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Measuring the Quality of Corporate Governance – A Review of Corporate Governance Indices**

Darko Tipurić[a,*], **Katarina Dvorski**[b], **Mia Delić**[c]

[a] Faculty of Economics and Business, University of Zagreb, Croatia
[b] Zagreb School of Business, Zagreb, Croatia
[c] Faculty of Economics and Business, University of Zagreb, Croatia

ABSTRACT

The aim of this paper is to provide an insight in to the world of corporate governance quality as well as to shed light on efforts in measuring the quality of corporate governance through an overview of relevant academic and commercial corporate governance indices by. As the paper will show, measuring the quality of corporate governance is still a relatively new concept. The construction of the index for measuring the quality of corporate governance still comes down to simplification of standards or criteria which mainly revolve around three dimensions - compliance, performance and accountability. In contrast to the level of compliance with good governance standards, scientific assessment of the quality of corporate governance remains a mystery.

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**Corresponding author:*
dtipuric@efzg.hr
Professor Darko Tipurić, Ph.D.

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1. INTRODUCTION

Corporate governance can be defined as a form of "management of management" or *meta-management*, since it embodies the set of relations between the management, board, shareholders and stakeholders of a firm; it defines the framework for setting goals and determining the means to achieve those goals, as well as for monitoring the performance and efficiency of the firm (Tipurić, 2008).

One of the main challenges of corporate governance research is related to defining a measure of good corporate governance, i.e. identifying corporate governance mechanisms that lead to financial performance and social legitimacy, or the realization of the set goals (Judge, 2010; Aguilera et. al., 2008).

In order to analyse the influence that corporate governance has on the success of the firm, a number of researchers and practitioners used one particular variable of corporate governance in their studies, whereas others tried to create a composite measure or an index of corporate governance.

The idea behind the development of corporate governance indices refers to the comparison/benchmarking of a firm's corporate governance characteristics with those governance provisions that the authors consider to be examples of best practice.

There are three possible reasons for the development and use of a corporate governance index. Indices supplement the regulatory governance framework and provide incentives for firms to adopt better corporate governance practices. In addition, firms with developed corporate governance evaluation systems have the possibility of differentiating themselves from other competitors in the market and gaining strategic advantage. Finally, corporate governance index as a composite measure of quality of corporate governance processes might be one of the relevant indicators of firm's potential to access new capital sources and to minimize capital costs in relation to its peers.

The aim of this paper is to provide an insight into the phenomenon of corporate governance quality and its determinants as well as to present relevant academic and commercial corporate governance. This will help us in understanding which aspects of corporate governance have the strongest effect on the overall governance quality and will also provide us with a better understanding of current corporate governance methodologies and related research.

2. QUALITY OF CORPORATE GOVERNANCE

Sound corporate governance depends on the balance between internal and external mechanisms which ensure the efficiency of governance and help in solving natural problems and potential conflicts that arise from corporate structures. In that manner, it should create the conditions in which the behaviour and actions of top managers is aligned with the interests of the firm, its shareholders and key stakeholders and it should also ensure that poor managers are replaced with better ones. In other words, corporate governance helps to prevent and overcome the imbalance between different interests and demands of the firm and it also helps to reduce the negative effects of opportunistic behaviour of important stakeholders (especially the top management) which may endanger the efficient functioning of a firm.

It is believed that effectiveness and quality of governance systems depend on the application of corporate governance principles and performance standards in such a way that following these principles may

affect solving issues arising from corporate structures, e.g. conflict of interest, control and transparency increase for shareholders (Mousavi, Moridipour, 2013). According to Beeks and Brown (2006), the quality of corporate governance increases when the firm meets the common standards of corporate governance. Thus, a firm with a high quality of corporate governance is the one which possesses and meets the usual standards of corporate governance set by the government (Lokman et al., 2012). That is, an effective governance system should ensure compliance with applicable laws and regulations, and in addition, allow firms to avoid costly litigation. On the other hand and form a firm's point of view, "good governance" represents quality in terms of responding to the firm's guiding principles and strategic directions: does the firm do what is right, reliably and responsibly, in order to ensure the desired effect in the context of an integrated surveillance system for business control.

