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Corporate Governance: Known, Unknown, and the Wrongly Known

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Abstract: We survey the literature and identify the different measures of corporate governance used in the academic literature and those used in the corporate world. We also analyze the characteristics of the firm captured by academic researchers and the commercial vendors to compose such indices. Even though corporate governance in accounting and finance deals with shareholder rights and corporate disclosures we document that none of the measures account for corporate disclosures. We argue that shareholder rights and corporate disclosures are complementary components of corporate governance. In the absence of timely information shareholders cannot exercise their rights effectively. Therefore, we conclude with the recommendation that future measures incorporate timeliness and quality of corporate disclosures in corporate governance measures.

Key words: corporate governance; timely corporate disclosure; shareholders rights; shareholder activism; governance structure

JEL code: M14

1. Introduction

Corporate governance refers to the process and policies followed in governing organizations to ensure that business is conducted for the mutual benefit of the corporation and the society within social and legal frameworks. Corporate governance may be viewed from different perspectives. In accounting and finance, the term relates to timely corporate disclosures and legal rights of the shareholders. In law, corporate governance is generally used in the context of mergers and acquisitions. In management and marketing literature, corporate governance has more to do with administration and leadership. In this study, we will refer to corporate governance from the accounting and finance perspectives.

2. Literature Review of Corporate Governance

Researchers define corporate governance from the perspectives of different entities and aspects. Shleifer and Vishny (1997) state that corporate governance deals with the ways in which the suppliers of finance to

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corporations assure themselves of getting a return on their investment. La Porta, Lopez-de-Silanes, and Shleifer (1999) state that corporate governance is, to a large extent, a set of mechanisms through which outside investors protect themselves against expropriation by the insiders. They define insiders as managers and controlling shareholders. Stulz (1999) defines governance as the set of mechanisms that affect how the information asymmetry and agency costs problems impact firm value. Bhagat, Bolton, and Romano (2007) state that the panoply of mechanisms by which managers are incentivized and/or constrained to act in the shareholders' interest constitute a firm's corporate governance. Gompers, Ishii, and Metrick (2003) state that the power-sharing relationship between investors and managers is defined by the rules of corporate governance.

Corporate governance came into the limelight after the financial scandals of 2001-2002 at Enron and WorldCom. Government and stock exchanges tried to contain the possibility of such scandals in the future by both enacting legislation and increasing listing requirements. The SEC required mutual funds to adopt written policies on proxy voting and disclose their specific votes in 2003 (Bhagat, Bolton, and Romano, 2007). In the aftermath of the global financial crisis of 2008 the regulators, the investors, and the academic community alike directed their attention once again to corporate governance. The highly publicized bonuses awarded to employees deemed responsible for irresponsible risk-taking at the financial institutions that had to be rescued by the US government fueled discussions on executive compensation. Consequently, new regulations have been enacted that give shareholders a non-binding vote on executive compensation. More than ever before, the regulatory environment and shareholder skepticism demands that companies understand the implications of a weak governance structure. Said differently, corporations needs to be made aware of the benefits associated with a strong, improved governance structure.

Core, Holthausen, and Larcker (1999) suggest that firms with weaker governance structures have greater agency problems which affect their performance. Such firms have greater CEO power and management entrenchment as compared to firms with stronger governance structures. Weak governance can result in firms incurring higher debt financing costs (Ashbaugh-Skaife, Collins, LaFond, 2006). Corporate governance also impacts stock market liquidity and bond ratings (Bhojraj and Sengupta, 2003). Improvements in corporate governance mechanisms bring several benefits to firms. These include enabling companies to access capital markets on better terms, reducing default risk, lowering information asymmetry, and achieving narrower spreads and superior stock price performance. Governance mechanisms can reduce default risk by mitigating agency costs and monitoring managerial performance and by reducing the information asymmetry between the firm and the lenders (Bhojraj and Sengupta, 2003). Chung, Elder and Kim (2010) find that firms with better governance have narrower spreads, higher market quality index ratings, smaller price impact of trades, and lower probability of information-based trading. Their results suggest that firms may alleviate information-based trading and improve stock market liquidity by adopting corporate governance standards that mitigate informational asymmetries. Chi and Lee (2010) find that firm value is an increasing function of improved governance quality among firms with high free cash flow. Specifically, Tobin's Q, calculated as the market value of a company divided by the replacement value of the firm's assets, is higher for firms with fewer anti-takeover provisions, higher concentrated institutional ownership, higher equity-based managerial incentives, and separate CEO-chairman leadership among firms with high free cash flow. In contrast, governance benefits are lower or insignificant among firms with low free cash flow.

Farber (2004) found that the fraud firms that take initiative to advance their governance mechanisms can have better governance characteristics in terms of numbers and percentages of outside board members in a period of three years. Such firms that take action also have more audit committee meetings. The results indicate that such firms have superior stock price performance showing that the investors notice and value such governance improvements. However, no change in the level of analysts following and institutional holdings indicates that the credibility of the firm does not recover that fast. Current literature suggests that the benefits of corporate governance differ across different types of firms and improvements in corporate governance depend critically on the development of capital markets (Doidge, Karyoli, and Stulz, 2007).

