Assessing the applicability of a corporate governance index in Maltese listed entities

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Abstract: This paper sets out to establish to what extent, if any, a corporate governance index (CGI) is suitable and applicable to Maltese listed entities (MLEs). Two sets of semi-structured interviews were held with seven financial analysts and 13 MLEs. This was followed by a CGI survey sent to the same MLEs previously interviewed and an analysis of their Annual Reports for the three-year period 2011–2013. A CGI model purposely designed for the present study was then tested on two MLEs. Findings show that corporate governance in Malta is not given appropriate importance by MLEs. Yet respondents agreed to CGI introduction in order to improve current CG practices. The study goes on to assess the impact, benefits and limitations of such a CGI in Malta and provides feasible recommendations which may help towards the consolidation of corporate governance in MLEs.

Keywords: corporate governance; corporate governance index; CGI; attributes; listed entities; financial analysts; Malta.
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1 Introduction

Several recent corporate collapses, such as Arthur Andersen and Parmalat, were the result of bad corporate governance (CG) and one direct consequence of this is that as time went by, CG has become increasingly important (Khanchel, 2007). Various CG definitions exist but they usually refer to “the system by which companies are directed and controlled” [Cadbury, (1992), p.15]. CG has been promoted with the aid of codes that encouraged public companies to have a proper CG structure (ECGI, 2006). The Maltese Code of Good Corporate Governance for Listed Entities (the code) was introduced in 2001, with revisions in 2005 and 2011 (MFSA, 2011). In its latest revision, the ‘comply or explain’ type of Code together with the ‘non-compliance section’ became mandatory. Since then, Maltese listed entities (MLEs) have had to provide reasonable explanations for non-compliance with any particular principle or provision in the code (Bezzina et al., 2012). Notably, in the case of Malta, there is no legal obligation for listed entities to disclose in their Annual Report the assurance that reflects CG quality. This is clarified by the auditors themselves as in the report they explicitly state that they are not required to perform any additional work as regards CG effectiveness. However, such a position has certain limitations, as it is a very simplistic requirement based on simple disclosures (Gower and Davies, 2003). CG codes have been looking too generous for companies in just answering ‘yes’ or ‘no’ and giving explanations, where such explanations frequently lack certain details (Medland, 2013).

As a result, various countries have felt the need to depart from the Code of Best Practice by taking “a quantitative evaluation approach” [Strenger, (2004), p.11] and providing a measurement capable of showing the quality level of CG whilst simultaneously reflecting its efficiency and effectiveness. This is usually referred to as a corporate governance index (CGI), being an independent opinion based on transparent measures and a standardised analytical process assisting interested parties in clearly analysing relevant characteristics of good CG (Standard and Poor’s, 2004; Strenger, 2004). Bhagat et al. (2008) referred to the CGI as a standard with the aim to benchmark an entity’s governance characteristics against what is considered to be best practice by its provider. In response to this, a number of organisations have been offering CGIs so as to reflect governance quality and performance of listed companies (Schnyder, 2012).

Every country has its own approach to constructing the CGI by tackling different governance areas that include particular governance attributes. Given that in Malta there is as yet no such index, this study examines whether such an index is applicable and useful to Maltese investors. Malta is a small island state situated in the centre of the Mediterranean and has only 21 companies with listed equity (excluding collective schemes). A Maltese CGI may equip investors to answer questions concerning governance performance through a more efficient and effective process. Thus, the objective of this paper is to establish the extent to which, if in any way, a CGI is suitable and applicable to Maltese Listed Companies (MLEs). For this purpose, it will

1 assess the needs and attitudes towards CG measurement in MLEs and determine the entity that may be responsible for providing and assessing the CGI in Malta

2 ascertain the construction of an MLE index including its attributes and its benchmarking
test our constructed CGI on two MLEs by assessing its impact, benefits and limitations.

The paper will conclude by providing particular recommendations, particularly which of the CGI model being proposed which may help towards the consolidation of CG in MLEs.

2 Literature review

2.1 The CGI provision

CGIs were introduced by parties interested in the field of CG. Normally, such CGIs were specifically built to cater for the needs of a particular market. Two examples of academically constructed CGIs are the LLSV index which caters for 49 countries and the G-index, both built to be used in the USA (La Porta et al., 1998; Gompers et al., 2003). As time went by, commercial CGIs were becoming an established product of most credit-rating agencies while new specific governance-rating agencies were then purposely born for providing this service (Balling et al., 2005). Unlike academic providers, commercial CGI providers had the ability to look beyond country borders and thus derive more meaningful comparisons in governance practice (Aguilera and Desender, 2012). Moreover, such providers were better equipped in the market especially owing to their ability to easily access company records (Schnyder, 2012).

Yet, a study conducted by the Stanford Law and Business Faculty in California showed that commercial CGI’s are not as credible as they seem (Snyder, 2009). Daines et al. (2010, p.46) also argued that such CGIs “have either limited or no success in predicting firm performance or other outcomes to shareholders”. Although usually based on the same publicly disclosed information, differently constructed CGIs were found to be little correlated and differing considerably (Daines et al. 2010). Moreover, Snyder (2009) found serious negative correlations in CGI results provided by rating agencies, with better performance being achieved by weak CG. Such conflicting results were due to either different CGI construction methods being used or to measurement errors being incurred (Daines et al., 2010; Snyder, 2009). Furthermore, Schnyder (2012, p.5) argued that rating agencies usually use “the kitchen-sink-approach to index construction” by including many index elements of limited use rather than focusing on the important ones, this resulting in a score misrepresenting the entity’s governance performance. Additionally, conflicts of interest and independence between CGI providers and assessors required high attention so as not to get results compromised (IOSCO, 2004).

