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Consultancy on a Survey on the Corporate Governance Regimes in Other Jurisdictions in connection with the Corporate Governance Review

Final Report

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EXECUTIVE SUMMARY

1 Background

The objective of this consultancy brief is to examine and understand corporate governance regimes, including the legal, regulatory and institutional frameworks of Hong Kong, the UK, the USA, Australia, Malaysia, Taiwan and Singapore and compare the strengths and weaknesses of these regimes to Hong Kong including corporate disclosure requirements. A comparative analysis of the initiatives undertaken in these jurisdictions to improve their respective corporate governance regimes would shed light on how corporate governance has evolved in these jurisdictions and this, in turn, is likely to have a bearing on any proposals for corporate governance reform in Hong Kong.

The theoretical background for this comparative study of corporate governance and the role of different legal regimes including corporate ownership patterns draws on the economics of agency theory and incomplete contracting theory and the problem of information asymmetry. The essence of this theoretical paradigm relies on the notion that effective corporate governance is required to overcome the agency and incomplete contracting problem. The main requirements for effective corporate governance that are identified are transparency, equity and accountability. These requirements ensure that a firm is managed to increase firm value and achieve efficient resource allocation. Failure to achieve appropriate and efficient corporate governance could result in sub-optimal allocation of resources, abuses and theft by management, expropriation of outside

shareholders and creditors, financial distress and even bankruptcy. Indeed, the recent financial crisis in Asia has been attributed in large part to weak corporate governance.

In evaluating the role of corporate governance, it is imperative to also consider the levels of development of market institutions and other legal infrastructure including the laws and associated enforcement that provide the minimum standard for investor protection as well as ownership structures. In considering the role of laws, it is important to note there are essentially two major distinct legal systems in the world, namely common law and civil law which encompass varying degrees of legal protection of investors. Examples of common law countries are Australia, Singapore, the UK, the USA, Malaysia and Hong Kong and civil law countries are Indonesia, Philippines, Germany and Taiwan. Civil law countries have been found to have weaker investor protection and less developed capital markets including smaller equity markets compared to common law countries. Ownership structures present a complex set of problems for corporate governance and, in particular, Hong Kong family ownership presents different agency problems such as accusations of minority shareholder expropriations. These different ownership structures need to be recognized in evaluating and understanding corporate governance.

As expected, there is a plethora of suggestions that have emerged to mitigate the agency problems and improve corporate governance. One suggestion that has received popular support is to introduce independent non-executive directors (INEDs) on company boards. They are expected to play an important role in aligning the interests of managers and shareholders by monitoring through the board and board committees. INEDs are

expected to bring their individual experience and expertise to the board and its committees. Unfortunately, empirical evidence regarding the effectiveness of INEDs in exercising their independent judgment and performing their monitoring roles on the boards or its committees is somewhat inconclusive and remains an open empirical question. The poor results could be due to the fact that previous attempts to study linkages between INEDs and firm performance may have failed to consider the complexities of the business environment including growth opportunities, size of organizations, types of business including industry and nature of ownership structures including existing corporate governance in the organizations under study.

Our approach in this comparative study of different corporate governance regimes recognizes that corporate governance systems evolve in the context of the legal, political and institutional infrastructure in each of the jurisdictions. These corporate governance systems can be broadly categorized into two types, namely the relationship-based system characterizing most East Asian countries and market-based system characterizing more developed markets such as the USA, Australia and the UK.

There is no universal approach to promote good corporate governance but three different regulatory approaches to good corporate governance have been identified in the literature. We use these three different approaches to facilitate our analysis of comparative systems. These are the prescriptive approach, non-prescriptive approach and balanced approach. The prescriptive approach requires companies to adopt specific corporate governance practices by legislation or regulation. The non-prescriptive approach allows companies to design and determine the specific corporate governance practices that would suit their

circumstances subject to appropriate disclosures of corporate governance practices. The balanced approach would specify the best corporate governance practices or code of best practices and requires companies to provide appropriate disclosure if they depart from the code of best practices. This framework is adopted to analyze the regulatory approaches to corporate governance in each of the countries under study and critically consider how the measures could be adopted for enhancing corporate governance in Hong Kong.

Our methodology included a comprehensive review of key corporate governance reports and studies, academic literature, legal and regulatory requirements, and board practice surveys in the USA, the UK, Australia, Taiwan, Singapore, Malaysia and Hong Kong. We also reviewed the literature on the association between corporate governance variables and corporate performance as well as the literature on costs of disclosures. Interviews were also conducted with selected key regulators and personnel from government departments and prominent corporate governance experts from private sector institutes in different countries, namely the UK, the USA, Australia, Malaysia.

A review of the key corporate governance reports shows that they focused on board composition, the role of the chief executive officer (CEO), the importance of non-executive directors (NEDs), the role of auditors and accountability issues. A crystallization of the main issues in the reports suggests the following: (1) board members should in all respects act in the interest of shareholders, (2) boards should be made up of a combination of executive directors and outside NEDs and that the process by which members are appointed to the board should be transparent, (3) the roles of the

chairman and the CEO are best kept separate or have a non-executive chairman, or designate an independent lead director, (4) NEDs should be able to objectively review the performance of the board, and take the lead where potential conflicts arise. It was also suggested that more attention be paid to the diversity of backgrounds for bringing special expertise or experience to the company in the selection of NEDs, and (5) the pivotal role of independent external audit to ensure transparency and timeliness of reports is also emphasized.

2 Main Findings

2.1 Literature Review on Corporate Governance

Our review of this literature provides mixed evidence on the relationship between corporate governance and corporate performance. This can be attributable to the fact that different measures of corporate performance and corporate governance were used in different studies. Generally, the majority of prior studies found that an increase in shareholders' and directors' ownership is associated with improved performance though the evidence between institutional shareholder activism and firm performance is not clear. Another strand of literature which focused on the relationship between board characteristics and firm performance also failed to find conclusive evidence regarding the association between board size, CEO duality, board composition and firm performance. It is, however, worth noting that some recent studies suggest that boards with more than 6 – 7 members could be less effective and that there was some optimal level of board size. This would of course depend on the size and nature of the organization. More promising results have emerged regarding the link between higher quality directors measured in

terms of expertise and experience and more board activity with better firm performance. Most of the opinions and rankings by investors or experts generally supported the notion that corporate governance is associated with better firm performance.

Though the above academic literature review does not provide conclusive evidence on the positive relationship between corporate governance and firm performance, there is an increasing trend in the business and legal literature to emphasize the point that good corporate governance should lead to better performance. The reason is that, in the final analysis, corporate governance is a reflection of management quality. In order to sustain high performance in the long term, quality management will need to establish controls to prevent fraud and reduce opportunities for financial manipulation (CLSA, 2002). On balance, the weight of the evidence and the opinions in the legal and professional business literature suggest that corporate governance is one of the factors that could ultimately affect firm performance. In addition, prior literature showed that financial disclosures, an element contributing to good corporate governance, are not without costs, and these costs should be factored in when considering changes in financial disclosure policies in Hong Kong.

2.2 Comparative Analysis of Various Jurisdictions

We conducted a comparative analysis of the legal and regulatory requirements and recommendations of corporate governance including accounting standards and disclosures such as issues on related party transactions in various jurisdictions. Three broad aspects of corporate governance, namely board characteristics, disclosure of

corporate governance policies and practices required by regulators and the definition of independence with reference to INEDs were reviewed.

2.3 Findings of Literature Review and Extent of Implementation

In the following paragraphs, we integrate the main findings of the literature review and comparative analysis. In this way, we are able to present the major recommendations found in the literature review and assess their implementation in each of the jurisdictions under study.

The common recommendations and the extent of implementation in the jurisdictions is as follows:

2.3.1 Board composition

The emphasis is on ensuring that no individual or group can dominate decision making on the board though the number of NEDs on the board varies. The Combined Code of the London Stock Exchange goes a little further by stating that NEDs should make up a minimum of one-third of the board. The recommendations on INEDs are more specific than those for NEDs. Either a specific number of INEDs is required, typically three (such as in the USA), or a portion of the board is required to be independent. The majority of the jurisdictions except Taiwan, specify that a minimum portion, usually one-third, of the board be INEDs. Taiwan requires a company to have at least one INED at the time it is first listed (but with no corresponding requirement to continue having an INED on the board).

2.3.2 Directors’ education and training

There is no specific requirement for directors’ education and training in all jurisdictions surveyed except Malaysia. However, in Australia and the USA, directors’ education and training are facilitated by respective company director institutes.

2.3.3 CEO duality

CEO duality (one person filling the roles of both CEO and chairman) is common practice in the USA, but discouraged (though not prohibited) in other jurisdictions such as the UK, Australia, Malaysia and Singapore. The rationale is that the chairman, as head of the board, should be independent of management. It would be difficult for the chairman to perform his role well if he is also the head of the management. Some believe that the running of the company and the running of the board are two distinct jobs, and that one individual should not be responsible for both. If the roles are combined, some jurisdictions, such as the UK and Malaysia, have a requirement to disclose the reasoning behind such a decision. Presumably, the combined role may have advantages particularly for small high growth firms that require strong direction and leadership.

2.3.4 Access to information

In order to perform their responsibilities, directors must have access to all relevant information pertaining to the company. It is often the case that NEDs do not receive the same information as the executive directors because they are not so intimately involved with the day-to-day business of the company. It is essential that all directors receive as much accurate and up-to-date information as is available in order to make sound

decisions. Failure to ask for and receive appropriate information may expose directors to liability under their fiduciary duties to exercise due care. Hong Kong, the UK, and Singapore have explicit requirements that all directors have equal access to relevant information.

2.3.5 Outside advice

Director access to outside legal or other professional advice in carrying out their duties at company expense is a common requirement. This is to ensure that directors perform their duties in accordance with the law and regulations, without having to be dependent on the company.

2.3.6 Disclosures

All jurisdictions in our study, with the exception of the USA and Taiwan, require a statement on the corporate governance practices in place during the reporting period to be disclosed in the annual report, providing details as to whether or not the company has complied with mandatory corporate governance requirements (if applicable). If they have failed to comply with mandatory requirements, they must disclose the reasons for non-compliance. This kind of a statement may take the form of a separate statement, included in the annual report, or form part of the financial statements.

Extensive disclosure requirements relating to the board are common. As a minimum, names and qualifications of directors, their status as NEDs or INEDs, as well as other biographical information that would enable shareholders to better evaluate the directors'

ability to fulfill their responsibilities should be disclosed. Less common is a requirement to disclose details of individual directors' service contracts.

2.3.7 Definition of independence

The definition is not always exactly the same across jurisdictions but it is very similar, differing only in wording or in details. The general definition is that a director who is independent is free from relationships with the company, companies related to the company, or the company's officers, or any other relationship that could be seen as interfering with a director's independent judgment. Where the rules differ, it is in the details as to exactly what relationships would compromise independence, and the time frames of the relationship. Another condition is to restrict the percentage holding of a director to be no more than 1% of the issued capital to ensure director independence.

3 Related Party Disclosures

According to International Accounting Standards (IAS, 24), a related party is defined as one party who has the ability to control the other party or to exercise significant influence over the other party in making financial and operating decisions (either party would be considered related to the other). Parties subject to common joint control or common significant influence would also be considered related parties.

This definition is widely adopted in all jurisdictions, and in Hong Kong SSAP 20. The disclosure requirements for all jurisdictions are fairly similar and include details on the nature of relationship types and elements of transactions. Hong Kong Companies

Ordinance and Listing Rules and Singapore's standards include more disclosures on directors' remuneration, loans, and connected party transactions.

4 Professional Surveys of Corporate Governance Practices

The survey results suggest that there is some diversity in the practices of CEO duality, board size, board composition and board meetings across the jurisdictions with the UK and the USA leading the way with larger board size.

5 Regulation of the Accounting Profession

The majority of the jurisdictions reviewed have self regulating accounting professions with some government departments having oversight of accounting standards setting.

6 Interview Findings

The interviewees believed that the Hong Kong SAR Government should take the lead to legislate and regulate the basic elements of corporate governance such as connected party transactions in order to set a "level playing field" for investors. They believed that corporate governance reform should adopt a balanced approach that clearly specifies corporate governance best practices but allows companies to deviate from these stated practices with explanations and appropriate disclosures. They generally disagreed with the contention that corporate governance measures should be legislated. They realized that corporate governance reform is a long-term process that involves changing the mindsets and culture of corporate management. To enhance corporate governance practices, training and education of directors is crucial since it would improve the quality

(in terms of their integrity and competence) of directors, including independent non-executive directors (INEDs). However, they were skeptical about the existence of "truly independent" INEDs in Hong Kong because the business community is relatively small and many companies are family controlled. Many interviewees suggested that companies can outsource this hiring function to professional recruitment agencies. With their worldwide networks, they can possibly recruit good quality candidates abroad. They also recognized that it is becoming more and more difficult to recruit good quality INEDs unless more incentives such as more attractive compensation are provided. Some interviewees commented that Hong Kong lacks the influence of powerful institutional investors like TIAA-CREF in the USA to act as an external monitoring device to oversee corporate management. They believed that the Hong Kong SAR Government should impose more stringent measures (including heavier penalties) and implement more effective enforcement measures for directors in order to deter mismanagement.

Some interviewees believed that the introduction of class actions Hong Kong could help to protect the interests of investors, particularly the minority shareholders. However, others cautioned against it since this may affect the overall litigation environment in Hong Kong with potentially high social costs.

7 Recommendations

Our study and overall analysis provides us with the opportunity to make some recommendations. In considering these recommendations, we are mindful of the fact that the corporate governance approach that is prevalent in any given jurisdiction is largely

dependent on the current state of economic development, the existing legal, regulatory and political framework as well as patterns of ownership. Our recommendations are couched in terms of the three corporate governance approaches identified in our analytical framework. In emerging markets where laws are typically less well-defined or inadequately enforced, investor protection becomes more of a concern. This is particularly true in the case of the rights of minority shareholders when there are dominant shareholders exerting significant influence over companies and are suspected of expropriating the wealth of minority shareholders through improper transactions. This is not uncommon in Asian companies, where the company's founding families often still retain substantial ownership and control (in some cases through a complex web of cross listings and pyramid holdings) over the company. In some cases, companies are also under the influence of political parties. In order to provide some protection to investors, regulators will often impose extensive rules and regulations regarding corporate governance for listed companies. For example, Malaysia and Taiwan (perhaps partly due to their civil law heritage which emphasizes codification of rules) have adopted a more prescriptive approach as compared to the other regimes. This prescriptive approach is also discernible in Singapore, though to a much lesser extent than Malaysia or Taiwan. The Report of the Corporate Governance Committee in Singapore (2001) recently specifically recommended that Singapore should move away from a prescriptive approach and adopt a balanced approach tilted towards a disclosure-based system.

The USA is a good example of a jurisdiction that has adopted a non-prescriptive approach with its developed economy and markets, a long business history, well-defined

and predictable common law, and strong enforcement (i.e., class action suits) available to investors for protecting their rights as shareholders. There may be codes of best practices published by various professional bodies or interested private institutions, but there is no compulsory requirement to follow these codes. Companies may follow these codes, and that may work in their favor through the market seeing them as being "responsible" corporations with respect to corporate governance. It has been noted in our literature review that investors will pay a premium for well-governed companies who voluntarily comply with codes of best practice which ultimately benefit them. The other country in our study that follows a predominantly non-prescriptive approach is Australia. Companies are required by the Listing Rules of the Australian Stock Exchange to make a statement of the corporate governance policies they practice. The policies are not stipulated, and the companies are free to follow established guides to best practice or develop their own.

The UK perhaps best exemplifies the balanced approach, i.e. "comply or explain". The London Stock Exchange Listing Rules require companies to state how they apply the principles of the Combined Code and disclose if they are not in compliance and the rationale for their non-compliance.

