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DBRS Criteria: Evaluating Corporate Governance

DBRS views corporate governance as an important component of its credit rating analysis. As indicated by its name, corporate governance is concerned with how well a rated company, institution or other entity is being governed under its articles of incorporation or other legal organization. The focus of DBRS analysis is primarily to determine cases where governance poses a significant risk to a company that could affect its rating rather than assigning a “corporate governance rating” for each company. Companies can be stronger in some areas, but weaker in others. In assessing governance, DBRS is concerned with the risk that poor corporate governance could result in the deterioration in a company whose franchise, financial performance and risk profile would indicate it is in much better “shape”; hence, DBRS views and ratings may be more positive than deserved.

This criteria is an overview of the framework DBRS uses to ensure that the rating process gives due consideration to key areas in evaluating how a company is governed. In general, the DBRS evaluation homes in on the review of certain key underlying motivations and processes to ensure that they are effective and honest. In most cases, entities will get a pass on governance. However, if a company gets a fail, the rating could be seriously affected. Where information is highly unreliable, the rating could even be discontinued.

Although assessing governance can be highly subjective and difficult to gauge, it is viewed as an important part of the credit rating process at DBRS. Strong corporate governance provides a company with a value-added board and senior management that can set the foundation for long-term sustainability by improving the likelihood that the business will be healthy and productive. It will also reduce the risks of lost time and added costs that can come from a wide variety of areas if governance is ineffective. From a DBRS perspective, there is also a correlation between governance and the extent to which a rating agency can trust the board and management.

KEY AREAS FOR CONSIDERATION

Within credit analysis, DBRS segments corporate governance considerations into the following general areas:

(1) Board or Other Controlling Body

- Independence, appropriate structure and process, accountability and oversight.

(2) Senior Management

- Expertise, integrity, reputation and ethics, commitment, self-interest, appropriateness and rigour of practices.

(3) Audit

- Quality and independence of the audit committee, external and internal auditors and completeness of the audit process.

(4) Accounting Practices

- Appropriateness of accounting policies and practices, quality and stability of financial reporting.



(5) *Other*

- **Ownership Structure:** Appropriateness of company ownership and stock structure, behaviour of owners, political influence, conflicts of interest.
- **Regulatory Issues:** Relationships with relevant regulators, nature of any regulatory issues. These are especially important for highly regulated institutions.
- **Legal Issues:** Lawsuits, record of legal actions and settlements, legal problems of board members or management.

Some understanding of each area of governance is needed for the approach to be optimal. There can be considerable variation in how the evaluation is accomplished. For example, some areas are best dealt with as part of the rating process (including management expertise, risk management processes and contribution of the board of directors or other governing body), while others are important for determining the reliability of information used in the rating process (including financial reporting, audit processes and transparency of company disclosures). There is also a wide variety in terms of complexity, subjectivity and measurement. Issues of ownership and management compensation are relatively easy to measure, although evaluation is complex. Transparency and openness are somewhat less straightforward, while an assessment of appropriate board oversight, management expertise, completeness and independence of the audit process and the effectiveness of the audit committee can be quite subjective.

RATING IMPACT

When an entity exhibits weakness in a governance issue, it may affect the rating by raising questions with respect to certain areas, such as the accuracy and reliability of its financial statements. Some entities may also face a wide range of regulatory penalties that could affect both financial results and the ability to continue and/or expand a business. Concerns in one aspect of governance would cause DBRS to delve deeper into that area and most likely into other governance areas as well.

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