

Chapter 5

Corporate Governance as an Internal Process Objective

by Christian C. Johnson and John K. Thompson

BearingPoint has implemented state-owned enterprise (SOE) restructuring and privatization projects, which often involve corporate governance assessments and improvements, in more than 60 countries.⁴¹ We have consistently found those SOEs that are monitored, controlled, and governed in accordance with international best practices are more successful in terms of profitability and growth. Conversely, we found those enterprises lacking in proper corporate governance practices are more susceptible to poor performance, leakage, and insolvency. In fact, improving corporate governance of SOEs has been a priority in both the Organisation for Economic Co-operation and Development (OECD) and developing countries alike.

Because improving corporate governance has recently become a major policy objective (for both SOEs and non-SOEs) in countries around the world, many countries have adopted Codes of Corporate Governance that specify common standards for corporate behavior that should be followed by all organizations. Early Codes of Corporate Governance were created mainly for companies listed on a country's stock exchange. More recent Codes

⁴¹ BearingPoint (NYSE: BE) is a global management and technology consultancy with 17,000 employees. Its Emerging Markets practice provides management, economic, and technology consulting services to developed and developing economies worldwide. Also, BearingPoint is a trusted advisor to donor institutions and to central, regional, and local governments around the world.

of Corporate Governance were often modeled after the OECD Principles of Corporate Governance, first issued in 1999, and later updated in 2004.

In September 2005, OECD published the OECD Guidelines on Corporate Governance of State Owned Enterprises.⁴² These guidelines were developed based on a growing need among OECD economies for guidance on how to best govern their state-owned organizations, but they have also been embraced by transitional economies as well. Countries are now using the OECD Principles and OECD Guidelines as a baseline for creating country-specific guidance on SOE corporate governance.

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The OECD Guidelines represent the first international benchmark to assist governments in improving the corporate governance of SOEs. These Guidelines can be used to help governments evaluate and improve the way they carry out their ownership function. The OECD Guidelines address the State as an owner, and represent what OECD governments agree are the core elements of good corporate governance practice for SOEs. In short, they provide standards and good practices for corporate governance, as well as guidance on implementation. The OECD Guidelines can also be used by individual countries to design country-specific Codes of Corporate Governance for SOEs with adaptation to the specific circumstances of an individual country or region.

Some examples of countries that are specifying Guidelines or Principles of their SOEs: India proposed the Principles of Corporate Governance for Public Enterprises in 2001, and South Africa released an updated Protocol on Corporate Governance in the Public Sector in 2002. In Indonesia, the Ministry of State Owned Enterprises has a core mission to reform SOEs based on Good Corporate Governance Principles. Egypt in June 2006 published a Code of Corporate Governance for the Public Enterprise Sector (after publishing a Code of Corporate Governance for corporations in 2005).

Development of such Codes and Guidelines are useful in focusing governments on the importance of corporate governance

⁴² Available online in English, French, and Polish at www.oecd.org.

for SOEs. Such focus is especially important given the following challenges that are unique to state-owned institutions:

- Ensuring SOEs operate on a level-playing field with the private sector
- Reinforcing the ownership function within the state administration
- Improving transparency of SOEs' objectives and performance
- Strengthening and empowering SOE boards
- Providing equitable treatment of minority shareholders in SOEs with multiple shareholders

However, many of the principles and guidelines in these documents are, for the most part, voluntary. (We note some provisions in the country-specific principles and codes are based on a country's company law and are, thus, required.) In other words, unless an SOE Code of Corporate Governance is specifically enshrined within a law or regulation, an SOE will not be required to meet the entirety of the standard, code, or guideline.

Also, while guidelines, standards, and codes of corporate governance are now in place in many countries, what has not been adequately addressed is how to hold enterprises (and especially SOEs) accountable for meeting the corporate governance provisions of these guidelines, codes, or standards. We have found that developing a straightforward, simple, country-specific corporate governance rating system is particularly useful in educating government leaders and SOE executives about the extent to which an individual SOE has adopted corporate governance best practices.

For this reason, we suggest governments consider the following steps to improve the corporate governance of their SOE sector:

- (1) If SOEs comprise a large segment of a country's economy, create a working group to review the country's SOE Governance policy and to consider drafting a Country Code of Corporate Governance for SOEs.

