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Dana R. Hermanson
Kennesaw State University, dhermans@kennesaw.edu

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Hermanson, Dana R
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CORPORATE GOVERNANCE RATINGS: GOOD OR BAD?

If something is important, eventually it gets measured. The last several years clearly have demonstrated that corporate governance is important, so it is no surprise that an industry has emerged to provide ratings of companies' corporate governance. Investors have witnessed numerous governance disasters of late, and those seeking to make sound investment decisions want to understand the governance quality of their investment targets. In this column, I provide information on three prominent governance ratings providers and comment on some of the pros and cons of such ratings, including some harsh criticisms from the academic community regarding the quality of the ratings and independence of some ratings providers.

Ratings providers

There are several governance ratings providers, and I have chosen three to illustrate the types of rating systems currently in use. For each service, I present the rating system's purpose, methodology, and criteria. The information on each provider is quoted directly (excerpted due to space limitations) from each provider's website. I encourage interested readers to consult the websites themselves for more complete information.

Institutional Shareholder Services (ISS)—Corporate Governance Quotient (CGQ). Website: www.isscgq.com.

Purpose. "Today, many investors view governance as an issue in making investment decisions. . . . This widespread view that 'governance matters' necessitates the creation of metrics that allow investors to quickly and accurately identify the relative performance of companies. To meet this rising demand, Institutional Shareholder Services (ISS)—with input from a panel of advisory board members—spent 18 months developing a tool for monitoring and comparing the corporate governance structures of America's leading publicly-traded companies."[1]

Methodology. "Disclosure documents (proxy statements, annual reports, prospectuses, etc.) supply most of the required data. ISS analysts also review corporate web sites and press releases for governance-related information. Issuers may supplement these filings with additional data in order to create an accurate picture of each company's governance practices."[2]

Criteria. "Eight core topics comprise the CGQ rating: (1) board structure and composition, (2) audit issues, (3) charter and bylaw provisions, (4) laws of the state of incorporation, (5) executive and director compensation, (6) qualitative factors, (7) D&O stock ownership, and (8) director education. The score for each core topic reflects a set of key governance variables. The current list comprises 61 of these sub issues."[3] (See www.isscgq.com/Rating Criteria.htm for the list of sub issues.)

The Corporate Library—Board Effectiveness Ratings. Website: www.thecorporatelibrary.com.

Purpose. "Shareholders are becoming increasingly aware of governance risk. . . . Board effectiveness is at least as important a measure of investment risk as creditworthiness; with its Board Effectiveness Ratings, The Corporate Library provides the tools to measure that risk. The Corporate Library's ratings are based on a small number of proven dynamic indicators of special interest to shareholders and investors. We want to determine which boards are most likely to enhance and preserve shareholder value, and which boards might actually increase investor risk."[4]

Methodology. "Our proprietary ratings formula identifies and highlights certain key 'red flag' indicators of potential board

DANA R. HERMANSON, Ph.D., is a professor of accounting at Kennesaw State University in Georgia and a research fellow at the Corporate Governance Center at the University of Tennessee. Dr. Hermanson is a member of the Institute of Internal Auditors (IIA) and the National Association of Corporate Directors (NACD). He serves on NACD's Atlanta Chapter Advisory Board. Dr. Hermanson welcomes feedback on this column and can be reached via e-mail at Dana_Hermanson@coles2.kennesaw.edu.

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ineffectiveness and is combined with additional in-depth analysis by our senior analysts and associates. Each indicator, or subcategory, is evaluated with letter-based ratings using the common A-F scale and is visually represented on a company's profile webpage as a color-coded bar."[5]

Criteria. "[W]e consider the following eight categories: Board Composition, CEO Compensation, Shareholder Responsiveness, Accounting, Strategic Decisionmaking, Litigation & Regulatory Problems, Takeover Defenses, and Problem Directors. We also include an Analyst Adjustment in the group of factors considered in determining a company's Overall Rating."[6]

GovernanceMetrics International (GMI)—GMI Ratings. Website: www.gmiratings.com.

