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The effects of corporate governance on firms' credit ratings ☆

Hollis Ashbaugh-Skaife[a], Daniel W. Collins[b,*], Ryan LaFond[c]

[a]University of Wisconsin, Madison, USA
[b]University of Iowa, USA
[c]Sloan School of Management, MIT, USA

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Abstract

We investigate whether firms with strong corporate governance benefit from higher credit ratings relative to firms with weaker governance. We document, after controlling for firm-specific risk characteristics, that credit ratings are negatively associated with the number of blockholders and CEO power, and positively related to takeover defenses, accrual quality, earnings timeliness, board independence, board stock ownership, and board expertise. We also provide evidence that CEOs of firms with speculative-grade credit ratings are overcompensated to a greater degree than their counterparts at firms with investment-grade ratings, thus providing one explanation for why some firms operate with weak governance.
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*Corresponding author. Tel.: +1 319 335 0912; fax: +1 319 335 1956.
E-mail addresses: hashbaugh@bus.wisc.edu (H. Ashbaugh-Skaife), daniel-collins@uiowa.edu (D.W. Collins), rzlafond@mit.edu (R. LaFond).

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1. Introduction

We investigate whether firms that possess strong corporate governance benefit from higher credit ratings relative to firms with weak governance. A firm's credit rating reflects a rating agency's opinion of an entity's overall creditworthiness and its capacity to satisfy its financial obligations (Standard & Poor's, 2002). Credit agencies are concerned with governance because weak governance can impair a firm's financial position and leave debt stakeholders (hereafter referred to as bondholders) vulnerable to losses (FitchRatings, 2004). To structure our analysis, we adopt a framework developed by Standard & Poor's (2002) for assessing firms' corporate governance structures and practices. Standard & Poor's (2002) framework focuses on four major components of governance: Ownership Structure and Influence, Financial Stakeholder Rights and Relations, Financial Transparency, and Board Structure and Processes. The governance attributes we examine within each of these components are designed to increase the monitoring of management's actions to promote effective decision making, limit their opportunistic behavior and reduce the information asymmetry between the firm and its external stakeholders. We investigate what effect, if any, these governance features have on firms' overall credit ratings.

Our analysis yields several key findings. First, we find variables that capture each of the four major components of corporate governance enumerated above help explain overall credit ratings after controlling for firm characteristics that prior research has shown to be related to firms' credit ratings. Specifically, we find that firms' overall credit ratings are: (1) negatively associated with the number of blockholders that own at least a 5% ownership in the firm; (2) positively related to weaker shareholder rights in terms of takeover defenses; (3) positively related to the quality of working capital accruals and the timeliness of earnings; and (4) positively related to overall board independence, board stock ownership, board expertise, and negatively related to CEO power on the board. To provide an indication of the economic significance of our results, we find that moving from the lower quartile to the upper quartile of the governance variables doubles a firm's probability of receiving an investment-grade credit rating—from 0.46 to 0.93.[1] During the time frame of our analysis, the average yield for firms with investment-grade debt with a 10-year maturity was approximately 6.00%. In contrast, the average yield for firms with speculative-grade debt with a 10-year maturity was approximately 14.0%. This 800-basis point spread translates into an annual interest cost differential of $38.4 million for the median firm in our sample with a speculative-grade credit rating.[2]

[1]For purposes of this analysis, we hold the firm characteristic variables (ROA, LEV, SIZE, etc.) constant at the mean values for the sample. For those governance attributes found to be positively (negatively) related to credit ratings, our benchmark probability is determined by assigning governance values equal to the first (third) quartile and then moving to the third (first) quartile value. For governance attributes measured as 0–1 dummy variables, the benchmark probability is determined with the zero (one) value when the governance attribute is positively (negatively) related to credit ratings.

[2]To calculate this interest cost differential, we first determine the mean debt-to-asset ratio for our sample of investment-grade firms (0.28). We then multiply this ratio times the total assets of each speculative-grade firm to estimate the "as-if" capital structure if the speculative-grade firm was an investment-grade firm. Finally, we multiply the estimated debt level times the 800-basis point spread to determine a speculative firm's hypothetical incremental interest cost due to weak governance. This additional interest can be viewed as a cost that shareholders bear if the firm chooses not to implement stronger governance to preclude management from stealing firm assets. However, this spread overstates the cost of weak governance from the shareholders viewpoint when weaker governance allows wealth transfers from bondholders to shareholders to take place. To the extent that

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