

CORPORATE GOVERNANCE MECHANISM IN THE CONTEXT OF PORTUGAL

Elisabete Vieira ^{*}, Joaquim Neiva ^{*}

^{*} University of Aveiro, Portugal



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Abstract

Corporate governance is a mechanism to protect investors in the markets around the world. This study analyses the board of directors' specificities in the context of Portuguese corporate governance. The results show that the Latin Model (Two-Tier Model) is the most (least) adopted by Portuguese firms. The percentage of executive members is higher than that of non-executive members. In the year of 2014, women held only 9.5% of positions on board, which is very low. With this study, we contribute to the state of art of Corporate Governance in a country in which investigation is still scarce.

1. INTRODUCTION

The development of securities markets has led to a strong debate on the structure and control of listed companies. This issue is related to Corporate Governance (CG), which is a universal question of achieving mechanisms to protect investors in the international markets.

The genesis of the CG is attributed to Berle and Means (1932), in the consequence of the great crisis of 1929. More recently, considering the effects of economic and financial globalization, the development of capital markets, the evolution of information, the introduction of the Euro, and the financial scandals of some international firms, CG cannot be ignored around the world, as well as in Portugal.

The CG system is the set of principles and rules that the companies must implement in their activity. According to the Organisation for Economic Co-operation and Development (OECD), the CG is a system through which organizations are directed and controlled. It can also be assumed as a model that favours an environment of confidence, ethics and morality, by giving the BD the mission of protecting the interests of shareholders and, at the same time, maximizing the companies' value (Crowther & Sefi, 2011).

The Portuguese Securities Market Commission - Comissão do Mercado de Valores Mobiliários (CMVM), which regulates and supervises the market stock exchange in Portugal, characterizes the CG as a system of rules of conduct regarding the exercise of management and control of shareholders (CMVM, 2013b). According to the Portuguese Corporate Governance Institute - Instituto Português de Corporate Governance (IPCG, 2018), the CG should promote and enhance corporate performance, as well as the capital market, and strengthen the confidence of investors, workers and the public in the quality and transparency of management and oversight, as well as in the sustainable development of societies.

In what regards the Portuguese market, CG issues have a relevant role, since Portugal is a civil-law country, with weak legal protection of investors, a high concentration of shares ownership, and limited information transparency (La Porta et al., 1998). In addition, the crisis in the banking and financial systems, as well as the related consequences in the Portuguese capital market, have raised awareness about the CG issues (Resende, 2017).

The main legal regulations associated with CG in Portugal are the Commercial Companies Code - Código das Sociedades Comerciais (CSC), the CMVM and the IPCG.

The CMVM on CG¹ recommendations focuses on the disclosure of information, the exercise of voting rights and representation rights by shareholders, corporate rules, BD, and institutional investors.

The IPCG code includes principles and recommendations regarding several issues, such as conflicts of interest, related parties' transactions, the role of independent managers, diversity in the composition of corporate bodies, risk management and supervisory functions.

Although the CG issues are important for all the companies, we will focus our analysis on Portuguese firms listed on the Euronext Lisbon.

The rest of the paper is organised as follows. Section 2 presents the legal framework of CG, including the models applied in Portugal. The next section exposes the corporate BD' practices, considering the different types of board members. Finally, Section 4 concludes the study.

¹http://www.cmvm.pt/en/Legislacao/National_legislation/RecCorporate%20Governance/AnexosCG/Pages/fullversion_2005.aspx

2. THE LEGAL FRAMEWORK OF CORPORATE GOVERNANCE

Legal systems are divided into two main groups: civil law and common law. In countries with a civil law tradition, such as Portugal, investor protection is lower, with a negative correlation between ownership concentration and investor protection (La Porta et al., 2008). The Portuguese capital market is not expressive in terms of dimension and has low liquidity, which results in an excessive concentration of ownership and dependence on banking (Costa & Santos, 2011).

Portugal published, in 1999, a set of recommendations, principles and guides through the CMVM (1999). These recommendations were revised several times, being the last version published in 2013 (CMVM, 2013a), which were in force since January 2014 to the end of 2017.

The existence of two regulatory sources of CG (CMVM and IPCG) caused some problems, namely because the Portuguese capital market is narrow in scope (Resende, 2017). Consequently, in October 2017, the two entities established the principles of cooperation between them, and the new CG code of the IPCG came into force in January 2018, replacing the CMVM code. The new code includes principles and recommendations regarding, for example, conflicts of interest, related parties' transactions, and the role of independent managers, diversity in the composition of corporate bodies, risk management and supervisory functions.