The literature on corporate governance is very rich and researchers have focused on different means of corporate governance. Bhagat, Bolton, and Romano (2007) identify board of directors (BOD), shareholder meetings and shareholder voting, and executive compensation as the basic parts of a corporate governance system. Bebchuk and Weisbach (2010) have identified seven areas of corporate governance in their article which reviews and comments on the state of corporate governance research. These areas are shareholders and shareholder activism; directors; executives and their compensation; controlling shareholders; comparative corporate governance; cross-border investments in global capital markets; and the political economy of corporate governance. However, researchers agree that resolution/mitigation of agency problems lies at the heart of corporate governance (Shleifer and Vishny, 1997).

2.1 Controlling Shareholder

Governance can be very effective if the owner is also the manager of the firm; this structure eliminates any agency problems. But as a firm grows it needs finance, expertise, and professional acumen for growth and effective management of the operations which leads to separation of ownership and management. The external sources of finance include shareholders, banks and creditors. One of the most important motives behind shareholders' investment in companies is that they receive certain rights with regard to the assets of the firm (Hart, 1995). To a large extent, potential shareholders and creditors finance firms because their rights are protected by the law (La Porta, Lopez-de-Silanes, and Shleifer, 1999).

The most important legal right shareholders have is the right to vote on important corporate matters such as mergers and acquisitions. Another significant right is the election of members of the Board of Directors (BOD) (Manne, 1965; Easterbrook and Fischel, 1983). Being the owners of the company, shareholders have the incentives to monitor the management of the companies in which they own stock. Shareholdings can be small and dispersed or large and percentage block shareholdings. But the free-rider problem encountered by small and dispersed shareholders leads to lack of shareholder involvement in monitoring the performance of firms. The role of institutional investors in monitoring management is essential for investor protection (Shleifer and Vishny, 1997).

Carleton, Nelson, and Weisbach (1998) provide evidence that institutional investors with large ownerships can achieve success through private monitoring. Large shareholders actively participate in the monitoring of firms mainly to enhance the value of their investments (Gillan and Starks, 2007). Shleifer and Vishny (1986) document blockholders as a mechanism of corporate governance. Many studies, including Morck, Shleifer and Vishny (1988), have documented the relation between large shareholdings and corporate performance. Blockholders affect firm performance measures and policies related to investment, financial, executive compensation decisions. Cronqvist and Fahlenbrach (2009) note that blockholders with a larger block size, board membership, direct management involvement, or with a single decision maker are associated with larger effects on corporate policies and firm performance. Some literature also focuses on the downside of large blockholdings. Classens, Djankov, Fan, and Lang (2002) suggest that deviation between ultimate control and ownership decreases firm value due to the entrenchment effects of large shareholding. Guthrie and Sokolowsky (2010) present evidence that firms inflate earnings around the time of seasoned equity offerings in the presence of large outsider blockholdings, but not in their absence. Specifically, accruals increase by two percent of assets around the time of equity offerings in the presence of large outsider blockholdings. But no such evidence was found in the firms without outsider blockholdings. Despite these findings, earnings management is not solely a symptom of weak governance.

Bebchuk and Hamdani (2009) showed that governance should be assessed differently for companies with and without a controlling shareholder. According to Bebchuk and Weisbach (2010), with a controlling shareholder, the fundamental governance problem shifts from opportunism by managers to opportunism by controlling shareholders at the expense of minority shareholders. Many publicly traded companies in numerous countries have a controlling shareholder (Becht and Roell, 1999; La Porta, Lopez de-silanes, and Shleifer, 1999; Franks and Mayer, 2001). Holderness (2009) shows that the ownership of U.S. firms is similar to, and by some measures more concentrated than, the ownership of firms in other countries.

Gompers, Ishii, and Metrick (2010) identify dual-class shares as an extreme form of governance. In their article, a sample of dual-class firms in the United States is used to investigate the relationship between insider ownership and firm valuation. Their analysis shows that a typical dual-class firm has a superior (nontraded) class of shares that have ten votes each and an inferior (traded) class of shares that have one vote each, with insiders controlling 60 percent of voting rights and 40 percent of cash-flow rights (i.e. claims to cash payouts). They find strong evidence that firm value is increasing in insiders' cash-flow rights and decreasing in insider voting rights. Voting rights exceed cash-flow rights because of the use of dual-class stock, pyramid structures, and cross-holdings in many countries (Claessens, Djankov, and Lang, 2000; Faccio and Lang, 2002). Bebchuk, Kraakman, and Triantis (2000) show that such structures have the potential to create very large agency costs an order of magnitude larger than those associated with controlling shareholders who hold a majority of the cash flow rights in their companies. These authors describe the ways in which such arrangements enable a controlling shareholder to maintain complete control on the control of a company while holding less than a majority of the cash flow rights associated with its equity. Aggarwal et al. (2008) find that minority shareholders benefit from governance improvements partly at the expense of controlling shareholders.