While guidelines, standards, and codes of corporate governance are now in place in many countries, what has not been adequately addressed is how to hold enterprises (and especially SOEs) accountable for meeting the corporate governance provisions of these guidelines, codes, and standards

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(2) Once a country's SOE Governance Policy is drafted (either via an SOE Code of Corporate Governance or similar SOE Governance Policy Statement), the same working group can work to create a country-specific corporate governance rating index (CGRI) for their SOEs. A CGRI is a simple index that helps enterprise managers and stakeholders understand how fully an SOE has adopted modern corporate governance principles and country-specific corporate governance requirements.

Governments should be aware that international funding organizations may be able to provide technical assistance when taking these two steps. (It is possible for a government to create an SOE CGRI prior to issuing a formal Country SOE Code of Corporate Governance. However, creating an SOE CGRI is a much easier and more straightforward task if the SOE Code of Corporate Governance Standard is used as the baseline requirement.)

Not all countries will necessarily benefit from the creation of an SOE Code of Corporate Governance or even an SOE CGRI. For instance, a country that has few SOEs will see fewer benefits from such a SOE Code of Corporate Governance or SOE Policy Statement. Conversely, a country with large numbers of SOEs that drive segments of the economy will likely see greater benefits. However, since many transition and emerging economies tend to have large SOE sectors, these countries are the ones that stand to benefit most from implementing the above steps.

Before we explore the concept of an SOE CGRI for a particular country, it is useful to review corporate governance rating systems in use today. The following corporate governance rating systems are generally used to rate corporate governance globally—rather than in one particular country. In other words, the systems use a very high (stringent) benchmark of corporate governance that is expected from western institutional investors. These systems measure a company on how it rates according to this stringent international standard. Later, we will examine how a country-specific SOE CGRI can be developed to rate SOEs on how well they meet local standards of corporate governance.

CORPORATE GOVERNANCE RATING SYSTEMS

During the 1990s, major institutional investors from the largest markets increasingly sought to diversify their portfolios by investing in foreign companies. As the demands and needs of investors grew, a more detailed and focused analysis was needed. Thus, analysts began rating individual companies on their corporate governance practices, rather than the corporate governance systems of entire countries. Consequently, today there are more than a dozen different rating systems used throughout the world. The largest and most widely used corporate governance rating systems are summarized below.

Table 6: Global Corporate Governance Rating Systems (Summary)

Corporate Governance Rating System	Coverage (number of companies)	First Report Issued In	Categories	Variables
The Corporate Library (TCL)	1,750 (US)	2000	7	> 1,100
Intl Shareholder Services CGQ	7,500 (US & Intl)	2001	8	61
Governance Metrics International	1,625 (Intl)	2002	7	600
S&P	Europe & US	1998	4	~100
Deutsche Bank	DJ EuroStoxx 50	2002	5	Undisclosed
Deminor Ratings	300+ (Europe)	1998	4	300

Source: Author (Johnson)

Table 7: Global Corporate Governance Rating Systems (Overview)

Corporate Governance Rating System	Rating Score (Good to Poor)	Cost
The Corporate Library (TCL)	A to F	Up to \$1,200/year subscription
Intl Shareholder Services CGQ	100 to 0	Up to \$17,000/rating
Governance Metrics International	10 to 1	Up to \$50,000/year subscription
S&P	10 to 1	Up to \$200,000/rating
Deutsche Bank	50 to 1	Free (Annual Ranking of 50 companies)
Deminor Ratings	10 to 1	Not Disclosed

Source: Author (Johnson)

Some of the above rating systems are based solely on quantitative scoring analysis while others provide qualitative judgments. Some corporate governance scoring systems are used and paid for by the company being reviewed while others are used and paid for by outside interested parties, especially investors.

Some systems require the active cooperation of the company being rated, but others do not. Some scoring systems publicly disclose a company's corporate governance score, while others are available only to those who purchase the scores.

The contents of the various scoring systems vary, partially due to the needs of the particular rating system's target audience.

The Standard & Poor's (S&P) Corporate Governance rating system was one of the first corporate governance rating systems to be created. The S&P System rates corporate governance according to four broad categories and assigns a score between 0 and 100.