Purpose. "GMI's premise is straightforward: companies that emphasize corporate governance and transparency will, over time, generate superior returns and economic performance and lower their cost of capital. The opposite is also true: companies weak in corporate governance and transparency represent increased investment risks and result in a higher cost of capital. . . . While companies with weak governance structures and practices are the subjects of newspaper headlines, there are as many companies with outstanding governance policies and disclosure levels that go unrecognized. GMI's ratings hope to correct that. Subscribers to our service receive an independent and dispassionate evaluation of the governance characteristics of each company in our research universe."[7]

THE FACT THAT THESE RATINGS SYSTEMS EXIST SHOULD ADVANCE THE CORPORATE GOVERNANCE DIALOGUE IN THE UNITED STATES.

Methodology. "GMI Ratings are prepared by GMI at no cost to the company and are based on publicly disclosed information only. Companies are first rated when they are added to a market index already covered by GMI or when GMI adds a new index to our coverage universe. . . . GMI research analysts start the rating process by developing a detailed database profile for each company in our system. We review regulatory filings, articles of incorporation, bylaws, environmental, health and safety reports, company Web sites and other public sources to answer the hundreds of metrics on corporate governance and corporate accountability used to generate GMI ratings. We repeat this process with each semi-annual ratings cycle."[8]

Criteria. "'GMI Research Categories and Sample Metrics' are available upon request." (These can be requested from the GMI website free of charge.) "While the document doesn't itemize every metric in our system, it does provide a great deal of insight into the ratings categories GMI reviews in order to generate company ratings."[9]

The need for information

The descriptions above all point to the need for governance-related information in making investment decisions. While the ratings providers vary in the amount of information they share about their methods, it does appear that there are two distinct approaches to the ratings. ISS and GovernanceMetrics both appear to focus on many publicly available governance input (structure) and process variables, while The Corporate Library appears to focus more on the decisions made by the board (outputs). While each approach may offer benefits, The Corporate Library's approach is strongly favored by Yale University Professor Jeffrey Sonnenfeld, who states, "Some newer governance ratings firms such as The Corporate Library are making far more cautious claims about governance links to financial performance and are looking beyond simple public documents and governance clichés about board structure to examine actual governance conduct in making their assessments and have produced more accurate assessments."[10]

Pros and cons of governance ratings

What is good about governance ratings? First, the ratings further promote the importance of good governance, and they can focus attention on key governance elements (e.g., independence, diligence, and shareholder protection) that often are linked to positive corporate outcomes. The fact that these ratings systems exist should advance the corporate governance dialogue in the United States.

Second, as company executives and directors react and respond to the ratings, it is reasonable to expect some elements of cor-

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porate governance to improve. Simply highlighting governance and issuing report cards may go a long way toward creating an environment of continuous improvement in corporate governance.

Finally, the existence of these governance ratings opens up the door to a host of research possibilities. Research on governance has been hampered over the years by the need for painstaking collection of data from company proxy statements. With academics able to subscribe to certain ratings databases, I expect a flurry of governance research that may provide new insights into the link between governance quality (as measured by the ratings providers) and corporate performance. In fact, as this was being written, ISS sent out information to academics on the nature of the CGQ ratings and database subscription, with a call for researchers to use the data to advance the field.

AN ISSUE THAT HAS RECEIVED MUCH ATTENTION IN THE MEDIA IS THE INDEPENDENCE OF THE GOVERNANCE RATINGS PROVIDERS.

What are the limitations of governance ratings? "Good governance" is a nebulous construct, and the inside of the boardroom is not observable to outsiders. As a result, we must use variables to proxy for the quality of board oversight. Some of these proxies may be inputs (structural measures such as who is on the board), process variables (e.g., how often the board meets without management present), or outputs (e.g., how much the CEO is compensated relative to company performance). None of these proxies is perfect, so the rating systems each will have their limitations, and companies may have very different ratings from one system to the next.

Consistent with these limitations, researchers at the University of Pennsylvania have been very critical of the ratings. A recent study by Larcker et al. concludes, "[T]he typical structural indicators of corporate governance used in academic research and institutional rating services have a very limited ability to explain managerial decisions and firm valuation." Professor Larcker states, "Lots of people are coming up with governance scorecards. . . . As far as we can tell, there's no evidence that those scorecards map into better corporate performance or better behavior by managers."[11] Similarly, Jeffrey Sonnenfeld of Yale University states, "Good governance matters, it's just not easily measured." He also charges that "the governance peddlers uncritically staple together every governance reform dimension regardless of the existence of research support."[12] In contrast to such criticisms, a recent *CFO* article states that a "group of 26 companies that got the highest score from GovernanceMetrics International's twice yearly corporate governance ratings outperformed the S&P 500 index." This suggests, according to GMI's CEO, "a correlation between corporate governance practices and portfolio returns."[13]