A non-prescriptive approach is clearly not practical nor effective in an emerging market, or even a developed market where there are still dominant shareholders. It works in the USA because of a well-established legal system, sophisticated investors, and extensive disclosure requirements stipulated by the regulatory agency. A prescriptive approach is

often ineffective because it tries to be a "one-size fits all" approach, when in reality, companies of different sizes operate in different circumstances, and what may be good for one might not necessarily be good for another. However, the recent financial scandals in the USA such as Enron, WorldCom and Xerox is a concern since it raises some questions about the effectiveness of the USA's non-prescriptive mode of corporate governance. The balanced approach gives freedom to companies to adopt the practices that are the most suitable at any particular time, but enhances accountability to investors through the requirement to explain their corporate governance practices when they differ from accepted best practice.

In Hong Kong, the situation is not identical to any of the other jurisdictions we have examined, but does bear strong similarities in some areas. Although family ownership is very common in Hong Kong as with countries such as Malaysia and Singapore, the market is better developed due in no small part to the presence of multinational companies that have to meet internationally accepted standards of best practice. From a legal perspective, Hong Kong directors have similar responsibilities and obligations of directors in the USA, but the mechanisms for enforcement of their duties and remedies for the breach of their responsibilities are not nearly as powerful as those in the USA (e.g., class actions). We recommend a two-pronged approach for Hong Kong to improve its corporate governance standard:

(1) A set of fundamental rules needs to be mandated as minimum requirements, preferably through the Listing Rules of the Exchange. This would include the number of independent non-executive directors (INEDs), the proportion of INEDs on the board, a more comprehensive definition of independence and better quality disclosures such as related party transactions. These rules would be mandatory for all listed companies.

(2) A comprehensive code of best practice should be established whereby listed companies are encouraged to comply with the code or explain their non-compliance. The code can include matters relating to CEO duality, board composition, disclosures of corporate governance practices, and possibly the formation of a corporate governance committee. The corporate governance committee would be an umbrella corporate governance mechanism designed to evaluate, implement and monitor corporate governance policies in an organization depending on the size and circumstances of the organization. It could assume some of the responsibilities of the remuneration and nomination committees as an intermediate step to a longer term goal of formally establishing those committees.

The implementation of (1) and (2) is essentially a balanced approach, and would be very similar to the situation in the UK, but with additional rules mandated due to the need to enhance Hong Kong's international image. The basic rules will provide fundamental protection against some of the "major" corporate governance problems, while a code of best practice will bring increased public awareness and investor scrutiny to companies who choose not to follow good practice. This essentially is compatible with the disclosure-based philosophy.

The existence of laws and regulations without enforcement is quite useless and based on our analysis of the enforcement mechanisms across different jurisdictions, we believe that Hong Kong needs to pay more attention to increase the powers of the Securities and Futures Commission to investigate breaches of related laws and regulations. This can act as a deterrent to offenders who flout the minimum laws and regulations designed to protect shareholders and as a complement to the balanced approach to corporate governance.

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CHAPTER 1 INTRODUCTION

1.1 Introduction

Most writers attribute the recent Asian financial crisis to various structural defects in the East Asian economies such as prolonged moral hazard, lax regulation and supervision, crony capitalism and weak corporate governance. In particular, weak corporate governance and inadequate financial supervision are seen by many as the major culprits for the crisis.

A useful framework to understand how weak corporate governance contributed to the crisis is provided by Rajan and Zingales (1998) who characterized corporate governance systems into two broad types: relationship-based and market-based. The business environment in East Asia was largely relationship-based involving close links between firms, banks, and government through ownership, family connections, and political affiliations. Since firms could rely on banks for finance and there was a system of implicit and explicit government guarantee, the relationship-based system led to little need for an elaborate system of corporate governance. As a result of weak institutional mechanisms to protect long-term investments, investors were forced to confine themselves to primarily short-term investments that can be pulled out at short notice. Thus, it is argued in some quarters that the currency crisis in Asian countries led to several bankruptcies that were accompanied by a loss of foreign investor confidence which resulted in a rapid pull-out of short term investments.

By contrast, the market-based (arm’s length) system allocates resources through explicit contracts and to the extent that contracts are inevitably incomplete, investors

who supply funds are better protected if the firms operate in an environment with strong investor protection laws and have better corporate governance. Thus, countries that seek capital market development and liberalization have to accept the risk of financial fragility as a result of the relationship-based system or improve their financial infrastructure through a market-based system with sound corporate governance for firms.

In the aftermath of the crisis, regulators from several countries in the region have begun attempts to address these problems including the introduction of more market-based characteristics into their financial infrastructures to ensure greater transparency and accountability. It is in this context that we try to obtain a better understanding of corporate governance regimes including the legal and regulatory frameworks in Hong Kong, the UK, the USA, Australia, Malaysia, Taiwan and Singapore and survey any initiatives that have been undertaken by these jurisdictions to improve their corporate governance regimes.

1.2 Objectives and Structure

The objectives of this report are:

- To obtain a better understanding of the corporate governance regimes, including the legal, regulatory and institutional frameworks of Hong Kong, the UK, the USA, Australia, Malaysia, Taiwan and Singapore.

- To ascertain any initiatives taken or to be taken by these jurisdictions in improving and developing their corporate governance regimes.

- To compare these jurisdictions to Hong Kong in terms of the strengths and weaknesses of the corporate governance regimes and, in particular, the systems for monitoring and ensuring compliance with corporate disclosure requirements.

- To collect information on the studies conducted on the cost of disclosure in these jurisdictions.

Chapter 2 provides the theoretical basis for corporate governance including the legal infrastructure and the methodology of the study. In the main, this chapter draws on the economics of agency theory and incomplete contracting and the legal regimes that influence the evolution and development of corporate governance. Chapter 3 contains a review of the key corporate governance reports. These include the Cadbury Report, the Dey Report, the General Motors Corporation Guidelines, the Hampel Report and the OECD Report. The literature review regarding corporate governance and firm performance including disclosure issues is provided in Chapter 4. This chapter in particular reviews studies that relate various dimensions of corporate governance such as board composition, the quality of directors, chief executive director (CEO) duality, shareholder activism and firm performance. The comparative analysis of corporate governance with country analyses covering the legal and regulatory requirements and disclosures in each country is contained in Chapter 5. This chapter forms the core of the report since it provides a comparative analysis of the legal and regulatory infrastructure (including accounting standards and disclosures) in the seven jurisdictions under study. This chapter also analyzes the issues concerning related party transactions. Our findings from interviews with regulators and prominent corporate governance experts in the private sector on the effectiveness of corporate governance practices in the different jurisdictions are summarized in Chapter 6. The final chapter contains a synopsis of the issues and our recommendations.

CHAPTER 2 THEORY AND METHODOLOGY

2.1 Introduction

This chapter presents the theoretical background for corporate governance and the role of different legal regimes including corporate ownership patterns. A framework to facilitate an analysis and understanding of the corporate governance regimes in selected jurisdictions, namely the UK, the USA, Australia, Malaysia, Taiwan and Singapore and to compare these jurisdictions with that of Hong Kong is also provided. The chapter then ends with an outline of our approach and methodology adopted in this study.

2.2 Theoretical Background

The economics of agency theory and incomplete contracting theory and the problem of information asymmetry provide the theoretical basis for corporate governance. The agency problem arises from the separation of ownership (in simplest terms, shareholders) and control (management) in modern corporations (Shleifer and Vishny, 1997). The manager requires the financier's funds since he/she usually cannot supply the capital required. The financier lacks the level of information the manager has and therefore faces the risk that the manager can directly expropriate his/her capital. According to agency theory, managers (risk averse agents) are expected to act opportunistically at the expense of the shareholders' (principals') interests (Jensen and Meckling, 1976; Fama and Jensen, 1983). This agency problem can also be applied to the situation where majority shareholders expropriate the interests of minority shareholders. However, the problem of "incomplete contracting" can affect the severity of the agency problems.

The firm is viewed as a set of contracts between a multitude of parties and individuals. The firm wishes to design the contracts in such a way as to minimize contracting costs including agency costs. These contracts include formal contracts such as legal contracts and informal contracts such as administrative policies and arrangements. Accounting is also an integral part of the contracts that define the firm. Contracts, and their enforcement and monitoring are costly and can affect the firm's profitability and survival. It is not possible to write contracts that cover every contingency in the business environment, hence the idea of incomplete contracts. The difficulties associated with writing contracts to cover every possible situation or contingency and the monitoring of these contracts becomes significant because of agency problems.

The separation of ownership and control allows managers to pursue opportunistic behavior by expropriating from investors or misallocating company funds. This agency problem is one of the factors considered by investors when making investment decisions (Williamson, 1991; Grossman and Hart, 1986). Corporate governance offers a way of overcoming these problems in modern corporations and may be defined as the mechanism whereby suppliers of corporate finance can assure themselves of a return on their investment (Shleifer and Vishny, 1997).

The main requirements for effective corporate governance that are usually identified are transparency, equity and accountability. Efficient coordination, motivation and efficient allocation of resources require transparency of information. Equity is about legal protection and the enforcement of contracts and accountability provides incentives and discipline so that management is monitored and properly motivated. These requirements ensure that a firm is managed to increase firm value and achieve efficient

resource allocation. Failure to achieve efficient corporate governance results in sub-optimal allocation of resources, abuses and theft by management, expropriation of outside shareholders and creditors, financial distress and even bankruptcy.

Many corporate governance devices have surfaced in corporations, particularly in the USA, and they include increasing management ownership of shares, institutional investors, audit committees, issues relating to independent non-executive directors (INEDs) on the boards of directors and the separation of the roles of chairman and chief executive officer (CEO). A critical element in the effectiveness of any corporate governance device is the independence of non-executive directors (NEDs) on the board.

In evaluating the role of corporate governance, it is important to also consider two matters that go beyond corporate governance *per se*. First, in many Asian countries, a number of families dominate the ownership of firms. It is also known that cross shareholdings and pyramid schemes are widely used to acquire and maintain control of several firms by a single family. Some concerns have been expressed that the control of firms by closely-knit family groups may facilitate the expropriation of non-controlling shareholders by controlling shareholders. The levels of development of market institutions and other legal infrastructures will also affect the effectiveness of any corporate governance regime.

2.3 Legal Systems

In any corporate governance environment, the legal system including the laws and associated enforcement provides the minimum standard for investor protection. For rules to be effective, an enforcement mechanism must be at work. When there are no

negative consequences for breaking rules, the rules will be followed only when convenient or advantageous. In a corporate environment, majority shareholders would exert influence to gain unfair advantage over minority shareholders, if rules and the associated enforcement mechanism do not exist to prevent such behavior. In the absence of laws, managers are likely to maximize their own benefits at the expense of shareholders (Stone, 1991). Thus, a set of minimum laws/rules should be legislated/regulated to prevent such opportunistic behavior.

There are different ways to examine how regulation and enforcement mechanisms function. Wells (2001) identified four models of regulation[1]. Of these four models, only the rational-legal model explicitly refers to enforcement. It states that a rule is designed to eliminate problems, and enforcement is assumed to be a natural consequence of law. Some argue that "a strong system of legal enforcement could substitute for weak rules since active and well-functioning courts can step in and rescue investors abused by the management" (La Porta *et. al.*, 1998). For example, La Porta *et al*. (1998) put forth an argument that in cases where legal protection for investors is weak, a strong system of legal enforcement may act as a substitute. It was observed that investors may prefer to invest more in markets with stricter law enforcement, especially in markets where legal protection is weak (such as French-civil-law countries which score lowest in both investor and creditor protection). However, after examining more than 49 countries around the world (including common law jurisdictions and civil law jurisdictions), there was no evidence suggesting that law enforcement was indeed a substitute for strong laws. Both the laws and the system that enforced them offered poor protection for an investor in a French-civil-law country. Though this argument has yet

[1] The four models identified were the criminal justice, the rational-legal, the economic, and the conflict models.

to be empirically supported, intuitively one could argue that a higher level of corporate governance could be attained with stricter enforcement.

There are essentially two major distinct legal systems in the world, namely common law and civil law[2]. Shleifer and Vishny (1997) argued that the two legal systems which encompass varying degrees of legal protection of investors and concentrated ownership are two key elements of a corporate governance system in any one country. La Porta *et al.* (1997) found that the legal environment as distinguished by the legal rules and their enforcement would affect the breadth and depth of a country's capital market. Their study classified a sample of 49 countries into common law countries such as Australia, Canada, Singapore, the UK, the USA, Malaysia and Hong Kong and civil law countries such as Indonesia, Philippines, Germany and Taiwan. They found that civil law countries have weaker investor protection and less developed capital markets compared to common law countries (La Porta *et al.*, 1997; 1998). Legal protection includes both voting rights such as the one-share-one-vote rules and anti-director rights such as the rights and mechanisms for minority shareholders to put their representatives on the board through cumulative voting for directors or proportional representation on the board. The above studies reinforce the idea that investors are better protected by laws and related enforcement in common law jurisdictions such as Hong Kong than in civil law countries. Apart from the legal system and enforcement that forms the basis for corporate governance practices, ownership structures present different agency problems

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[2] There are three categories of civil law systems – the French, German and Scandinavian systems. The French Commercial Code originated as early as 1807 and extended its legal influence to the Near East and Northern and sub-Saharan Africa, Indochina, Oceania, and French Caribbean islands. The German Commercial Code was written in 1897 after Bismarck's unification of Germany and was not as widely adopted as the French code. It had an important influence on the legal theory and doctrine in Austria, Czechoslovakia, Greece, Hungary, Italy, Switzerland, Yugoslavia, Japan, and Korea. The Scandinavian family is usually viewed as part of the civil law tradition although its law is less derivative of Roman law than the French and German families (La Porta *et al.*, 1998, pp. 1118-1119).

that are inherent in companies and thus needs to be well understood in evaluating and understanding corporate governance.

Our review of legal systems and enforcement of rules regarding corporate governance in the various jurisdictions enables us to make some generalizations about how enforcement typically occurs. The following is a summary of a typical enforcement mechanism.

Responsibility for enforcement is usually found to operate at three distinct levels. The highest level is that of the nation's or jurisdiction's Company Law (or equivalent), and enforcement takes place at a nationwide level by a governmental or quasi-governmental body. These apply to all companies incorporated under the Company Law.

The next level is the securities laws, with enforcement through a securities commission. These laws typically apply only to entities (i.e., brokers, exchanges, issuing companies) that are involved in the sale and trade of the securities of corporations.

The lowest level of enforcement is that of the individual stock exchange. Exchanges are often self-regulated, and as such, are responsible for setting rules/regulations for listed corporations and monitoring such compliance. The exchanges often work closely with the jurisdiction's securities commission where enforcement may go beyond the rules of the exchange and involve securities law as well. Rules of the exchange may be enforceable through contractual agreement (as a condition of listing), and may also be supplemented by legal requirements of the securities law. Naturally, at this level of enforcement, the rules are only applicable to market participants.

There are several ways in which enforcement is commonly initiated. Exchanges typically are responsible for maintaining some kind of market surveillance to ensure compliance such as disclosures. Inappropriate, or the lack of required disclosures, and unusual activities would attract further investigation which may reveal breaches of rules and regulations. Where breaches have occurred, the exchange may impose disciplinary action (discussed further below). Breaches of securities or company law would be referred to the appropriate authority for further investigation and enforcement of those laws.

The governmental/quasi governmental units responsible for the enforcement of company and securities laws often respond to potential breaches reported by the exchanges. Another common way for investigations and enforcement action to be initiated is through complaints from individuals or other entities that are aware of potential breaches of rules. Finally, enforcement sometimes occurs privately, where an individual or entity initiates legal action against a company or individual. This is sometimes referred to as "private enforcement".