2.2 Shareholder Rights

Researchers hold opposing views on the role of shareholders in the corporate governance process. Some favor increasing shareholders' power and rights. This group contends that governance can be improved by giving more rights and power to the shareholders. On the contrary, some oppose shareholder activism mainly because shareholders have short-term interests. Chi (2005) shows that increasing shareholder rights is an effective way to reduce agency costs and enhance firm value. Bebchuk (2005) shows that shareholders' existing power to replace directors is insufficient to secure the adoption of value-increasing governance arrangements that management disfavors. Providing power to shareholders improves all corporate governance arrangements mainly by inducing the management to adopt value-increasing changes. Furthermore, because of such power to amend governance arrangements, shareholders should be able to adopt provisions that give them additional power to intervene in specific business decisions. Power to intervene in critical matters (such as to merge, sell all assets, or dissolve) could address management's bias in favor of the company's continued existence. Power to intervene in scaling-down decisions (to make cash or in-kind distributions) could address management's tendency to retain excessive funds and engage in empire-building. Shareholders' ability to adopt provisions empowering themselves to intervene could thus produce benefits in many companies.

Opponents argue that increasing shareholders' powers will intensify myopic corporate behavior and lead to shareholder opportunism (Stout, 2007). But in an empirical study, Listokin (2010) suggests that simply altering shareholder power without changing other governance mechanisms is unlikely to lead to widespread changes in corporate governance. He shows that increasing shareholder power by enabling shareholders to alter governance terms unilaterally via bylaw amendment does not cause shareholders to significantly change governance terms, but instead has the potential to raise costs (by distracting management). Gutherie and Sokolowsky (2010) also conclude that increasing shareholder power to alleviate the conflict between shareholders and mangers can end up intensifying the conflict between current and future shareholders.

2.3 Shareholder Activism

Shareholders supply funds to the company, but can they do anything to initiate change in the company and ensure that the funds are put to the appropriate uses? The answer to this question is shareholder activism. Shareholder activism refers to the actions taken by shareholders to protect their interests. Researchers are of the opinion that firms that do not have defenses against takeover have good governance structure. The bulk of shareholder activism has historically been aimed at annulling firm-level defenses against hostile takeovers (Romano, 2001).

One form of shareholder activism is through lawsuits. Cheng et al. (2010) investigate the effectiveness of using securities class action lawsuits as a device of monitoring firms by institutional investors. On the basis of a large sample of securities lawsuits from 1996 to 2005, they show that securities class actions with institutional owners as lead plaintiffs are less likely to be dismissed and have larger monetary settlements than securities class actions with individual lead plaintiffs. They also find that after the lawsuit filings, defendant firms with institutional lead plaintiffs experience greater improvement in their board independence than defendant firms with individual lead plaintiffs. This suggests that securities litigation is an effective disciplining tool for institutional investors. Gillan and Starks (2007) noted that the involvement of large institutional shareholders increased significantly with the initiation of public pension fund activisms in 1985. But they find little evidence of improvement in the long-term operating or stock-market performance of companies in which shareholder activism takes place. Bebchuk and Weisbach (2010) suggest further research on shareholder activism by questioning to what extent (and when) shareholder activism can improve firm value and performance.

So is shareholder activism effective in achieving results? Del Guercio and Hawkins (1999) find that pension funds mainly motivated by fund value maximization are more successful at monitoring and promoting change in target firms. Becht et al. (2008) study the private engagements by an activist fund which earns abnormal annual returns net of fees of 4.9% and estimate that around 90% of the abnormal fund returns is due to the activism program. They study privately obtained data from Hermes, the fund manager owned by the British Telecom Pension Scheme, regarding engagements with management in companies targeted by its UK Focus Fund between 1998 and 2004. They document the way in which Hermes frequently seeks and achieves significant changes in the company's strategy, including refocusing on the core business and returning cash to shareholders, as well as changes in the executive management, such as replacement of the CEO or chairman. Their study shows that such activism is very important and that financial institutions can increase in value by creating value inside of firms by providing monitoring services.

2.4 Board of Directors

Apart from the shareholders, the management is also monitored by the BOD which plays a very critical role in the governance process. The shareholders elect the BOD to protect their interests and entrust the board with the responsibility of monitoring management's performance and decision-making. Bebchuk and Weisbach (2010) note governance by BOD as an alternative to direct monitoring by shareholders. But effective governance by the BOD requires that BOD comprise of independent directors.

