



## General Article

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# Corporate Governance Rating Management: Lack of Correlation Between Governance Rating Criteria and Corporate Performance

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Corporate governance rating agencies currently do not include in their rating criteria an employee assessment of managerial behavior and ethics. Governance rating agencies strive to distinguish themselves from their competitors by establishing governance rating criteria that are indicative of whether directors and officers are serving shareholder interests instead of management prerogatives. Adding a rating criterion that is based on a company's implementation of, and the results from, periodic assessments of managerial behavior and ethics would provide insight into whether the company's directors and officers are performing their responsibilities to advance shareholder interests.

Governance rating agencies are for-profit providers of corporate governance ratings. These governance rating agencies have experienced tremendous growth in size as well as influence during the past decade. There is a wide range of users and uses for the corporate governance ratings. Some of the users include investors, insurance companies, financial and securities analysts, lawyers, accountants, financial institutions, and the rated companies themselves. These users utilize the data compiled and the ratings assigned by governance rating agencies to make investment and voting decisions, determine premiums, prepare financial and stock reports, provide governance advice, determine credit risk, and benchmark governance practices. Knowing that there is a broad base of clients for and users of corporate governance ratings, public companies pay close attention to the governance ratings assigned to their companies. The rated companies strive to adopt governance practices advocated by governance rating agencies

in order to gather favorable governance ratings.

Governance rating agencies develop rating criteria that mirror disclosure obligations and operational measures required under law or for listing on stock markets. Rating agencies also establish standards of governance that extend beyond legal and listing requirements or dominant corporate practices to include governance mechanisms that may not be prevalent but that are perceived by rating agencies to be conducive to enhancing directors' and officers' performance of their responsibilities to advance shareholder interests.

Empirical evidence has not established a strong correlation between corporate financial profitability and the structural mechanisms relied upon by rating agencies in their rating systems. The rating criteria also do not provide assurance that officers and directors of the corporation are performing their respective responsibilities of management and oversight. The lack of strong linkage between governance rating criteria and corporate performance, financial or otherwise, may be due to the rating agencies' focus on observable, structural mechanisms as indicators of corporate conduct. Structural mechanisms such as board composition and charter provisions neither indicate the board's fulfillment of its responsibility to monitor managerial performance nor ensure management's fulfillment of its responsibility to apply fundamental business precepts. Missing from the current governance rating criteria is an evaluation of the actual conduct and decision-making of the management group, an evaluation that would provide necessary data for the board to perform its oversight responsibility and enhance

shareholder value. Assessment of management's business standards and conduct can be implemented through a company-wide survey of employees, the internal stakeholders with daily and direct access to the actual conduct and decision-making of the management group. Employee assessments can provide valuable information to the board in carrying out its fiduciary duty to monitor management performance. Employee assessments can also provide information that is of interest to investors, customers, and other stakeholders, but which is currently unavailable, about management's affinity for ethical behavior or inclination for ethical lapses.

There is lack of correlation between governance rating criteria and corporate performance, on both financial and nonfinancial dimensions. With insider access and opportunity to witness managerial conduct on a routine basis, employees constitute a unique source of nonpublic information about the realities of the company's governance. A rating criterion that focuses on management's behavior and ethics may correlate more closely with the corporation's performance on both financial and nonfinancial measures.

### **The Lack of Correlation between Rating Criteria and Management Behavior and Ethics**

In addition to lacking empirical support that governance ratings are strong indicators of corporate financial performance, governance rating criteria are also not indicative of corporate performance on nonfinancial measures. The management role entails the board providing insights in setting corporate policies and providing authority in making enterprise decisions. The oversight role includes ensuring that the appropriate officers have been hired to operate the business, and that these business leaders are performing satisfactorily. Although there has been disagreement over whether the board's primary role is management or oversight, it is well settled that a corporate board is empowered to delegate its management authority to corporate officers. It is the officers who in fact manage most public corporations on a day-to-day basis. Having delegated their management responsibilities to the executives, directors retain the important responsibility of oversight in order to monitor and respond to the progress and performance of the corporation. The oversight function requires the board to monitor management's performance in achieving the company's business and financial objectives. The oversight function encompasses

more than financial metrics, however. The board must also monitor performance from the perspective of management conducting the company's business free of fraud, conflicts of interest, personal enrichment, and other unethical or illegal behaviors that jeopardize shareholder value. A board can monitor management's performance with respect to reaching the company's financial goals by analyzing various financial measures. Governance rating agencies likewise collect and analyze information about the company's financial performance, information which is readily available from regulatory filings, press releases, corporate websites, analyst reports, industry studies, and other public sources. The public financial data reveal the company's financial performance, performance trend, performance compared to industry competitors and the overall market, and the compensation that the board bestows upon company management. It is unclear what information a corporate board has or utilizes in carrying out its responsibility to oversee management's performance on non-financial measures. How does the board monitor whether management is conducting the company's business free of fraud, conflicts of interest, personal enrichment, and other unethical or illegal behaviors that jeopardize shareholder value? What data is available to the board to assess management's actual, instead of merely espoused, values and ethics?