A body of literature in corporate governance shows that one of the main questions in discussing the quality of corporate governance refers to why firms within the same contractual environment voluntarily choose to present different firm-level corporate governance quality (perceived as governance practices recommended by market agents) (Leal et. al., 2007).
Klapper and Love (2004) indicate that there are three main potential determinants of firm-level corporate governance quality: the "utility" of corporate governance, the nature of the firm's operations, and the size of the firm.

Firstly, because the main goal of corporate governance is to reduce the firm's cost of capital by improving investors' confidence, we should expect that firms with greater need to access new capital in the future (firms with better potential growth opportunities) would perceive a greater "utility" in adopting better corporate governance practices, in relation to firms with poor prospects for raising capital from external investors.

With regard to the nature of firms' operations, it is believed that firms with greater tangible assets would find it harder to divert or steal investors' resources, given that these assets would be more easily monitored and hard to be channelled to other uses (Leal et. al., 2007). As a result, firms with greater possession of intangible assets would have more incentives for adopting better corporate governance practices, because they would have to signal investors that they have no intention of squandering their resources.

The size of the firm represents the third important originator of firm-level corporate governance. According to Klapper & Love (2004), the firm's size influences corporate governance quality ambiguously. For example, larger firms could face greater agency costs due to greater free cash flow, leading them to voluntarily adopt better corporate governance practices in order to mitigate this problem. On the other hand, small firms are expected to have more growth potential and a greater growth rate

which implies the need for more external capital. The need for financing could lead small firms to embrace better governance practices. Thus, both would have different incentives to voluntarily achieve better corporate governance standards.

Growth opportunities and the need for external financing along with ownership concentration were also identified as important determinants of corporate governance quality by Durnev and Kim (2005). These authors also stated that firms with better governance practices are valued higher by markets; and adopting better governance practices is more relevant in countries characterized by weaker legal protection of investors. Consequently, they conducted empirical tests and found evidence confirming the stated hypotheses.

Corporate governance also affects the liquidity of the stock market, because poor governance increases the information asymmetry between insiders (e.g. managers, majority shareholders and informed traders) and external liquidity providers, which can lead to poor financial and operational transparency (Cheung et. al., 2010). The establishment of appropriate corporate governance is thus a fundamental task in achieving the optimal use of resources, improving accountability, transparency and fulfilment of the rights of all stakeholders of the firm.

In addition to recognizing the relevance of good corporate governance, question of measuring its quality arises. Apart from being able to distinguish "good" from "poor" corporate governance, it is essential to take a step further and establish measures that will enable us to discuss firms' differences and compare different firms across the entire spectrum of corporate governance quality.

Many researchers in the field of corporate governance have suggested a number of different indices to measure the quality of corporate governance, whereas a unified formula for calculating the index does not yet exist. Some of the existing indices of corporate governance quality will be shown below.

3. REVIEW OF CORPORATE GOVERNANCE INDICES

Despite the common belief in the importance of governance mechanisms for resolving agency problems, the empirical literature on individual governance mechanisms has not consistently established a relation between governance and performance which stems from the fact that governance mechanisms are numerous and interaction effects are quite probable. In other words, examining the effect of only one dimension of a firm's governance system on performance is quite constraining. That is, without a doubt, a factor contributing to the attention aimed at governance indices, which combine various dimensions of governance into one number. Moreover, another coercive reason for the success of governance indices

is the simplicity of having a single number for capturing the multidimensionality of corporate governance.

Corporate governance indices vary considerably with regard to which dimensions of firms' corporate governance are considered sufficiently important to be included. The initial foray into creating these indices was academic inquiry. In the following sections, we provide an overview of significant indices currently in use by academics and commercial vendors (specialized rating agencies).

Section 1.01 **3.1. Gompers, Ishii and Metrick's G-Index**

Gompers, Ishii and Metrick (2003) (hereinafter GIM) constructed an index on the basis of 24 governance provisions that, according to the authors, reflect the balance of power between shareholders (owners) and managers. The G-Index was constructed from data on the governance characteristics for more than 1,000 public companies amassed by the Investor Responsibility Research Center (IRRC) and published in 2003.

The governance provisions were grouped into five dimensions as follows:

1) "**Delay" -** consists of four provisions for delaying hostile takeover bidders[1].
2) **"Voting" -** deals with shareholder voting rights[2].
3) **"Protection" -** refers to six provisions protecting directors and officers from legal liability or compensating them for termination[3].
4) **"State" -** refers to incorporation in a state with one of six state takeover laws[4].
5) **"Other" -** other takeover defences[5].