The move towards "independent directors" began as a part of improving the corporate governance process. Having independent directors on the board has become mandatory in some cases. The New York Stock Exchange requires most listed companies to have boards with a majority of independent directors and audit and compensation committees comprised solely of independent directors. The Sarbanes-Oxley Act of 2002 also requires the independence of audit committees. Klein (2002) finds that earnings management decreases with the independence of the Audit Committee. In light of the current financial crisis, legislation at the federal level intended to encourage the independence of the compensation committees is under consideration. Gordon (2007) finds that the fraction of independent directors for large public firms has increased from 20 percent in the 1950s to approximately 75 percent in the mid-2000s. He claims "independent directors" to be the answer to the question: how to govern firms so as to increase social welfare (as proxied by maximization of shareholder value). He documents that independent directors enhance the reliability of the firm's public disclosure, which makes stock market prices a more reliable signal for capital allocation and for the monitoring of managers at *other* firms as well as their own. He concludes that independent directors are an important component of a new corporate governance paradigm.

Cotter, Shivdasani, and Zenner (1997) show that boards that comprise majority of independent directors help control the agency problems between shareholders and managers of target firms in a takeover offer. They document that the gains to target shareholders are significantly greater when the target's board is comprised of a majority of independent directors. Salas (2010) finds evidence that entrenchment is less likely if the board has a high proportion of outsiders.

While helpful, a high percentage of outside directors do not always prevent entrenchment. There are several other factors at play. Farber (2004), in a study of firms identified by SEC as fraudulently manipulating their financial statements, found that such firms have fewer numbers and percentages of outside board members, fewer audit committee meetings, fewer financial experts on the audit committee, a smaller percentage of Big 4 auditing firms, and a higher percentage of CEOs who are also chairman of the board of directors. Takeover defenses, accrual quality, earnings timeliness, board independence, board stock ownership, and board expertise are positively related to credit ratings (Ashbaugh-Skaife, Collins, LaFond, 2006). Firms with greater institutional ownership and stronger independent boards enjoy lower bond yields and higher ratings on their new bond issues (Bhojraj and Sengupta, 2003). Firms with zero nonexecutive board members actually have fewer agency problems and achieve a better alignment of shareholders' and managers' interests (Fernandes, 2008).

Fama and Jensen (1983) propose that outside directors' motivation to monitor the management is their desire to retain their reputation as experts of their fields. They contend that if outside directors find it difficult to monitor the management for any reason, then such directors are more likely to resign publicly to maintain their reputations. Dewally and Peck (2010) find that directors that resign publicly criticizing the firm are more likely to be finance professionals who were members of the audit and compensation committees. These directors resign from firms with weak boards and financial performance. The authors conclude that such public resignations are motivated by the reputational concerns of the directors. They also highlight the use of public statements criticizing management as another corporate governance mechanism available to pressure management to act in shareholders' interests.

A downside of independent boards identified in research is the higher monitoring costs. That is, it is more costly to gather and communicate relevant information to outside board members than insiders (Raheja, 2005). Researchers and policymakers assume that BOD monitor management to protect the shareholders. Bebchuk and Weisbach (2010) document that financial economists should not generally assume that independent directors seek to maximize shareholder value; rather, their decisions, like those of other economic agents, might well be influenced by their working environment.

The source of information of the independent directors is also endogenous rather than exogenous. Analysis of hundreds of board meetings transcripts show that BOD do not maintain constant levels of attention toward monitoring, but instead selectively allocate attention to their monitoring function. Deviation from prior performance and CEO duality interactively affect this monitoring. Deviation from prior performance is negatively correlated to boards' attention to monitoring (Tuggle, Sirmon, Reutzel, and Bierman, 2010).

Directors will be able to add value and evaluate decisions critically if they possess knowledge and information in addition to that provided by management. DeFond et al. (2005) find that it is not the independent directors in the audit committee, but independent directors with appropriate financial accounting expertise, that improve value. The effectiveness of BOD is also affected by many factors. Jensen (1994) argues that the board effectiveness can be compromised if the CEO controls the composition of the board. Klein (2002) suggests that boards structured to be more independent of the CEO are more effective in monitoring the corporate financial accounting process. Duchin et al. (2010) find that the effectiveness of outside directors depends on the cost of acquiring information about the firm: when the cost of acquiring information is low, performance increases when outsiders are added to the board, and when the cost of information is high, performance worsens when outsiders are added to the board. This finding supports a nascent theoretical literature emphasizing information asymmetry. Karamanou and Vafeas (2005) find that managers in firms with more effective board and audit committees are more likely to announce or update an earnings forecast which is more accurate, thus eliciting a favorable market response.

The importance of independent directors has gained momentum making it critical to study the relationship between board independence and firm value. So far, the research on this relationship has not been able to establish any links between the two. Bhagat and Black (1999a, 1999b, 2002) do not find any evidence that higher board independence leads to better firm performance. A study examining the determinants of board monitoring activity and its impact on firm value shows that prior performance, firm characteristics, and governance characteristics are important determinants of board activity. Corporate events such as an acquisition or the restatement of financial statements also impact the board monitoring. The passage of the Sarbanes-Oxley Act of 2002 has increased board activity. Such regulations have led to some increase in firm value. After the passage of the Sarbanes Oxley Act, firms have also increased the independence of Board committees like Audit, Compensation and Nominating committees. A point to note is that increased monitoring does not necessarily improve the firm's operating performance. Brick and Chidambaran (2010) assert that the board's main function is to provide strategic advice in order to increase the value of investment opportunities. Hermalin and Wiesbach (2006) argue that board activity due to the pressure of externally imposed regulations can be costly and can have unintended outcomes.