Three world-renowned CGI providers are Institutional Shareholder Services (ISS), Governance Metrics International (GMI) and S&P’s. The former two are governance rating agencies founded in 2002 and 2000 respectively and the latter was founded in 2002 with a new CGI department.

2.2 The CGI model

In their CG Score paper, Standard and Poor’s (2004) argued that different countries and companies require specific CGI models owing to market need differentials. Various studies also acknowledged the fact that a number of constructed CGIs are based entirely
on their respective national CG codes (Grimminger and Di Benedetta, 2013; Khiari et al., 2007; Spanos et al., 2006). If a CGI is based exclusively on the CG code, the index strength will be equal to the strength of the code itself, implying that if such code is being deficient in certain criteria, so will the CGI (Grimminger and Di Benedetta, 2013). Additionally, Khanchel (2007) as well as Martynova and Renneboog (2010) highlighted that CGIs based on national codes might quickly turn obsolete because CG codes are usually left outdated with respect to current market changes. It was thus determined that the elements of the index should go beyond this, leaving the CGI open to adjustments – reflecting, say, more international aspects rendering it more globally convergent (Martynova and Renneboog, 2010; Grimminger and Di Benedetta, 2013). A case in point was the initiative taken by the ISS (2014) to construct a new CGI with the aim “to compare companies within global portfolios using a single index” [Brown, (2004), p.3].

Six most common governance areas emerging from various academic and commercial CGIs are board of director structure, director remuneration, ownership structure, shareholder rights, audit committee and process and transparency and disclosure. We note below a selection of attributes under each area indicating why each is so important for the construction of the CGI.

a Board structure: a bigger board reduces likelihood of inactivity and delays (Kim et al., 2010); the higher the presence of non-executive directors, the better the results (Khanchel, 2007); the presence of a non-executive majority with a non-executive Chairman ensures higher independence (Bezzina et al., 2012); frequency of meetings is an important determinant of effectiveness (Albert-Roulhac, 2008; ISS, 2014); the more experienced the board, the more effective (Kim et al. 2010); CEO/Chairman duality might lead to abuse of power (Sarkar et al., 2012); and a CEO serving more than one company could dedicate lesser attention (Platt and Platt, 2012).

b Director remuneration: the more appropriate the remuneration committee and its policies, the more probable the attractiveness and adequacy of remuneration (MFSA, 2013); performance-based remuneration could promote higher director’s incentives (Mallin, 2004); and fixed/variable segregation of remuneration could result in more verifiability (Bezzina et al., 2012; Barrett et al., 2004.)

c Ownership structure: institutional shareholders lead to agency cost minimisation and pressure for better director decisions (Bezzina et al., 2012; Sarkar et al., 2012); minority shareholder safeguards could minimise expropriation problems (Guedes and Loureiro, 2007; Standard and Poor’s, 2004); and director or employee shareholding could promote goal congruence (Noamene and Hassairi, 2012).

d Shareholder rights: fairness requires one-share-one-vote adoption (Martynova and Renneboog, 2010); proxy rights could lead to higher AGM participation (MFSA, 2013); adequate AGM attendance could depend on timely notification (MFSA, 2013); an appropriate shareholding threshold to call an AGM encourages shareholder activism (MFSA, 2013); shareholder representation could highlight shareholder’s say (MFSA, 2013); and dividend policy disclosure would help regularise returns and diminish problems (Standard and Poor’s, 2004).

e Audit committee (AC) and process: non-executive directors on the AC are a means towards more independence (Mallin, 2004); adequacy of meeting frequency and
attendance is important for the proper function of the AC (MFSA, 2013); the shorter the lifespan, the more independent is the AC (Mallin, 2004); internal auditing could improve internal controls (Spencer Pickett, 2011); predetermined auditor rotation could enhance audit independence (Sarkar et al., 2012); and non-audit services by the statutory auditor could compromise independence (Sarkar et al., 2012).

2.3 CGI construction and presentation considerations

When selecting attributes, one has to be careful not to omit important ones (Balling et al., 2005) as this would contribute to an index bias (Schnyder, 2012). Selection is not easy to perform as the choice of areas and attributes is highly subjective, resulting in a common construction limitation (Mostafa, 2012).

Furthermore, Balling et al. (2005) attributed the considerable variation in the selection of attributes from one CGI to another to the lack of theoretical basis in the identification of the governance criteria. Indeed, Schnyder (2012) concluded that a simpler index has more predictive power, being less complex and subjective. Another debate in this respect concerned the use of weightings. In a weighted CGI, the selection of weightings was found to be crucial as it was very subjective and difficult where such selection depended on the judgement of the rating provider (Spanos et al., 2006). Balling et al. (2005) stated that when weightings are applied, information is used better. Indeed, the use of weightings seems to be more beneficial, reflecting the importance of certain governance areas in the light of “public accountability and transparency” [Mostafa, (2012), p.11]. Conversely, Sarkar et al. (2012) argued that equal weightings have the advantage of avoiding complexity and bias as all attributes are treated equally. Both the selection of attributes and the choice of weightings could therefore hinder CGI comparability between countries and companies (Khiari et al., 2007).