Disciplinary action can range from a written warning to a company or individual, publication of a warning, injunction, temporary or permanent suspension of a listing of a company, fines, to jail terms. The penalty increases with the severity of the breach of the rule or law. If the breach concerns a criminal matter (such as fraud), then legal/criminal proceedings leading to jail terms may result.

2.4 Ownership Structure

Concentrated ownership exists in various forms in different parts of the world. In the developed capital markets such as the USA and the UK, concentrated ownership in the form of institutional shareholding can itself be a corporate governance device to monitor management to act in the interests of the shareholders. In the 1990s, concentrated ownership in the USA and the UK took the form of institutional shareholding which, in turn, developed into investor activism. This type of ownership is characterized as the "equity market corporate governance system" in which a diverse number of large shareholders collectively own US and UK listed companies.

In other parts of the world, concentrated ownership exists in other forms. Though takeovers and institutional investors were virtually absent in Japan, good corporate governance practices were maintained by the concentrated and stable ownership and active role played by banks (Yafeh, 2000). This Japanese model of corporate governance is known as "the bank lending corporate governance system" and is characterized by the existence of closely held companies and banks called *keiretsus*. The banks themselves are influential shareholders who have reciprocal cross-shareholding ties between different companies and would assume a disciplinary function role (Franks and Mayer, 2001; Gorton and Schmid, 1999).

Claessens *et al*. (2000) also studied ownership and control of 2,980 listed companies in nine East Asian economies[3] for the year 1996. Using data obtained from the Worldscope database, they found that the majority of the above East Asian companies were affiliated to a group and thus were controlled by an entity that also controlled a

[3] The nine East Asian economies include Hong Kong, Indonesia, Japan, South Korea, Singapore, Malaysia, Philippines, Taiwan and Thailand.

large number of other entities. In Hong Kong, more than 60% of the 330 sample listed companies were group affiliated. The corporate groups were controlled by a complex web of ownership links, with a pyramidal structure ending with an ultimate owner[4] at the top. In this study, all countries, except for Japan, had a high proportion of family owned corporations. The above evidence suggests that the existence of controlling owners, dominant founders and families are the norm in Hong Kong and Southeast Asian countries rather than the exception, and this is known as the “family based corporate governance system”.

Family Based System

An element of the relationship-based system identified by Rajan and Zingales (1998) is the family ownership of companies. Family control is a significant feature of Hong Kong listed companies with 66% being family owned (HKSA, 1997a). Typically, a single extended family owns a significant proportion of the listed company’s shares with the controlling family members or their nominees occupying senior management positions (Tsui and Lynn, 2001). One study found that the top 15 families in Hong Kong held shares with market capitalization accounting for 84% of 1996 Gross Domestic Product (SCMP, 2000). It is not uncommon that the CEO and chairman are the same person representing the controlling family as well. A recent survey conducted by Tsui and Gul (2000) found that 15% and 2% of the Hang Seng 100 Index companies in 1998 and 1999 respectively, had CEOs and chairman being the same person representing the controlling family. With such a closely held shareholding structure, the typical agency problem arising from the separation of ownership from control may not be an issue. In fact, it is argued that family ownership can even be considered a

[4] This study classified ultimate owners as either family, state, widely held financial institutions, or widely held corporations. A company was classified as widely held if no ultimate owners controlled 20% or more of the shares in each link in the chain of control.

corporate governance device as well, since agency conflicts arising from the separation of ownership from control between shareholders and management are reduced (SCMP, 2000). Family held shareholders who are actively involved in management are likely to pursue long-term value maximization objectives. Tricker (1998) suggested that shareholders in Hong Kong might be seen as part of the family business where the owner manager was the center of the family business, surrounded by "concentric rings", first of the immediate family members of the owner manager, then those related parties in the business, and finally "the shareholders in the outer ring of this extended family". In this case, there could be no agency problem as the directors, being family members, could be trusted to work in the interests of the shareholders.

On the other hand, others have argued that the nature of the agency problem could be different since the controlling shareholder in family owned firms can expropriate funds from the minority shareholders through a pyramidal organization structure whereby a private holding company sits at the top, with a second tier company holding the most valuable assets and the listed company at the third tier of the overall structure. Family domination and entrenchment in the shareholding ownership structure in Hong Kong has given rise to accusations of minority shareholder expropriations.

These minority shareholder expropriations are common agency problems that occur in countries with concentrated ownership (Shleifer and Vishny, 1997). La Porta *et al.*'s (1998) study showed that countries with poor investor protection have more concentrated share ownership (La Porta *et al.*, 1998). In Hong Kong, we can infer that the highly concentrated share ownership by families is associated with relatively poorer protection for minority shareholders. The agency problems associated with

concentrated family ownership such as the expropriation of minority interests presents a problem for regulators and one suggestion to mitigate this problem is the presence of INEDs on company boards.

2.5 Role of Independent Non-Executive Directors (INEDs)

It is widely recognized that the INEDs play an important role in aligning the interests of managers and shareholders by monitoring through the board and board committees (Agrawal and Knoeber, 1996). Apart from the monitoring role, INEDs may bring their individual expertise including their political and legal influence to the board and its committees (Cravens and Wallace, 2001). Overall, INEDs play a crucial role in selecting, monitoring, rewarding or punishing managers through the nomination, audit and remuneration committees respectively. It is also documented that outside directors will act independently from management in order to fulfill their fiduciary duties and to maintain their good reputation as astute executives and effective monitors (Perry, 1999). In the developed capital markets, these INEDs are provided with stock-based incentive plans to motivate them to perform their roles effectively. No conclusive evidence has been found to support the link between the presence of INEDs and better firm performance. The question of how effective the INEDs are in exercising their independent judgment and performing their monitoring roles on the boards or its committees still remains an empirical question which will be further discussed in the latter part of this report. In any case, it is clear that the extent to which the three committees would be able to fulfill their roles and functions effectively depend to a large extent on the role played by the INEDs. Other practical issues relating to the quality of INEDs in terms of the recruitment, training and continuing education in

Hong Kong's unique family held shareholding structure will also be discussed in the latter part of this report.

2.6 Analytical Framework

In evaluating corporate governance systems in other jurisdictions, it is necessary to recognize that these systems have evolved in response to the legal and political infrastructure in those environments. All the countries identified for comparison (except for Taiwan) are embedded in the common law system. However, fundamental differences within these jurisdictions should also be recognized. For example, the USA has a more litigious environment and the US Securities and Exchange Commission plays a pivotal role in the monitoring of US companies. Unlike the USA, the absence of an active market for corporate control in Asian countries deprives these countries of an effective market disciplinary device. In some Asian countries, it is not uncommon for political parties to be involved in the management of listed companies. For example, the major political party (United Malay National Organization) and ruling groups in Malaysia are actively involved in the management and ownership of more than 50% of listed companies (Cheong, 1997). Political infrastructure thus plays a major role in the corporate governing structure and has implications with regard to the monitoring and corporate disclosure policies of listed companies.

Apart from the legal and political infrastructure, institutional factors also matter. The extant literature clearly documents that differences in the legal and institutional environment including patterns of ownership structure would also affect the extent and nature of the agency and incomplete contracting problems that exist in any one jurisdiction (La Porta *et al*., 1998).

Our approach thus recognizes that corporate governance systems evolve in the context of the legal, political and institutional infrastructure in each of the jurisdictions that we intend to survey. An in-depth understanding of the fundamental differences in developed markets vis-à-vis those in Asia needs to be considered. For example, the characteristics of the market-based corporate governance systems existing in the USA and the UK that require more transparency for investor protection and Asian countries such as Malaysia, Taiwan and Hong Kong that have the relationship-based systems. In some of these countries such as Malaysia, relationship-based systems are entrenched giving rise to difficulties in implementing corporate governance reform based on market-based systems.

Three different regulatory approaches to promote good corporate governance have been identified in the literature. These are the prescriptive approach, non-prescriptive approach and balanced approach. The prescriptive approach requires companies to adopt specific corporate governance practices by legislation or regulation. The non-prescriptive approach allows companies to design and determine the specific corporate governance practices that would suit their circumstances subject to appropriate disclosures of corporate governance practices. The rationale for this approach is that there is no one size that fits all. This approach emphasizes substance over form and encourages companies to implement the spirit of good corporate governance rather than adhere to the letter of the legislation or regulation. The balanced approach would specify the best corporate governance practices or code of best practices and requires companies to provide appropriate disclosure if they depart from the code of best practices. This framework is used to analyze the regulatory approaches to corporate

governance in each of the countries under study and critically consider how the measures could be adopted for good corporate governance in Hong Kong.

2.7 Methodology

The overall objective of this study is to gain an in-depth understanding of the corporate governance regimes in the selected jurisdictions as mentioned above. The next section outlines our methods.

2.7.1 Comprehensive Literature Review

We conducted a comprehensive review of academic literature, board practice surveys and corporate governance studies in the USA, the UK, Australia, Taiwan, Singapore, Malaysia and Hong Kong. It included a review of the legal and regulatory requirements and promulgations of best practices by the relevant professional institutes. An analysis of the key international reports of corporate governance has been conducted. A review of the literature focusing on the association between corporate governance variables and corporate performance as well as the literature on costs of disclosures was also conducted.

The following lists the titles of the key academic journals, key international corporate governance reports and international board practice surveys conducted by international professional organizations:

2.7.1.1 Academic literature

Given the time constraint, we focused only on the following major top tier international accounting and finance journals for the last ten years. The journals are as follows:

- Journal of Accounting and Economics
- Journal of Accounting Research
- The Accounting Review
- Journal of Financial Economics
- Journal of Law and Economics
- Corporate Governance: An International Review
- Journal of Financial and Quantitative Analysis

2.7.1.2 Key international corporate governance reports

We recognize that a plethora of reports on corporate governance have appeared worldwide and were instrumental in influencing developments in corporate governance in the developed capital markets. However, we focused on the more important reports. They are as follows:

- Cadbury Report (December 1992)
- Dey Report (December 1994)
- Hampel Report (January 1998)
- OECD Principles of Corporate Governance (April 1999)
- General Motors Corporation Corporate Governance Guidelines (2001)

In addition, all the Hong Kong Society of Accountants (HKSA) publications on corporate governance were reviewed.

2.7.1.3 Professional literature and board practices surveys/studies

To appreciate the extent of enforcement and disclosures on corporate governance practices, we review the surveys conducted by private sector organizations. They are as follows:

- The 27th, 28^{th,} and 29th Annual Board of Directors Study conducted by Korn/Ferry International (2000, 2001, and 2002).

- The Structure of Boards at S&P 1500 Companies published by Russell Reynolds Associates & Investor Responsibilities Research Center (1999).

- Board Committees: Considerations, Structures and Uses in Effective Governance published by American Society of Corporate Secretaries (2000).

- Corporate Governance and the Board – What Works Best published by PricewaterhouseCoopers (2000).

- CG Watch – Corporate Governance in Emerging Markets published by Credit Lyonnais Securities Asia (2001).

- Board of Directors Global Study published by Egon Zehnder International (2000).

- Corporate Governance: 1998 Survey of Public Listed Companies published by PricewaterhouseCoopers Malaysia.

- Corporate Governance Survey, 1999 published by Ernst & Young Australia.

- Guidelines for Good Corporate Governance Practice, released by Pacific Economic Cooperation Council (November 2001).

2.7.2 In-depth Interviews

We have interviewed the key regulators and personnel from government departments and prominent corporate governance experts from private sector institutes in different countries, namely the UK, the USA, Australia, Malaysia and Hong Kong (See Appendix 1). The objective of conducting in-depth interviews was to obtain an understanding of the differences that exist in these jurisdictions compared to that in Hong Kong in terms of strengths and weaknesses, and monitoring and compliance with corporate disclosure requirements. The most up-to-date developments with respect to their country experience were also obtained in the in-depth interviews. Findings from the in-depth interviews are summarized in Chapter 5.

2.8 Summary

This chapter outlines the theoretical basis for corporate governance which draws on the ideas behind agency theory and incomplete contracting. In order to understand corporate governance one needs to recognize the legal systems in each jurisdiction and various ownership patterns as well as in some cases political patronage. We also provide an analytical framework to facilitate the study and evaluation of corporate governance regimes. To achieve the objective of this study, two main methods were outlined, namely a comprehensive literature review and in-depth interviews. The comprehensive literature review covered the legal and regulatory requirements on corporate governance in the chosen jurisdictions including a survey of key international corporate governance reports, board surveys and the legal and regulatory framework of different countries. In-depth interviews with regulatory agencies and prominent corporate governance experts were conducted. These two methods were expected to provide us with an understanding of the differences that exist in these jurisdictions compared to that in Hong Kong in terms of strengths and weaknesses, and monitoring and compliance with corporate disclosure requirements. The next chapter provides a review of key corporate governance reports.

CHAPTER 3 REVIEW OF CORPORATE GOVERNANCE REPORTS

3.1 Introduction

This chapter reviews the key international reports on corporate governance that have been published over the last decade. The issues that are presented here pertain to the board as a whole rather than any specific board committee. The key reports considered in this chapter are:

- "Report of the Committee on the Financial Aspects of Corporate Governance" (Cadbury Report, 1992)
- "Where were the Directors? Guidelines for Improved Corporate Governance in Canada" (Dey Report, 1994)
- The General Motors Corporation Guidelines (GMC, 2001)
- "Committee on Corporate Governance" (Hampel Report, 1998)
- "OECD Principles of Corporate Governance" (OECD Report, 1999)

Detailed recommendations contained in each report can be found in Appendix 2.

3.2 International Corporate Governance Reports

After a series of unexpected failures of major companies[1] in the UK in the 1980s, the Financial Reporting Council, the London Stock Exchange, and the accountancy profession, under the chairmanship of Sir Adrian Cadbury, formed a committee in the UK to address the lack of a uniform code of corporate governance. The report of this committee, known as the Cadbury Report, was the first private sector initiative to develop a corporate governance code of best practices that forms the basis of development of corporate governance in the UK.

The Cadbury Report, published in 1992, focused on the financial aspects of corporate governance such as financial reporting, and reviewed primarily the roles of boards

[1] These companies included the Maxwell group, Pollypeck, and BCCI, among others.

and auditors. The main objectives were to provide a code of best practice that would set out guidelines for the promotion of good corporate governance. It was hoped that companies would apply the code with flexibility, giving due regard to individual circumstances, and follow the spirit rather than the letter of the code.

The Dey Report published in Canada in 1994 was one of the first corporate governance reports with a full set of corporate governance guidelines that a company could follow for listing on a stock exchange. This set of guidelines was subsequently adopted by the Toronto Stock Exchange (TSE) in 1995. All TSE listed companies must provide an explanation of the differences between their own corporate governance approach and the Dey guidelines. This requirement effectively brought corporate governance issues into the public eye, and put pressure on companies to improve their own corporate governance practices. Since the publication of this report, there have been many similar reports in other jurisdictions.

The General Motors Corporation in the USA (GMC), criticized by shareholders for poor corporate performance and questionable board practices, introduced its own corporate governance guidelines in 1994. This self-imposed set of guidelines was developed in consultation with its board, shareholders, and corporate governance activists. This set of guidelines was welcomed by the industry and particularly institutional investors such as the California Public Employees' Retirement System (CalPERS). The GMC guidelines have since become a benchmark for individual corporate governance structures in the USA.

Subsequently, the Hampel Committee (1998) was formed to consolidate the recommendations of the Cadbury Report (1992) and the Greenbury Report (1995, a report on executive remuneration), as well as to address some gaps not covered by these two reports. It examined the extent of the implementation of the recommendations of the Cadbury and Greenbury Reports and provided more explicit recommendations on remuneration policy, accountability and audit.