2.5 Executive Compensation

One very common way to overcome the agency problem is direct alignment of managers' interests with those of the shareholders through executive compensation. Bebchuk and Weisbach (2010) note that the decisions made by the executives, assumed to be in the interests of the shareholders, are influenced by the directors' oversight and by the compensation arrangements provided to them. The literature on CEO compensation shows that CEO's compensation is higher in interlocked firms, firms that adopt antitakeover charter amendments, firms with greater agency problems, firms with more nonexecutive board members, and firms that have less effective governance structures (Borokhovich, Brunarski and Parrino, 1997; Hallock, 1997; Fernandes, 2008, Core, Holthausen, and Larcker, 1999). Compensation is also higher when outside directors serve on multiple boards, when more of the outside directors have been appointed under current CEO, when there are no large outside blockholders, and when a small percentage is owned by institutional investors. Ashbaugh-Skaife et al. (2006) find 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. CEO compensation has decreased significantly in companies affected by the new board requirements issued by major U.S stock exchanges after the scandals of 2001 and 2002 (Chhaochharia and Grinstein, 2009).

2.6 Cross-country Comparison

A stream of literature in corporate governance has focused on the cross-country differences along with cross-firm differences. Some countries have legal systems in place that provide strong investor protection and some do not. The U.S. is known for its strong investor protection system. A direct implication of these systems is that companies in such investor-protection oriented countries have to invest in and improve their governance mechanisms. Aggarwal et al. (2008) investigate how the country-level and firm-level governance choices interact. They construct a governance index which increases as a firm grants more rights to minority shareholders. They compare foreign firms with comparable U.S. firms and find that only 12.7 percent of foreign firms have a higher index. The value of foreign firms falls as their index decreases relative to the index of matching U.S. firms. The authors note that their findings are consistent with the hypothesis that lower country-level investor protection makes it suboptimal for foreign firms to invest as much in governance as U.S. firms do. Bebchuk and Hamdani (2009) point out that the data used by Aggarwal et al. (2008) is U.S. centered, as it focuses on companies that do not have a controlling shareholder, but companies in most other capital markets around the world have a controlling shareholder. They also suggest that a single governance standard should be replaced with global governance standards for evaluating governance in firms with and without a controlling shareholder.

3. Measures of Corporate Governance

3.1 Governance Indices

3.1.1 Gompers, Ishii and Metrick "G" Index

Gompers, Ishii and Metrick (GIM, 2003) created the first index (G-index) to measure corporate governance. They used data from Investor Research Responsibility Center (IRRC) publications. These documents provided 24 distinct corporate governance provisions for approximately 1500 firms since 1990. G-index has been used in over 100 studies since its introduction. G-index uses 22 provisions in firms' corporate documents (17 of which are takeover-related) and six types of state laws (four of the laws overlap with four firm-level provisions). GIM group the provisions into five groups and then constructs a governance index called "G-index" which it considers to reflect "balance of power between shareholders and managers".

The categories and provisions in the G-index are as follows: (1) Delay-Blank check, Classified Board, Special Meeting, Written Consent; (2) Protection-Compensation Plans, Contracts, Golden Parachutes, Indemnification, Liability, Severance; (3) Voting-Bylaws, Charter, Cumulative Voting, Secret Ballot, Supermajority, Unequal Voting; (4) Other-Antigreenmail, Directors' Duties, Fair Price, Pension Parachutes, Poison Pills, Silver Parachutes; and (5) State-Antigreenmail Law, Business Combination Law, Cash-out Law, Directors' Duties Law, Fair Price Law, Control Share Acquisition Law.

The approach for each firm is to add one point for every provision that reduces shareholder power. For example, firms that have Antigreenmail or Golden Parachutes, add one point for each. For Classified Boards, one point is added as classified boards increase the power of managers and weaken the control rights of large shareholders. But exceptions to this rule are Secret Ballots and Cumulative Voting, where one point is added if firms do not have these items. For state laws that overlap with firm provisions, one point is added if the firm is covered under the firm-level provision, state law, or both. For example, for a firm that has an Antigreenmail provision and is also covered under the Antigreenmail state law, one point is added to both the *State* subindex and the *Other* subindex, but only one point and not two is added to the overall *G* index. *G* has a possible range of 1 to 24. The firms in the highest decile of the index are referred to as having "highest management power" or "weakest shareholder rights" ($G \geq 14$) and are placed in "Dictatorship Portfolio" and firms in lowest decile of the index are referred to as "lowest management power" or "strongest shareholder rights" ($G \leq 5$) and are placed in "Democracy Portfolio". Gompers, Ishii and Metrick (GIM, 2003) found that the Democracy Portfolio outperformed the Dictatorship Portfolio by a statistically significant 8.5 percent per year during their sample period. They also find that firms with weak shareholder rights are less profitable, have lower Tobin's Q, and have lower sales growth than other firms in the industry. However, GIM refrain from asserting causal relationship between corporate governance and firm performance. Additionally, though studies since GIM have used the G-index as a measure of corporate governance, GIM designed the measure specifically to test their hypotheses regarding shareholder rights and not corporate governance in general.