Nonetheless, an appropriate CGI benchmark should be constructed for a selected number of companies through various information sources (Mostafa, 2012). This should be a guide for companies to target for and operate around (Khanchel, 2007). Typically, benchmark information would be that publicly available, mainly from annual reports, company websites, stock exchanges, press releases and company prospectuses (Barrett et al., 2004; Grimminger and Di Benedetta, 2013). The advantage of using such information was more transparency and comparability among entities as in view of its easier verifiability (Spanos et al., 2006). In contrast, Ramlal (2009) highlighted those studies using surveys with company personnel as a source of information. Indeed, Hodgson et al. (2011) found that both questionnaires and public information were in use. However, according to Ananchotikul (2008), the survey method on its own is unreliable as there is a higher risk of having biased or poor responses.
As for presentation, the CGI is either a percentage score – with 100% indicating sublime governance practice (Strenger, 2004) – or in a ranking scale ranging between ‘X’ and ‘Y’ representing very poor and excellent governance performance in their extremes. As for location of disclosure, Mostafa (2012) stated that the Annual Report should be the ideal place because it was the most suitable medium to contain all relevant information in one place – rendering its use highly reliable.

However, some prefer to disclose only up to a certain level of detail regarding CGI criteria and methodologies used (Grimminger and Di Benedetta, 2013). Moreover, it was found that when the index criteria and methodology are disclosed by the rating provider, accessibility was very limited. Companies were also found to avoid disclosing low rating scores in order to avoid a bad press (Brown, 2004). Such avoidance was found to affect the degree of usage of the CGI (Strenger, 2004). The more information is disclosed, the more meaning could be attained from the CGI (Grimminger and Di Benedetta, 2013).

2.4 The perception and influence of a CGI

A CGI affects the way directors and stakeholders look at CG. On the one hand, if it indicates problems, such an index will quickly lead to director action (Hermanson, 2004), and so it incentivises them to perform better (Khanchel, 2007), making the organisation more attractive (Daines et al., 2010). On the other hand, a CGI promotes transparency and stakeholder awareness about the expected director performance (Hermanson, 2004), enhancing confidence that “the business is well managed and will continue to be profitable” [Mallin, (2004), p.1]. Consequently, an index would be convenient for investors in picking the best governed entities (Sarkar et al., 2012), helping in manoeuvring investment decisions in promising markets, and avoiding high risk companies (Grimminger and Di Benedetta, 2013; Khanchel, 2007).

Durnev and Kim (2005) verified that company valuation is sensitive to its CGI: companies that achieved a higher governance score tended to be valued higher, particularly in large dynamic markets or in those with a poor legal framework. A slight increase in the CGI score would reflect into a short-run positive share price effect (Durnev and Kim, 2005; Walker, 2013). Additionally, within a weak legal system, there is more investor appreciation of the CGI as clearly not everyone would be on equal footing and a higher CGI would possibly enable better access to capital and growth opportunities (Grimminger and Di Benedetta, 2013).

Yet, a company’s CGI should not be used on its own but complemented by other factors, including the verification of the corporate strengths and weaknesses to help it develop the ideal network within which to operate (Khanchel, 2007). Additionally, Sarkar et al. (2012) claimed that the market should be left alone in dictating the pace for companies to carry out governance improvements at the appropriate time, this implying that a CGI should not be legally imposed.

3 Method

As stated earlier, the main objectives of this paper are to construct a CGI for Malta and to establish the extent to which, if in any way, our CGI is suitable and applicable to MLEs. The MLEs targeted were 21 and included only those entities capable of issuing share capital on the stock exchange and hence those entities that provided only debt securities
were excluded. The major Maltese financial services firms involved in dealing and advising on local securities were approached to give their views on the subject.

Empirical data came from three sources: semi-structured interviews, the Annual Reports of listed companies and the CGI survey. For the semi-structured interviews, we targeted all 21 MLEs but eight of them did not grant us permission to interview one member of the Board of Directors (the Board), resulting in 13 interviews. Similar interviews were also conducted with seven financial advisors/analysts in different financial services firms in Malta. The questionnaire comprised six sections and 25 questions; Section 1 focused on the needs and attitudes towards CG measurements, Section 2 on the CGI provider and assessor, Section 3 on the CGI model, Section 4 on the CGI presentation and disclosure, Section 5 on the impact of the CGI and Section 6 on concluding considerations. This source was chosen as it provided more opportunities for flexible and informal interactions and probing was used to provide more detailed explanations in the responses. The second source was the 2011–2013 Annual Reports, where we conducted an analysis of the 13 MLEs, including online company data of the MSE listed entities, with specific reference to the ‘CG Statement of Compliance’. This information was necessary to test current adherence to the Code. The 2013 Annual Reports were also used for both the construction of the CGI benchmark and CGI test. Finally, the third source involved a CGI survey that required MLE representatives (MLE reps) to react to 33 CG attributes in the four selected areas.

The data recording and analysis consisted of first transcribing and summarising each interview. For the selection of attributes, a reduction process identified by Mostafa (2012) was used as to verify their importance. This consisted of an ascending rating scale of 1 to 3 where ‘1’ represented low importance, ‘2’ fair importance and ‘3’ high importance. Then the data obtained through Annual Reports and CGI survey was analysed through the use of ‘retained measures’ being: numerical measurements (absolute or percentage numbers 0–100); ‘yes’ or ‘no’ measurements (1 = positive, 0.5 = both and 0 = negative); and Likert-type measurements ranging from 1 = lowest to 10 = highest.