There is the potential for some directors or executives to become fixated on their company's governance rating, while almost forgetting about providing sound oversight that works given the company's characteristics. Value can be destroyed if boards make changes to improve their governance ratings, but these changes actually reduce board effectiveness. Professor Larcker notes, "Don't do anything rash just to appease a ratings service or because a popular consultant whispered his favorite formula to your CEO on the golf course."[14]

An issue that has received much attention in the media is the independence of the governance ratings providers. Professor Sonnenfeld states, "Some of the governance ratings agencies look dodgier than the companies they watchdog. If you purchase accredited director training from [ISS] . . . and purchase their consulting services to evaluate your director incentive packages, the client's payoff is a nice boost in scores."[15] Sonnenfeld also charged in late 2003 that "unlike truly independent ratings such as those by Consumer Reports, these firms [GMI and ISS] treat client companies differently from non-clients. GMI clients are assessed on a much richer array of metrics. . . . Firms rated by ISS cannot raise their scores on some opaque dimensions unless they become clients and have their scores interpreted."[16]

Users of governance ratings should consider such issues as whether the ratings provider consults with rated companies for a fee (to improve their governance process and rating), and what safeguards are in

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place to promote accurate, independent, credible governance ratings.

Conclusion

The governance rating industry is still young and admittedly imperfect, but it has the potential to provide important inputs to assist with investors' decisions. From an internal audit perspective, I encourage readers to examine the types of factors used by the various ratings providers. These factors may be helpful when considering governance quality in your own organization. In addition, I encourage internal auditors to be alert to indications that your company is becoming too focused on a particular rating and changing effective governance processes. In such cases, it's important to remember that the real goal is "good governance," not "good governance ratings." ■

NOTES

1 Institutional Shareholder Services, "ISS Corporate Governance Quotient," available online at www.isscgq.com/abouttheratings.htm (accessed September 2004).

2 *Ibid.*

3 *Ibid.*

4 The Corporate Library, "Board Effectiveness Ratings," available online at www.thecorporatelibrary.com/Products-and-Services/board-effectiveness-ratings.html (accessed September 2004).

5 *Ibid.*

6 *Ibid.*

7 GovernanceMetrics International, "The GMI Rating Process: Information for Rated Companies," available online at www.gmiratings.com/(tu1cfy55gia2bobzntrl5g55)/Default.aspx (accessed September 2004).

8 GovernanceMetrics International, "GMI Ratings and Market Coverage," available online at www.gmiratings.com/(tu1cfy55gia2bobzntrl5g55)/RatingProcess.aspx (accessed September 2004).

9 GovernanceMetrics International, "GMI Rating Criteria," available online at www.gmiratings.com/(tu1cfy55gia2bobzntrl5g55)/RatingProcess.aspx (accessed September 2004).

10 Jeffrey Sonnenfeld, "Good Governance and the Misleading Myths of Bad Metrics," *Academy of Management Executive* vol. 18, no. 1 (2004).

11 See "Corporate Governance by the Numbers: It Doesn't Work," *Leadership and Change*, available online at http://knowledge.wharton.upenn.edu/article/1041.cfm (accessed September 2004). This presents a summary of "Does Corporate Governance Really Matter?" by David Larcker, Irem Tuna, and Scott Richardson.

12 Jeffrey Sonnenfeld, "Introducing the Watchdogs for Corporate Governance," *CareerJournalAsia.com*, available online at www.careerjournalasia.com/columnists/managersjournal/20030311-managersjournal.html (accessed September 2004).

13 Stephen Taub, "Governance Champs Outperform the Market," *CFO* (September 10, 2004), available online at www.cfo.com/article.cfm/3190988/c_3190995 (accessed September 2004).

14 "Corporate Governance by the Numbers: It Doesn't Work," *op. cit.* note 2.

15 Sonnenfeld, *op. cit.* note 12.

16 Jeffrey Sonnenfeld, "The 'Compliance Industry' Is Going Too Far," *The Chief Executive* (November 2003).

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