3.1.2 Bebchuk, Cohen, and Ferrell E Index

Bebchuk, Cohen, and Ferrell (2009) investigate which provisions of G-index are correlated with firm value and stockholder returns. The authors create an entrenchment index called "*E*-index" based on six provisions: staggered boards, limits to shareholder bylaw amendments, supermajority requirements for mergers, supermajority requirements for charter amendments, poison pills, and golden parachutes. BCF consider golden parachutes as a defense against hostile takeover. But scholarly literature disagrees with BCF's view. Lambert and Larcker (1985) find that adoption of golden parachutes produces significantly positive price effects in contrast to other defenses. BCF also follow the same approach used by GIM of assigning one point for the presence of any one of the six provisions stated above. The range of E-index is zero to six. In their examination of the relation between E index and Tobin's Q and stock returns, BCF findings reconfirm those of GIM. BCF also reconfirms that a strategy of buying low entrenchment firms and selling short high entrenchment firms outperforms the market. They find that buying an equally-weighted portfolio of firms with a zero E-index score and selling short an equally-weighted portfolio of firms with E-index scores of five or six would have yielded an average annual abnormal return of approximately 7 percent during their sample period.

BCF conclude that E-index provides a better measure of governance quality as it is not affected by the "noise" created by the 18 provisions that are used in G-index and not included in E-index. They claim that E-index helps in identifying which IRRC provisions matter and which do not matter. E-index has been used by numerous papers since 2004 and has also been applied for commercial purposes. Glass Lewis & Company, which provides research and advisory services to institutional investors markets a governance ranking, called the "Board Accountability Index", that is derived from BCF's research.

3.1.3 Cremers and Nair

Cremers and Nair (2005) also use the G-index created by GIM. The authors place emphasis on internal governance as represented by institutional block ownership since effective governance requires both internal and external measures. They find that the relation between governance and performance identified by GIM is changed when internal governance variable of block ownership is included. The authors use shareholder activism as a proxy for internal governance, but do not examine which internal provisions matter in firm valuation. They investigate how internal and external governance mechanisms interaction affects equity prices. They find that internal and external governance mechanisms are complements rather than substitutes. They conclude that it is not just the firm's defenses that result in superior performance but the combination of the quality and strength of the firm's internal and external governance mechanisms.

3.1.4 Brown and Caylor Gov-Score Index

Cremers and Nairs document that both the G-index and E-index are focused on external governance. Brown and Caylor (2006) support BCF's finding that only a few provisions are related to firm valuation and Cremers and Nair (2005) findings that firm value is affected by both internal and external governance mechanisms. Brown and Caylor created "Gov-score", a summary governance measure that is based on 51 firm-specific provisions that represent both internal and external governance. Gov-score is based on data of Institutional Shareholder Services (ISS), the largest corporate governance data provider to institutional investors. Unlike IRRC, ISS provides data on both internal and external governance factors. ISS is a larger database than IRRC. But Gov-score suffers from a disadvantage because it is constructed using data of just one year, 2003. A benefit in disguise is that it captures changes in governance environment after the financial scandals of 2001-2002.

The authors claim that Gov-score is a better alternative to G-index and E-index because it has a broader scope, covers more firms, and measures governance after financial scandals like Enron, hence is more dynamic. They develop a parsimonious index (Gov-7) based on seven provisions underlying Gov-score and show that these seven provisions drive the relation between Gov-score and firm value. The seven provisions are: (1) board members are elected annually; (2) company either has no poison pill or one approved by shareholders; (3) option re-pricing did not occur within the last three years; (4) average options granted in the past three years as a percentage of basic shares outstanding did not exceed 3 percent; (5) all directors attended at least 75 percent of board meetings or had a valid excuse for non-attendance; (6) board guidelines are in each proxy statement; and (7) directors are subject to stock ownership guidelines. The first two provisions are external measures and the authors identify the remaining five as internal provisions that matter for firm valuation. They note that only one of these seven provisions important for firm valuation was incorporated into legislation and requirements by the major stock exchanges. Of the 51 provisions, one is accounting-related and four are audit-related. They find that these five provisions related to accounting and public policy are not related to firm valuation.

Consistent with prior literature, the authors find that governance measure (Gov-score) is significantly and positively related to firm valuation as measured by Tobin's Q, thus indicating superior performance is associated with higher quality governance. They confirm the finding of extant literature that only a small subset of governance factors marketed by database providers is relevant for firm value. BCF show that only 25 percent of the IRRC factors fully drive the relation between G-index and firm valuation. Brown and Caylor show that only 14 percent of the ISS factors fully drive the relation between Gov-score and firm valuation. Gov-score differs from G-index and E-index because it consists of more dimensions than takeover defenses, which are the main provisions used in both the G-index and E-index. One finding different from the findings of GIM and BCF is that board and compensation factors are more highly associated with good performance than most of the takeover defenses.