The average compliance rate of the CMVM recommendations on CG has improved significantly, increasing from 73% in 2008 to 80% in 2009 (CMVM, 2009). In 2011, the average compliance rate of the CMVM recommendations was 89% (CMVM, 2012). Carvalho (2019) analyse whether Portuguese listed firms apply good practices and recommendations of CG. The author concludes that in 2015 and 2016, Portugal presents a 92% adoption rate of CG recommendations, increasing this percentage to 93%, in 2017.

The CMVM maintains three large responsibilities: i) ensure that companies choose a CG code; ii) ensure that companies make the disclosure of the CG report, and; iii) ensure that the whole comply is in agreement with the requirements of the securities code, this is, the information must be complete, true, up-to-date, clear, objective and lawful. On the other hand, the IPCG must promote, in biennial cycles and with the cooperation of the CMVM, the updates that may prove necessary, in line with the international best practices. The CMVM remains responsible for the "hard law", which implies the sanctioning part, and the IPCG has "soft law", that is, it monitors the recommendations, but without the sanctioning associated.

On December 31, 2017, there were 48 companies under Portuguese law listed on the Euronext Lisbon², compared to 43 on December 31, 2014 (CMVM, 2014)³. According to this report⁴, a singular person or a

² <https://www.bolsadelisboa.com.pt/cotacoes/accoes-lisboa>.

³ In this number, neither the sports corporations (three) admitted to trading on Euronext Lisbon nor Caixa Económica Montepio Geral are included. If the report considers these corporations, the number will be 47.

company controlled at least 50% of the voting rights in 24 of the listed companies. Domain positions ranged from 50.0% to 94.7% and corresponded, on average, to 67.1% of the share capital of these companies and 64.9% of the market capitalization. These figures indicate an approximate free float of 24.3% of share capital and 29.7%, in terms of market capitalization. Nowadays, the scenario of a low number of Portuguese listed firms and a high level of ownership concentration (Vieira, 2018) remain a reality.

2.1. Models of corporate governance

The process of organizational structures of management and supervision varies according to the legal and institutional framework of each country (Rodrigues, 2014). The Portuguese law, CSC, Article 278, allows firms⁵ to choose one of three Corporate Governance Models:

1. BD and a supervisory board⁶: Latin Model⁷;
2. BD, including an audit committee and an auditor⁸: Anglo-Saxon Model;
3. Executive management body, general and supervisory board and officially chartered accountant: Two-Tier Model.

2.1.1. Latin Model

In the Latin Model, a supervisory board and officially chartered accountant, independent from the board, carries out the supervision of the company. The BD is in charge of management, which has authority over all matters related to the management of the company which are not specifically set forth as falling under the competence of the shareholders' meeting. It may also delegate to one or more directors or to an executive committee the day-to-day management of the company. It is a corporate body, so decisions are made in a specific meeting, after analysis, discussion, and voting. For the board to validate a decision, most of its members must be present at the meeting. Resolutions are taken by the majority of the votes of the directors.

According to Resende (2017), this model has the advantage of providing effective control of management decisions, since supervisors have privileged access to information related to the resolutions to be taken by the BD, as well as to the financial situation of companies.

This is the model most adopted by Portuguese listed and unlisted firms (Silva et al., 2006).

⁴ We would like to have more recent information, but the CMVM (2014) report is the most recent one that has been published.

⁵ The shareholders' meeting appoints the several boards.

⁶ Companies may have a board of directors or a sole director, in companies whose share capital does not exceed € 200, 000, and a supervisory body with a sole auditor or a supervisory board.

⁷ The Latin Model is also known as One-tier model. However, in the CSC, in CMVM and other documents, as well as on empirical studies and governmental reports, it is usually named as Latin Model.

⁸ The auditor can be an official chartered accountant or an official chartered accountant company.

2.1.2. *Anglo-Saxon Model*

In the Anglo-Saxon Model, the BD is responsible for managing the company, but it can delegate some powers on an executive committee, the management board. The responsibility for the supervisory activities belongs to the audit committee and the statutory auditor.