In order to develop the G-Index the authors adopted the following methodology: they assigned one point for each provision that they viewed as restricting shareholder rights. In other words, GIM equally weighted the governance features tracked by IRRC in developing their measure of corporate governance quality. Thus, the G-Index varies from 1 to 24 where the highest score refers to the highest management

[1] A classified (staggered) board, the presence of blank check preferred stock, restrictions on shareholders' ability to call special meetings, and restrictions on shareholders' ability to act by written consent.
[2] Presence of cumulative voting, confidential voting, supermajority voting requirements for certain business combinations, dual class stock, and limitations to shareholders' ability to alter the bylaws or certificate of incorporation.
[3] Limited liability provisions, indemnification provisions in charters or bylaws, indemnification contracts, golden parachutes, severance contracts not conditioned on control changes, and compensation plans with changes-in-control provisions.
[4] Anti-greenmail, business combination freeze, control share acquisition, fair price, other constituencies, and redemption rights statutes.
[5] Anti-greenmail provisions, fair price provisions, other constituent provisions, poison pills, silver parachutes, and pension parachutes.

power, or the weakest shareholder rights protection; the lowest score instead represents the lowest management power.

GIM examined the relation between the firms' governance quality and several measures of performance: stock returns; Tobin's Q and three accounting measures (net profit margin, return on equity, and sales growth). The examination focused on a comparison between the highest and lowest G-Index portfolios, which the authors called the "Dictatorship" (firms with the weakest shareholder protection) and "Democracy" (firms with the strongest shareholder protection) portfolios. GIM found that firms with weaker shareholder rights (implying a higher index) were less profitable both in terms of stock returns and Tobin's Q. In particular, an investment strategy of buying the Democracy portfolio stocks and selling the Dictatorship portfolio stocks would have earned abnormal returns of 8.5% a year during the 1990s. (Bhagat et. al., 2008).

Despite the documented negative correlation between the 24 provisions included in the index, GIM did not conclude that they have demonstrated causation and firm-performance due to potential endogeneity problems. In other words, governance provisions adopted by a company might be endogenous and it is thus difficult to assess whether poor performance is caused by bad governance provisions or vice versa. As a result, GIM called for further research in order to properly address the endogeneity issue, as well as to give a more definitive interpretation on the causality of the relationship between corporate governance and performance.

Section 1.02 **3.2. Bebchuk, Cohen and Ferell's E-Index**

A question that remained unresolved throughout the GIM's research was which arrangements among the 24 governance provisions included in the G-Index have the most value for shareholders. To answer this question, Bebchuk, Cohen and Ferrell (hereafter BCF) constructed a competing governance index in order to identify the IRRC provisions that really affect shareholder value.

BCF presented an index based on six provisions: staggered boards, limits to shareholder bylaw amendments, poison pills, golden parachutes, and supermajority requirements for mergers and charter amendments. Of the six provisions, four set constitutional limits on shareholder voting power, which is the main power they possess. These four provisions are: staggered boards, limits to shareholder amendments of the bylaws, supermajority requirements for mergers, and supermajority requirements for charter amendments and they limit the extent to which shareholders can impose their will on management. Two other provisions are the most well-known and salient measures taken in preparation

for a hostile offer: poison pills and golden parachute arrangements. The BCF index is called the "Entrenchment Index" or "E-Index“ (Bebchuk et. al., 2009).

In developing the E-index, BCF followed GIM's methodology, allotting equal weight (one point) to the presence of any of the six provisions. Examining the relation between the E-Index and industry-adjusted Tobin's Q and stock returns, they confirmed the correlation between governance and future performance found in GIM's study. They also confirmed, with a few more years of available data (1990-2003), that a portfolio of low entrenchment/good governance (GIM's Democracy) firms outperformed a portfolio of high entrenchment/poor governance (GIM's Dictatorship). However, the negative correlation between the E-Index and firm valuation did not establish the direction of causation. Despite the endogeneity problems, the BCF study has important policy implications, because they identified the governance provisions that really matter for shareholder value by showing the substantial relevance of only 6 provisions (the entrenching ones). As highlighted by Bebchuck et. al., the quality of governance could be evaluated more precisely by focusing only on the most relevant governance provisions, rather than considering broader indices which might include provisions that do not matter at all.

