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Do institutional shareholder services (ISS) corporate governance ratings reflect a company's operating performance?

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Abstract

Little is known about the relation between the actual governance rating received by a firm and the firm's performance. In this study, we examine the relation between the actual corporate governance rating received by a firm and the firm's performance during the years 2002–2004. We use the institutional shareholder services (ISS) corporate governance quotient (CGQ) rating of a firm's corporate governance structure and analyze this rating in relation to the firm's operating performance. We compare the institutional shareholder services' CGQ rating to two measures of the firm's operating performance, return on assets (ROA) and return on equity (ROE). Based upon our results, we do not find statistical evidence suggesting that the firms' operating performance is related to the firms' ISS corporate governance rating.

Keywords: Corporate governance; Firm operating performance; Governance rating; Return on assets; Return on equity

1. Introduction

The Organization for Economic Cooperation and Development (OECD)[1] defines corporate governance as, "the way in which boards oversee the running of a company by its

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[1] Found at http://www.oecd.org.

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managers, and how board members are in turn accountable to shareholders and the company." OECD elaborates that corporate governance "has implications for company behavior towards employees, shareholders, customers and banks". Implicitly, this definition of corporate governance implies there is a relationship between a firm's results of operations and the governance rating score received.

In response to the corporate scandals during the period 2000 and 2001, Congress enacted the Sarbanes-Oxley Act (SOX) on July 30, 2002[2]. The act specifically targets corporate governance reform and has created a reporting system that now makes corporate governance more transparent to the public. SOX requires firms to disclose annually the structure, composition, and size of its board and whether it has adopted a code of ethics for its senior financial officers in its Form 10-K. Additionally, both the New York Stock Exchange (NYSE), and the National Association of Securities Dealers (NASDAQ) have corporate governance rules regarding the role and authority of independent directors (Lander, 2004).

A corporation's corporate governance structure is important to today's market participants. Investors view corporate governance as an important criterion when making investment decisions and are willing to absorb higher costs for corporations that are well governed and have boards of directors with a high degree of independence. According to a survey conducted by McKinsey and Company (2002), 14% of the investors in the U.S. say they are willing to pay a premium for a well-governed company.

The requirements of SOX are meant to address the concerns of investors and to restore investor's confidence in the corporate governance mechanism. SOX has imposed requirements on public firms to improve their governance practices, to increase director independence and to create boardroom structures that hold management accountable. The overall impact of SOX along with the regulations imposed by the major U.S. stock exchanges should be reflected in the improvements of the corporate decision-making process, improvements in the organization's accountability system and ultimately improvements in the firm's overall efficiency and performance. Thus, if the regulations achieve the desired results of improved corporate governance, investors should expect to see an overall increase in corporate governance ratings from 2002 to 2005. Additionally, investors should also be able to identify a positive relationship between the corporate governance ratings and firms overall operating performance.

Although our study is not the first to examine the impact of corporate governance structure on firm performance, our approach differs from previous studies. First, we are studying one corporate governance rating system, institutional shareholder services (ISS). ISS is the most widely known and used governance rating system, rating over 5000 U.S. firms and 2000 global firms. This system is chosen because of the size of the database and the potential pervasive impact of the findings of the research. Second, while previous research uses various components of the corporate governance rating metrics as indicators of corporate governance, we use the actual aggregate corporate governance score obtained by the firm as our indicator of corporate governance. We believe this aggregate measure is important in the investor decision-making process because this information is more readily available for comparative firm analysis.

[2] http://www.sec.gov, Publication L. No. 107-204, 116 Stat. 745.