For setting the CGI benchmark, measures of central tendency (median) and spread (minimum and maximum) were calculated for each attribute. The median attribute scores were then normalised using the following formula: (median – minimum) / (maximum – minimum), thus bring the resulting scores between 0 and 1. Furthermore, CG area weightings were applied to the total attribute score of each area by the multiplication of the average applicable CGI weightings for Malta as found in Appendix A. This contributed to a weighted sub-index for each CG area. The CGI final benchmark score for each MLE was then determined by adding all the weighted sub-indices to attain a final CGI of 100%. The CGI as compiled above was applied for Company X (CoX) and Company Y (CoY) using the actual company data for 2013, then compared with the CGI benchmark to determine the CG position of each company.

4 Findings and discussion

4.1 Needs and attitudes towards CG measures in Malta

The analysis revealed different views between MLE reps and analysts towards CG practices. MLE reps foresaw no added benefit in such reporting - they may be adhering to the Code simply because they are forced to do so by the listing rules. Reconfirming this
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was the lack of detail and soundness of certain non-compliance explanations observed in the CG Statement of Compliance of the participating 13 MLEs. These mainly related to shareholder conflicts, the absence of the Nominations Committee and the lack of board performance evaluation. On the contrary, analysts found proper CG reporting as an indication of better accountability and transparency, highlighting the impending need to address the several CG defaults of MLEs. These included the lack of transparency of board members, a lack of communication on board meeting outcomes and conflicts of interest.

MLE rep attitude therefore indicated resistance to CG progress. Going for better disclosures was not a priority for nine of them, who referred to the need for simpler statements or for competition issues as the grounds for their stance. Nonetheless, both groups declared that they were not against a CGI as such as they saw it as an opportunity to improve CG. The main concern of MLE reps was that the effectiveness of such a CGI could be easily hampered by the inadequate size of the Maltese Stock Exchange, with companies in varying industries, this implying that no standard CGI could be suitable to all companies. Moreover, three MLE reps pointed out that, prior to CGI application, the market needed to be made aware and knowledgeable about the index, particularly because stakeholder acceptance to it was as yet questionable. Some MLE reps also feared that a CGI might be overrated by their investors, to the detriment of other factors such as future financial prospects.

Respondents indicated the need for the CGI to be constructed in Malta but to be modelled on international practices. In this respect, 7 MLE reps and all analysts believed that Malta should opt for an index which has already been tried and tested abroad, but tweaked to fit the Maltese environment.

4.2 The CGI provider and assessor in Malta

The MFSA, as regulator, was seen as the body best placed to be involved in the different steps of the CGI implementation: for constructing or appointing the body responsible for constructing, and also for assessing the index. Two financial analysts pointed out that, as a body already experienced in the local sector, the MFSA would not only fit such a role but also be cost efficient; also that for such a structure to succeed, it is to be composed of separate in-house committees or segregated departments within the MFSA, each being independently responsible for the different CGI stages so as to keep each stage autonomous. However, most interviewees indicated the need to consider also the alternative of appointing a private CGI provider, subject to the continuous monitoring of the regulator. A dilemma in fact remained as to whether to opt for a foreign credit-rating agency rather than the MFSA in the provision and assessment of the CGI. While credit-rating agencies may be more reputable in providing rating, the MFSA benefits from its specialised expertise in CG. Three analysts emphasised that the assessor needed to be free from any fear of potential liability resulting from any consequent adverse effect on company share performance, and that, as a government agency, the MFSA would therefore be stronger for this function. Additionally, three other financial analysts referred to the possible risk of manipulation in the case of a foreign-rating agency being appointed: other rating agencies may try to enter the market to compete, with fees being possibly manipulated for the sake of client engagement.
Furthermore, six MLE representatives and one analyst favoured the possibility of making the CGI a self-assessment exercise as is done with the current Statement of Compliance. However, with self-assessment, both real and apparent independence are threatened unless this exercise is also reliably reviewed. Indeed, index review is considered by respondents to be beneficial in any case, even if the MFSA is chosen to perform the functions of the CGI: in the latter situation, the dilemma only remains whether one should opt for the statutory auditor or else for another reviewer, perhaps a CG specialist.

However, independently of which bodies are ultimately involved, the MFSA as regulator is to remain a watchdog over the entire CGI framework as this will facilitate any required sanctions for misconduct.

4.3 The Maltese CGI playing field

The code could be the departing point of the CGI. If this option is taken up, initial costs are minimised. Yet, respondents preferred a CGI to be based on an international model like the OECD code as this is a more comprehensive model benefitting from a harmonised CGI – one capable of including most international developments and minimising the number of unaddressed issues. Nonetheless, index modifications were still considered necessary in order to make the CGI more flexible to meet current changes. Yet, those opting for the adoption of a Maltese code pointed out that such adjustments may be costly and confusing to the local market.

The next step in construction concerns the selection of governance areas and attributes. Such selection was left to the respondents and it emerged that the four most important CG areas to be included in the CGI for Malta were: board of director structure, transparency and disclosure, audit committee and process, and shareholder rights. With respect to such areas, the respective attributes were then selected with the aid of the ascending 1-to-3 rating scale referred to earlier. The least-rated attributes were then eliminated so that that only 65% of the original ones were retained. Appendix B lists these selected attributes under the respective governance area. Thus, with the inclusion of four governance areas and the limited number of attributes in each area, the CGI was meant to be easier to adopt. Governance areas were also weighted according to respondent preferences (Appendix A) so that the relative importance of each selected area would be taken into account. However, in order to retain index simplicity, the selected attributes were retained with equal weighting (Sarkar et al., 2012).

Some interviewees (two MLE reps and one analyst) highlighted that most information should be obtained from the public domain for the sake of transparency, thus also facilitating its verification. Accordingly, wherever possible, in the construction of the CGI benchmark for MLEs from derived sources, referencing was only made to non-public information when such information was not available. Yet, using such mixed sources of information had its clear advantages, providing the necessary insights and explanations.