In this model, the management of the company is carried out by a BD. However, some members of the BD (at least three) form an audit committee. The authority of the audit committee is similar to that of the supervisory board. The Anglo-Saxon Model has the advantage of providing more effective control of administrative decisions since supervisors have information on the resolutions to be taken by the BD as well as information on the financial situation of the company. The directors that make up the audit committee may not have executive powers, however, will have fixed remuneration that may not be waived, except with just cause and may participate in the BD' resolutions, as well as in the executive committees' meetings (Resende, 2017).

2.1.3. *Two-Tier Model*

In the Two-Tier Model, the management of the company is performed by an executive BD, which has the power of representation of the company. The executive BD may be appointed and dismissed by the general and supervisory board or by the general meeting, in accordance with the company's articles of association. Decisions of the executive BD must be taken by a majority of the votes and, for their validity, a majority of their members must be present at the meetings.

As we can see in Figure 1, the Latin Model is so far the most adopted model (with always more than 70% of firms adopting it). This model is followed by far by the Anglo-Saxon Model, with no more than about 26% of companies adopting it. Finally, the Two-Tier Model has a very low percentage of adoption by Portuguese companies.

Figure 1. Governance Model of listed companies: 2010-2014⁹



Source: CMVM (2012, 2013c, 2014).

⁹ The last year of analysis (2014) is conditioned by the availability of data.

3. CORPORATE BOARD OF DIRECTORS' PRACTICES

3.1. Board of directors

The BD is a recognized group of people that supervise the activities of a company. It is recommended by the IPCG (2018) that the BD should have a number of members that must ensure the optimization of the decision-process making, and that allows the companies to maximize their value and performance. It is also advised that the BD should include a sufficient number of non-executive directors, whose role is to monitor and assess the management of the company by the executive members of the board.

The formal evaluation of the BD is of the general meeting responsibility. Heidrick and Struggles (2014) survey shows that, in 2013, the average number of directors on board was 14.1 in Portugal compared to 12.3 in Europe. In Portugal, during the year of 2014, the BD was, on average, composed of 10 members, with a minimum of three and a maximum of 21 elements (CMVM, 2014).

The executive directors are the members of the BD to whom day-to-day management powers have been delegated, under article 407(1) of the CSC. The executive directors must be focused on the aim of achieving the mission and goals of companies, safeguarding the interests of all shareholders, independently of their shareholding structure. It is supposed that executive board members are updated on matters of interest to the firms, as well as on Corporate Governance subjects. They must also guarantee the transparency and the professionalism of companies.

The non-executive directors are the members of the BD who are not part of the executive board or to whom the current management of the company has not been delegated, under article 407(3) of the CSC. In order to be considered independent, the non-executive board member cannot be associated with interest groups in the company, nor be in a situation that could affect his exemption from analysis or decision.

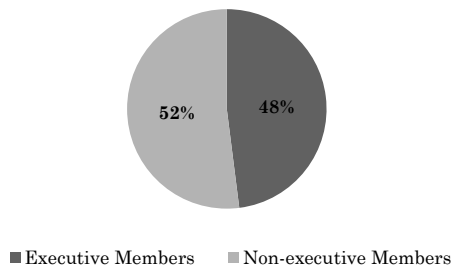
The Portuguese corporate board structure includes non-executive directors, who are supposed to control management decisions in order to protect the shareholders' interests (Alves, 2011). In addition, non-executive directors contribute to the alignment of the interests between managers and shareholders, which reduces the probability that managers act opportunistically and helps to reduce the agency costs. These type of directors are a key element in defending minority shareholders against the risk of expropriation (Bertoni et al., 2014), supervising management activity, giving advice, exercising the right of veto, or even dismissing the Chief Executive Officer (CEO).

The IPCG (2018) recommends that a majority of the board members should be non-executive directors and at least one-third (minimum two), should be independent, in order to ensure that their action is effective as well as that all shareholders must be protected even the minority ones.

Although Fernandes (2008) concludes that non-executive board members do not help to align the interests between managers and shareholders, Alves (2011) states that non-executive directors protect the interests of shareholders, by monitoring management decisions.

In 2014, 52% of the BD was executive members, and 48% were non-executive members (Figure 2).

Figure 2. Executive and non-executive members on board in 2014



Source: CMVM (2014)

Although the percentage of non-executive members on board is higher than that of executive members, three of the 43 companies had only executive members on board. The weight of non-executive members considered independent was on average 34%, with two companies presenting 100% of independent non-executive members. In 12 companies, none of its non-executive members could be considered independent.