S&P has developed three products in corporate governance assessment. The Corporate Governance Score, as the name implies, assesses companies' corporate governance performance for investors. The Corporate Governance Evaluation Service confidentially diagnoses corporate governance for companies. The Corporate Governance Customized Research tailors research for investors, companies, regulators, or other organizations.

The Corporate Governance Evaluation Service enables the company being rated to use the S&P score as a means to assess its own corporate governance practices and to identify areas for improvement and reform. (Often, this product is purchased prior to the purchase of a Corporate Governance Score.) Also, S&P rates companies at a single point in time rather than on an ongoing basis.

To determine a company's Corporate Governance Score, S&P analysts visit the executives and members of the Board of Directors of each rated company. S&P also forms a "rating team" to assess a company's corporate governance. Due to its high labor and analysis content, a single S&P corporate governance report can cost a corporation as much as \$200,000.

The Institutional Shareholder Service (ISS) rates a company's corporate governance practices by issuing a Corporate Governance Quotient (CGQ), a score between 0 and 100. The CGQ is established by analyzing eight broad categories related to corporate governance. Initially, ISS only rated companies in the United States. However, ISS now rates companies outside the United States. Thus, the ISS universe of rated companies now includes 2,000 international companies, as well as more than 5,500 US companies.

Governance Metrics International (GMI) rates enterprises using seven categories.⁴³ The GMI rating includes a combination of quantitative factors and qualitative assessments by GMI staff. GMI thus is able to provide subscribers with a narrative explanation of its rating in addition to the quantitative scores. Unlike S&P, which receives its fees from the company being rated, GMI receives fees from subscribers to its services. Most subscribers are investors seeking corporate governance-related information to guide their portfolio selection process. The cost of a subscription to GMI's corporate governance ratings ranges from \$18,000 to \$50,000 per year.

Deminor Rating is the largest European-based corporate governance rating service. *Deminor* clients are institutional investors seeking an opinion on a company's corporate governance practices, as well as individual companies that desire to improve their corporate governance. *Deminor* uses a model that includes more than 300 governance indicators, where each criterion is based on internationally accepted corporate governance guidelines.⁴⁴

Deminor offers two products: (i) Corporate Governance Review and (ii) Corporate Governance Rating. Typically, a company first engages *Deminor* to perform a Corporate Governance Review, which is an internal assessment of a company's corporate governance practices and includes recommendations for improvement. Companies often then engage *Deminor* to provide a Corporate Governance Rating, which includes an investor-friendly report summarizing the corporate governance structures and practices of the rated company. With the rated company's permission, a Corporate Governance Rating and Investor Report is issued to the public.

The Corporate Library (TCL) determines a Board Effectiveness Rating (and provides a grade of A to F) to more than 1,750 US companies. *TCL* rates Board's on their effectiveness and uses this rating as a reflection of a company's strength or weakness in the area

⁴³ See Governance Metrics International's website, www.gmiratings.com, for more information.

⁴⁴ See *Deminor Rating's* website, www.deminorrating.com, for more information.

of corporate governance. The rating is based on TCL analyst reviews of publicly available information (SEC filings, proxy statements, corporate governance policies, and CEO contracts). TCL notes that particular emphasis is placed on CEO pay and CEO influence in the boardroom.⁴⁵

COUNTRY “SOE CORPORATE GOVERNANCE RATING INDEXES”

In order to manage and improve SOE corporate governance, it is necessary to measure it. A logical method for measuring SOE corporate governance—at the country level—is to develop a corporate governance rating index (CGRI). (Recall: “If you can’t measure it, you can’t manage it!”) Such CGRIs are themselves valuable tools for SOE managers, regulators, and government shareholders as they provide a standard measure of how well an individual organization has adopted set standards for corporate governance and how the enterprise measures up with respect to accepted norms of corporate governance.

Also, in the context of the balanced scorecard (BSC), the index score is an extremely useful measure that can be included in the Internal Process Perspective of an organization’s BSC. Finally, used appropriately, the CGRI can be an educational and diagnostic tool for management. In this context, the CGRI can be used to educate management about the different aspects of corporate governance, the legal framework for corporate governance, and reveal areas of corporate governance improvement within each SOE.

In summary, the CGRI has three purposes and uses. First, it is a stand-alone tool to measure how well an SOE performs with respect to local corporate governance provisions. Secondly, the CGRI may be used as an objective and measure in the Internal Process Perspective of an organization’s BSC. And, thirdly, the CGRI is an educational and diagnostic tool for SOE management.