The relevance of the CGI probably depends mostly on the CGI benchmark. The mathematical reliability of such a benchmark and its capacity to distinguish between acceptable and unacceptable practices are crucial. In this case, simple descriptive statistics was used based on three types of retained measures, as already referred to in Section 3. The absolute benchmark and the normalised benchmark figures are shown near each attribute in Appendix B. Each normalised attribute was assigned a score of ‘1’ reflecting
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best practice that is expected from each attribute. In this respect, an argument relates to
the relevance of the average benchmark figures in reflecting best practice. The average
may be a clear pointer to the norms in those particular attributes, though not necessarily
to best practice. However, the law may allow a different value to the attribute. A relevant
example here is the “time to file financial statements with the regulatory body”. The law
(MFSA, 2013) allows 120 days as maximum while the benchmark being adopted is 87
days. Probably, the law is materially out of sync with current practice rather than the
benchmarks not being in themselves best practice.

4.4 The CGI preview

Most respondents (9 MLE reps and 7 analysts) were in favour of the disclosure of a
sub-index score for each CG area. This was found to contribute to the support of the final
CGI result by the specification of the different areas. Final scores in isolation may easily
be misleading and will make sense provided that investors do actually note sub-index
scores. Furthermore, CGI users are probably not so sensitive to the type of CGI scores
selected – whether a percentage or a scale – as, irrespective of the type, the major
question remains whether such scores are high or low. Response was in fact inconclusive
in this regard. Therefore, while percentage scores were adopted in this study, the parties
involved with the CGI might still need to delve more into the matter.

CGI criteria and methodology were found to depend on the market size, the market
need for this information and the scope of the CGI itself. Six MLE reps and six analysts
agreed to disclose both CGI criteria and methodology as this may help improve CGI
analysis. Yet, as two MLE reps emphasised, when taking into account the size of the
Maltese market, it may be unnecessary for MLEs to disclose the CGI methodology as this
would probably be common to all listed companies. Nonetheless, this possibility may not
eliminate particular disclosures owing to, say, changes in the size and nature of
companies.

Regarding CGI access, respondents agreed that a CGI should be publicly disclosed
given that such companies are PIEs and most information sources are public. Yet, it is
shareholders and their analysts who are probably most interested in the CGI. This clearly
makes the Annual Report a possible medium in which CGI results are disclosed, with the
advantage of information being easily retrievable. However, the online disclosure of the
CGI on its own or in an alternative location was also agreed to so as to attract more
attention to it. Moreover, most respondents (9 MLE reps and 6 analysts) were after a
compulsory CGI so as to ensure universal MLE adoption.

4.5 The possible CGI influences in Malta

With the exception of one MLE rep, all respondents agreed that the CGI would leave
great impact on the CG Statement of compliance as it will boost shareholder interest in it.
Yet, the CGI remains mostly relevant for the majority shareholders, who are probably
following developments in this area in any case. Moreover, the CGI was seen to be
positively correlated with both company reputation and gearing. Better CGI scores are
seen as an indication of good directorship, rendering suppliers of capital increasingly
confident in doing business with an MLE. Regarding the CGI impact on MLE share
prices, most respondents commented that the CGI level reflects investment
soundness – thus affecting share price changes and probably also the cost of capital.
However, two analysts claimed that such price impact is not that possible in Malta given the slow trading activity in most listed shares.

Yet, irrespective of such impacts, 10 MLE reps agreed that cost would be a major issue for MLEs in adopting the CGI. They already have enough compliance obligations, and the CGI obligations may be seen as comparable to those of another audit. Conversely, the others argued that costs will not be an issue if the CGI is simple and compliance to it remains very similar to that of the Maltese Code. Nonetheless, doubt clearly lingered, particularly among most MLE’s, as to whether it was worthwhile investing in a CGI involving new compliance costs.

Furthermore, as for index applicability, analysts indicated that the CGI could prove to be useful also to entities listing in debt securities only. At a later stage, one may therefore consider introducing the CGI for adoption by such companies.

4.6 CGI test application on two MLEs

The CGI was then tested on two approximately equally-sized listed companies within the same industry. Table C1 in Appendix C illustrates such testing on two MLEs with respect to the Board Structure area.

The following summarises the results found per area.

4.6.1 Board structure index

Both companies were rewarded with benchmark scores for separating the roles of the Chairman and CEO. However, none received any scores as the CEOs and the Chairpersons served on other boards.

For the other attributes in this area, different scores were attained. In both companies, Board size composition exceeded the benchmark and as a result the CGI gave an excess credit. Company Y (CoY) was abiding with the accepted mix of directors and achieved the benchmark scores. However, Company X (CoX) was entirely composed of non-executive directors. For this attribute, the CGI awarded CoX a score greater than ‘1’, reflecting the incentive to have a totally independent board. Furthermore, both companies were penalised for the lack of directors’ experience – in both cases it below the benchmark (six and ten years respectively).

More significant differences were observed in the number of board meetings and the percentage attendance. CoX was rewarded for holding 24 meetings while CoY was penalised for holding only four meetings. Moreover, CoX board members attended 79% of such meetings whereas CoY’s registered attendance stood at 92%, results indicating that both companies needed improvement.

4.6.2 Transparency and disclosure index

Full benchmark scores were assigned to both entities in disclosing proper accounting standards and policies, in presenting remuneration disclosures including a remuneration report and for handling sensitive information. Conversely, no scores were received by either company as they did not permit shareholder access to company records.