Bebchuk and Cohen (2005) find that the controlling for other governance provisions, staggered boards, and poison pill have a strong effect on market value and that their effect is several times larger than the average effect of other provisions in the G-index. Brown and Caylor also confirm that the absence of staggered boards and poison pills has a significant positive association with firm valuation.

3.1.5 Proprietary Indices

Bhagat, Bolton, and Romano (2007) document that commercial governance indices differ from academic governance indices on a few dimensions. First, academic governance indices such as the G-index, E-index and Gov-score are constructed by summing equally weighted governance factors. However, commercial index providers assign weight to each governance factor based on the perceived importance of the factor or quantitative analyses.

Another dimension to consider is that good governance features may be substitutes rather than complements. Gillan, Hartzell, and Starks (2006) find that some measures of high quality internal and external governance are inversely correlated. They also find that such correlated sets of governance features are correlated with other firm characteristics such as firm age, institutional ownership, R&D expenses, tangible assets, and capital expenditures. They conclude that corporate governance structures differ across firms and industries and therefore one measure of governance quality thought to be best may not be best if viewed from another dimension. Summing up the various features, whether weighted or not, treats all the features as complements and results in inaccurate measures of governance quality. In addition, there might be interaction effects between two or more governance features.

Daines et al. (2010) document that governance rating firms such as RiskMetrics/ISS, GovernanceMetrics International, and The Corporate Library provide consulting services to institutional clients such as mutual funds and pension funds. The importance of the role played by these companies in the U.S. public markets has increased significantly due to the critical nature of the services provided: ranking the quality of firms' corporate governance, advising shareholders how to vote, and sometimes pushing for governance changes. These companies make strong claims regarding the ratings' value in predicting future outcomes, such as accounting restatements, operating performance, and stock returns. The users of these ratings also include directors who use these ratings as a guide to estimate how much they need to monitor firms. But how accurate are these rankings and do they fulfill the claims made by the providers? Daines et al. find that such rankings do not provide useful information to the shareholders and do not predict governance-related outcomes with enough strength or precision to support the claims. Some commercial indices are relative rankings of firms in relation to other firms in their industry, market, or geographic region, whereas, academic indices are absolute rankings of firms and are not impacted by comparable firms. Bhagat, Bolton, and Romano (2007) document that institutional investors use commercial indices in making investment and proxy voting decisions mainly to fulfill their fiduciary obligations, even if their use might lead to incorrect decisions in a good number of cases. However, one positive effect of the extensive commercial use of governance indices is that it has led both the IRRC and ISS to compile governance data more frequently. ISS updates the factors in its index depending on the trend in corporate governance world.

3.2 Non-index Measures

Today the most common way of measuring corporate governance is by using an index that covers many dimensions of governance mechanisms. But many researchers believe that specific board characteristics are the most important and critical determinants of corporate governance (Brickley, Coles, and Jarrell, 1997 and Hermalin and Weisbach, 2003). Bhagat, Bolton, and Romano (2007) point that the boards play a very pivotal role in the governance process and therefore concentrating on its characteristics and dimensions can assist in identifying one particular variable that might serve as an alternative to an index. Using a single board characteristic as a governance measure has advantage of lower measurement error as compared to that of an index, which requires accurate identification of more governance attributes. The authors state that a simple single governance variable, outside directors' stock ownership, performs better than the leading academic indices, as that factor is positively correlated with more performance measures.

Many studies have examined the effect of overall board composition on performance, but have not been able to pinpoint the relation between board independence and performance. Bhagat and Black (2002) do not find any convincing evidence that greater board independence correlates with greater firm profitability or faster growth. In fact, they do not find support for the "supermajority-independent boards" with one or two inside directors proposal. However, they do document that firms that have supermajority-independent boards are less profitable as compared to other firms. Klein (1998) states that a positive relation exists between percentage of inside directors on finance and investment committees and accounting and stock market performance measures.

Similarly, studies document no significant impact of shareholder activism on performance. Black (1998) and Romano (2001) agree that shareholder activism does not affect the bottom line performance. On the contrary, empirical literature finds significant positive price effects of proxy fights (Romano, 2001). Blockholders have been documented as a governance mechanism and studies document positive price effects upon the formation of outside blocks (Jarrell, Brickley and Netter, 1988). Mehran (1995) finds that firm performance is positively related to the percentage of equity held by managers and to the percentage of their compensation that is equity-based. Stock ownership of board members is significantly positively correlated with better contemporaneous and subsequent operating performance. The authors propose using dollar value of stock ownership as a measure of corporate governance.

