

# **Rating the Raters: Are Governance Ratings Any Good?**

Robert Daines, Ian Gow, and David Larcker

Stanford University Law School and Graduate School of Business  
The Rock Center for Corporate Governance

## **Abstract**

Corporate governance and proxy advisory firms play an increasingly important role in U.S. public markets. Governance firms advise shareholders on the quality of a firm's governance, advise shareholders how to vote, and take an active role in persuading management to change governance arrangements. They also provide ratings that claim to evaluate the effectiveness of a firm's governance and predict future performance, risk, and undesirable outcomes such as accounting restatements and shareholder litigation. We provide the first objective evidence about the accuracy of these important ratings and examine claims for the commercial corporate governance ratings produced for 2005 by Institutional Shareholder Services (part of RiskMetrics), Governance Metrics International, and The Corporate Library.

These governance ratings do not perform well in our tests, certainly not well enough to support the bold claims made for them. On average, highly rated and "well governed" firms do no better than poorly rated firms and are no more likely to avoid problems like restatements or shareholder suits. With few exceptions, a random number generator would do as well as these ratings the ratings when it comes to predicting outcomes shareholders care about.

These results suggest that firms should not make governance changes just to boost the governance rankings offered by these firms. Given the influence of the ratings firms, they should perhaps be pressed to disclose the historical performance of their governance ratings.

## **Introduction**

Corporate governance is big business and, increasingly, front page news. Spurred in part by the spectacular collapse of Enron and revelations of financial fraud at Adelphia and WorldCom and the option-backdating scandals, interest in corporate governance has produced new federal regulations for public boards (Sarbanes-Oxley), accounting firms (Public Company Accounting Oversight Board), calls for additional reform (including the debate on “shareholder democracy”), and an entire industry of corporate governance advisors, educators and activists. The typical director of a public firm has heard more about corporate governance in the past few years than board members even a decade ago would have heard in a lifetime.

Perhaps the most prominent of the new corporate governance players are proxy advisory firms like Institutional Shareholder Services (ISS) (part of RiskMetrics) and governance-monitoring firms like Governance Metrics International (GMI), and The Corporate Library (TCL). These firms evaluate the governance of public firms and advise shareholders whether a firm’s governance is up to snuff. And, most importantly, they can be extremely powerful. ISS provides voting advice to (and often actually casts the votes for) over 1,700 institutional clients managing \$26 trillion in assets, including 24 of the top 25 mutual funds, 25 of the top 25 asset managers and 17 of the top 25 public pension funds. Governance Metrics International advises clients managing \$15 trillion. Thus, these advisors appear to control up to 20-25% of the shareholder vote and can determine the outcome of proxy battles, merger votes, and director elections. These firms are also increasingly active in directly seeking governance reforms themselves - dismantling takeover defenses, adopting majority voting, and challenging CEO pay. They are thus something like self-appointed governance watchdogs and are especially prominent during proxy season.

Small wonder that the typical director spends so much time thinking about proxy advisors and governance watchdogs. In a recent survey, public firm directors were asked what groups influenced

their board the most.<sup>1</sup> They listed ISS third, behind only institutional investors and analysts, and *ahead* of activist hedge funds and shareholder plaintiffs. These same directors also listed a low governance rating from one of these firms as a red flag that they use to step up their monitoring efforts, falling just behind the firm missing analysts' estimates in importance. Directors and advisors frequently share anecdotal evidence that boards of directors, under pressure from the ratings firms or on their own initiative, change the firm's governance practices in order to increase their ratings.

The basis for these firms' activism and the source of their influence is the claim that they can identify and measure good governance in the same way that credit rating agencies (hopefully) can measure and evaluate default risk. These firms evaluate firm's governance arrangements and produce "governance ratings" that purport to identify well and poorly governed firms. Firms with low governance ratings are targeted for opposition. The firms make bold claims that their ratings allow shareholders to identify and avoid "future Enrons" and thus to earn superior returns by spotting well governed firms.