The CGI of both companies was inflated by their disclosure efficiency, tested through the time they usually take (120 days each) to file financial statements with the regulator.
CoY was assigned full benchmark scores for sufficiently disclosing non-financial information and for the frequent update of its website. On the other hand, CoX received a lower score as it was less forthcoming about such disclosures and updating its website. Furthermore, CoY was disclosing performance benchmarks together with trends and targets to stakeholders, while CoX was not doing so. As a result, CoY was accredited with twice the score of CoX, the sub-index indicating that CoY was stronger in its transparency and disclosures.

4.6.3 Audit committee and process index

The structure of the both audit committees was as required by the listing rules (MFSA, 2013), consisting of three members, all non-executive directors. Such Audit Committee members attended all 2013 meetings. Moreover, the audit reports of both companies in the previous 10 years were unqualified and both had an internal auditor. For such attributes, both companies received the benchmark scores. However, they had not performed auditor rotation in the previous ten years and therefore lost the relevant scores. They also lost further scores for engaging the statutory auditor for non-audit services.

CoY received the benchmark scores for conducting the monthly monitoring and review of internal procedures, while CoX was awarded twice the standard credits for performing such functions twice monthly. Furthermore, CoY determined the life span of an Audit Committee cycle which was that of one year. CoX did not establish this and was therefore not awarded with any score for such attribute. As for Audit Committee meetings, CoX had held nine meetings as against the four meetings held by CoY. This was the main attribute that inflated this sub-index for CoX.

4.6.4 Shareholder rights index

Both entities achieved almost similar sub-index results in this area where most attributes received full scores. Indeed, both companies attained benchmark scores for four attributes, namely: “Adoption of the one-share-one-vote principle”, “AGM shareholder attending records kept”, “dividend policy in place and disclosed” and “proxy arrangements in place and disclosed”. Moreover, unlike CoX, CoY also gained the full scores by having an Internal Shareholder Representative. Differences from the benchmark were noted in the other attributes. Both entities notify shareholders 21 days before an AGM in accordance with the law. Moreover, shareholders may call an AGM if they possess a 10% threshold, which is lower than the 19% legally required. Both companies varied in their scores from the benchmark for these two attributes.

These results were then weighted with the average applicable CGI weightings presented in Appendix B to achieve the sub-index results which ultimately contributed to the final CGIs. Such CGIs were of 91.87% for CoX and 80.12% for CoY (see Table C2 in Appendix C). CoX outperforms CoY in the Board Structure and Audit Committee and Process, while CoY outperforms CoX in Transparency and Disclosure and Shareholder Rights. Thus, the CGI user may not only conclude that, as per the overall index, CoX is somewhat superior to CoY in CGI practice, but perhaps even more significantly that, as per the sub-indices, while CoX tends to be more compliance-oriented, CoY tends to be more shareholder-oriented.
4.7 CGI benefits and limitations

The following benefits and limitations of adopting a CGI in Malta emerged:

4.7.1 Benefits

One benefit is that the CGI challenges the Board towards improving CG practices. In this connection, four MLE reps noted that this challenge would probably lead to enhanced Boardroom professionalism. Furthermore, with the CGI, directors will probably become more accountable to the annual general meeting. More transparency and responsiveness to shareholder queries will be expected, this rendering the general meetings more meaningful, with proceedings going seriously beyond bottom-line figures. In other words, the CGI could help minimise the prevailing asymmetry of information in this fundamental principal/agent relationship. Additionally, the CGI is cost-beneficial. Its construction exercise is simple enough, and also relatively inexpensive. Furthermore, quantifying a CG deficiency against a benchmark renders it easier and quicker to notice, monitor and correct.

4.7.2 Limitations

A limitation in the application of the CGI, as pointed out by three analysts, is the attitude towards change in Maltese businesses: given their small-island state culture, businesses have a strong tendency to resist change at initiation stage. In referring to the resistance to change with respect to CG, Baldacchino (2011) highlighted the ‘cold-hot phenomenon’, a stronger resistance at initiation stage though a much weaker resistance at later stages. Resistance may be even more pronounced in this case of a new measure to be presented to an already overcrowded regulatory regime. In applying CGI, another issue which may arise when companies differ in size and industry is that such companies may have different needs. The proposed CGI benchmarks assume that companies are circa the same size and industry and such benchmarks are somewhat ineffective if this is not so. This implies that these benchmarks are most reliable either in intrafirm comparisons or limitedly in interfirm comparisons with companies of the same size and industry.

A further limitation relates to the relevance of the selected attributes and the weightings being applied. The perceptions of what is important may change both by person and over time and are often difficult to substantiate objectively. This leads to a somewhat subjective selection where certain companies may be judged on not-so-relevant attributes, with more useful others being ignored. Related to this, the interpretation of CGI scores may easily be misleading. A higher score may reflect superlative practice in that attribute, meaning extra credits for the company. Yet, excessive attribute scores may not necessarily reflect proper practices. Indeed, companies may be tempted to improve their index position by overdoing in attributes which do not result in extra corporate benefits and even to the detriment of significant priorities. This might actually result in a disservice to CGI users. Moreover, index reliability is hard to check if the score is based on information that is not all publicly available. The less transparency in the information being transmitted, the greater will be the possibility of manipulation, particularly by those responsible for the CG of the company, themselves already used to the mechanics of the index.
5 Conclusions