Hampel observed that good corporate governance goes beyond a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. It drew attention to the fact that a "box ticking" approach to corporate governance is a serious issue and that form over substance would always remain a potential problem. Good corporate governance requires informed judgment, flexibility and common sense depending on the various circumstances of individual companies. Companies should be prepared to review and explain their governance policies, including any special circumstances justifying departure from generally accepted best practice. Equally, shareholders and other stakeholders should show flexibility in the interpretation of the code and should listen to directors' explanations and judge them on their merits.

In 1999, the OECD Principles of Corporate Governance (OECD) was published and was intended to be a non-binding set of corporate governance principles for listed companies in OECD member countries. The principles provided are designed to be a starting point for local policymakers, and cover topics in the main subject areas of the rights and equitable treatment of shareholders, the role of stakeholders, disclosure and transparency, and the responsibilities of the board.

The Pacific Economic Cooperation Council (PECC) released the "Guidelines for Good Corporate Governance Practice" in November 2001. The PECC is an organization established by government officials, academics, and business leaders as a forum to discuss cooperation and policy coordination in Pacific Region countries. One of the major initiatives is to develop corporate governance guidelines based upon the more general OECD principles with special consideration to appropriate practices in PECC Member Committee countries[2]. The next section discusses some of the major corporate governance mechanisms and issues of concern that are contained in the key reports.

3.2.1 Structure of the Board

There are two types of board structures commonly found in companies, depending on whether the jurisdiction the company operates in is governed by common law or civil law.

In common law jurisdictions, such as the UK, the USA, Hong Kong and other regions that have been influenced by the UK legal system, boards are referred to as a unitary board. These boards consist of directors elected by shareholders, and have the role of overseeing management. Management is responsible for the day-to-day functioning of the company while the board is responsible for ensuring the long-term success of the company.

[2] PECC Member Committees represent the economies of: Australia, Brunei Darussalam, Canada, Chile, China, Colombia, Ecuador, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, the Pacific Islands Forum, Peru, the Philippines, Russia, Singapore, Taiwan, Thailand, USA, Viet Nam, France (Pacific Territories), and Mongolia.

In civil law jurisdictions, such as Taiwan, Japan and Germany (and other countries influenced by German, French or Scandinavian civil law systems), companies will typically have dual boards, a supervisory board and a management board. While both boards consist of directors, they fulfill very different functions. The management board is responsible for the day-to-day operation of the company, while members of the supervisory board (supervisors) are individually responsible for overseeing the work of the management board.

Because only one of the jurisdictions in our study follows the civil law model with dual boards (Taiwan), our emphasis is on unitary boards and codes of best practice directed at unitary board corporations. Of all the codes reviewed, only the OECD Guidelines are directed towards both unitary and dual boards. All others originate in unitary board jurisdictions hence are intended to apply to unitary boards only.

3.2.2 Responsibilities of the Board

Although board responsibilities will vary from region to region, there are general responsibilities that are applicable for all companies. The OECD Guidelines provide a description of the board's responsibilities:

- "Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
- Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.
- The board should ensure compliance with applicable law and take into account the interests of stakeholders.
- The board should fulfil certain key functions, including:
    - Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring

implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.

  - Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.

  - Reviewing key executive and board remuneration, and ensuring a formal and transparent board nomination process.

  - Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.

  - Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for monitoring risk, financial control, and compliance with the law.

  - Monitoring the effectiveness of the governance practices under which it operates and making changes as needed.

  - Overseeing the process of disclosure and communications."

- "The board should be able to exercise objective judgement on corporate affairs independent, in particular, from management.

  - Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are financial reporting, nomination and executive and board remuneration.

  - Board members should devote sufficient time to their responsibilities.

  - In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information."

These guidelines emphasize the legal responsibility of boards and directors, explicitly state their responsibility to all classes of shareholders, and also recommend the consideration of stakeholders' interests. They also review the key functions of the board, but do not explicitly state how the board will fulfil these functions. The OECD Guidelines are meant to be broad and avoid specifics so that they may be readily adaptable to a variety of jurisdictions. The functional structure of the board and committees will be dependent on the legal environment (i.e., common law or civil

law) and regulatory framework of the jurisdiction. For more specific guidance on how boards should be structured and how they should function, one must look to codes of best practice and/or listing rules, and corporate law. In the following sections, we will examine the specific recommendations of the main codes of best practice and corporate governance guidelines. Rather than identifying what each code or guideline recommends on each corporate governance criterion, we will identify what the consensus is and then highlight where any code or guideline deviates from this consensus. A comparison of the detailed recommendations of the key corporate governance reports and guidelines is found in Appendix 2.

3.2.3 Board Composition

The Cadbury Report (1992) made general recommendations regarding board composition as follows. The board should be made up of a combination of executive directors and outside non-executive directors (NEDs) under a chairman (4.1). The shareholders are responsible for electing the board members from candidates selected by a nomination committee (4.30). Hampel made some further recommendations regarding board membership. First, the process by which members are appointed to the board should be transparent (3.19). Second, the appointment of directors to represent outside interests is generally incompatible with board cohesiveness, and should be avoided (3.20). Third, appointments should be fixed as to duration. Directors should have to re-submit themselves for nomination at intervals not exceeding three years if they wish to continue to be a member (3.21). Fourth, in the case of a resignation, it is suggested that an open discussion with shareholders would be held to dispel rumours about a resignation if the facts are not widely known (3.23). There were no requirements for mandatory retirement. The Dey Report recommended

that a board should have a majority of unrelated directors. An unrelated director is defined as a director who is independent of management and free from any business or other relationship that could or could be perceived to interfere with the director's ability to act in the best interest of the company. The GMC guidelines had a requirement for an annual review of the skills and characteristics of board members. The objective was to correct deficiencies and reduce redundancies in terms of the skills and expertise directors bring to the board through the addition of new members and termination of excess or unneeded members. No term limits are recommended, but an age of 70 was considered to be an appropriate retirement age.

Cadbury stated that all boards require a minimum of three NEDs, one of which may be the chair. Further, a majority of the NEDs on the board should be independent. Hampel provided more guidance by stating that NEDs should represent at least one-third of the board. The OECD report, being more general in nature, simply stated that there should be a sufficient number of independent non-executive directors (INEDs). The definition of what constitutes a "sufficient" number is not specified. The Dey report supported a board size of ten to sixteen members, but did not specify an ideal number. Dey also noted that the board is in the best position to assess whether the current size best promotes an effective board, and that they should periodically review the size and composition to ensure effectiveness. However, Dey warned that board effectiveness will tend to decrease when board size exceeds 20 members. The GMC guidelines required a majority of INEDs, and while not recommending a specific board size, noted that the current size of 15 members was about right.

3.2.4 Chairman

The chairman's role is to run the business and is responsible for the day-to-day functioning of the board, including policy and strategy implementation. Cadbury, Hampel and OECD all agreed that the roles of the chairman and the chief executive officer (CEO) are best kept separate. Cadbury recommended that if the chairman is also the CEO, there is a requirement for a strong and independent element on the board. Hampel suggested that this presence should be on the board at all times. Hampel also suggested that there be a senior NED to convey concerns to the board other than through the chairman or CEO. Dey noted that the board must function independently of management. This could be achieved either by separating the role of CEO and chairman, and having a non-executive chairman, or by designating an independent lead director. GMC's recommendation was that the board should decide, while considering relevant issues at the time, whether a separate CEO and chairman is appropriate.

As the effectiveness of the board is largely dependent on the form, timing and quality of information upon which it bases its decisions, the chairman must ensure that all members of the board are properly briefed on all issues, and are appropriately empowered to perform their duties. All directors are equally responsible in law for the board's actions and decisions, but it is up to the board collectively to ensure that it meets its obligations.

3.2.5 Non-Executive Directors (NEDs)

Cadbury described the essential quality of NEDs as being "independence of judgment". NEDs should be able to objectively review the performance of the board,

and take the lead where potential conflicts arise. While Cadbury looked at the role of the NED with respect to accountability, Hampel took a business-growing perspective, that is, how the NED can add more value to the company and shareholders' wealth. He suggested that more attention to the diversity of backgrounds for bringing special expertise or experience to the company should be made in the selection of NEDs.

Cadbury suggested that the selection of NEDs is best left to a nomination committee, and that they should be chosen with the same impartiality and care as senior executives. Hampel elaborated by stating that the NEDs should be of such a calibre that they command the respect of the executive directors, which is essential to running the business in a cohesive manner. GMC's guidelines recommended that the assessment of suitable board members should include issues such as judgment, diversity, age, skills, and international experience.

Experience since the Cadbury report has indicated that it is more difficult for smaller companies to find qualified INEDs, but Hampel pointed out that it does not lessen the need for them. However, the governance arrangements for smaller companies must be considered with flexibility and due regard to the company's circumstances.

Dey recommended the use of NEDs with diverse backgrounds but cautioned that it must be balanced against favouring specific constituencies. In particular, if there is a significant shareholder who can elect directors to the board, the board should include a number of directors that are unrelated to the company or the significant shareholder to fairly reflect the investment of the other shareholders other than the significant shareholder.

3.2.6 Board Meetings

Cadbury provided some recommendations concerning board meetings. The board should meet regularly, with sufficient information distributed to the members in advance of the meeting to ensure effective use of the directors' time. A schedule of matters reserved for the board's decision should be kept up to date and provided to newly appointed members as part of their induction into the company. The board should keep a record of the minutes of meetings. The GMC guidelines echoed the recommendations of Cadbury.

3.2.7 Other Director Issues

Directors, whether executive or non-executive, must act in good faith, and exercise due care. To ensure adequate skills and knowledge, newly appointed directors should receive an induction into the affairs of the company, and ongoing internal or external training to ensure they are aware of new laws, regulations and changing commercial risks. All directors should have access to independent professional advice at the company's expense if it is considered necessary for discharging their responsibilities on matters relating to the company.

Hampel specifically stated that board appointment should not be considered a reward for good performance in an executive role. They must also be able to express views that may differ from those of the chairman or CEO, without fear of any reprisals.

3.2.8 Board Committees

Cadbury recognized that the effectiveness of a board would be enhanced through formal structures and procedures. An effective system of internal controls is one good

way to implement board policies and procedures. Another is through the formation of committees, such as the audit, nomination and remuneration committees. Through these committees, the board can delegate responsibility for certain functions. Regardless of how committees are formed, the ultimate responsibility for the delegated duties rests with the board.

3.2.9 Audit and Accountability

3.2.9.1 Statement of compliance

Cadbury recommended that all listed companies make a statement of compliance with the Code of Best Practice which should be reviewed by the external auditor. The company should explain non-compliance with any item of the code. The external auditor should review those items that can be objectively verified, but does not need to formally report unless there is non-compliance.

Hampel and the OECD recommended that the statement of compliance would increase transparency by requiring the company to explain *how* they applied relevant corporate governance principles to their particular situation.

3.2.9.2 Financial reporting to shareholders

Cadbury advised that the guiding principle for financial reporting should be openness. While recognizing that there is sometimes a need for providing information other than the annual or half-yearly reports, it was not recommended that a quarterly reporting practice be adopted. All reports should aim for wide circulation, and should include statements of income and cash flow, and a balance sheet. Cadbury advised that very careful consideration must be made of the balance between detail and simplification

of reports. Cadbury also recommended that regular contact between companies and institutional investors be maintained.

Hampel expanded on a number of Cadbury's recommendations on reporting to shareholders. It was suggested that institutional investors could advise the company as to their investment objectives, provide feedback, and arrange for regular meetings with the company. It was also recommended that institutional investors carry out investor relations training, and improve fund manager awareness of the relevant industry. To ensure appropriate communications, and to avoid providing some shareholders with more information than others, the company should develop and follow a written policy on investor communications.

3.2.9.3 External audit

The goal of an external audit is to ensure an objective and efficient examination of the annual report of accounts, carried out against strict accounting standards. However, Cadbury pointed out that the framework in which external auditors operate is not well designed in some respects. Often, accounting standards and practice allow boards too much scope in accounting treatments which puts auditors in a difficult position if they disagree with the boards selection of a particular treatment. Another concern is the increasing pressure on companies to reduce audit costs, while at the same time audit firms are competing against each other, often on the basis of price. These pressures can lead to auditors meeting the demands of management, but not the needs of shareholders. Cadbury described the central issue here as being the relationship between management and the external auditors. To assist in the maintenance of an appropriate relationship, Cadbury recommended more effective accounting standards

and the presence of an audit committee in all listed companies. OECD recommended the adoption or development of high quality internationally recognized accounting standards.

Cadbury also pointed out that there is sometimes an "expectation gap" between what audits really achieve and what is often perceived to be achieved. In order to reduce the expectation gap, there should be clarification of what the respective roles of the external auditor and management are.

Another issue addressed by the Cadbury committee was the "going concern" concept. It was felt that the disclosure of a going concern issue would precipitate the collapse of a company. It was also believed that few directors understood what "going concern" meant, and their responsibilities for addressing going concern issues early. Cadbury specifically recommended that the board states in the annual report that the business is a going concern, and that the auditors report on that statement.

In general, Hampel agreed with all of Cadbury's recommendations relating to going concern. However, it provided some more guidance on auditor independence. Hampel acknowledged that when an auditor relies on any one client for a significant portion of the auditor's revenue, there could be an impairment of independence. It recommended that no more than 10% of an auditor's revenue should come from one client. The audit committee should review the relationship between the company and the external auditor, especially in situations where the auditor provides a substantial amount of non-audit work.

3.2.10 Institutional Shareholders

Cadbury observed that the major shareholder of a company is often an institutional investor, such as a pension fund. As these investors are generally holding the shares for individuals, there is a large degree of communal interest between individual and institutional investors, and institutional investors are in a special position because of the size of their holdings. It recommended that institutional shareholders use their influence to encourage companies to comply with the code. Institutional investors should encourage regular and systematic communication with senior executives in the company, take a positive interest in compositions of the board and its committees, and exercise their voting rights.

Hampel noted that institutional investors are taking a more active role in corporate governance, and they should continue to take a more constructive interest in company strategy and performance over time. The institutional investor has a duty to their client to make considered use of the voting rights associated with their shareholdings. It was recommended that institutional investors vote all shares under their control to the best of their ability, and report to their clients on how the votes are used.

OECD recommended that institutional investors exercise the voting rights they hold, but individual shareholders may elect to vote some of the shares personally. Above all, the institutional investors are to vote the shares in a way that is consistent with the best interest of the shareholders.

3.2.11 Stakeholders

The OECD Report made some recommendations with respect to stakeholders. This is an area that was not covered in the other reports. Specifically, the report emphasized that through the contributions of stakeholders, wealth, jobs, and sustainability are created for a business. Corporations need to recognize the value and importance of stakeholders. The corporate governance framework should assure that the rights of stakeholders are protected, including the right of redress where their rights under the law have been violated. The framework should also permit performance-enhancing mechanisms, such as employee representation on boards and employee stock ownership plans. When stakeholders are involved in the corporate governance process, they should be allowed access to the relevant information required for them to meaningfully contribute.

3.3 Summary

This chapter surveys the five corporate governance reports beginning with the Cadbury Report. The major issues raised by these reports focused on board composition, the role of the CEO, the importance of NEDs and board committees such as audit committees and remuneration committees, the role of auditors and accountability issues. The reports also considered the role of institutional investors and the responsibility of the company towards other stakeholders such as employees.

CHAPTER 4 LITERATURE REVIEW ON CORPORATE GOVERNANCE

4.1 Introduction

The argument in favor of corporate governance reform hinges on the notion that good corporate governance leads to better corporate performance and higher firm value. Such a relationship needs to be empirically demonstrated in order to encourage corporate management to accept the additional rules and regulations for establishing better corporate governance practices. To this end, we review in the following sections prior literature on the relationship between corporate governance and corporate performance. This is followed by a discussion on the costs of disclosure and related issues, as disclosure is an important element contributing to corporate governance.

