that are relevant across a range of jurisdictions. These are:

- Fairness
- Transparency
- Accountability; and
- Responsibility

These same principles are used by IIRA as cornerstones in Corporate Governance rating for individual entities.

IIRA'S APPROACH

IIRA's Corporate Governance Methodology takes into consideration the above recommendations and guidelines. IIRA assesses the level of compatibility of entities with these guidelines, in addition to the local regulatory authorities' requirements (such as central banks, security and exchange commissions, stock exchanges, and other regulators).

IIRA's CGR is an independent third party opinion on the corporate governance practices of an entity. The rating reflects the extent to which an entity has adopted the codes and guidelines of the accepted practices of Corporate

Governance. A scale of CGR-10 (highest) to CGR-1 (lowest) is used to state the overall strength of Corporate Governance processes and practices.

IIRA's CGR requires an in-depth study of the corporate governance practices of an entity and their comparison with global 'best practices'. Rating agencies are uniquely placed to carry out this function because managerial assessment is the most important qualitative aspect examined during the credit rating process. These agencies are also in close contact with the regulatory frameworks. In addition, they have a comprehensive understanding of the various kinds of risks the financial stakeholders are exposed to.

Major components of IIRA's analysis for CGR are:

- Regulatory compliance
- Ownership structure
- Board structure and processes
- Executive management structure and processes
- Transparency
- Internal control and discipline; and
- Stakeholders' relations

REGULATORY COMPLIANCE

IIRA ascertains the entity's level of compliance with all applicable laws, listing requirements and rules of regulatory, taxation and statutory bodies. These laws and rules include labor and environmental regulations to ensure continuation of operations and optimization of profit. Abiding by these regulations ensures protection from adverse legal actions and the loss of business and customer confidence.

OWNERSHIP STRUCTURE

IIRA analyzes the breakdown of shareholding to identify majority holders, indirect ownership, and executive equity ownership. Such an analysis is required to screen out the issues of concentration and large block-holders (who may exert influence that is detrimental to the interests of other shareholders). This scrutiny also ensures that the entity is not disadvantaged by shareholders who are shielded from accountability and that minority shareholders are protected against loss of value or dilution of their interest.

The ownership rights are evaluated by analyzing the arrangements of transfer registration, shareholding structure, shareholder agreement, dividend payout history, and information on share repurchases and swaps. This process examines the existence of secure methods of transferability of shares and fair financial treatment.

BOARD STRUCTURE AND PROCESSES

IIRA studies the board composition and questions whether the members of the board have the relevant education and experience to operate independently, and actively. IIRA looks at the board's responsibilities to ensure that it provides a strong base of independent directors, evaluates the entity's strategy regularly, and guides management performance. To assess the board's performance for internal risk control and overall accountability, IIRA monitors the board committee meetings and their agendas, record of deliberations and any dissenting opinions to the decisions of the board.

IIRA places extra emphasis on separation of authority. Therefore, IIRA scrutinizes the board's structure, leadership of committees, and representation of constituencies to assess the extent to which the interests of all the shareholders are represented fairly. Moreover, IIRA examines the compensation of board members to check whether they are fairly remunerated and motivated to ensure the success of the entity. At the same time, the compensation should not be extravagant, which could result in the directors perpetuating themselves without contributing to the entity's development.

IIRA checks if all directors are submitted for re-election at regular intervals to allow effective rotation and a combination of directors who are competitive in achieving entity's objectives. Similarly, IIRA also places emphasis on the procedures adopted for the selection of chief executive officer, chief financial officer, entity secretary and departmental heads. The hiring on these senior management positions must follow a criteria which should delineate the sets of skills, education and experience profile and personality traits.

IIRA attempts to make sure that the organizational structure clearly defines a set of responsibilities for key executives to work together and independently to achieve the entity's objectives. Furthermore, IIRA examines the procedure and criteria for selection of key executives by the board and the importance given to integrity, technical competence and experience to handle operations.

IIRA searches for a clear division of responsibilities between running the board and running the business. It looks at the frequency and outcome of internal meetings in light of board decisions to see if the organization is working cohesively. IIRA also examines the level of delegation of powers by the board to the executive management. This analysis helps ascertain whether the executive management has sufficient independence to handle day-to-day operations, take proactive actions, avail business opportunities and counter any adverse developments to protect the entity. IIRA also sees if the presence and composition of any executive management committee is separate from the board committees to ensure the appropriate distribution of powers.

EXECUTIVE MANAGEMENT STRUCTURES AND PROCESSES

IIRA analyzes the management structure, effectiveness and operations to ensure the success of the entity. IIRA also examines the record keeping of all executive meetings and evaluate the availability of information for planning, organizing and controlling the operations and decision making. IIRA also scans the evaluation and remuneration criteria of management and the procedure for disciplinary actions whenever required to assess their motivation to fulfill the entity's objectives.

IIRA explores relations between shareholders and management. It screens the annual general meeting minutes and assesses the quality of shareholder participations. IIRA sees if the shareholders are furnished with sufficient and timely information to allow equal access of all shareholders for effective deliberations in the meetings. Moreover, IIRA assesses the quality of management's participations in the meetings and their actions and responses to shareholder observations and queries.