If these claims are right—if the governance ratings can spot good governance—these commercial firms are providing an extremely useful service and board members should listen to their demands for change. However, if the claims are wrong – if, as it may be, "the emperor has no clothes" then boards and institutional investors should be careful in weighing their calls for change.

So, are these ratings any good? Do the governance watchdogs know good governance when they see it? Until now there has been no independent examination of the value of these governance rating and no evidence on the fundamental question: do these ratings accurately predict governance problems or firm performance?

---

<sup>1</sup> Corporate Board Member, 2007

In a recent study, we provide the first objective evidence about whether these ratings actually work. We obtained the ratings from the three major proxy and governance advisory firms, put them to test, and found them largely wanting. In short, there is little evidence to support bold claims that these ratings are able to spot the well-governed firms from the poorly governed firms. Stated bluntly, a *ranking created by a random number generator would have performed about as well as the most prominent of the rankings we evaluated.* Thus, an important lesson from the data is that governance is a complicated business and likely varies a lot from firm to firm. “One size fits all” and “check-the-box” ratings from firms like ISS are not useful to shareholders and directors should not make governance changes simply to boost their commercial governance ratings.

## **The Claims**

Governance -watchdogs, such as ISS and GMI, claim to be able to distinguish good governance from bad. ISS claims that its ratings “identify the worst corporate offenders”<sup>2</sup> and that “[t]here is no doubt that [its] ratings could have helped some investment managers avoid the gigantic losses experienced during the corporate scandal era defined by meltdowns at Enron, Global Crossing and WorldCom.”<sup>3</sup> The Corporate Library, a firm associated with frequent governance commentator Nell Minow, says its approach “led to our successfully identifying the Enron, WorldCom, Global Crossing, HealthSouth, Kmart, Warnaco and DPL boards as likely to encounter problems well BEFORE those firms imploded, even while most other ratings systems awarded those boards generally high marks.”<sup>4</sup> GMI’s says its “premise is simple: companies that focus on corporate governance and transparency will, over time, generate superior returns and economic performance and lower their cost of capital.

---

<sup>2</sup> Institutional Shareholder Services, Solutions Overview. [www.issproxy.com/pdf/cgq.pdf](http://www.issproxy.com/pdf/cgq.pdf)

<sup>3</sup> ISS website: [www.riskmetrics.com/issgovernance/esg/cgq.html](http://www.riskmetrics.com/issgovernance/esg/cgq.html)

<sup>4</sup> TCL website: <http://www.thecorporatelibrary.com/Products-and-Services/board-effectiveness-ratings.html>.

The opposite is also true: companies weak in corporate governance and transparency represent increased investment risks and result in a higher cost of capital.”<sup>5</sup>

It appears plausible that these claims are true for a number of reasons. First, the firms selling ratings appear to be commercially successful, suggesting the possibility that the ratings are useful to their clients. Second, commercial rankings use proprietary, quantitative algorithms and huge databases and analytical tools that supposedly weight governance mechanisms according to their relationship to firm performance. Finally, commercial rating algorithms also explicitly change each year to “take into account market trends,” whereas most academic ratings tend to be time-invariant, which may enable these firms’ computations to quickly respond to important changes in the sectors of the economy.

## **The Evidence**

If bold claims of the rating firms can be supported by rigorous empirical analysis, these governance rating organizations are providing valuable information to the stakeholders of the firms. However, objective evidence about how these ratings perform has been scarce and, when available, sponsored by the companies themselves. The ratings firms have not been eager to make their data, even their old data, available for independent verification.

However, we obtained the ratings for 2005 and decided to put them to the test. We examined whether commercial governance ratings had any ability to predict future firm performance or undesirable outcomes such as accounting restatements and shareholder litigation.