4.2 Corporate Governance and Firm Performance

A number of prior academic studies have focused on the link between corporate governance and corporate performance. However, the establishment of such a link is not straightforward and the results are equivocal. The divergence of findings might be partly attributable to the fact that different measures of corporate governance and corporate performance were used in different studies (Patterson, 1998; 2000). Patterson surveyed all the major studies on corporate governance and corporate performance conducted from 1982 to 1998 (with an update in 2000) and found that both the terms "corporate governance" and "corporate performance" were elusive because of the different ways in which different studies defined and proxied "'corporate governance" and "corporate performance". This has resulted in "an array or matrix of different definitions of governance matched against different measures of

performance" (Brancato, 2000). A summary of the various measures of corporate governance and corporate performance used in prior studies is presented in the next section. This will be followed by a discussion of the results of studies on the relationship between corporate governance and corporate performance.

4.2.1 Measures of Corporate Performance

Patterson (2000) noted that different measures of corporate performance were employed in different studies and the most common performance measures were as follows:

- Stock market measures, such as the cumulative abnormal returns (CAR)[1] (some studies used the term "cumulative excess returns [CER]");
- Accounting-based measures, i.e., figures and ratios from the financial statements such as return-on-equity (ROE)[2], return-on-assets (ROA)[3]; and
- Combined stock market and accounting measures, like Tobin's Q[4] or the ratio of market-to-book values[5].

4.2.2. Measures of Corporate Governance

Similarly, different studies have used a variety of measures to proxy for "corporate governance". For example, some studies proxied shareholder ownership as an indicator of active corporate governance, while others used more specific activities such as shareholder proposals or target lists by activist shareholders. Other studies have employed various board characteristics such as board size, composition, the quality of directors, board leadership, etc. as proxies for corporate governance. As

[1] Cumulative abnormal returns (CAR) is the cumulative difference between the observed return and the normal return as predicted by the capital asset pricing model (CAPM).
[2] Return on equity (ROE) is net income divided by total equity.
[3] Return on assets (ROA) is net income divided by total assets.
[4] Tobin's Q is measured by dividing the market value of capital by replacement cost of assets.
[5] The ratio of market-to-book values is the market value of assets divided by book value of assets.

different measures may tap different dimensions of corporate governance, it is not surprising that the results on the relationship between corporate governance and firm performance have been inconclusive.

Our review of the academic literature in the next section cover the various types of corporate governance measures used to study the relationship between corporate governance and firm performance. The different dimensions of corporate governance considered are as follows:

- Concentrated shareholder ownership
- Shareholder intervention
  - Shareholder proposals
  - Target lists for shareholder intervention by activist shareholders
- Board characteristics
  - Board size
  - Quality of directors
  - Chief executive officer (CEO) duality
  - Board composition
  - Board activity
  - Directors' ownership
- Cross-country rankings on corporate governance
- Others including opinion rankings by investors or experts

4.2.3 Literature Review on the Corporate Governance / Performance Relationship

4.2.3.1 Concentrated shareholder ownership

Prior studies have found that concentrated shareholder ownership can lead to more active monitoring, thereby leading to better corporate governance (La Porta *et al.*, 1997; 1998). This active monitoring effectively reduces the probability of management expropriating shareholders' wealth. This includes the active role played

by institutional investors. Since the effect of institutional investors' share ownership and activism on corporate performance has already been thoroughly examined in Brief 1, our literature review below will not focus on their roles on corporate performance.

The majority of prior studies found that an increase in shareholders' ownership is associated with improved performance. Examples of the studies are as follows:

- Weiss and Nikitin (1998) analyzed the relationship between the concentration and composition of ownership and subsequent changes in the performance of 125 Czech companies during 1993-1995. It was found that corporate performance (measured by the change in value added per worker, value added per unit of capital, operating profit per worker, change in operating profit per unit of capital, and the Solow residual[6]) improved with the increase in shareholder ownership concentration. It concluded that the presence of large and powerful shareholders (as a form of corporate governance) would lead to improvement in firm performance.

- Hill and Snell (1988) argued that shareholders prefer strategies which maximize their wealth, while managers prefer strategies which maximize their self interests. Therefore, when shareholders dominate management decisions, innovation strategies would be favored over diversification since innovation is associated with higher firm profitability than diversification. This hypothesis was tested using 94 Fortune 500 firms and results showed that a higher concentration of shareholder ownership was positively associated to R&D expenditure suggesting that shareholders prefer innovation to diversification. Further, higher shareholder ownership was also associated with higher profitability (in terms of return on assets and return on sales).

- McConnell and Servases (1990) studied 1,173 US firms for 1976 and 1,093 US firms for 1986 and found a positive relationship between institutional ownership and corporate performance, i.e., the higher the level of institutional shareholding, the higher the corporate performance (Tobin's Q). This suggests that institutional investors are, to a great extent, effective monitors of management leading to lower risk and better performance.

[6] Solow residual was used in the study to measure the contribution of management expertise to firm performance.

In contrast to the above findings, the following study did not find supporting evidence regarding the positive association between ownership concentration and corporate performance:

- Bhagat *et al.* (2000) studied the relationship between relational investing[7] and firm performance by examining 1,534 large, publicly traded firms in the USA during the period 1983-1992. There was no evidence that firms with the presence of relational investors would perform better in terms of both stock price performance measures and accounting measures of performance.

4.2.3.2 Shareholder intervention

Event studies on specific "corporate governance events" including the filing of shareholder proposals, announcements of corporate governance related charter amendments and other forms of shareholder intervention by institutional investors or activists are reviewed in the following sections.

Shareholder Proposals

The following studies found that the filing of shareholder proposals had a positive impact on firm performance:

- Smith (1996) examined the firm characteristics that would lead to activism by CalPERS, the leading institutional investor in the USA, and investigated whether shareholder activism is an effective means of monitoring. Using 51 firms that were involved in the 78 targeting events[8] of CalPERS from 1987 to 1993, he examined whether such events of activism resulted in changes in target firms' governance structure and shareholder wealth. He found that CalPERS tended to target larger firms with poor stock performance, lower market-to-book ratio and more industry diversification. Changes in governance structure were observed in 72% of the sample during the period, suggesting that there were positive effects of

[7] A 'relational investor' was defined in the study as a shareholder, other than a company officer or employee stock ownership plan, which holds at least a 10% stake, generally for a minimum of four years.

[8] Issues dealt with by these targetings included resolutions to redeem a poison pill that had been implemented, those related to board composition, and compensation, as well as resolutions for the creation of a shareholder advisory committee with representatives from shareholder groups to provide input in major decisions.

shareholder activism by CalPERS. In addition, activism was shown to lead to net benefits for the activist/shareholder wealth (proxied by cumulative abnormal returns) though no statistically significant change in operating performance (including operating income, operating income/sales and operating income/assets) was found.

- Strickland *et al.* (1996) in a US study examined 53 proposals sponsored by the United Shareholders Association in 1990-1993, and reported a total shareholder wealth gain of US$1.3 billion after the agreement date for those resolutions. This provided evidence that shareholder proposals enhance shareholders' wealth.

However, other studies failed to find empirical support for the above relationship:

- Del Guercio and Hawkins (1999) examined the motivation and impact of pension fund activism using 266 shareholder proposals submitted to 125 US firms from 1987-1993. No significant effects on stock return or accounting measures of performance in the three years following an initial targeting were observed.

- Karpoff *et al.* (1996) examined 866 shareholder proposals on corporate governance for 317 US companies from 1986-1990. They found that firms attracting governance proposals had poor prior performance (as measured by the market-to-book ratio, operating return and sales growth). However, it was found that the proposals did not lead to any changes in operating returns, company share values or top management turnover. Even those proposals that received a majority of shareholder votes typically did not lead to any share price increases or discernible changes in firm policies.

- Daily *et al.*'s (1996) study used a random sample of 200 Fortune 500 corporations from 1990 to 1993 and did not find significant results to link (i) the number of governance-related shareholder proposals (a proxy for shareholder activism) with firm performance (proxied by return on equity and return on investment); and (ii) institutional investor holdings with performance.

- Wahal (1996) examined 356 targetings of 146 US firms by nine major pension funds during the period 1987-1993. It was found that the monitoring mechanisms employed by the activist pension funds were reasonably successful in changing the governance structure of targeted firms, in that 40% of the proxy proposals initiated by such funds were adopted by the targeted firms. Despite this finding, there is no evidence documenting any improvement in performance for the targeted firms proxied by either stock price performance (measured by cumulative abnormal returns) or by accounting measures of performance (measured by industry-adjusted operating and net income).

Target Lists by Activist Shareholders and Other Forms of Shareholder Activism

When companies are targeted by activist shareholders such as CalPERS, it is expected that some forms of shareholder activism (which includes, but is not limited to, shareholder proposals discussed above) would exist due to more active monitoring and firm performance would improve. The following summarizes some of the studies that support the positive relationship between target lists and firm performance:

- Opler and Sokobin (1995) studied 96 firms that were on the "focus list" of the Council of Institutional Investors (CII) during 1991-1993. Using cumulative excess returns and operating cash flows to measure firm performance, they found significant above-market performance with both the cumulative excess returns and operating profitability substantially improved for the targeted firms in the year after targeting. This suggests that a higher degree of such governance mechanism would improve firm performance. These results were questioned by a number of scholars including Black (2001) who questioned the reliability of the results simply "because they are too strong… the 12% mean (9% median) abnormal returns they find are implausibly large, given the mild nature of CII listing -- which may or may not result in targeted activism by CII's members, which may or may not succeed" (Black, 2001, p.12).

- Nesbitt (1994) studied the long-term stock price performance of 42 companies targeted by CalPERS during the period 1987-1992. They assessed whether shareholder value improved as a result of intervention by CalPERS such as the establishment of shareholder advisory committees, executive compensation committee reforms and pressure for more independent non-executive directors (INEDs). It was found that with CalPERS intervention, these targeted companies outperformed the Standard & Poor's (S&P) 500 by 41% over the subsequent five years, measured by cumulative excess returns.

- Carleton *et al*. (1998) investigated the effect of negotiated targetings[9] on corporate performance by examining correspondence between Teachers Insurance Annuity Association-College Retirement Equities Fund (TIAA-CREF, a major institutional shareholder in the USA) and 45 firms (with a total of 62 targetings) on governance issues during 1992-1996. Results show that TIAA-CREF was generally successful in reaching agreements with the firms it contacted (over 90%), and the short-term valuation effects from such activism were highly correlated with targetings such as those on board diversity and confidential voting issues. It was found that board diversity targetings (e.g., asking a woman or minority to be present on the board) yielded statistically significant negative abnormal returns, and targetings that opposed firms that were about to issue preferred stock as a takeover defense without shareholder approval yielded significant positive abnormal returns. Further, requests by institutional investors for the adoption of confidential voting

[9] Negotiated targetings occur when institutional investors negotiate informally with management on various corporate issues.

for all shareholder votes yielded insignificant abnormal returns. All the above findings suggest that there was no conclusive evidence on the effect of such negotiated activism on corporate performance.

The above review of studies suggests that the empirical evidence linking shareholder activism and firm performance is equivocal.

4.2.3.3 Board characteristics

Board Size

The hypothesis that board size is a significant variable affecting corporate governance is not clear. Some scholars posited that companies with a larger board would be better governed, while others argued that a smaller board would enhance corporate governance and hence promote better performance. No conclusive evidence has been documented in prior academic literature.

It is, however, argued that when there are more directors on the board, the firm would be more likely to secure critical resources, such as external funding (Pfeffer, 1972; 1973; Zahra and Pearce, 1989). Others maintain that as the board becomes larger, the CEO could obtain quality advice from non-executive directors (NEDs) (who might themselves be the CEO of other companies) who would be able to provide more expertise than other executives (Zahra and Pearce, 1989). Empirical evidence supporting this argument includes the following:

- Golden and Zajac (2001) surveyed 3,198 US hospitals and found that the relationship between board size and strategic decisions (i.e., changes that conformed more to industry best practice were adopted) was non-linear. In particular, they found that as board size increased for smaller boards, there was a positive effect on the firm’s strategic decisions but further increases in board size led to negative effects on strategic decisions. In other words, an increase in the number of directors on an existing large board would reduce its efficiency. This

result suggests that there is an "optimum" size for the board. This is evidence that board size would indirectly affect firm performance.

- Dalton *et al.* (1999) performed a meta-analysis[10] of 131 observations (N = 20,620) across 27 studies on the relationship between the board size and financial performance. Both accounting-based indicators of financial performance (such as return on assets, return on equity) and indicators based on market returns (such as Jensen's alpha, the Treynor measure, the Sharpe measure)[11] were used to measure financial performance. Their analysis found that there existed a strongly positive relationship between the two variables, suggesting that corporate governance, in the form of a larger board, is associated with better firm performance.

- Chaganti *et al.* (1985) investigated the differences in board size of 21 pairs of failed[12] and non-failed retailing firms in the USA during 1970-1976. They found that non-failed firms tended to have larger boards than the failed ones, showing that companies with a larger board size would perform better than those with a small board, and companies with larger boards have greater chances of survival.

Though the above evidence is supportive of larger boards, other scholars argued that firms with a smaller board would have better (or more efficient) corporate governance and hence better firm performance. They pointed out that large boards might suffer from the problem of social loafing, i.e., as the board increases in size, the individuals would exert less effort (Kidwell and Bennett, 1993; Latane *et al.*, 1979; Shepperd, 1993). Large boards may also be less participative, less likely to reach consensus and more likely to develop factions and coalitions which could lead to group conflicts (Judge and Zeithaml, 1992; Goodstein *et al.*, 1994). Further, CEOs might gain advantages in power relations with board members through tactics such as divide and rule or coalition building when the board is large and diverse (Mintzberg, 1983;

[10] "Meta-analysis is a statistical technique which, while correcting for various statistical artifacts, allows for the aggregation of results across studies to obtain an estimate of the true relationship between two variables in the population" (Dalton *et al.*, 1998; 1999).
[11] These measures were based on portfolio returns.
[12] A firm was defined as a failed firm in the study if it had filed for bankruptcy under Chapter XI of the Bankruptcy Act in the USA. A non-failed firm was one which had remained in existence during the examination period.

Alexander *et al*., 1993). A number of empirical studies support this argument and they are summarized below:

- Eisenberg *et al*. (1998) studied 879 small (in terms of sales, total assets and number of employees) Finnish firms during 1992-1994, and found that the larger the board size (i.e., more than 6–7 members) the lower the firm performance as measured by industry-adjusted return on assets. They pointed out that large boards tend to have more communication and coordination problems which might hamper the effectiveness of efficient decision making and management control. In addition, large boards tend to have a larger proportion of outside directors who usually are biased against high risk projects (which also have higher potential returns) in order to maintain their reputation (Yermack, 1996). It is was also found that firms with a higher proportion of outside directors (which is typical in a large board) would be less likely to outperform their competitors.

- Brown and Maloney (1998) examined the effects of different board characteristics[13] on the stock price returns for acquiring firms in takeovers. They argued that since any given director's influence on a large board is small, directors in a larger board would have incentives to shirk. It is difficult for a large board to give every director sufficient opportunities to review all the relevant issues. Therefore, it is expected that monitoring in firms with large boards would be less effective and hence lead to lower performance. Using the acquisition performance (measured by the three-day abnormal returns) of 82 US companies that attempted 106 acquisitions during the period 1982-1986[14], it was found that board size was negatively related to performance, thus confirming the above hypothesis.

- Yermack (1996) studied 452 large US industrial corporations between 1984 and 1991 and reported that there was a significant *negative* correlation between both the board size as well as board composition (measured by the proportion of independent directors in the board) and firm's stock price performance (measured by Tobin's Q) as well as operating performance (measured by return on assets and the ratio of capital expenditures to sales). This suggests that there might be a negative relationship between board size and corporate performance.