3.3 Summary

Bhagat, Bolton, and Romano (2007) conclude that consistent relation does not exist between academic and commercial governance indices and measures of corporate performance. They advocate that good governance is highly context-specific and is something which even the best-constructed index simply cannot capture and convey. Simply stated, there is no "best" measure of corporate governance: the most effective governance institution appears to be contextual, and dependent on firms' specific circumstances. An important conclusion is that governance indices are very imperfect screens for determining how to vote corporate proxies, and that investors and policymakers should be very careful in forming an opinion regarding a firm's quality or future stock market performance from its ranking on any particular governance measure. The authors document that there are numerous governance mechanisms which interact with each other. So recommendations should not be made on the basis of research investigating the effect of only one dimension of a firm's governance on performance. In the authors' opinion, the median independent director's stockholdings is a better variable to measure corporate performance.

4. Corporate Governance Measures: A Comparison

In this section we compare the different measures of corporate governance used in the academic literature and the corporate world based on the number of corporate governance attributes covered by each measure. As noted above, the literature identifies the following attributes: shareholder rights, board of directors, executive compensation, disclosure. Shareholders rights are affected by disparity in cash flow and voting rights, takeover defenses, and state of incorporation. The characteristics of board members, their independence and accountability, and restrictions placed on them determine the effectiveness of the board of directors as corporate governance mechanism. Executive compensation attributes also include restrictions on participation in pension plans and stock option plans. Timely and quality information disclosure enables shareholders to exercise their rights effectively. Shareholder activism is treated by some studies as corporate governance attribute but shareholder activism is more likely to be a result of corporate governance (the lack thereof) rather than source of, or a measure of, good corporate governance. Hence we do not treat them as a separate attribute in our analysis.

Table 1 Weights of Different Attributes in Academic Corporate Governance Measures

Measure	Shareholder rights	Board of directors	Executive compensation	Disclosure of information
G-index	Special meeting	Classified boards	plans	
	Written consent		contracts	
	Blank check preferred stock		golden parachutes	
	Bylaws		Indemnification	
	Charter		Liability	
	Secret ballot		Severence	
	Super majority		Silver parachutes	
	Antigreenmail provisions			
	Poison pills			
	Fair price provisions			
	Pension parachutes			
	Cash-out law			
	Business Combination law			
	Cumulative voting			
	Dual class stock			
	Directors duties to other constituents			
Weight	67%	4%	29%	0%
E-index	Bylaws	Classified Boards	Golden Parachutes	
	Super moajority			
	Charter			
	Poison Pills			
Weight	67%	17%	17%	0%
Gov 7	Poison pill,	Elected annually,	Option repricing	
	Statemens	75% attendance	Granted	
	Stock ownership guidelines			
Weight	29%	43%	29%	0%

Table 1 shows the weight allotted to each attribute in the different governance measures used in the academic literature. We note that G-index is heavily weighted towards shareholder rights and so is the E-index which is composed of a subset of the factors in the G-index. This overweighting of the shareholder rights in the two indices is justified because these indices were designed for the primary purpose of measuring the strength of shareholder rights rather than as corporate governance measures. The Gov-7 is more evenly distributed across shareholder rights, board of directors, and executive compensation. However, we note that none of the three measures account for the level of disclosures by the firm. Timely and quality disclosure of information allows shareholder to exercise their rights and therefore we contend that shareholder rights and disclosures are complementary in nature. Yet none of the academic measures of corporate governance account for disclosure attributes.

In Table 2 we show the weights allotted to different attributes in the 51-factor governance score, the corporate library board effectiveness rating, and ISS corporate governance quotient. Unlike the G-index, E-index, and Gov-7 these measures include additional factors related to management actions, audits, and accounting. We note that unlike the academic measures commercial measures place relatively lower weight on shareholder rights and takeover defenses but continue to place significant importance on the characteristics of the board of director. Though Brown and Caylor (2006) find that accounting measures and those related to audit are unrelated to firm valuation, the commercial indices place significant weight on such attributes but fail to account for timely and quality disclosure by the firm.

Table 2 Weights of Different Attributes in Corporate Governance Measures

Shareholder rights	Board characteristics, independence requirements	executive compensation	Management actions, restrictions, &issues	Audit auditor requirement, Accounting
22%	49%	20%	2%	8%
10%	35%	25%	20%	10%
20%	40%	30%	0%	10%

5. Conclusion

We survey the literature on corporate governance and document the array of factors deemed to affect the quality of corporate governance. As a society we have developed several mechanisms to mitigate the agency problem faced by the investors when they effectively pass the control of their funds to the managers. The most important line of defense for the investors against agency problem remains to be the board of directors. However, we contend that the second most important factor used by investors to exert control over the use of their funds and mitigate agency problem is to require the management to disclose material information. In the absence of timely and quality information investors would find it difficult to exercise their rights or to evaluate the performance of the board of directors as a watchdog. We review the different measures of corporate governance used in the academic literature and those provided by commercial vendors. We find that widely used measures of corporate governance fail to account for the information environment of the firm. We recommend that corporate governance measure give adequate weight to timely and quality disclosures made by the firm and account for the complementary nature of shareholder rights and firm disclosure policy.

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