### *1. Low Correlation*

The first obvious thing to note about the governance ratings is that there is very little agreement among the competing measures of governance quality. Firms that are highly rated by one ratings firm

---

<sup>5</sup> TCL website.

are often poorly rated by another. Consider the firms in the table below, which are highly rated by ISS, but poorly rated by The Corporate Library (who gave all these firms a “D”).

<b>Company</b>	<b>ISS</b>	<b>TCL</b>
ATT	99	D
Autodesk	100	D
Black & Decker	99	D
General Electric	100	D
General Motors	99	D
Pfizer	100	D
Safeway	99	D
Wyeth	100	D

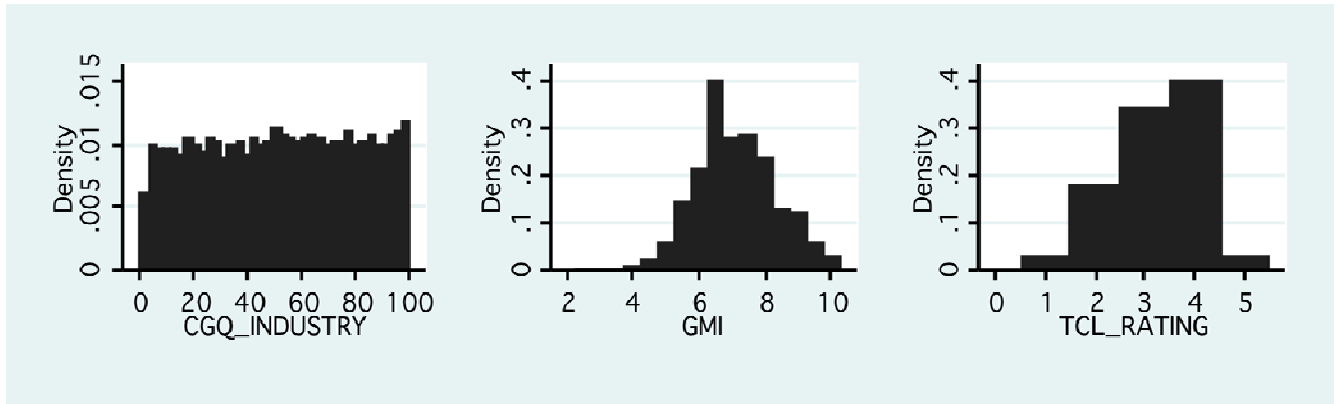
Or consider the firms below, which were given a perfect grade by Governance Metrics International and a failing grade by The Corporate Library.

<b>Company</b>	<b>GMI</b>	<b>TCL</b>
Home Depot	10	F
Lockheed Martin	10	F
3M	10	F
Xerox	10	F

Note that *these are not small, obscure firms whose governance arrangements are ambiguous and uncertain*. Even for the biggest, most visible, most studied firms in the country, the rating firms are in fundamental disagreement about whether they have good or bad governance. We suspect that some of these differences are due to the algorithm used to compute the rating. ISS and GMI both rely on “check the box” methods (of simply adding up the numbers of scores for “good” features), whereas TCL ratings reflect the subjective judgment of their analysts.

And it’s not just that these ratings differ on a few firms. In formal tests, we find very little or no overall statistical correlation between most of the ratings. In fact, they are close to being uncorrelated.

Consider for example, the overall distribution of the ratings. Due to their relative percentile methodology (where firms are ranked and then assigned to a relative percentile), as shown in the Figure 1 below, ISS's ratings are spread pretty evenly between good and bad firms, GMI's overall scores are skewed positively, and TCL's are skewed negatively.



**Figure 1**

That these governance firms are in such wild disagreement suggests either (a) the firms are rating different things and do not agree about what governance is (a pretty basic problem) or (b) they measure governance with a very high degree of error. We suspect it's a little of both.

## 2. *Can the ratings predict important outcomes?*

But this disagreement would all be fine if the ratings ultimately made sense somehow – if the ratings ultimately helped shareholders and managers predict firms that would suffer poor performance or a governance failing that generated shareholder lawsuits or accounting restatements. Do they?