Data currently collected and analyzed by governance rating agencies likewise do not provide any means of evaluating whether the management group is performing its duties in accordance with fundamental business precepts. The governance rating criteria do not include an analysis of the action and behavior of the management group. This lack of information is due to the rating agencies' unfamiliarity with, and lack of access to, the daily activities and behavior of corporate executives. Being outside of the organizations that they rate, rating agencies do not have access to the management group's decision-making and actions other than through the anecdotes gleaned from a lone insider or the occasional exposé by the press. Governance rating agencies lack a comprehensive source and database of information about the standards of behavior and ethics of the corporate officers in charge of the rated companies. Faced with informational limitations about the behavior and ethics of corporate executives and how the board monitors management's decision-making and conduct, governance rating agencies' approach is to rely on simple, objective yardsticks in their rating

criteria. Many of the criteria employed by governance rating agencies relate to the board's management function, such as adopting charter and bylaw provisions, setting policies and procedures, and establishing committees and compensation. The governance rating criteria do not relate much to the board's oversight function over management. One of the rating criteria used by Institutional Shareholders Services (ISS), Governance Metrics International (GMI) & The Corporate Library (TCL) is the number of independent directors on the board. Although the expectation is that an outside board member will be more likely to exert oversight and to challenge the conduct of an inside manager, there is no consensus that having an independent board will result in better monitoring of management conduct. One argument casting doubt on the monitoring ability of an independent board is that when most of a board's members are independent, the board's ability to monitor corporate misconduct may in fact be weakened because most of the board's members are not involved in the daily operation of the company and are thus unlikely to be able to discover management misconduct.

Governance rating agencies' primary methodology is to measure the presence or absence of observable, structural mechanisms that can be identified and quantified, such as the composition of the board, the amounts of audit and non audit fees, the compensation paid to corporate executives, and whether the company's charter and bylaws provide shareholders with various voting rights. While most rating criteria focus on readily verifiable governance structures and practices, hardly any rating criteria focus on the actual decision-making and behavior of those individuals managing or monitoring the corporation. The very few governance rating criteria that focus on the action and decision-making of the corporation are limited to the board level. Some governance rating agencies assign positive value to boards that conduct performance self-assessments. These self-assessments involve each director completing questionnaires to evaluate the performance of fellow board members and the performance of the board as a whole. Governance rating agencies may review the board's reaction to shareholder proposals, with high responsiveness to shareholder proposals signifying a board that is furthering shareholder interests instead of management pursuits. Rating agencies may also consider whether the board has approved mergers or acquisitions that have resulted in significant positive or negative financial impact on shareholder

value. Note that even this evaluation focuses on the verifiable financial end results of the board's decision-making, rather than the process and ethical dimensions of the decision-making. Governance rating criteria do not include any assessment of the conduct and decision-making of the management group. The governance structures and processes used in the rating criteria are weak indicators of managerial behavior and ethics. Receiving high scores on the rating criteria, similar to complying with structural mechanisms required by law and listing standards, does not signify that the highly rated company's leaders are operating with high standards of business conduct. The collapse of prominent corporations in recent years provides ample evidence of the ability of management to tout structures and processes that align with governance "best practices," while at the same time carry out corporate conduct that are the antithesis of good management. The fact that the current rating criteria do not tell us anything about managerial behavior and ethics should cause concern, as poor management ethics can destroy a company's financial value and lead to its ultimate collapse.

Although a high governance rating may confirm the presence of mechanisms that are claimed to be indicative of good governance, structures and processes such as independent directors and board committees, codes of ethics, and whistleblower hotlines do not assure the board, the shareholders, or other stakeholders that management conduct at companies with those governance structures will be consistent with fundamental business ethics. Take the case of Fannie Mae, a federally chartered company that operates in the secondary mortgage market, which received a highly favorable governance rating of nine on a ten point scale in 2003. Shortly after the positive governance score was publicly disclosed, problems regarding Fannie Mae's accounting and executive compensation became public headlines, which prompted the governance rating agency to downgrade the score and then to eventually withdraw its governance rating of the troubled company.

Governance ratings are primarily based on public data, namely regulatory filings such as prospectuses, annual reports, and proxy statements.<sup>168</sup> Rating agencies also monitor company press releases and review corporate websites for information. In addition, companies may submit data directly to rating agencies for consideration in the rating process. For most of the

information that rating agencies look to in determining the governance ratings, it is the management group that decides the information to be disclosed, whether that disclosure is mandatory or voluntary.

The quality of the information that management discloses to the public or to the rating agencies should be examined with a keen eye. Many CEOs have an unwritten policy that all communication of information from inside the corporation to the public or to the board must first be approved by the CEO. The potential conflict of interest in this system of disclosure is easily discernable. The CEO has an incentive to highlight information that reflects favorably on the corporation's performance and ultimately on the CEO's performance, while downplaying information that has the potential to cast the corporation and the CEO's performance in a negative light. The foregoing is not meant to imply that all information prescreened by the CEO is tainted by self-interest or is unreliable. Instead, it is meant to suggest that the oversight role dictates that directors maintain a healthy skepticism for information that management provides to the board. Similarly, rating agencies should analyze with a keen eye the information that management provides to the public or directly to the rating agencies.

## **Conclusion**

Corporate governance rating agencies exert strong influence over the governance practices of public companies. Through their governance rating criteria, rating agencies motivate public companies to adopt governance practices that are perceived by rating agencies to be conducive to enhancing officers' and directors' performance of their respective management and oversight responsibilities. Missing from the current governance rating criteria is an evaluation of the behavior and ethics of the management group—an evaluation that would provide information that the board of directors needs to assure that management's decisions and conduct uphold the integrity of the organization and do not undermine the financial performance of the company.