According to the IPCG (2011), the size of the board depends on several factors, such as the shareholder structure, the free float level, the size of the company and the presence of independent members on the board. Consequently, the board must include a number of non-executive members that ensure effective supervision and evaluation of executive members' activity (CMVM, 2013b; IPCG, 2011).

The presence of non-executive directors that are also independent on boards is a recent phenomenon in Portugal, being more common in large companies and firms with dispersed capital (IPCG, 2011). The CMVM recommend a minimum of 25% of independent directors on boards in order to ensure an effective supervision and monitoring of the executive members on boards. The independent directors promote the interests of other stakeholders (Chen & Roberts, 2010) and monitor the management decisions (Fama & Jensen, 1983; Ntim et al., 2013). Azevedo (2013) argues that a greater number of non-executive directors on boards motivates the alignment of interests, particularly in countries where there is concentration of ownership, as it is the case in Portugal.

Romano (2005) alerts for the true independence of these board members, since they are classified as independent, but their recruitment and selection may be done or influenced by personal contacts, or by management.

3.2. Role of women on board

Diversity on board can improve skills, knowledge and experience of the board as a whole. Consequently, requirements for the new members of the board and supervisory bodies should take into consideration general diversity requirements, paying particular attention to gender diversity. Portugal has introduced demanding quotas for female members in each administration and supervisory body of each company, and it cannot be less than 20% and 33% in 2018 and 2020, respectively (Law n.º 2/2017, from 1st August).

There are several authors finding evidence that the presence of women on board influences positively the firm's performance (Barber & Odean, 2001; Adams & Ferreira, 2007; Julizaerma & Sori, 2012; Bart & McQueen, 2013, Vieira, 2018). However, Olsen and Cox (2001) argue that women on board worse firm performance.

Heidrick and Struggles (2014) found that, in 2012, the share of women on boards of the largest Portuguese listed companies was 6%, compared to 13.7% in European Union (EU). In 2013, there was a mean of 8% of women on board, and there were 30% of boards with no women directors, compared to 17% and 12% in Europe, respectively. These percentages contrast with the ones of the USA, where female represent 36% among directors, for the S&P 500 (Stuart, 2017).

In Portugal, in the year of 2014, from the 422 positions on board, only 40 were held by women (less than 10%), and in 19 companies the management body consisted of men only (CMVM, 2014).

Table 1. Characteristics of the BD: 2010-2014

	2010	2011	2012	2013	2014
BD' size (mean)	10	10.1	10.6	10	10
Executive members on board (%)	45.2	55	42	48	48
Non-executive members on board (%)	54.8	45	58	52	52
Independent members on board (%)	30	29.1	22.1	32	34
Women on board (%)	5.9	7.2	6.6	8.8	9.5
Annual meetings (mean)	12.9	12.7	12.3	13	n.a.

Source: CMVM (2010, 2011, 2012, 2013c, 2014); n.a.: not available.

The BD has, during the period from 2010 to 2014, a mean of about 10 members. The executive members on board vary between 42% (2012) and 55% (2011). The number of non-executive members is always higher than the executive ones, with the exception of 2011. The evolution of the proportion of non-executive directors may be related to the recommendations of the CMVM, which encourages the participation of these members on the BD. The proportion of independent directors on

board has increased progressively, except in the period 2011-2012, reflecting greater compliance with the recommendations issued by the supervisory authorities. The percentage of women on board has increased consistently during the period considered, reflecting a higher degree of diversity in the board. Finally, the mean of annual meetings was between 12.3 and 13.

3.3. Remuneration of the board members

Usually, the responsibility to determine the remuneration policy for the members of the board is attributed to a remuneration committee, composed by independent directors. In the Portuguese context, according to the CSC, article 399, the remuneration of the board members, which may include a fixed and a variable part, is related to the function that the member executes, as well as the financial and economic situation of the company.

The CMVM recommends that the remuneration of members of the board should be structured in such a way as to permit that the interests of board members are in line with those of the company and should be disclosed annually in individual terms, and the IPCG (2018) reinforces these recommendations. According to the EU Commission, companies should benefit from remuneration policies that stimulate longer-term value creation, and executive pay should be related to performance. To encourage shareholder engagement in their investee companies, the EU Commission introduces the concept of "say-on-pay".

