DBRS Criteria: Evaluating Corporate Governance

Assessing corporate governance can be a subjective exercise; nonetheless, it is 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 improve the likelihood of long-term financial health and can reduce the costs of having to address issues that arise from ineffective governance. From DBRS’s perspective, there is also a correlation between governance and the extent to which a rating agency can trust the board and management to do what they say they will do (with respect to future strategy, delivery of future performance or maintenance of certain maximum leverage levels, etc.).

Key Areas for Consideration
To the extent that information is available, DBRS segments corporate governance considerations into its credit analysis within the following general areas:

(1) Board or Other Controlling Body
- Independence, appropriate structure, process and skills, accountability, internal controls and oversight.
- **Key Issue:** Is the board effective in establishing proper and clear oversight, policy and strategic direction for the firm?

(2) Senior Management
- Expertise, integrity, reputation and ethics, commitment, depth, self-interest, appropriateness and rigour of practices, culture and, to the extent that it is possible, alignment of interests with other stakeholders may also be a consideration.
- **Key Issue:** Is senior management effective, does it have an acceptable record of integrity and is it implementing strategies and risk management as set by the board?

(3) Audit
- Independence of the audit committee, external auditors and completeness of the audit process and any examination of material weaknesses.
- **Key Issue:** Is audit oversight sufficient to provide for financial statements that are timely, informative, free from auditor qualification and unlikely to suffer from material weaknesses?

(4) Accounting Practices
- Appropriateness of accounting policies and practices, quality and stability of financial reporting.
- **Key Issue:** Within the context of the industry and region in question do financial statements provide for a reasonable, timely and transparent overview of the entity’s performance? Are there ongoing tax, regulatory, legal, financial restatement or frequent auditor change issues or any material weakness disclosures?

(5) Enterprise Risk Management
- Presence of a risk management governance structure (e.g., Risk Committee of the Board, centralized risk management function, etc.) in place that is appropriate for the organization.
- **Key Issue:** Does the company have in place a process for assessing and (where appropriate) mitigating each of the key strategic, financial, operational, legal and reputational risks the company could reasonably face?
Criteria

(6) Other

- **Ownership Structure**: Appropriateness of company ownership and stock structure, behaviour of owners (including impact from activist shareholders), political influence, conflicts of interest (including related party transactions). Additional diligence may be required in the case of private companies, where there can be more challenges in areas such as the appropriate alignment between shareholder, board and management.

- **Direct Regulatory Issues**: Relationships with relevant regulators and the nature of any regulatory issues. These are especially important for highly regulated entities.

- **Legal Issues**: Lawsuits, record of legal actions and settlements, legal problems of the organization, board members or management.

- **Country Issues**: Does the host country of the issuer raise any concerns with respect to accepted best practices in accounting, legal, security laws or securities regulation in general.

- **Unique Situations**: Situations that are highly complex or involve non-investment-grade credits or privately owned firms may require additional attention to governance issues.

- **Related Party Transactions**: Are major dealings here negotiated at arm’s length and with effective board oversight?

- **Key Question**: Outside of the board, management, audit and accounting practices, are there any other governance-related areas that raise concerns at the entity in question?

**Analytical Approach**

Assessing corporate governance can involve many different and subjective topics, any of which can be complex and difficult to evaluate from DBRS’s external position. Management expertise, risk management processes and the contribution of the board of directors, for example, are all best examined during discussions with management. Financial reporting and audit processes involve a review of the transparency of company disclosures. Ownership and management compensation information is readily available, but evaluation can be complex. DBRS will generally take as broad a view as possible and examine each area using whatever analytical tools are appropriate.

**Rating Impact**

DBRS’s expectations may vary by industry, type of ownership, size of the company and complexity of the company’s product line, operations or geographic presence. A publicly traded, regulated universal bank rated AA, for example, would be expected to have substantially greater resources dedicated to risk management and corporate governance, generally, than would a small privately owned single-location oil production company. In the final analysis, the assessment of corporate governance is somewhat of a pass/fail type of exercise against the appropriate expectations for that issuer. While it would be unusual, but not impossible, for a “pass” conclusion, all else being equal, to lead to a higher rating, when a corporate governance assessment does affect a rating, the much more usual situation would be that a “fail” conclusion leads to downward pressure on a rating. Indeed, in some cases, critical issues with governance may prevent DBRS from being able to provide a rating at all.