We have conducted extensive empirical testing and find that they *do not usefully predict outcomes that are important to shareholders* and stakeholders. Specifically, if the ratings services are able to tell well-governed firms from poorly governed firms, poorly governed firms should have (a) more accounting restatements; (b) more fraud and misbehavior that would lead to shareholders suits;

and (c) poor performance, as measured by return on assets and, stock price returns, or market-to-book ratios.

We therefore collected governance and financial data for more than 6,500 firms from a variety of websites and research services.<sup>6</sup> Our analysis focuses on the ratings available on December 31, 2005 and examines whether the 2005 ratings predicted outcomes in 2006 and 2007.

We looked at several outcomes. Two of these outcomes are discrete, “bad” outcomes. First, we looked at whether the probability of accounting restatements is higher for companies with bad governance ratings. Second, we examined whether poor governance ratings are associated with higher likelihood of being the subject of class-action shareholder litigation. We then examined whether good governance ratings are associated with better operating performance (measured using return-on-assets) or higher stock returns.<sup>7</sup>

We summarize our findings in the report card below (blank cells in the table below mean that there is no statistically significant relation between a rating and an outcome). In short, we find very little evidence to support the claims made for governance ratings. The ratings are unable to tell good performers from poor performers. ISS’s rating (CGQ), if it matters at all, is backward: well-governed firms are more likely to be subject to class-action lawsuits. The performance of GMI’s rating is mixed – there is weak evidence that poorly rated firms have more restatements (“weak” means that the relationship is marginally statistically significant but economically trivial) which is consistent with their ability to pick out well-governed firms, but on the other hand, firms that GMI considers poorly governed have better return on assets, which is inconsistent with this rating identifying bad governance. Although the rating from TCL seems to better predict outcomes, the statistical relations are not

---

<sup>6</sup> Not all firms have ratings from all four governance rating firms.

<sup>7</sup> We measured return on assets using data for the fiscal year ending between June 2006 and May 2007. We measured stock returns as “alphas” (risk-adjusted returns) over the time period January 2006 to September 2007.

economically meaningful. The effects are not large enough or accurate enough to predict future firm performance.

### Ratings Report Card

#### Relationship between governance ratings and outcomes

Future Outcomes	CGQ	GMI	TCL
Restatements		<b>Weak</b>	
Class-Action Lawsuits	<b>Opposite</b>		<b>Weak</b>
Return on Assets		<b>Opposite</b>	<b>Weak</b>
Stock Price Return			<b>Weak</b>

When we look closer at the ratings of the biggest and most influential advisor, ISS, we find no evidence that even the sub-ratings for firms' audit, takeover defenses, board effectiveness, or compensation policies usefully identify good governance. In fact, if anything, the data seems to indicate that *the firms that ISS considers well governed by these measures have significantly worse outcomes*. ISS's well-governed firms by these measures have more class actions lawsuits, lower return on assets and abnormally bad stock price performance.

## Ratings Report Card

### Relationship between ISS rating sub-scores and outcomes

<b>Future Outcomes</b>	<b>Audit</b>	<b>Board</b>	<b>Compensation</b>	<b>Takeover</b>
Restatement				
Class-Action Lawsuits		<b>Opposite</b>		
Operating Performance	<b>Opposite</b>	<b>Opposite</b>		
Stock Performance		<b>Opposite</b>		

### Summary

Shareholders, regulators, hedge fund managers, press commentators, board members and policy makers increasingly stress the importance of good governance, arguing that it improves firm performance, shareholder welfare and the health of the public markets. However, defining good governance and distinguishing good governance from bad governance has proved more elusive, especially given the great variety of corporate governance mechanisms (and combinations) employed by firms.