The findings of this study suggest that a simple and cost-effective CGI may be implemented that is suitable and applicable for MLEs. The need for simplicity calls for few yet highly significant areas and attributes, relevant area weightings and an unsophisticated but reliable mathematical model as a benchmark. In addition, for the CGI to be cost effective, its provider and assessor will probably best be a centralised and experienced body such as the MFSA, provided that proper safeguards are taken for the complete segregation of CGI provision and assessment even within the same body and for the MLE assessments to be reviewed by a specialist in CG. Such CGI is an initiative towards higher director accountability. Yet, before its introduction, a promotion drive needs to be undertaken to increase shareholder CG awareness, possibly led by the financial services regulator itself so as to minimise market misinterpretations and counter the expected initial resistance. Additionally, the following recommendations need to be considered to consolidate the adoption of such as CGI:

- **Developing a menu of CGIs applicable to entities both listing in equity and debt securities**: the one-size-fits-all assumption is to be ultimately addressed by having industry-specific CGIs possibly taking into account also the varying sizes and complexities of companies. This could be achieved by having a menu of CGI standards based on the same structure but containing different measurement criteria in line with the characteristics of specific companies. The scope of the CGI can be further enlarged in the future by including also entities listing only in debt securities. As more companies adopt CGIs, their use becomes increasingly useful for comparative purposes.

- **Adopting the code of good corporate governance as a basis for the CGI**: by adopting the Code as the basis of best current CG practices, the CGI benchmark for score rewards and penalties may be quickly understood and become more easily acceptable to all parties.

- **Tying up CGI benchmarking to the regulatory framework**: the CGI benchmark needs to be kept in line with the regulatory framework. Regular revisions to both will be essential in order to ensure that they remain appropriately consistent with each other, thus preventing any unnecessary confusion.

- **Incentivising the market to adopt the CGI by promoting more CG awareness and education**: MLE stakeholders need to be made more aware of CG issues. Therefore, the relevant bodies have to work harder on the education of market players to render them more knowledgeable of CG developments.

Following this study, further research could examine the CGI from the shareholders’ perspective in order to extract their needs and preferences in the construction of the Index. Given that this study highlights the possibility of making the CGI a self-assessment exercise, it would be also relevant to investigate the feasibility of such an option. Finally, a related interesting area relates to the CGI review. While this has already been somewhat referred to earlier, further research may, for example, help to identify and assess the nature and role of the reviewers suitable for such an exercise.
To conclude, we believe that the CGI is a significant CG practice that, once introduced, calls for continuous attention and reflection as it may easily become a powerful means for aligning corporate stakeholders towards a major common goal; that of improving the CG performance of the company.

References


Assessing the applicability of a corporate governance index in Maltese


ISS (2014) ISS Governance Quick Score 2.0. Overview and Updates, Institutional Shareholder Services Inc., USA.


Standard and Poor’s (2004) Standard & Poor’s Corporate Governance Scores and Evaluations; Criteria, Methodology and Definitions, Standard & Poor’s Governance Services, New York, USA.


Appendix A

Table A1 shows the relative CGI reapportioned weightings in four CG areas across each type of respondent and overall. Such weightings were based on the proportion of ticks for each area after eliminating the three least weighted areas.

<table>
<thead>
<tr>
<th>Respondents</th>
<th>Structure of board of directors</th>
<th>Transparency and disclosure</th>
<th>Audit committee and audit process</th>
<th>Shareholder rights</th>
</tr>
</thead>
<tbody>
<tr>
<td>MLEs</td>
<td>28.31%</td>
<td>23.66%</td>
<td>27.30%</td>
<td>20.73%</td>
</tr>
<tr>
<td>Financial analysts</td>
<td>28.13%</td>
<td>28.95%</td>
<td>21.97%</td>
<td>20.95%</td>
</tr>
<tr>
<td>Average applicable CGI weighting</td>
<td>28.22%</td>
<td>26.31%</td>
<td>24.64%</td>
<td>20.84%</td>
</tr>
</tbody>
</table>

Appendix B

Tables B1 to B4 list the attributes selected under each corresponding governance area. For benchmark calculations, the following steps were used:

a. data was collected from annual reports of MLEs and interviews
b. attributes were quantified
c. descriptive statistics comprising the median, minimum and maximum scores were computed
d. the median was used as the attribute benchmark
e. the median attribute score was normalised using the following formula: 
   \[
   \frac{\text{median} - \text{minimum}}{\text{maximum} - \text{minimum}}.
   \]