⁴⁵ See The Corporate Library’s website, www.thecorporatelibrary.com, for more information.

As an internal process measure, an SOE would use the CGRI to determine its corporate governance “score.” The CGRI score can be viewed as a proxy for how well the SOE has reformed its corporate governance practices to be aligned with a country’s SOE code of corporate governance and/or international best practice. It is important to note that initial CGRI scores will generally be low, but can rise dramatically as SOE managers implement necessary improvements to their corporate governance. For example, if the system requires the formation of an audit committee, the enterprise raises its score by forming such a committee. The net result is improved CGRI scores and improved SOE governance.

GERMANY’S CORPORATE GOVERNANCE SCORECARD FOR LISTED COMPANIES

While not specific to SOEs, Germany in 2003 developed a useful “DVFA Scorecard for German Corporate Governance” that enables publicly traded corporations in Germany to determine how well they comply with Germany’s Code of Corporate Governance and the OECD Principles of Corporate Governance.⁴⁶ Notably, the German Code contains both “Shall Recommendations” and “Should Recommendations.” And, the German Code follows the “comply or explain principle,” which means that listed companies in Germany have to either comply with the “Shall Recommendations” of the Code or explain in their annual report why they do not comply.

If a German company fulfills all the “Shall Recommendations,” the company will receive a minimum score of 75%. The remaining 25% of a company’s score can be obtained by fulfilling the “Should Recommendations.” The total score cannot exceed 100%. The Scorecard is included as Appendix 2 in this book. It serves as an example of a straightforward tool to enable companies and stakeholders to determine a company’s compliance with German Corporate Governance standards.

⁴⁶ An electronic spreadsheet of the German version of this scorecard is available at www.dvfa.com.

Again, while this German Corporate Governance Scorecard is applicable only to listed companies, the scorecard is a valuable illustration of how a CGRI may be developed to measure compliance with a set of Corporate Governance norms for SOEs.

PRC'S SOE CORPORATE GOVERNANCE RATING INDEX (CGRI)

In 2004, as part of an Asian Development Bank (ADB) Project, BearingPoint designed a CGRI for SOEs in the PRC. The SOE CGRI is designed to be used as (i) a measure for the SASAC BSC, (ii) as a stand-alone index measuring compliance with Chinese and international corporate governance standards, and (iii) an educational and diagnostic tool for educating SOE management about corporate governance.

In seeking to apply international standards in the Chinese context, the CGRI accepted the OECD Principles of Corporate Governance as its starting point. The OECD Principles are the recognized global benchmark for corporate governance. However, the OECD Principles are stated at a broad level so as to be applicable in countries with different historic traditions, legal systems, and institutional structures. The implementation of OECD Principles of Corporate Governance requires elaboration at the national and regional levels by legislators, regulators, stock exchanges, self-regulatory organizations, professional bodies, and individual firms.

BearingPoint designed a CGRI that is a stand-alone index measuring the degree to which SOEs comply with established standards - both International and Chinese. Such standards include (1) the OECD Principles of Corporate Governance (2) other international corporate governance standards and research, and (3) Chinese governance standards, including the PRC Company Law, the "Code of Corporate Governance for Listed Companies"⁴⁷, and

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⁴⁷ Issued by the China Securities and Regulatory Commission on 7 January 2001. Many SOEs are listed on PRC's stock exchanges.

the “PRC Code of Corporate Governance for SOEs.”⁴⁸ The design of the CGRI is, therefore, based on international best practices in the area of corporate governance ratings.

A partial listing of PRC’s laws and regulations affecting corporate governance that were considered by the drafting team is included in Appendix 3. The CGRI is based upon measurable objective criteria, rather than subjective scoring and is expandable and scalable. For example, BearingPoint and SASAC examined implementation of the CGRI on a web-based HyperText Markup Language (HTML) platform. The software design, pilot testing, and implementation of the CGRI was deemed to be a practical and cost-effective mechanism for educating SOE managers about corporate governance and for obtaining periodic CGRI measurements from SOEs.