Proxy and governance advisors frequently press managers for governance changes on the grounds that the firm's governance, according to their analysis, is sub-standard. These ratings are also used in formulating recommendations that are influential in shareholder voting and can have an important effect on shareholder votes.

However, we find that most ratings have either limited or no success in predicting firm performance or other outcomes of interest to shareholders. Even when there is a statistical association with future outcomes, the economic or substantive effect seems small.

Our findings raise several questions. First, should boards of directors go out of their way to raise their company's governance scores? It appears that increasing one's governance ranking may well have no economic impact. This does not mean that governance does not matter or that particular

mechanisms do not affect firm value. It may be that firms should make governance changes, but the ratings we examine would not be a reliable guide in doing so.

Second, these results raise the question why institutional investors, shareholders, and other parties buy them. Several options seem plausible. First, customers may believe that ratings can help them produce higher returns or “avoid the next Enron.” To the degree that this occurs, one possible “consumer protection” policy response would be to require ratings firms to provide additional disclosures about the predictive power of their ratings. Rather than disclosing their ranking’s correlation with past performance, they could disclose their success at predicting future outcomes.

Another explanation that is offered for the growing popularity of governance ratings is that institutional shareholders purchase the ratings as protection against future claims that they have invested or voted unwisely and thereby breached their fiduciary duties to their clients. However, we do not understand how these data would provide such insurance.

A final possibility is that we do not have the right model for estimating the impact of firm governance or the right measure of firm performance. Ratings firms may object that, given the right model specification, their ratings are significant and informative. We are open to this possibility and suggest that, to the degree this is true, ratings firms could disclose the “right” model and periodically disclose how well their ratings predict future performance using this “right” model. This type of transparent disclosure would enable investors to evaluate the net benefits produced by their purchase of the ratings. Moreover, this policy would be consistent with the rating companies’ public stance about the virtue of transparency that they urge on the firms they rate. As stated on the RiskMetrics/ISS website,

‘[a]s more and more investors, insurers and credit rating agencies recognize the link between corporate governance performance and risk, the more important it is for companies to understand how their corporate governance practices are measured. . . . We believe profoundly that transparency instills trust and, with trust comes confidence and more intelligent decisions.

One especially interesting result is that *CGQ* (perhaps the most visible governance rating) exhibits virtually no predictive validity. However, the level of predictive validity even for the best ratings seems well below the threshold necessary to support the bold claims by the corporate governance rating firms.

## **Appendix**

### **Additional Detail about Commercial Corporate Governance Ratings**

#### *1. Institutional Shareholder Services CGQ ratings*

The Corporate Governance Quotient (CGQ) is produced by Institutional Shareholder Services (ISS), now a division of RiskMetrics. The rating “evaluates the strengths, deficiencies and overall quality of a company’s corporate governance practices and board of directors” and “is designed on the premise that good corporate governance ultimately results in increased shareholder value.”<sup>8</sup>

ISS ratings are less reliant on financial ratios than Audit Integrity and focus more on more on structural variables taken from public filings and company surveys. They gather data on eight categories: 1) board of directors (composition, independence), 2) audit, 3) charter and bylaw provisions, 4) anti-takeover provisions, 5) executive and director compensation, 6) progressive practices, 7) ownership, and 8) director education.

ISS conducts “4,000+” statistical tests to examine the link between governance variables and 16 measures of risk and performance. The result of “this exhaustive study” is a single model of governance quality (CGQ) that includes some 64 variables weighted according to their correlation with firm risk and prior performance.<sup>9</sup> The ratings are then back-tested and calculated for more than 9,000

---

<sup>8</sup> Institutional Shareholder Services. 2003. ISS Corporate Governance: Best Practices User Guide & Glossary, Revision 2.4, Wednesday, October 8, 2003.