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Benchmark scores</th>
<th>Normalised benchmark</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board size</td>
<td>7</td>
<td>0.50</td>
</tr>
<tr>
<td>Percentage of non-executive directors on board</td>
<td>80</td>
<td>0.60</td>
</tr>
<tr>
<td>Number of board meetings held annually</td>
<td>9</td>
<td>0.24</td>
</tr>
<tr>
<td>Percentage of board meetings attended by non-executive directors</td>
<td>100</td>
<td>1.00</td>
</tr>
<tr>
<td>Average years of experience as directors at this or in another company</td>
<td>15</td>
<td>0.47</td>
</tr>
<tr>
<td>Avoidance of Chairman and CEO duality</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Chairman and/or CEO not serving on another board</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Attributes</td>
<td>Benchmark scores</td>
<td>Normalised scores</td>
</tr>
<tr>
<td>----------------------------------------------------------------------------</td>
<td>------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td>Sufficient disclosure of accounting standards and policies used</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Time to file financial statements with the regulatory body</td>
<td>87</td>
<td>0.56</td>
</tr>
<tr>
<td>Board remuneration disclosure including Remuneration report</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Disclosure of specific performance benchmarks</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Updated company website</td>
<td>10</td>
<td>1.00</td>
</tr>
<tr>
<td>Sufficient level of non-financial information disclosed</td>
<td>10</td>
<td>1.00</td>
</tr>
<tr>
<td>Access to company records for shareholders</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Procedures for the handling of sensitive information</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Disclosure of trends and targets to stakeholders</td>
<td>1</td>
<td>1.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Benchmark scores</th>
<th>Normalised scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit committee size</td>
<td>3</td>
<td>0.50</td>
</tr>
<tr>
<td>Percentage of non-executive directors on audit committee</td>
<td>90</td>
<td>0.67</td>
</tr>
<tr>
<td>Number of audit committee meetings held annually</td>
<td>5</td>
<td>0.33</td>
</tr>
<tr>
<td>Percentage of audit committee meetings attended by its members</td>
<td>100</td>
<td>1.00</td>
</tr>
<tr>
<td>Life span of an audit committee cycle (in years)</td>
<td>1.6</td>
<td>0.27</td>
</tr>
<tr>
<td>Internal auditor availability</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Non-audit services not currently provided by the current statutory auditor</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Auditor changes in the past ten years</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Annual frequency of monitoring and review of internal procedures</td>
<td>12</td>
<td>0.48</td>
</tr>
<tr>
<td>Unqualified audit opinion in the last ten years</td>
<td>1</td>
<td>1.00</td>
</tr>
</tbody>
</table>
Table B4  The selected attributes for the CGI in MLEs including their benchmark: governance area – shareholder rights

<table>
<thead>
<tr>
<th>Attributes</th>
<th>Benchmark scores</th>
<th>Normalised scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>Availability of shareholder director or officer</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Adoption of the one-share-one-vote principle</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Days of notice before AGM</td>
<td>25</td>
<td>0.15</td>
</tr>
<tr>
<td>AGM shareholder attending records kept</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Dividend policy in place and disclosed</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Proxy arrangements in place and disclosed</td>
<td>1</td>
<td>1.00</td>
</tr>
<tr>
<td>Current threshold of shareholding to call an AGM (%)</td>
<td>19</td>
<td>0.20</td>
</tr>
</tbody>
</table>

Appendix C

Table 1 illustrates the application of part of the CGI model on two MLEs while Table 2 shows the sub-indices and overall CGIs for the two MLEs.

Table C1  Testing the CGI for Company X and Company Y in the one governance area

<table>
<thead>
<tr>
<th>Structure of board of directors</th>
<th>Benchmark</th>
<th>CoX</th>
<th>CoY</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>N  S</td>
<td>ND SS*</td>
<td>ND SS*</td>
</tr>
<tr>
<td>Board size</td>
<td>0.50 1.00</td>
<td>0.83 1.66</td>
<td>0.83 1.66</td>
</tr>
<tr>
<td>Percentage of non-executive directors on board</td>
<td>0.60 1.00</td>
<td>1.00 1.67</td>
<td>0.60 1.00</td>
</tr>
<tr>
<td>Number of board meetings held annually</td>
<td>0.24 1.00</td>
<td>1.00 4.20</td>
<td>0.00 0.00</td>
</tr>
<tr>
<td>Percentage of board meetings attended by non-executive directors</td>
<td>1.00 1.00</td>
<td>0.00 0.00</td>
<td>0.62 0.62</td>
</tr>
<tr>
<td>Average years of experience as directors at this or in another company</td>
<td>0.47 1.00</td>
<td>0.00 0.00</td>
<td>0.21 0.44</td>
</tr>
<tr>
<td>Avoidance of Chairman and CEO duality</td>
<td>1.00 1.00</td>
<td>1.00 1.00</td>
<td>1.00 1.00</td>
</tr>
<tr>
<td>Chairman and/or CEO not serving on another board</td>
<td>1.00 1.00</td>
<td>0.00 0.00</td>
<td>0.00 0.00</td>
</tr>
<tr>
<td>Total score for area</td>
<td>7.00</td>
<td>8.54</td>
<td>4.73</td>
</tr>
<tr>
<td>Total score as a percentage of benchmark</td>
<td>100</td>
<td>121.93</td>
<td>67.57</td>
</tr>
<tr>
<td>Area Weight</td>
<td>28.22</td>
<td>28.22</td>
<td>28.22</td>
</tr>
<tr>
<td>Structure of board sub-index (%)</td>
<td>28.22</td>
<td>34.43</td>
<td>19.07</td>
</tr>
</tbody>
</table>

Notes: N = normalised benchmark, S = score awarded for benchmark; ND = normalised data for company; SS = score awarded to company = ND/N; *some discrepancies are present in decimal numbers as original data were rounded to 2 d.p. to avoid clutter.
## Table C2  Sub-indices and overall CGIs for company X and company Y

<table>
<thead>
<tr>
<th>Sub-index</th>
<th>Benchmark (%)</th>
<th>CoX (%)</th>
<th>CoY (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structure of b</td>
<td>28.22</td>
<td>34.43</td>
<td>19.07</td>
</tr>
<tr>
<td>Transparency and disclosure</td>
<td>26.31</td>
<td>16.46</td>
<td>24.40</td>
</tr>
<tr>
<td>Audit committee and audit process</td>
<td>24.64</td>
<td>26.09</td>
<td>18.79</td>
</tr>
<tr>
<td>Shareholder rights</td>
<td>20.84</td>
<td>14.89</td>
<td>17.86</td>
</tr>
<tr>
<td><strong>Overall</strong></td>
<td><strong>100.00</strong></td>
<td><strong>91.87</strong></td>
<td><strong>80.12</strong></td>
</tr>
</tbody>
</table>