The Two Scoring Mechanisms of the CGRI in the PRC. Another factor that challenged the project team was that SOEs in the PRC use many different forms of organizational structures. A survey of 2,473 SOEs by the Chinese State Statistics Bureau in 2000 revealed that 2,106 (81.5%) restructured according to the 1993 company law, 713 (35.4%) were restructured into limited liability companies, 700 (34.7%) restructured into Wholly-State Owned Companies, and 603 (29.9%) were transformed into joint stock companies. Some of these companies were organized with operational boards of directors and others were organized with a Director at the apex who did not report to a board of directors. In other words, some of the essential institutional features of an acceptable governance regime were lacking in some SOE structures.

Thus, two separate CGRI-scoring mechanisms were created: one mechanism scores companies that are 100% owned by the Government and the people of the PRC; and a separate mechanism scores SOEs that have multiple shareholders. The main difference between the two systems is that the second index includes a section on the equitable treatment of shareholders.

⁴⁸ The last sentence of paragraph 7 of the TA for this Project made reference to the existence of a PRC Code of Conduct for SOEs. The actual title of this (provisional) regulation is Fundamental Code on the Modern Corporate System Establishment and Management Enhancement of State-owned Large and Medium-sized Enterprises (Provisional) issued on 27 October 2000 by the State Economic and Trade Commission.

Structure of the Chinese CGRI. BearingPoint designed a scoring system to determine the degree to which companies in the PRC are observing corporate governance practices and keeping with internationally accepted standards. In order to do this, five key categories were selected and assigned weights. (The five categories were chosen as they align the CGRI to the OECD Principles of Corporate Governance and other international corporate governance rating systems described above.)

For SOEs that are 100% owned by SASAC, the four categories are (1) Role of the Board of Directors, (2) Transparency and Disclosure, (3) Audit, and (4) Stakeholders and Corporate Citizenship. A fifth category, Equitable Treatment of Shareholders, is included for companies that have multiple shareholders.

Measurements (in the form of questions) were designed for each category. The scores for each measure (question) in each category are added together to provide a component category score. Category scores are then added together to provide an overall score (between 0 and 100) for the company.

Table 8: Structure of Corporate Governance Rating Index

Category	100% Government-Owned Companies (%)	Non-100% Government-Owned Companies (%)
I. Role of the Board of Directors	30	25
II. Transparency and Disclosure	30	25
III. Audit	30	20
IV. Stakeholders and Corporate Citizenship	10	10
V. Equitable Treatment of Shareholders	0	20

Source: Asian Development Bank TA 3933-PRC Project Team

The selected categories and measurement questions are deemed to be the most significant measures of corporate governance in the Chinese context as explained below. The system design is such that companies will receive higher scores if they comply with the most stringent corporate governance requirements in the PRC—those requirements for Joint Stock Companies listed in the Company Law of the PRC and the Code of Conduct on Corporate Governance for Listed Companies in the PRC.

The selection of the specific measurement questions and their weights within each category was, therefore, based upon four considerations: (1) the relevance of each variable to effective governance based on international best practices in corporate governance; (2) actual legal requirements pertaining to corporate governance that now exist in the PRC; (3) relevance to the Chinese situation and SASAC's mission; and (4) the ease with which data can be obtained and compliance can be evaluated.

As shown in the table below, the Chinese SOE CGRI is structured to include 72 discrete measures for 100% SASAC-owned companies and 84 discrete measures of non-100% SASAC-owned companies. (By way of comparison, the corporate governance rating system of ISS uses 61 measures and S&P uses about 100 measures or variables.) A brief summary of each CGRI category is provided below.

Table 9: Measurements in the Chinese SOE CGRI

Category	100% Government-Owned Companies	Non-100% Government-Owned Companies
I. Role of the Board of Directors	22	22
II. Transparency and Disclosure	18	19
III. Audit	24	20
IV. Stakeholders and Corporate Citizenship	8	8
V. Equitable Treatment of All Shareholders	0	15
Total number of measurements (questions)	72	84

CGRI = Corporate Governance Rating Index, SOE = state-owned enterprise.
Source: Asian Development Bank TA 3933-PRC Project Team

BRIEF EXPLANATION OF EACH CATEGORY OF THE CHINESE CGRI⁴⁹

Board of Directors. Measures involving the Board of Directors are critical components of the CGRI. The pivotal role of the board, particularly its role as an independent check on the management, is recognized in the OECD Principles and in virtually all corporate governance codes and standards. It is especially critical in the

⁴⁹ This section is taken from the ADB TA-3933-PRC Project Report. The section was largely drafted by Dr. John Thompson in 2004 while designing the CGRI.