Quality of Directors

Qualitative dimensions of the board such as the quality of directors is found to lead to better firm performance. The study cited above by Brown and Maloney (1998)

[13] Board characteristics include board composition, director turnover, board size and director reputation.
[14] As commented by the authors, acquisition performance is regarded as "an excellent measure of corporate performance. Since companies are never forced to expand, this managerial decision is purely discretionary and hence is the clearest signal of managerial quality" (page 11).

found that firms with more reputable board members[15] (represented by the higher number of other directorships held by the board directors) positively affected corporate performance. It should be noted that "more reputable board members should be better board members. Firms that are able to attract and keep these directors are more likely to be well-managed firms." Golden and Zajac's (2001) study found that both the tenure and age of board members would positively affect firm performance. An increase in the number of years of involvement of the board members correlates with better strategic decisions by the firm. In addition, the older the board members, the better the strategic decisions are. This may lead to better firm performance.

Other qualities of the directors might also affect their ability to influence the board and exert their influence on the strategic decisions that would improve firm performance. Westphal and Milton (2000), for example, examined the effects of prior experience and the social connections of directors on board decisions. Through a questionnaire survey, they investigated 526 outside directors of large- and medium-sized US companies listed in the Forbes 500 index in 1995 and found that when directors were previously minority directors in other boards[16], they had an appreciation for their role as a minority director, as well as a greater ability to present their ideas in a way that other board members would be more likely to

[15] Recent accounting scandals in the USA such as Enron may not be consistent with this evidence.
[16] "majority" and "minority" are defined in terms of the proportion of directors in the board with the same functional backgrounds, industry backgrounds, education, race and gender.

accept. This could facilitate better discussion and the exchange of ideas, and the board would be more likely to make better decisions that improve firm performance. Where minority and majority directors had some other social connection (such as common membership on another board or other societies), the ability of minority directors in exerting an influence on the strategic decisions of the firm would be enhanced. This would also have a positive impact on firm performance.

CEO Duality

CEO duality is defined as whether the chairman of the board is also the CEO and is generally viewed as “a sign of power accumulation and power hoarding” (Fortune, 1991, p.13). Therefore, it is argued that with the separation of the two roles, the company would be better governed, and this would induce a positive influence on the firm performance. Evidence supporting the separation of CEO from chairmanship is summarized below:

- Sundaramurthy *et al.* (1997) analyzed 261 S&P 500 firms in the USA that adopted 486 antitakeover provisions[17] for the period 1984-1988. It was found that, although the adoption of antitakeover provisions would negatively affect stock price performance, such negative market reactions would be less prominent when the positions of CEO and chairman were separated. This suggests that the monitoring role of the chairman seemed to have an effect on the market reaction to antitakeover provisions.

- Daily and Dalton (1994) examined the relationship between board leadership structure and corporate bankruptcy. They investigated 57 matched pair US bankrupt and non-bankrupt firms[18] during a ten-year period from 1972 to 1982. Results showed that bankrupt firms (53.8%) had a greater incidence of the joint CEO-Chairman structure than surviving firms (37.5%). This showed that firms which separated the roles of CEO and chairman would have a higher chance of survival, suggesting that board leadership is an important variable in firm performance.

[17] These antitakeover provisions included 20 supermajority amendments, 106 classified board amendments, 110 fair-price amendments, 21 provisions for reduction in cumulative voting, 33 anti-greenmail provisions, and 196 poison pill provisions.

[18] Bankrupt firms were defined by the study as firms that had filed bankruptcy over the examination period.

- Gul and Leung (2002) using 385 observations from Hong Kong companies for the year 1996 examined whether a separate CEO structure was associated with higher voluntary corporate disclosure[19]. The results, after controlling for firm size, family ownership and other important variables showed that CEO duality was associated with lower levels of voluntary corporate disclosure. More interestingly, they also showed that the negative relationship between CEO duality and corporate disclosures was weaker for firms with more "quality" NEDs. "Quality" was measured in terms of the number of other directorships held by the NEDs. These results are consistent with the Westphal and Milton (2000) study cited above which showed that there was a positive relationship between the prior experience of directors and the quality of board decisions.

- Tsui *et al.* (2001) using 650 observations from Hong Kong companies for the years from 1994 to 1996 found that non CEO-dominated boards are associated with lower audit fees after controlling for firm size, profitability and other important variables. Since independent corporate boards provide more effective internal control, there is lower control risk and lower audit effort that translates to lower audit fees. A limitation of this study is that other corporate governance variables were not considered and there could be a omitted correlated variable problem in the analysis.

The following studies failed to find conclusive evidence supporting the separation of CEO and chairman on the board:

- Dalton *et al*. (1998) performed a meta-analysis on 31 empirical studies of board leadership structure (69 samples with a total number of observation = 12,915) and their relationships to firm financial performance (both on market performance indicators and accounting performance indicators). No significant correlation was documented between the two variables, suggesting that separating the roles of CEO and Chairman might not lead to better firm performance.

- Daily and Dalton (1993) examined the effects of CEO duality, board composition and firm performance for 186 small listed companies in the USA. They found that the separation of the roles of CEO and chairman had no significant relationship with either accounting (measured by return on assets and return on equity) or market (measured by price/earnings ratio) performance.

- Rechner and Dalton (1989) compared shareholder returns of 141 *Fortune* 500 firms with and without CEO duality from 1978 to 1983. Though it is argued that the "dual role represented a prima facie case of conflict of interests", no differences in company performance were found for the two groups of firms, suggesting that there might not be a significant association between CEO duality and firm performance.

[19] Disclosure items are detailed in Appendix 3.

Board Composition

Board composition has been viewed as a corporate governance mechanism since management should be better monitored if the board is more independent (with a higher proportion of INEDs in the board). Two approaches to study the relationship between board composition and firm performance have been identified (Bhagat and Black, 1999). The first approach is to study how well the boards with different composition would perform in discrete board tasks (such as replacing the CEO or defending against a value-decreasing takeover bid) which should ultimately affect firm performance. This approach can provide insights into how different board composition behave on specific tasks. The major weakness is that it cannot give direct evidence on how board composition affects overall firm performance. As observed by Bhagat and Black (1999), "firms with majority-independent boards could perform better on particular tasks, such as replacing the CEO, yet worse on other tasks, leading to no net advantage in overall performance". The second approach is to directly investigate the effect of different board compositions on corporate performance. Prior studies using both approaches are included in the following brief reviews.

The majority of these prior studies found that companies with a more independent board (measured by the proportion of INEDs in the board) are likely to perform better than others suggesting that board composition is an important element that would enhance firm performance:

- Brown and Maloney (1998)[20] studied the characteristics of corporate boards for 82 companies that attempted 106 acquisitions during 1980s, and found that higher inside director turnover and lower outside director turnover was associated with higher acquisition performance. They argued that when competent outside directors believe that the managers are not acting in the best

[20] Please refer to page 46 for details of this study.

interest of the shareholders, they would remain on the board and challenge the manager. If they chose to resign (resulting in a higher outside director turnover), lower firm performance would result. However, if they replaced the managers (leading to a higher inside director turnover), firm performance would improve. It is also suggested that the increase in directors' ownership would encourage outside directors to engage in active monitoring, thus leading to better firm performance.

- Davidson *et al.* (1998) studied the effects of board composition on the stock market reactions of 83 US firms when a golden parachute amendment[21] was adopted between 1984 and 1990. Results suggested that golden parachutes could either be beneficial or harmful to shareholders, depending on the monitoring power of the board. They found that if the compensation committee of the board was dominated by insiders and affiliated directors, negative returns were more likely to occur with the adoption of golden parachutes. This showed that when the board was more independent, the decision to adopt golden parachutes was more likely to be in the interests of shareholders, thus resulting in better firm performance.

- Barnhart and Rosenstein (1998) investigated the combined effects of ownership structure and board composition on corporate performance. By analyzing 321 S&P 500 firms in 1990, it was found that a firm's performance (measured by Tobin's Q) was jointly determined by the proportion of independent directors and managerial ownership, showing that governance structures such as board independence and managerial ownership would have positive effects on firm performance.

- Cotter *et al.* (1997) examined the role of the target firms' independent outside directors during takeover attempts. They analyzed 169 tender offer targets that were traded in the USA during 1989-1992 and investigated whether the presence of a more independent board would enhance shareholders' wealth during the tender offer by comparing the target shareholder gains[22] between targeted firms with an independent board (i.e., INEDs comprising at least 50% of the board) and those without an independent board. Results showed that the target shareholder gains were about 20% higher for those targets with an independent board, suggesting that companies with a better governance structure (proxied by an independent board) are associated with better shareholders' gains during tender offers.

- Daily and Dalton (1994)[23] study found that bankrupt firms (59.5%) had a higher proportion of affiliated directors than surviving firms (44.9%). This suggests that

[21] A golden parachute is a potential takeover defense mechanism that protects the top management if the takeover bid succeeds. Since takeovers are generally regarded as a form of corporate governance mechanism especially in the USA, the establishment of anti-takeover arrangements such as golden parachutes may be viewed as lowering the level of governance. However, this could be in the interest of the shareholders if it defends the firm from value-decreasing takeovers.

[22] Target shareholder gain was measured as the final tender offer price minus the pre-tender offer stock price, divided by the pre-tender offer stock price (for successful tender offers) or the stock price, 90 days after the announcement that the offer has been withdrawn minus the pre-tender offer stock price, divided by the pre-tender offer stock price (for unsuccessful offers).

[23] Please refer to page 48 for details of this study.

companies with a lower proportion of affiliated directors in the board would have a better chance of survival.

- Byrd and Hickman (1992), by studying 128 acquisition bids made by 111 US firms during the period 1980-1987, investigated whether outside directors monitor the management thus leading to better performance. They found that generally, firms with majority-independent boards earned higher stock price returns than other firms when they made takeover bids, but this trend reversed for firms with more than 60% independent directors. They concluded that outside director membership on boards was an effective corporate governance mechanism to improve firm performance but beyond a certain threshold (i.e., 60%) outside director membership failed to enhance firm performance.

- Rosenstein and Wyatt (1990) examined 1,251 announcements of outside director appointments in the USA during the 1981-1985 periods and found that the abnormal returns were significantly higher for companies announcing outside director appointments. Though most boards were already dominated by outside directors before the appointment announcements, the addition of an outside director increased firm value, suggesting that outside directors were selected in the interest of the shareholders.

- Weisbach (1988) studied 367 US companies from 1974-1983 and examined the relation between monitoring of CEOs by inside and outside directors and CEO resignations. They reported that CEO turnover was more highly correlated with firm performance (measured by stock returns and accounting earnings) in corporations having a majority of outside directors (at least 60% outside directors) than in those where insiders dominated, suggesting that outside directors are important in monitoring management. Unexpected stock returns were found on days when resignations were announced, showing that boards with the presence of outside directors increased firm value by removing poor performing management.

Some other studies found that independent directors were not as effective in improving firm performance as hypothesized. The following studies document that since a significant positive relationship between board independence and firm performance cannot be found, it may be concluded that there was no impact of board independence on firm performance. It was also observed that executive and NEDs were "equally bad (or, possibly, good) at representing the shareholders' interests" (Hermalin and Weisbach, 1991).

- Dalton *et al.*’s meta-analysis (1998)[24] failed to find a relationship between board composition and firm financial performance (measured by market and accounting performance indicators).

- Klein (1998a) examined all the directors of the firms listed in USA on S&P 500 in 1992 and 1993. She found that there was no systematic relation between firm performance (measured by market to book value, return on assets and abnormal market returns) and director types. Contrary to expectations she also found that firm performance did not improve as a result of adding or deleting certain director-types (either insiders, affiliated directors or outsiders) from the board, though conventional wisdom suggest that corporate governance is generally expected to improve when there is a higher percentage of independent directors on the board. These results suggest that board composition might not be effective in improving firm performance.

- Klein (1998b) also examined 485 S&P 500 US firms for 1992 and 486 for 1993 and found little association between overall board composition and firm performance (measured by return on assets, Jensen productivity and market returns). However, inside director representation on a board's finance and investment committees correlated with improved firm performance, suggesting that inside directors, as a result of their superior understanding of their business, could contribute effectively to enhanced firm performance. These results suggest that an increase in outsiders on the board for the sake of better corporate governance might actually hamper the contribution of insiders to firm performance.

- Daily and Dalton (1993)[25] studied small companies in the USA and found that neither the composition of the board nor the separation of roles of CEO and chairman had any significant relationship with either accounting (return on assets and return on equity) or market (price/earnings ratio) performance. This suggests that increasing board independence by including more outside directors did not have an impact on firm performance for small firms.

- Hermalin and Weisbach (1991) examined the relationship between board composition and ownership structure on firm performance. They did not find any significant relationship between board composition (measured by the proportion of outside directors in the board) and Tobin’s Q. They argued that both inside and outside directors might be “equally bad (or, possibly, good) at representing the shareholders’ interests” in that both could contribute to firm performance. Outside directors could monitor management and inside directors could have knowledge and expertise that would also be important to enhance firm performance. If insiders and outsiders were both contributing to firm performance, it would be difficult to find a relationship between outside directors and firm performance.

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[24] Please refer to page 49 for details of this study.
[25] Please refer to page 49 for details of this study.

Some other studies have even found that more independent directors in the board are associated with worse firm performance. These studies are discussed below:

- Bhagat and Black (1999) examined the relationship between the degree of board independence level (measured by the proportion of independent directors minus the proportion of inside directors) and firm performance by analyzing 928 large US public companies during 1985-1995. Firm performance is measured using Tobin's Q, return on assets, turnover ratio, operating margin and sales per employee. They found that firms with an independence level of 0.4 or above performed worse than other firms, and there was no significant association between board independence and firm performance for firms with less than 0.4 level of independence. In addition, firms with a higher proportion of independent directors were found to be associated with slower growth. The study suggested that more independent boards were associated with worse performance.

- Another recent study by Bhagat and Black (2000) shed some light on the causality issue and found that it was poor performance that induced a more independent board and there was no evidence to suggest that greater board independence would lead to improved firm performance. They further suggested that board independence alone was not sufficient for better firm performance. They recommended that a reasonable number of inside directors on the board could add value, and that independent directors could be more effective if they were motivated by more significant shareholdings.

- Sundaramurthy *et al.*'s (1997) study found that when more outside directors were present in the board, the market reacted more negatively to antitakeover provisions, casting doubts on the effect of the monitoring role of outside directors.

- Yermack's (1996) [26] study reported that there was a significant *negative* correlation between both the board size and *board composition* (measured by the proportion of independent directors in the board) and firm's stock price performance (measured by Tobin's Q) as well as operating performance (measured by return on assets and the ratio of capital expenditures to sales).

These results are interesting since they suggest that an increase in independent directors on the board does not necessarily correlate with better firm performance.

[26] Please refer to page 46 for details of this study.

Board Activity

It is suggested that a more active board of directors would more effectively monitor management, leading to decisions more aligned with shareholders' interests and hence better performance. Vafeas's (1999) study investigated the association between board activity (as measured by board meeting frequency) and firm value. Using 307 US firms from 1990 to 1994, he found that the annual number of board meetings was positively related to firm value for firms with poor performance in prior years. He also found that operating performance improved following the years of abnormal board activity, and the improvements were also most pronounced for firms with poor prior performance. Overall, the results suggested that board activity (measured by board meeting frequency) is an important dimension of board operations that could enhance firm performance.

Director Ownership

The agency literature suggests that director ownership is a way of aligning the interests of managers and owners in order to reduce agency costs and a number of studies have investigated the relationship between director ownership and corporate performance. Generally, it was found that director ownership is an effective means to enhance firm performance. Brown and Maloney (1998)[27] examined the effects of director ownership of shares on the stock price returns for acquiring firms in takeovers. They argued that when directors hold more shares in the firm, it would be more costly for the directors to exit the board instead of voicing their opinions, leading to more effective monitoring and hence improved performance. Consistent with their expectation, their study found that increasing the directors' ownership in

[27] Please refer to page 46 for details of this study.

the company would lead to improved acquisition performance when directors' holdings were initially low. In a similar type of study, Gul *et al*. (2002) examined a number of issues including whether firms with low director share ownership were associated with poorer earnings informativeness (measured in terms of returns-earnings relationship). Their results, using Australian companies data for 1992 and 1993, showed that the informativeness of earnings was stronger for firms with high director share ownership, thus suggesting that firms with high director ownership had lower agency costs.