<sup>9</sup> <http://www.isscgq.com/cgqratings.htm>

companies. In addition, ISS states that it changes the ratings model and weights over time to “better reflect current market trends in corporate governance” and to align with ISS policies.<sup>10</sup>

ISS reports two main ratings for each firm. They report the firm’s standing within its own industry group (as defined using the SIC codes). We refer to this rating as *CGQ* and focus on this score. They also report the firm’s percentile within its index (e.g. S&P 500 for Microsoft), which we refer to as *CGQ\_INDEX*. ISS also produces four sub-scores concentrating on specific areas: audit (ranking the quality of the audit review), board (ranking the firm’s board of directors), compensation (ranking the firm’s director compensation and ownership), and takeover (ranking the firm’s level of takeover defense). These sub-scores are expressed as quintiles, where 5 indicate a company is in the top quintile relative to a relevant index and industry group.

ISS’s website claims its ratings are a “reliable tool for identifying portfolio risk related to governance and leveraging governance to drive increased shareholder value” and emphasizes claims of a “very strong relationship between governance and firm value, using CGQ data.”

## 2. *Governance Metrics International’s GMI ratings*<sup>11</sup>

GMI was “founded on the premise that the quality of corporate governance can add significantly to the risk-reward profile of credit and investment portfolios.”<sup>12</sup> GMI collects data on several hundred governance mechanisms (ranging from compensation to takeover defenses and board membership), as well as the firm’s compliance with securities regulations, stock exchange listing requirements and various corporate governance codes and principles. In all, it collects “hundreds of metrics structured in a manner that can only produce yes, no or not disclosed answers.” GMI develops a scoring model that examines each metric, weights it “according to investor interest” and then calculates a rating on a scale of 1.0 (lowest) to 10.0 (highest). The GMI scoring algorithm rewards (or

---

<sup>10</sup> CGQ Corporate Governance Fact Sheet – November 3, 2006.

<sup>11</sup> This sub-section was adapted from material found at <http://www.gmiratings.com/>, accessed February 9, 2008.

<sup>12</sup> Sept. 2006, Governance and Performance: Recent Evidence GMI

penalizes) “outliers” and ranks each firm relative to the other companies in the GMI sample. The *GMI* ratings are calculated for over 4,100 companies.

GMI says its “scoring algorithm has also been tested and validated by outside statistical experts and is patent pending.” Its materials tout the fact that “companies that emphasize corporate governance and transparency will, over time, generate superior returns and economic performance and lower their cost of capital” suggesting that firms with high *GMI* scores will “generate superior returns.”

### 3. *The Corporate Library’s TCL ratings*

Where the other ratings are the product of proprietary quantitative analysis, The Corporate Library ratings reflect subjective judgment and expertise. TCL analysts avoid data checklists and rely instead on their own experience and private assessment of a firm’s governance quality. TCL analysts review four specific areas (the company’s board and succession planning, CEO compensation practices, takeover defenses, and board-level accounting concerns) and then assign each firm a “grade” (*TCL\_RATING*) from A to F. A- and B-rated companies do not exhibit significant risk in any of the four basic categories; C-rated companies exhibit risk in no more than one category; D-rated companies in two or more categories; and F-rated companies were either bankrupt, delisted from an exchange, or described as companies “where management has achieved effective control over the company...and conducts its business with flagrant disregard for the interest of any minority public shareholders.” The analysts focus on “‘red flag’ indicators of board ineffectiveness and corporate mismanagement, supported by in-depth analysis and commentary by our senior research associates and analysts.” According to their marketing material, TCL’s ratings “have been proven to predict losses in shareholder value and the occurrence of securities class action lawsuits”<sup>13</sup> and “have been tested against actual investment returns.”<sup>14</sup>

---

<sup>13</sup> [http://www.thecorporatelibrary.com/UserFiles/Board\\_Analyst0907\(1\).pdf](http://www.thecorporatelibrary.com/UserFiles/Board_Analyst0907(1).pdf), accessed February 2, 2008.

<sup>14</sup> <http://www.thecorporatelibrary.com/info.php?id=53>, accessed February 2, 2008.