Section 1.03 **3.3. Brown and Caylor's Gov-Score Index**

Through their research, Lawrence Brown and Marcus Caylor (2006) developed a more comprehensive index of corporate governance, compared with the previously described E-Index and G-Index, using the data provided by the ISS (Institutional Shareholder Services Inc.).

Their Gov-Score index consists of 51 provisions divided into the following 8 groups[6]:

1) **Audit** – consists of four factors regarding the overall audit process of the firm as well as the powers and accountability of the audit committee.
2) **Board of Directors** – consists of seventeen factors analysing the board of directors as a mechanism of corporate governance.
3) **Charter/bylaws** – consists of seven factors regarding shareholders' rights.
4) **Director education** - represented with one factor: participation of directors in ISS-accredited director education program.
5) **Executive and director compensation** – consists of ten factors dealing with the compensation system in a firm.
6) **Ownership** – consists of four factors dealing with directors' ownership.

[6] *See more* Bhagat, S., Bolton, B. J., Romano, R. (2008), The Promise and Peril of Corporate Governance Indices“, Columbia Law Review, 108 (8), pp. 1871 - 1872.

7) **Progressive practices** – consists of seven factors which represent progressive corporate governance practices.
8) **State of incorporation** – consists also of one factor: incorporation in state with no takeover statutes.

Brown and Caylor used a point system that is the opposite of GIM and BCF, assigning one point to "acceptable," as opposed to "unacceptable," corporate governance practices. Consequently, a higher Gov-Score signifies higher quality corporate governance, in contrast to G-Index and E-Index values (Brown and Caylor, 2006). When compared to the G and E indices, the Gov-Score index has the potential advantage, noted by its authors, of providing a superior measure of firms' governance quality because it includes a broader set of corporate governance arrangements than takeover defences, which make up the bulk of the G and E indices and because it is derived from a larger database than the other two indices (over 2,000 firms). The main disadvantage lies in the fact that it was derived from only one year of data (2003) in contrast to the multiple years of data used for the other two indices. However, using 2003 data is valuable because it analyses firms' corporate governance in the *post Enron* environment.

One of the biggest differences between the Gov-Score and the BCF and GIM's approach lies in the relationship between takeover defences and firm performance. The results by Brown and Caylor show that the board as well as the compensation system of a firm play a much greater role than defensive tactics which represent the foundation of the other two indices. Brown and Caylor were also wary not to impute causality to their findings but nevertheless concluded that using a smaller index that consists of multiple governance provisions is preferable to focusing purely on takeover defences when measuring the quality of corporate governance.

On the other end of the corporate governance quality spectrum, there are the commercial indices of corporate governance. Bebchuk and Hamdani (2009) suggest that the use of commercial indices is becoming an increasingly prevalent practice in many businesses, especially in the financial industry. The attractiveness of these indicators stems from the fact that they were constructed by experts and practitioners in the field who generally have greater financial resources and data availability in comparison with the average academic researcher. Nevertheless, when used in a variety of studies examining the relationship between corporate governance and firm performance such indices do not generate consistent and robust results.

Studies have shown that a large number of these indicators is not effective enough in predicting the future performance of the company (Daines et. al., 2010), which in return influences the strengthening

of scepticism among the scientific and professional community and places the mentioned indexes under a magnifying glass. Below is the most exciting commercial index of corporate governance.

In the following sections, we provide an overview of the most well-known commercial indices of corporate governance.

3.3. Standard and Poor's GAMMA: Governance, Management, Accountability Metrics and Analysis

Standard and Poor's began to develop its corporate governance benchmark methodology in the late 1990s in the aftermath of the financial crises that had hit Russia and East Asia. While there are multiple approaches to evaluating corporate governance, the present GAMMA methodology takes a financial perspective with regard to the point of view of long-term equity investors.

GAMMA score wishes to evaluate the effectiveness of individual firm governance practices as a system of interaction between the management, board, shareholders and other stakeholders who build firm value and aim to ensure fair distribution of its earnings. Individual governance practices are thus measured against Standard & Poor's corporate governance criteria developed on a myriad of international corporate governance codes, academic and practitioner research and S&P's own research in conducting corporate governance analysis.