Other studies examined specifically the effect of *non-executive* share ownership on corporate performance. Bhagat *et al*. (1999) studied the link between significant outside director stock ownership, effective monitoring and firm performance by analyzing 4,874 directors in 449 US companies in 1993. It was found that outside directors' ownership was positively related to firm performance (in terms of earnings per share and stock returns) and growth opportunities (measured by ratio of market value divided by the book value of the company stock). They also found that the higher the outside directors' stockholdings, the higher the CEO turnover in poorly performing firms. This study concluded that equity ownership of outside directors could lead to enhanced monitoring of management, including the firing of poorly performing CEOs, and in this way contribute to better corporate performance.

The above studies provide support for the notion that higher director ownership could effectively improve firm performance.

4.2.3.4 Cross-country studies on corporate governance

An important strand of the recent literature on corporate governance examined the effects of legal protection and corporate governance on corporate performance across different countries or markets. These studies used indices for different levels of legal protection and law enforcement across different countries developed by various agencies (La Porta *et al.*, 1998). Results of these studies showed that firms in markets with a higher level of legal protection and corporate governance were in general associated with better performance and less earnings management. Some of the studies are reviewed as follows:

- Mitton's (2001) study examined the association between corporate governance (defined as disclosure quality, ownership concentration and corporate diversification) and firm performance (measured by stock returns) during the East Asian financial crisis in 1997-1998. He found that corporate governance had a positive impact on firm performance. The study included 399 firms from five countries, namely Indonesia, Korea, Malaysia, the Philippines and Thailand, that suffered disproportionately in terms of currency depreciation and stock market decline. The level of corporate governance of various firms was proxied by their disclosure quality (measured by whether the firm had an ADR listed in the USA and whether the firm's auditor was one of the Big Six CPA firms), ownership concentration and corporate diversification (measured by the number of industries in which each firm operates). It was found that:
    - Higher disclosure quality was associated with significantly better stock price performance during the crisis, showing that firms might create value by unilaterally opting for higher disclosure quality, even in countries where high disclosure quality might not be legally required.
    - Higher outside (excluding managerial) ownership concentration led to better performance during the crisis, showing that outside blockholders create value by monitoring management and preventing expropriation.
    - Diversified firms, particularly those with significant variation in investment opportunities across divisions, performed worse than single-segment firms during the crisis. This suggests that cross-subsidization of divisions could account for some of the value loss of diversified firms.
- Johnson *et al.*'s (2000) study supported the important role of corporate governance in the investment community and justified the need for improved corporate governance measures, especially in Asian countries/regions. They studied 25 emerging markets from Latin America, Eastern Europe, Greece and Portugal in Europe, Middle East, South Africa and Asia (including Hong Kong)

and presented evidence to show that countries with weak legal institutions for corporate governance experienced a greater decline of the exchange rate and stock market performance during the East Asian financial crisis. Corporate governance was measured in terms of enforceability of contracts (by assessing the efficiency of the judiciary, corruption, the rule of law and a general assessment of corporate governance) and shareholders' rights (including indices such as anti-directors' rights and creditors' rights). Results concluded that investor protection was not important as long as the economy was still growing. However, it mattered a great deal once growth prospects declined. The study found that the different measures of corporate governance explained the extent of exchange rate depreciation and stock market decline better than standard macroeconomic measures during the Asian financial crisis 1997-98. They concluded that corporate governance is an important factor affecting the financial performance of the companies.

- La Porta *et al*. (1999) studied 371 large firms from 27 markets (including Australia, USA, UK, Singapore, Hong Kong). They found that firms have higher valuations (measured by Tobin's Q and annual sales growth rate) in markets where investors were better protected (in terms of legal protection of minority shareholders), than markets with lower investor protection. This shows that the level of legal protection could affect the performance of the companies in general.

- Gul *et al*. (2002) used 11,127 firm observations across 48 countries for the years 1998 and 1999 to examine whether differences in legal protection and law enforcement across countries affected the positive association between debt and discretionary accruals. Prior studies suggest that firms with high debt levels are closer to debt covenant violations and therefore more likely to be associated with higher discretionary accruals, a proxy for earnings management. Higher discretionary accruals suggest that managers are manipulating earnings to loosen debt covenant restrictions. Their results show that the positive association between debt and discretionary accruals is weaker in countries with strong investor protection and law enforcement. These results suggest that a strong legal environment can act as a deterrent for managers to manipulate earnings to avoid debt covenant violations.

- Gul and Qiu (2002) sampled firms from 22 emerging markets for the period 1994 to 1996 to test whether there was a relationship between information asymmetry (a measure of the difference between investors' and managements' knowledge of a business) and the level of market development and/or legal protection/corporate governance in that jurisdiction. They found that in common law countries, where there is usually strong law enforcement and good corporate governance, levels of information asymmetry were lower than in civil law countries. They also found a negative association between the level of financial development and information asymmetry, that is, in countries with low levels of financial development there were typically higher levels of information asymmetry.

4.2.3.5 Opinions and rankings by investors or experts

Opinions from investors (especially institutional investors), financial analysts and company directors generally supported the notion that corporate governance is associated with better company performance. Their opinions are summarized below:

McKinsey & Company, 2000, Investor Opinion Survey 2000 (June)

The Investor Opinion Survey released by McKinsey & Company (2000) consisted of results from three surveys conducted by McKinsey & Company in co-operation with World Bank and *Institutional Investor*'s regional institutes in 1999 – 2000. They examined how shareholders perceived and valued corporate governance in developed and emerging markets. The surveys gathered responses from more than 200 institutional investors (20% from the USA, 40% from Latin America and 40% from Asia) who invested heavily internationally, and managed about US$3.25 trillion in assets. Results showed that 80% of the respondents stated that they would pay more for the shares of a company with good governance than for those with poor governance with comparable financial performances. They would pay 18% more for the shares of a well-governed UK or US company, 27% more for similar companies in Venezuela or Indonesia, 22% more for similar companies in Italy, 24-26% more for similar companies in Thailand, Malaysia and Korea, and 20% more for similar companies in Taiwan and Japan[28]. This indicated that companies could enhance their chances of attracting investments from international institutional investors by improving corporate governance practices and standards.

[28] The survey did not include Hong Kong and Singapore.

Business Week Surveys 1997 and 2000

Business Week conducted two surveys in 1997 and 2000 on corporate governance and reported a positive effect of corporate governance on firm performance (Byrne *et al*., 1997; Byrne, 2000). In 1997, Business Week surveyed 103 of the largest pension funds, money managers as well as directors in the USA, and they were asked to identify the level of corporate governance of companies by grading them according to their accountability to shareholders, quality of directors, board independence and corporate performance. Analysis showed that the best 25 boards identified by the respondents earned average annual total shareholder returns of 27.6% over the past five years, as compared with the 19.8% for the S&P 500-stock index, while the 25 worst boards reported average annual returns of only 5.9%. Consistent results were found for a similar survey conducted by Business Week in 2000, suggesting that good governance appeared to pay off.

Antunovich, P. and Laster, D.S. 1998. Do Investors Mistake a Good Company for a Good Investment? Working Paper, Federal Reserve Bank of New York

Antunovich and Laster (1998) analyzed long term firm performance (measured by cumulative abnormal returns) of the large US firms ranked by *Fortune* magazine's annual survey of America's Most Admired Companies (AMAC) during 1982-1995. The companies were ranked by the executives, outside directors, and financial analysts on various indicators of performance, including corporate governance.[29] It was found that the most admired firms earned an average annual return of 17.7% while the least admired firms earned only 12.5% in the five years after the survey was

[29] Firm attributes considered in the *Fortune's* survey include the quality of management, quality of products or services, innovation, value as a long term investment, financial soundness, ability to attract, develop, and keep talented people, community and environmental responsibility, and use of corporate assets.

published. This again suggests that the well-governed firms outperformed the other companies.

Millstein, I.M. and MacAvoy, P.W. 1998. The Active Board of Directors and Performance of the Large Publicly Traded Corporation. Columbia Law Review, 98, 1283

Millstein and MacAvoy (1998) studied the corporate performances of 154 US firms that were graded by CalPERS, a major institutional investor in the USA, based on companies' responses to a questionnaire on board and governance procedures during 1991-1995. Results showed that there was a statistically significant relationship between an active, independent board and superior corporate performance (measured by economic profit[30]). It was also found that the companies that received a grade of A+ from CalPERS performed 4-7% better (in terms of excess returns on operations over the period) than companies with lower grades on average.

4.2.3.6 Cross-country surveys on corporate governance

A recent Credit Lyonnais Securities Asia (CLSA, 2002) corporate governance study ranked 25 sample countries in the world, including Hong Kong Singapore, Taiwan, Malaysia, Indonesia, China in Asia, in terms of five macro factors that shape the standard of corporate governance in these respective countries. These macro factors and their corresponding weightings are:

[30] Economic profit is defined as operating earnings in excess of the cost of capital.

	Macro factors	Weightings
1.	clear, transparent and comprehensive rules and regulations	10%
2.	committed and effective enforcement of rules and regulations	30%
3.	political and regulatory environment affecting corporate governance and ability of corporate to maximize value without arbitrary restrictions	20%
4.	Adoption of International GAAP	20%
5.	Institutional mechanisms to promote awareness and a culture of good governance	20%

(Source: adapted from CLSA CG Watch – Corporate Governance in emerging markets 2002)

Enforcement of rules and regulations was given the highest weighting since it is clearly the most important macro determinant of the level of corporate governance in a market. Hong Kong is ranked third among East Asian countries in corporate governance practices. Singapore was ranked first (score 7.4) in country corporate governance ranking among the sample countries while Hong Kong ranked second (score 7.2). The evidence shows that Hong Kong is relatively weaker than Singapore in its enforcement of rules and regulations and corporate governance culture. Hong Kong scored similarly as Singapore in "rules and regulations" and "adoption of international GAAP".

S&P (2001) conducted a transparency and disclosure survey using three groups of attributes namely: ownership structure & investor relation, financial transparency & information disclosure and board & management structure & processes.

Sample international investors were required to review and rank the sample companies in decile order based on the above attributes. Results showed that Australia and Singapore companies ranked in the 8th and 7th decile (out of 10th) respectively. Hong Kong sample companies came after Australia and Singapore and

ranked in the 6th decile. Hong Kong lagged behind both Australia and Singapore in terms of ownership structure and investor relations dimensions.

The above results showed there is room for improvement in Hong Kong's corporate governance practices, particularly in terms of disclosure of ownership structure and investor relations, regulatory enforcement and a general awareness of corporate governance.

4.3 Literature Review on Costs of Disclosure

Several articles suggest that a major factor that precipitated the Asian financial crisis was the lack of transparency [31] and inadequate financial disclosures. Financial reporting including the quality of disclosure has been recognized as one of the most fundamental elements contributing to good corporate governance. Without reliable and timely information disclosure, monitoring the actions of management by external parties (either by the regulators or by the investors themselves) is virtually impossible. Proper and adequate disclosure is required to assist shareholders in effectively voting for value-increasing management proposals, and indirectly promoting the key mechanisms for controlling management, such as the market for corporate control, share price-based managerial compensation, etc. (Fox, 1999).

The academic literature generally supports the notion that increased disclosure could reduce the cost of capital, improve public relations with the investment community and promote market efficiency (Admati and Pfleiderer, 1998; Elliott and Jacobson,

[31] A survey by PricewaterhouseCoopers of different countries regarding the issue of opacity in 2001 gave the following ratings: UK, 38; USA, 36; Hong Kong, 45; Taiwan, 61; Singapore, 29. In this rating system, the lower the number, the lower the opacity (i.e., higher transparency).

1994). It is posited in economic terms that full disclosure of information should be an equilibrium strategy for firms (Grossman, 1989; Jovanovic, 1982; Milgrom and Roberts, 1986) and they should be willing to disclose voluntarily all their private information in order to capture all the benefits of disclosure. However, in practice, firms are subject to mandatory disclosures, and additional disclosures are not costless. As a result of the cost consideration, firms have incentives to withhold information from the public (Admati and Pfleiderer, 1998; Suijs, 1999; Fox, 1999; Kaufmann *et al.*, 1994). Thus there is always a tradeoff between costs and benefits of more voluntary disclosure. It should be recognized that disclosure costs would affect the willingness of the firms to disclose the information necessary for the regulators or the shareholders to monitor management. In order to promote corporate governance, disclosure costs should be minimized to an appropriate level or such disclosure should be made mandatory. However, the issue is further complicated by the fact that disclosure requirements might sometimes add to the costs of disclosure. For example, the American Institute of Certified Public Accountants called for fuller disclosure of company information (see Birchard, 1994; Mello, 1993) while the Financial Executives Institute questioned the cost-effectiveness of greater disclosure. These disagreements resulted in the recommendation by an internal study group of the US Securities and Exchange Commission to eliminate some rules and forms to reduce the cost of compliance on disclosure requirements (SEC, 1996).

In light of the above discussion, the following section reviews the literature on disclosure costs for companies.

4.3.1 Components of Disclosure Costs

According to Admati and Pfleiderer (1998) and Lev (1992), costs of disclosure can be broadly divided into two categories namely, direct costs and indirect costs.

4.3.1.1 Direct costs of disclosure

Direct costs are the costs associated with gathering, producing, disseminating and auditing the information to be disclosed (Fishman and Hagerty, 1998; Verrecchia, 1983; Langbert, 2001). These costs are comparatively easier to estimate and incorporate in the cost-benefit analysis of disclosure (Lev, 1992). The direct costs incurred by the firm include the opportunity costs of the firms' employees, auditing and legal expenses and the cost of printing and distribution (Fishman and Hagerty, 1989). It should be noted that the costs of disclosure should exclude the costs of producing information that is already incurred by management (Elliott and Jacobson, 1994).

Apart from the direct costs borne by the firm, the investing public would also incur a cost to understand and assimilate the information disclosed by the company (Fishman and Hagerty, 1989). The more complicated the contents and formats of the information disclosed, the higher the costs for the users to understand the information.

4.3.1.2 Indirect costs of disclosure

Indirect costs of disclosure result from the adverse effects of the disclosures on the company activities and its competitive position (Lev, 1992). The most frequently cited examples of indirect costs are political and litigation costs as well as competitive disadvantages. They are discussed as follows:

Political and Litigation Costs

When most of the other firms disclosed the same amount of information with one firm disclosing more, the latter firm might attract more attention from critics and outspoken shareholders, leading to additional political costs (Lo, 2000). More importantly, there might be litigation arising from allegations of insufficient informative disclosure or from allegations of fraudulently misleading disclosure (especially when share price declines after the disclosure of some forward-looking information) (Elliott and Jacobson, 1994). Some litigation costs, such as the payments to successful plaintiffs, out-of-court settlements, legal fees, etc., can be quantified (Kaufmann *et al*., 1994) whereas others are intangible in nature, including the distraction of management attention from productive activities, publicity, and the danger of being involved in more lawsuits in the future (Kaufmann *et al*., 1994; Elliott and Jacobson, 1994).