Analysing the Portuguese reality regarding the evolution of the highest average salaries of listed firms in Euronext Lisbon, considering the period from 2007 to 2011, Rodrigues (2014) points to the positive and significant relationship between total compensation and performance because this leads to the selection and maintenance of the managers with more capabilities and motivation.

Fernandes (2008) finds a positive relationship between size and board remuneration for the Portuguese market.

Table 2. Remuneration of the board members: 2010-2014

	2010	2011	2012	2013	2014
Total remuneration (million euros)	125.5	131	110	115.16	100.569
Maximum value (million euros)	1.42	2.723	3.1	2.035	n.a.
Average remuneration (thousand euros)	264	293.2	240.4	n.a.	n.a.
Remuneration of non-executive members (%)	n.a.	34.1	21.7	n.a.	n.a.
Remuneration of non-executive members - Fixed component (%)	63.7	60.6	63.8	75	76
Remuneration of non-executive members - Variable component (%)	23.8	27.3	27.8	25	24

Source: CMVM (2010, 2011, 2012, 2013c, 2014); n.a.: not available.

In the period 2010-2014, the total remuneration of the board has decreased from 125.5 million euros in 2010, to 100.569 in 2014. The year of 2012 is the one with the lowest value, justified by the intervention of

Troika in Portugal, and the subsequent measures of austerity. However, the 2012 year is characterised by the maximum value of remuneration, which contrasts with the lower value of the total remuneration.

The remuneration of executive members is significantly higher than the one of non-executive members, as we can see by the low percentage of remuneration of non-executive members¹⁰. This difference can be justified by the remuneration structure, since the compensation of the executive directors depends largely on elements related to performance, whereas the remuneration of non-executive directors is normally based on fixed components.

Finally, we can see that the fixed component of remuneration has increased and the variable component has decreased during the 2010-2014 period¹¹.

3.4. The role of the chairman

The role of the Chairman of the board is to head the BD. The Chairman is expected to promote and supervise the highest standards of CG within the board and the company. This figure is provided in the CSC (395).

The main roles of the Chairman are the following ones¹²:

- Promote and oversee the highest standards of Corporate Governance within the board and the company;
- Ensure that board members receive accurate, timely and clear information to enable them to monitor performance, make sound decisions and give appropriate advice to promote the success of the company;
- Manage board meetings, motivating the discussion of complex issues and ensure that all members' contributions are encouraged and valued;
- Create the conditions for the overall board and individual director effectiveness;
- Ensure that the board undertakes an annual evaluation of its own performance.

3.5. CEO-Chairman duality

In continental Europe, there is a distinction between the role of the President of the BD (Chairman) and the role of the CEO, being a clear division of responsibilities between them.

While the Chairman is responsible for the leadership of the board and for the effectiveness of the overall board, as well as individual directors, the CEO is in charge for the strategic plan's execution and the day-to-day management of the business, in line with the strategy

¹⁰ We want to emphasize the amount of information not available on the CMVM reports.

¹¹ In the first three years (2010-2012), the total of the fixed and variable components does not sum 100%, as the difference is associated with other components, such as funds and pension plans.

¹² <https://www.bupa.com/corporate/about-us/corporate-governance>.

approved by the board. The CEO suggests implements and reports on the strategic direction of the companies as well as business strategies and initiatives. If the president and the CEO is the same person, it is necessary to guarantee that the conditions are met for non-executive director's work to be efficient and independent from the executive board.

CEO-chairman duality has both advantages and disadvantages. The main advantages are the coordination costs and clear leadership. On the other hand, the main disadvantage is the concentration of power in a sole person. Although some authors find a negative effect of duality on performance (Valenti et al., 2011), others find a positive relationship between the two variables (Chang et al., 2015). Analysing Portuguese firms, Campos (2015), Cunha and Martins (2007), and Matos and Gois (2013) find a positive relationship between the CEO and Chairman independence, and the performance of the company.

Silva et al. (2006) analysed a sample of Portuguese listed companies, concluding that distinct people in about 70% of companies under analysis performed the functions of Chairman of the board and CEO. This percentage compares with about 80% in the European companies (Deutsche Bank, 2005). In the USA, more than 51% of S&P 500 boards have a separate chair and CEO (Stuart, 2017).

4. CONCLUSION

This study gives an overview of the legal framework of CG in Portugal and the evolution of CG practices in the last years, being this analysis, however, conditioned by the availability of information.