The components of the GAMMA scorecard are as follows (S&P, 2008; S&P, 2008a):

1) **Ownership Influences**
2) **Shareholders' Rights**
3) **Transparency, Audit and Enterprise Risk Management**
4) **Board Effectiveness, Strategic Process and Compensation Practicess.**

Each of the components is defined through a set of criteria and key analytical issues (corporate governance provisions) and the final GAMMA score is articulated on a scale of GAMMA-1 (lowest) to GAMMA-10 (highest). In that manner, a company in the GAMMA-10 and GAMMA-9 scoring category has, in S&P's opinion, few weaknesses in any of the four major areas of the analysis, whereas a company in the GAMMA-2 and GAMMA-1 category has significant weaknesses in most of the major areas of analysis (S&P, 2008). As is the case with most other commercial indices, a detailed methodology for creating the index is not publicly available.

Section 1.04 **3.4. ISS Governance QuickScore as a Measure of Corporate Governance**

The ISS corporate governance evaluation methodology was first presented in 2013 by the Institutional Shareholder Services as a quantitatively-driven data solution created to identify governance risks within portfolio companies (ISS, 2013). In 2014 an enhanced methodology (QuickScore 2.0) was presented and it is characterized with global coverage totalling 4,100 companies in 25 markets divided into ten regions, including the largest 3,000 U.S. companies and the largest 250 Canadian companies by market cap, as well as UK, Europe, Japan and Asia Pacific companies in the MSCI EAFE Index (ISS, 2014).

The methodology is based on examining best governance practices across various factors. ISS identified 40-80 of the most crucial corporate governance factors by which to measure governance-related risk and each factor is categorized into one of the subcategories within each QuickScore pillar, whereas the number of factors analysed in each region varies. Each factor and the rationale for inclusion, plus factor applicability by market, are discussed in the QuickScore Factor documentation.[7]

The pillars of the QuickScore methodology are as follows:

1) **Board Structure**
2) **Compensation/Remuneration**
3) **Shareholder Rights**
4) **Audit Practices.**

The methodology uses a numeric, decile-based score which indicates a firm's governance risk relative to their index or region. A score of 1 indicates relatively lower governance risk, and, vice versa, a score of 10 indicates relatively higher governance risk. For each factor, ISS analyses the correlation with 16 commonly utilized performance and risk factors grouped into 4 measures: Market (2 factors), Profitability (9 factors), Risk (2 factors), and Valuation (3 factors).

According to the ISS, QuickScore 2.0 delivers robust and timely insight, with event-driven data updates that capture changes to a firm's governance structure that are identified through public disclosures and integrated into a company's QuickScore on an ongoing basis and the companies within the QuickScore coverage universe can review, verify and provide feedback on the data used.

[7] Available at: http://www.issgovernance.com/file/files/ISSGovernanceQuickScoreTechDoc.pdf. (accessed May 31, 2014)

Section 1.05 **3.5. ISS Corporate Governance Quotient**

As a measure of corporate governance, the ISS Corporate Governance Quotient (hereinafter ISS CGI) is the predecessor of the aforementioned ISS Governance QuickScore indicator and also represents the basis for the FTSE ISS Corporate Governance Index; the FTSE ISS CGI was developed on the basis of 61 variables included in the ISS Corporate Governance Quotient.

The ISS CGQ was created in 2002, but from 2007 it is no longer in use as a commercial index of corporate governance. However, due to its importance for the other two indices mentioned above, it will be briefly explained.

The ISS Corporate Governance assessment focused on the following eight dimensions:

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) **Director and Officer Stock Ownership**
8) **Director Education**

The ISS assessment system compared the firm's corporate governance practices with the corresponding market index as well as with one of the 23 S&P's industry groupings. All of the companies were assigned two scores – one relative to the relevant market index (S&P 500, Mid-Cap 400, Small-Cap 600) and one relative to the appropriate peer (competitors) group. Each CGQ was a comparative score on a scale of 1 to 100 and represented a percentile rank among the relevant competitors' group (Barrett et. al., 2004).

It is also important to note that the ISS looked at many of the factors in combination "under the premise that corporate governance is enhanced when selected combinations" of practices are adopted.

Section 1.06 **3.6. FTSE ISS Corporate Governance Index**

The FTSE ISS Corporate Governance Index initiative started in 2004 when the FTSE, as one of the global leaders in index provision decided to engage with the ISS in a joint corporate governance ratings and index project.