Chinese context because many other institutional safeguards, such as the capital market and the legal system, are not well developed. Thus, the Board of Directors is relied upon to act as the main institutional counterweight to management.

Transparency and Disclosure. Transparency and Disclosure constitutes an important component of the CGRI. The concept underlying this section is that the company should provide its owners, credit rating agencies, and other interested parties with complete and accurate information so they may form an opinion of the true financial state of the company. The specific items that should be disclosed include information that will enable the “owners” (and outside investors in the case of listed companies) to make reasoned decisions about investment in a given company.

Moreover, the measures included in this section are identified in the OECD Principles and have been reaffirmed in a number of national codes. They are also cited by groupings of institutional investors as representing the kind of information investors need to make informed decisions. The measures are combined into three subcategories: (1) Annual Report, (2) Audited Financial Statements, and (3) Corporate Communications.

Audit. Audit is a critical area of importance in all countries, given the importance of the integrity of the disclosure process. The provision of inaccurate information to the market has been an important element in several prominent corporate scandals, such as Enron and Parmalat. As a result, corporate governance analysis conducted since the recent wave of corporate scandals has emphasized the audit process. For example, in a recently released study of best practices in corporate governance sponsored by a group of leading research institutes, corporations, and consultants, the audit process was given expanded coverage in a separate section.⁵⁰ The Sarbanes-Oxley Law in the United States was intended, in part, to respond directly to the shortcomings in corporate governance that surfaced with the Enron and WorldCom cases. This law also gave increased emphasis to the audit process.

⁵⁰ Brancato, C., and Christian. A. Plath. 2003. *Corporate Governance Best Practices: A Blueprint for the post-Enron Era*. The Conference Board. New York.

The CGRI Audit category is structured so that measures fall into four subcategories: (1) Audit Committee Procedures, (2) Audit Committee Structure, (3) Internal Audit, and (4) External Audit.

Stakeholders and Corporate Citizenship. Stakeholders and corporate citizenship are critical elements of corporate governance in all countries. Stakeholders in this context includes individuals, groups, or entities that are likely not owners of the firm, but who either have a significant relationship with the firm or are entities for whom the activities and performance of the firm have important consequences. Some stakeholders may have significant commitments to the company and the company may, in turn, have significant commitments to them. In recognition of the importance of stakeholders and the related concept of “corporate citizenship,” the Stakeholder and Corporate Citizenship category is assigned a moderate weight (10% of the total CGRI) in the scoring system. The design of the CGRI “Stakeholder and Corporate Citizenship” section includes measures in two subcategories: (1) Financial Obligations, and (2) Workplace Safety.

Equitable Treatment of Shareholders. Equitable Treatment of Shareholders applies only to companies that are not completely (100%) owned by SASAC. One of the OECD Principles regarding the rights of investors is that non-controlling shareholders are entitled to equal consideration with other shareholders and that the board and management should not favor one category of shareholders over the others.

Like other categories of the CGRI, the Equitable Treatment of Shareholders category is separated into three subcategories: (1) Annual Meetings, (2) Shareholder Issues, and (3) Shareholder Relations.

Appendix 4 contains the entire Chinese SOE CGRI developed by BearingPoint as applied to non-100% SOEs.⁵¹ Included in the appendix are the questions, scoring, and justification for the measures, along with reference to the various applicable laws, regulations, and international standard.

⁵¹ Dr. John Thompson was the primary contributor of Appendix 4, which was delivered to both the Government of the PRC and ADB as part of the ADB TA 3933-PRC Project.

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The Chinese SOE CGRI should only be used as an example of how a CGRI can be developed and applied to the conditions present in a particular country. In short, the Chinese CGRI was developed based on the concept of applying internationally accepted corporate governance standards within a Chinese context and based on the Chinese legal framework for corporate governance. Thus, it would not be appropriate to take the Chinese CGRI and reformulate it for use in another country. Rather, it is necessary to develop a new, different, and unique CGRI based on the corporate governance laws, regulations, and practices for each particular country.