The most widespread CG Model is the Latin Model. In 2014, 72.1% of the Portuguese listed companies employed the Latin Model, 25.6% used the Anglo-Saxon Model, and only 2.3% adopted the Two-Tier Model.

The members forming the BD belong to two main categories, which are executive and non-executive directors. The percentage of non-executive members is always higher than the executive ones, with the exception of the 2011 year. In addition, the proportion of independent directors on board has increased, except in the period 2011-2012, reflecting greater compliance with the recommendations issued by the supervisory authorities.

Referring to the gender diversity, the percentage of women on board have increased consistently during the period considered, reflecting a higher degree of diversity in the board, namely from 5.9% in 2010 to 9.5% in 2014.

With regard to the directors' compensation, data show a decrease in the total remuneration of the board, being the remuneration of executive members significantly higher than the one of non-executive members.

The relevance of CG has been increasingly focused as the market recognizes the positive impact that CG practices have on the economic growth and on the stability of financial markets. CG is related to controlling the business for what is vital to all organizations, regardless of size or structure. Thus, it is expected that CG makes a solid

contribution to the stock market and the protection of stakeholders, through changing attitudes in the management of organizations, and following CG good practices.

Heidrick and Struggles (2003) analysed the CG practices in Europe, and conclude that Portugal is significantly behind Europe. Despite this evidence, the country made the most progress. Regardless of the evolution of good practice in Portugal has been positive, there is a way yet to go.

The recent financial sector scandals in Portugal, as well as the 2007 financial crisis, have shown that CG goes beyond corporate models and should have effects on the internal control structures and the adequacy of the people who are members of its management and supervisory bodies, and revealed the weaknesses of internal control, non-executive directors, supervisory bodies and external auditors. In addition, it highlights the need for more effective CG models, in order to avoid further scandals for notoriously ineffective governance and control mechanisms.

Sometimes, it is not enough to create recommendations and advice companies to comply, ignoring existing norms of positive law. If necessary, compliance must be enforced. This is a role for the regulatory and supervisory bodies, which cannot fail to set an example as regards good practices. As long as there is no adequate educational and cultural literacy, which will only happen with high standards of education, it is necessary to regulate by prevention, by imposing perceptive rules and by being responsible, especially for those who do not enforce them (and not only those who infringe them and are caught).

Maybe, changing the regime of governance for institutional investors, who have management capabilities or the granting of more voting rights, are measures that could be considered for better long-term intervention in companies.

The literature review raises questions about the true effectiveness of some control mechanisms (Alves & Mendes, 2003), because of the existence of empirical evidence that supports the idea that some measures have the opposite effect on the performance of companies that adopted them. One way to mitigate these problems is to have independent members on board who are expected to question the managers' decisions and thus to put an end to their discretion.

Based on previous studies conclusions, it seems that the evolution of CG practices in Portugal is moving in the desired direction, namely in what respects to the following evidence:

- Growing concern about transparency, updating and availability of information supplied to the market;
- Growing concern about the alignment of the interests of managers with those of firms, namely through remuneration policies;
- Reasonable compliance with the recommendations for the creation of internal risk control;
- Increase of independent members on board;

- Reinforcement of committee independence, namely the increase of audit committees with non-executive members;
- Clearly identified the executive, non-executive directors, and the independent members.

From our point of view, this study has some limitations. First, we highlight the fact that official reports are outdated. For example, the most recent report of CMVM is from 2014, which conditioned the analysis and the conclusions obtained in this work. Second, the empirical studies done on this subject in Portugal are still scarce. Third, we cannot conclude about the effective role of CG on the stakeholders' protection, in general, and investors, in particular. Fourth, the women representation on the board of management is still rare. Finally, there is a gap between the CMVM rules and the IPCG code came into force. However, there is still a plenty of work to do on the governance front if Portugal wants to reach the higher European standards, but perhaps passing the baton from CMVM to IPCG will strengthen the CG environment in Portugal and allow for more rapid developments in the future.

In order to deal with the lack of data problem, we suggest a longitudinal study, with more recent information, to obtain conclusions that are more updated, and obtain tendencies of attitudes and effects. We would like to analyse the relationship between Corporate Governance and firms' performance. Finally, we suppose it would be interesting to develop a robust model to measure the quality of CG that can be used in several countries, and whose results are comparable.

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