The FTSE ISS Corporate Governance Index Rating System measures a firm's corporate governance performance against a specified set of governance indicators derived from the 61 variables of the ISS Corporate Governance Quotient System and divided into five core governance segments. Each of the five dimensions takes up a certain proportion of the overall index:

1) **Structure and Independence of the Board (44%)**
2) **Equity Structure (21%)**
3) **Compensation Systems for Executive and Non-Executive Directors (17%)**
4) **Executive and Non-Executive Stock Ownership (9%)**
5) **Independence and Integrity of the Audit Process (9%)**

Each company is evaluated in relation to its peers with regard to each of its five segments. Companies are then ranked by their total scores, within each segment, and allocated a number between one and five. Five is associated with a high rating, and one is associated with lower corporate governance rating.

The abovementioned FTSE ISS CGI Ratings are a component feature within the overall FTSE ISS CGI Series entitled The FTSE Global Equity Index Series (FSE GEIS). The following six FTTSE ISS indices were designed as a part of phase one: 1) **FTSE ISS Developed CGI;** 2) **FTSE ISS UK CGI;** 3) **FTSE ISS Japan CGI**; 4) **FTSE ISS US CGI;** 5) **FTSE ISS Europe CGI;** and **6) FTSE ISS Euro CGI**. The constituents of the FTSE GEIS were divided into local or regional review universes, which together form the FTSE ISS Developed CG Index**.** Each stock was classified by its FTSE ICB Supersector and ranked within each Supersector with regard to its corporate governance score. After the stocks were ranked, the cumulative investable market capitalisation was used to select each index constituent. Constituents representing the top 80 percent by investable market capitalisation of each Supersector were included in the index constituents, whereas the remaining bottom 20 percent were excluded from the index (ISS, 2005). The index is a consistent yardstick for measuring the quality of governance practices in almost 2,200 companies across 24 markets.

Section 1.07 **3.7. IFC Scorecard of Corporate Governance Standards**

The IFC Scorecard of Corporate Governance Standards was developed as a part of the IFC (International Finance Corporation) corporate governance evaluation methodology entitled „The Corporate Governance Development Framework" which covers most emerging markets around the world, including Africa, Latin America and the Caribbean, Asia, Middle East, Europe and Central Asia and represent assets of more than $850 billion in total. The corporate governance scorecard methodology is

closely related to specific (national) codes of corporate governance and as such contains all the crucial provisions of the same. It is used to translate the relevant dimensions of the code into the context of a firm and it evaluates how a firm's corporate practices meet certain criteria. Each of the corporate governance provisions is weighed differently depending on the national context and most of the grading systems are developed in accordance with the German scorecard model[8] following the OECD Principles of Corporate Governance (IFC, 2014).

The main steps in developing the scorecard model refer to: defining a large number of indicators used to evaluate corporate governance and selecting and customizing specific indicators. After the selection, if necessary, different ponders are assigned to a given category of indicators or to an observed indicator. Given the fact that the OECD principles are the starting point of most scorecard models, the commonly analysed and assessed dimensions of the corporate governance phenomenon are as follows:

1) **Rights of Shareholders**
2) **Protection and Equitable Treatment of Shareholders**
3) **Role of Stakeholders in Corporate Governance**
4) **Disclosure and Transparency**
5) **Responsibilities of the Board**

If we wish to sum up the IFC, we can say that the scorecard models are used in order to compare corporate performance with the current codes of corporate governance. Most countries today have at least one code of corporate governance, while some developed economies have several codes. In that context, one should consider the fact that the scorecard models depend on the ownership structure of the company, i.e. the system of corporate governance as well as the fact that the majority of codes are aimed at companies listed on the stock exchanges. However, there are codes and initiatives that deal with state-owned enterprises and small and medium-sized family businesses as well as codes that are aimed at a specific industry.

In terms of implementation, local codes of corporate governance are often considered the best choice for companies and their application is one of the main objectives in using the scorecard models. Feedback and experience gained from the use of scorecard models provide valuable input to the assessment of governance quality. On the other hand, international principles can provide a suitable measure of quality in situations where local or national principles do not yet exist.