IIRA examines the dividend payout history and projected dividend payments to determine if they are in line with the dividend policy. The dividend policy is looked at critically because it affects the financial structure of the entity. IIRA checks whether the dividend policy states the proportion of earnings to be distributed to the shareholders or it seeks to manage consistent dividend stream by managing equalization reserve. IIRA also checks the historical retention ratio of earnings and whether such retention is justified by the strategic growth objectives of the organization.

TRANSPARENCY

IIRA assesses transparency by monitoring the quality and timeliness of disclosure of adequate information regarding the entity's operational and financial performance. This enables stakeholders to effectively screen and suggest alterations on the course-of-actions of management. IIRA also monitors if all publicly released information (including entity by-laws, statues and/or articles and other information) are made promptly available to all stakeholders to ensure the effectiveness of internal disclosure policies. IIRA asks the key question, does the financial reporting facilitate a clear understanding of an entity's true underlying financial condition? IIRA also measures the entity's openness regarding non-financial performance, particularly relating to an entity's business operations and competitive position without compromising on the confidentiality of information.

INTERNAL CONTROLS AND DISCIPLINE

IIRA examines if the entity has selected qualified and independent external auditors by looking at the procedure for auditor's selection based on background, qualifications and reputation. IIRA checks whether they are given any other assignments which would give them the financial benefits that may run contrary to their independence. IIRA also scrutinizes the reasons behind changes of auditors. IIRA questions whether the entity is utilizing the independent and objective audit process by taking actions on the issues raised by external auditors. The adoption of internationally recognized accounting principles is a positive factor as long as they are not in conflict with the local accounting standards.

IIRA also evaluates the internal audit department personnel, checking their qualifications, experience, capabilities and competence to handle internal audit responsibilities. Their remuneration and its reflections on the auditor's motivations are also studied. IIRA also analyzes the audit committee and its responsibilities to find out if they promote a sound internal control environment. IIRA monitors the output of internal auditors. IIRA checks if the committee is comprised of directors who are independent. Moreover, IIRA questions whether they possess the financial savvy that can help promote unbiased and critical oversight of the entity's accounting practices.

IIRA assesses the outcomes of auditors' meetings and studies the deliberations with respect to audit, risk management and control systems. The actions based on such deliberations are also evaluated. In addition, IIRA monitors the overall level of financial discipline of the entity to ensure continued operations. IIRA also determines whether the auditors provide accurate accounting statements in line with the entity's financial position and fundamental risks to protect the integrity of financial reporting. IIRA establishes whether or not the entity demonstrates that its operations are measured, monitored and controlled by appropriate, effective and prudent risk management systems.

STAKEHOLDERS' RELATIONS

IIRA places emphasis on effective and positive employee-employer relations. Attracting appropriately qualified employees and matching them to the jobs for which they are best suited is significant for the success of an organization. IIRA looks at the entity's efforts to enhance morale and productivity, limit job turnover, and help the entity increase performance and improve business results. IIRA examines how effectively the entity uses employee skills, provides training and development opportunities to improve those skills. Does the organization attempt to increase employee satisfaction with their jobs and working conditions?

IIRA assesses the human resource management policies by looking at communication channels between employer and employees, work assignments, performance appraisals, employee turnover, hiring, disciplinary actions, training procedures and remuneration criteria. IIRA evaluates the adaptation and disclosure of code of business conducts and ethics. IIRA also analyzes the mode adopted to convey code of ethics and governance practices to internal employees.

IIRA focuses on an entity's social responsibilities and customer relations because they increase stakeholders' confidence in the entity and lead to profit maximization. It is the obligation of management to take actions which enhance the welfare and interests of the society as well as the entity. This is related to an entity's ethical, economic, legal, and discretionary responsibilities.

While a growing business needs to constantly capture new customers, the priority of a business should be to maintain existing customer relations. IIRA ascertains if the entity is investing in customer relations management to maintain customer goodwill. IIRA also studies the entity's relationship with immediate competitors. The entity's efforts to maintain a healthy competitive environment are given consideration during the rating process.

CORPORATE GOVERNANCE RATING SCALE AND DEFINITIONS

IIRA uses a scale of CGR-1 to 10 to rate corporate governance with CGR-10 being the highest possible rating and CGR-1 being the lowest possible rating.

CORPORATE GOVERNANCE RATING SCALE AND DEFINITIONS

CGR-10: Strongest corporate governance processes and practices overall with very few weaknesses in any of the major areas of governance analysis.

CGR-9: Very strong corporate governance processes and practices overall with few weaknesses in any of the major areas of governance analysis.

CGR-8: Strong corporate governance processes and practices overall with some weaknesses in certain of the major areas of governance analysis.

CGR-7: Moderately strong corporate governance processes and practices overall with weaknesses in certain of the major areas of governance analysis.

CGR-6: Satisfactory corporate governance processes and practices overall with some weaknesses in several of the major areas of governance analysis.

CGR-5: Adequate corporate governance processes and practices overall with weaknesses in several of the major areas of governance analysis.

CGR-4: Moderately weak corporate governance processes and practices overall with weaknesses in a number of the major areas of governance analysis.

CGR-3: Weak corporate governance processes and practices overall with significant weaknesses in a number of the major areas of governance analysis.

CGR-2: Very weak corporate governance processes and practices overall with significant weaknesses in most of the major areas of analysis.

CGR-1: Weakest level of corporate governance processes and practices overall with significant weaknesses in most of the major areas of analysis.