[8] The general method of the scorecard used in Germany is also used, after suitable local adaptations, in Croatia, Bulgaria, Macedonia, Bosnia and Herzegovina, Montenegro, Serbia, Indonesia, and the Philippines. *See more* at: http://www.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/Global+Corporate+Governance+Forum/Corporate+Governance+Codes+and+Scorecards/ (03 June, 2014)

Section 1.08 **3.8. The SEECGAN Index of Corporate Governance**

The *SEECGAN Index of Corporate Governance* (hereinafter SEECGAN Index) was created and presented in 2014 as a result of the joint efforts of the members of the South East Europe Corporate Governance Academic Network. The SEECGAN Index is designed and adapted with regard to the situation and the specificities of the business environment in the selected countries of the South Eastern Europe (Croatia, Bosnia and Herzegovina, Serbia, Montenegro, Slovenia and Macedonia).

The seven segments of the Index are as follows:

1) **Structure and Governance of Boards**
2) **Transparency and Disclosure of Information**
3) **Shareholders' Rights**
4) **Corporate Social Responsibility**
5) **Audit and Internal Control**
6) **Corporate Risk Management**
7) **Compensation / Remuneration**

These seven segments are represented by a total set of 98 questions that must be answered in the affirmative (YES) or negative (NO), depending on the governance practices in analysed firms. Affirmative answers imply good corporate governance practices and vice versa. A ponder is assigned to each answer, wherein the minimum value of the weight equals 1, and the maximum value of the weight equals 3. The maximum score for each segment is 10 (best possible practice), and the minimum is one (worst possible practice). The overall SEECGAN Index score is the average value of all seven segments with 1 being the lowest value, and 10 being the maximum index value.

It should be noted that the analysis of the quality of corporate governance practices in the selected South East Europe countries is currently in progress and the initial results will be available during 2014.

4. CONCLUDING REMARKS

Measuring the quality of corporate governance is still a relatively new concept. Every country / region is in a different phase of establishing of a democratic, market framework and a system of corporate governance. Although efforts to improve corporate governance by establishing international standards started over two decades ago, most of the developing countries are still at the beginning of

implementation of the corporate governance framework. Many indices, including the OECD Principles of Corporate Governance, have not answered all the relevant questions of the phenomenon. The main weakness of the existing guidelines arises from the fact that the rules do not apply to all companies, as well as to all markets equally.

To be effective, the existing guidelines should be capable of measuring the quality of corporate governance in all types of markets. The basic classification of corporate governance indices identifies academic and commercial indices of corporate governance. These two groups of indicators differ significantly in several important dimensions.

First of all, commercial indices of corporate governance, as opposed to academic, when determining the relative importance of each criterion, apply different weights for each provision based on authors' discretion, and the results of quantitative analysis in terms of the importance of the factors mentioned above.

Second, academic indices dominantly deal with takeover defences, while some commercial indices are not concerned with these issues or they allocate much less weight in comparison with internal governance mechanisms such as boards and top management compensation / remuneration systems.

Third, most of the commercial indices allow comparisons with respect to the relevant industry and other businesses, while academic indexes are mostly absolute scales, independent of the practices of comparable firms.

Finally, the advantage of commercial indices of commercial advantage stems from the fact that they continually adapt to market demands, while academic indexes are immutable in that context.

There are two key criticisms of the existing indices of quality of corporate governance: there is no theoretical justification for the composition of existing indicators (which variables to include and which not), as well as there is no rationale for the weights assigned to different variables included in the index. Due to the limitations of the complex corporate governance indices, some authors propose a return to simpler measures of corporate governance in order to avoid problems associated with measurement and errors, and errors related to index framing (Schnyder, 2012; Bhagat et. al., 2008). However, the claim that we should use simpler measures of corporate governance may seem as a step backwards. Even if we try to strengthen the predictive power of the model by using a single variable, it is very likely that using simpler measures, in contrast to complex indices, will lead us to missing potentially important relationships between different governance stakeholders.

A review of the literature in the field of corporate governance shows that most existing studies analyse the following characteristics of corporate governance: board structure, shareholder rights, transparency

and disclosure of information and the structure and effectiveness of the board. It is also important to point out that the annual reports cannot alone be used to compute the index of corporate governance. Each method of calculating the index of corporate governance is different; it varies from one author to another, from country to country and from region to region due to the structure of corporate governance, business values and culture. Also, the presence of measurement errors in the evaluation process also leads to the data heterogeneity which further promotes the need to develop a universal index of corporate governance quality.

In short, the construction of the index for measuring the quality of corporate governance comes down to simplification of standards or criteria which mainly revolve around three dimensions - compliance, performance and accountability. In contrast to the level of compliance with good governance standards, scientific assessment of the quality of corporate governance remains a mystery.

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