Some empirical studies found support for the notion that disclosure increases the risk of litigation. Lev (1995) investigated the characteristics of the firms sued by their shareholders against similar at-risk firms that escaped lawsuits, focusing on the differences in the disclosure policies of the two groups of firms. He examined 589 cases of large stock price declines following a quarterly earnings announcement during 1988-1990, and found that litigation targets (companies targeted by external parties for litigation) communicated with investors more extensively (i.e., more disclosures) than control companies, issued more optimistic announcements, but released fewer warnings about the forthcoming share price decline than similar at-risk companies. Though this study did not suggest that responsible communication with

investors should be restricted or suppressed, it concluded that the higher risk of litigation is one of the costs of disclosure.

Competitive Disadvantages

Admati and Pfleiderer (1998) argued that when information is leaked to competitors or others who 'interact strategically with the firm", the firm disclosing valuable information to the public may lose their comparative advantages or bargaining power. Some examples of possible competitive disadvantages are listed below:

- Suppliers of the firm might refuse to grant favorable terms of sales and credit to the firm in response to a negative earnings forecast (Lev, 1992).
- Competitors in the market might make use of the information disclosed to take an adverse action that imposes costs on the firm (Wagenhofer, 1990; Suijs, 1999). For example, information about technological and managerial innovation, strategies, plans and operations is traditionally sensitive information that firms are reluctant to disclose due to fear of competitive disadvantages (Elliott and Jacobson, 1994). The cost of disclosure in this case is the loss in profits due to increased competition (Wagenhofer, 1990). Sometimes such costs are so high that it is recommended that management should "work in the dark" (Zweig, 1998).
- By disclosing more compensation information, labor unions might be able to negotiate higher wages based on more complete disclosure of executive pay packages.

4.3.2 Costs of Required Disclosure

Though disclosure could promote market efficiency and corporate governance, the existence of disclosure costs to the firms discussed above provides incentives for management to withhold information from the public. Therefore, mandatory disclosure requirements may be considered necessary (Shaffer, 1995). However, one should take into account the additional costs for required disclosure. Failure to acknowledge such costs when formulating disclosure requirements might lead to sub-optimal conditions. The following are the costs of required disclosures:

- *Compliance costs*. Some studies documented that disclosure requirements imposed substantial costs on the company as well as the industry. According to a study done by the Federal Financial Institutions Examination Council (FFIEC) for the US banking industry, 14% ($14.5 billion) of the banking industry's total non-interest expense in 1991 represented the costs of regulatory compliance (Anonymous, 1992). The American Bankers Association (ABA) also found in 1992 that the most costly banking requirements were the Community Reinvestment Act (CRA) which contained extensive disclosure requirements. (Shaffer, 1995). The cost of compliance amounted to $10.7 billion, which equaled 59% of the industry's total profits in the same year (Rehm, 1992)[32]. Another survey conducted by the ABA (Cummins, 1994)[33] reported an increase in the industry's reporting costs by more than $100 million annually in order to comply with the new disclosure requirements in the proposed revisions to the CRA. Though it could be argued that the bank might still disclose the information voluntarily in the absence of regulations (in which case costs of reporting should be regarded as a normal cost of doing business instead of a cost of required disclosure), the disclosure requirements imposed further costs in terms of extra work on documentation and compliance with standardized formats (Shaffer, 1995).

- *Redundancy costs*. When the additional required disclosures are not useful to the users (i.e., the existence of such information does not influence the decision making of the users), they are regarded as redundant and add no benefit to the market participants. Some prior studies provided evidence of such redundancy costs. Smirlock and Kaufold (1987) studied whether disclosure requirements could help the investors to discriminate among banks with different levels of foreign exchange exposure. They examined the market valuation (in terms of stock prices) of 60 banks in 1982 and found that even in the absence of disclosure rules, the market was able to distinguish banks with lower levels of foreign exchange exposure than from those with higher levels of exposure. They questioned the validity of the regulatory view that disclosure rules were needed to provide investors with exposure information, and suggested that disclosure requirements might be unnecessary.

From the above, it can be inferred that if disclosure requirements are shown to be redundant and add no benefit to the market with additional costs of additional disclosure or compliance, they may be harmful (Shaffer, 1995).

- *The problems of over-disclosure*. Mandatory disclosures might increase the amount of information available in the market to a point that it exceeds the optimal level of information which society would prefer. Shaffer (1995) argued that once a certain amount of information has been disclosed, additional

[32] American Bankers Association (ABA) conducted a survey of 10,000 bankers in 1991-92 on the US banking industry with a response rate of 10%.

[33] This survey was conducted by ABA in 1993 on 143 banks with assets greater than US$250 million representing about 10% of the total banks.

information is of relatively little value to the market. Beyond the optimal level of disclosure, investors would prefer not to have additional disclosure. Fishman and Hagerty (1989) further argued that firms themselves already have the tendency to disclose 'too much information' (when each competing firm in a industry tries to attract more investors from others with similar profitability by increasing its disclosure a little over that of its rival), thus setting a disclosure requirement might in fact aggravate the problem, leading to a sub-optimal condition where all firms disclose more than society prefers. When firms disclose at the level where the society would prefer, any further increase in disclosure by regulation would be harmful to society (Shaffer, 1995).

- *Optimal disclosure*. Grossman (1989) argued that the market itself (demand for and supply of information) would adjust until the optimal level of disclosure is reached. Irrelevant but costly disclosures would then be eliminated. However, if the market mechanism is not allowed to operate with the imposition of mandatory requirements of disclosure, it is possible that there exists too much information in the market and 'disclosures may no longer reveal the quality of the seller because they have become so noisy" (Grossman, 1989). This might result in the problem of information overload for investors. Some commentators have voiced their concerns regarding excessive disclosures in mutual fund prospectuses in USA. They contained too many details and were often confusing (Cope, 1994).

- *Omission of relevant information*. Shaffer (1995) suggested that poorly designed disclosure requirements might have the "unintended effect of reducing the amount of useful information actually disclosed". It was argued that if the disclosure requirement has omitted some relevant information in favor of irrelevant information, firms might choose to disclose only at the required level so as to minimize their costs of disclosure, thus failing to disclose the relevant and useful information which they would have (perhaps instead) disclosed if there was no disclosure requirement at the outset.

Shaffer (1995) suggested that three conditions are necessary to justify imposing a disclosure rule:

- The existence of a problem, e.g., monopoly power, unrecognized risks.

- The perceived problem must be subject to alleviation through greater disclosure, e.g., revealing the full amount of risk in a market or firm, reducing transaction costs, etc.

- Total amount of useful information disclosed should be increased by the disclosure requirement (without omitting other important information).

Periodic subsequent monitoring and assessment should be conducted to evaluate the cost-effectiveness of the disclosure rules even after the relevant requirement has been

put into effect, so as to ensure that a disclosure requirement continues to remain beneficial to the market.

4.3.3 Costs of Disclosure in Different Jurisdictions

Since the cost of disclosure itself is very difficult to quantify (except for some direct costs such as the costs of printing, distribution or professional expenses), there is no easy way to measure the cost of disclosure in different jurisdictions or different markets. There is therefore little evidence on the difference in costs of disclosures in different jurisdictions except for a study by Fox (1999). He examined the role of required disclosures as it relates to corporate governance and noted that the optimal level of disclosure (optimal being defined as the level at which the required disclosure's marginal benefits equal its marginal *costs*) should maximize the shareholder returns (net of the costs of disclosure). He also posited that the optimal level of disclosure would be different for various jurisdictions due to differences in legal protection and governance structures across countries. He argued that the optimal level of disclosure for the USA (where voting power is less concentrated, institutional investors are less active and more reliance is placed on the hostile takeover threat and share price-based managerial compensation) might be higher than that for Germany and Japan because greater public disclosure is needed for corporate governance through the hostile takeover threat and share price-based managerial compensation. This suggests that the US market may be willing to bear higher costs of disclosure than Germany and Japan. On the other hand, the optimal level of disclosure is lower for Asian jurisdictions such as Hong Kong and Singapore which are characterized by relationship based corporate governance system and more family

owned or dominant shareholdings. In such situations where the incentives for more disclosure is lower, mandatory disclosure are perhaps necessary.

In conclusion, the costs of disclosure and its optimal level for each jurisdiction must be seen in the context of the institutional framework in the different jurisdictions.

4.4 Summary

The literature reviewed in this chapter provides mixed evidence on the relationship between corporate governance and firm performance. These different results could be partly due to the use of different proxies to measure both corporate governance and corporate performance in the various studies. Other factors could conceivably affect firm performance other than the event or board characteristics being examined in these studies (Brancato, 1998; Pozen, 1994). It should also be noted that there is no consensus on which proxies should be used for corporate governance and corporate performance (Brancato, 1998).

The majority of prior studies found that corporate performance improves with increase in shareholders' and directors' ownership. This is probably due to the fact that increased ownership leads to more active monitoring and less agency costs, resulting in enhanced firm performance However, other studies on the relationship between shareholder activism and firm performance were less consistent. Another strand of the literature which focused on the relationship between board characteristics and firm performance also failed to find conclusive evidence regarding the association between board size, CEO duality, board composition and firm performance. On the other hand, the evidence on the link between higher quality

directors and more board activity with better firm performance is quite consistent. Most of the opinions and rankings by investors or experts generally supported the notion that corporate governance is associated with better firm performance.

Though the above literature review does not provide conclusive evidence on the positive relationship between corporate governance and firm performance, there is an increasing trend in the business and legal literature which emphasizes the point that good corporate governance should lead to better performance. The reason is that corporate governance is a reflection of management quality. In order to sustain high performance in the long term, quality management will need to keep "checks and balances" to prevent fraud and provide opportunities for manipulation in the company (CLSA, 2002). On balance, the weight of the evidence suggests that corporate governance is one of the factors that could ultimately affect firm performance.

In addition, prior literature also showed that financial disclosures, an element contributing to good corporate governance, are not without costs, and these costs should be factored in when considering any financial disclosure policies in Hong Kong.

CHAPTER 5 COMPARATIVE REVIEW OF LEGAL AND REGULATORY REQUIREMENTS

5.1 Introduction

In this chapter, we examine the legal and regulatory frameworks including the accounting regulation of Hong Kong, the UK, the USA, Australia, Malaysia, Taiwan and Singapore. Corporate governance practices in any given jurisdiction are likely to depend on the legal and regulatory framework and the corporate governance structure in the business environment in that jurisdiction. This chapter provides a comparative analysis of the institutional and regulatory frameworks that are likely to have a bearing on corporate governance practices in the various countries.

An overview of the legal and regulatory environment, including the sources of company and securities law and enforcement for each jurisdiction is provided in Appendix 4. This is followed by a comparative overview of the regulatory requirements regarding corporate governance disclosures in Appendix 5. A detailed comparison of the regulatory requirements on board practices across jurisdictions is given in Appendix 6. To complete the legal and regulatory framework, Appendix 7 provides a summary of the regulation of the accounting profession in each of the jurisdictions.

After examining the legal and regulatory framework in each jurisdiction, we provide a comparative overview of issues concerning related party transactions. This chapter ends with a brief review of some corporate governance surveys undertaken by professional organizations, the summaries of which are contained in Appendix

8. Appendix 9 summarizes recent developments in corporate governance practices in different jurisdictions.

5.2 Hong Kong

5.2.1 Legal and Regulatory Framework

Corporate governance regulations and requirements currently in place in Hong Kong are derived from a number of sources including the Companies Ordinance, Securities Ordinance, Main Board Listing Rules, Growth Enterprise Market (GEM) Listing Rules and the Hong Kong Monetary Authority (HKMA) (Gul, 2002). The following sections briefly discuss these requirements.

5.2.2 Companies Ordinance

All companies in Hong Kong are regulated by the Companies Ordinance (Cap. 32). The Ordinance addresses several aspects of corporate governance:

5.2.2.1 Quality of management

The Ordinance lays down certain restrictions on the persons who may be appointed as directors of a company. A person cannot be the director of a company if he/she is an undischarged bankrupt (s156(1)), and the court may make a disqualification order under s168 if:

a. the person is convicted of an indictable offence in connection with the promotion, formation, management, receivership or liquidation of a company (s168E(1));

b. the person persistently fails to comply with the Companies Ordinance requiring any return, account or other document to be delivered to the Registrar (s168F(1));

c. the person is guilty of fraud or fraudulent trading in relation to the company (s168G(2) and s275); or,

d. the court considers that the person is unfit to manage the company (s168H).

If the director has a direct or indirect interest in a contract with the company, he must declare the nature of his interest (if it is material) at the earliest meeting of the directors (s162(1)), and any director failing to make such a declaration is liable to a fine. Table A article 86(1) also states that the director concerned cannot vote in respect of any such material contract. A company cannot directly or indirectly make a loan to a director or enter into any guarantee in connection with a loan made by the director or his/her controlled company (s157H(2)).

Under s142 and s143, the Financial Secretary is given the power to appoint Inspectors to investigate the affairs of a company in certain circumstances. These circumstances would include circumstances where:

(i) the business of the company has been or is being conducted with intent to defraud its creditors or the creditors of any other person or otherwise for a fraudulent or unlawful purpose or in a manner oppressive of any part of its members or that it was formed for any fraudulent or unlawful purpose; or

(ii) persons concerned with its formation or the management of its affairs have in connection therewith been guilty of fraud, misfeasance or other misconduct towards it or towards its members; or

(iii) its members have not been given all the information with respect to its affairs that they might reasonably expect." (Companies Ordinance Cap. 32 s143 (1)(c)(i) – (iii)).

5.2.2.2 Audit

Under s131, the company is required to appoint an auditor at the company's annual general meetings. The auditor has a right of access to the books and accounts of the company and is given the power to require information and explanations from officers of the company for the performance of his duties (s145(5)). If an officer of the company knowingly or recklessly makes a misleading or deceptive statement to the

auditors about a material item or issue, they are guilty of an offence and liable to a fine and imprisonment (s134).

5.2.2.3 Information disclosures

Section 121(1) requires every company to keep proper books of accounts, and the books of account must give a true and fair view of the company's financial statements (s121(2)). If the director fails to take all reasonable steps in ensuring that the company keeps proper books of accounts, he commits an offence and may be liable to a fine and imprisonment (s121(4)).The books of account must be open to inspection by the directors at all times (s121(3)).

In addition, a report by the directors must be attached to every balance sheet in the annual report (s129D(1)), which should include information such as the principal activities of the company, the names of the directors, the amount which the directors recommend should be paid as a dividend, the amount of donations, significant changes in the fixed assets of the company, and management contracts (s129D(3)). It is an offence if the director fails to comply with such requirements (s129F).

With reference to directors' remuneration, s161(1) requires the disclosure of the following information:

a. the aggregate amount of directors' emoluments;
b. the aggregate amount of directors' (or past directors') pensions; and,
c. the aggregate amount of any compensation paid to directors (or past directors) in respect of loss of office.

In addition, the register of members of the company and index of names must be open for inspection during business hours to members and the public (s98(1)). If inspection is refused, the company and every officer in default are liable to a fine (s98A).

5.2.2.4 Shareholders' rights

The Ordinance contains certain provisions which aim at ensuring that the rights of the shareholders of the company are adequately protected:

- Shareholders may require a special resolution (rather than a simple majority vote) for important matters such as alterations to the company's constitution (e.g. s13, s25A), reduction of the company's capital (s58), removal of directors (s157B), and winding up of the company (s228(1)(b)).

- One hundred members, or the holders of 10% of the company's issued shares, may apply to the Financial Secretary for the appointment of an inspector to investigate the affairs of the company (s142).

- The capital clause in the company's memorandum may divide the capital into shares of different amounts and shares may be issued with differing rights, but where a variation of class rights is approved by the consent of a proportion of shareholders or the passing of a resolution at a class meeting, the holders of not less than 10% in nominal value of the issued shares of the class may apply to the court to have the variation cancelled, and the variation can then have effect only if confirmed by the court (s64).

- The holders of 5% of the total voting rights, or 100 members holding shares on which there has been paid up an average of at least $*2,000* per member, may demand for a resolution to be considered at the company's next annual general meeting (s115A).

- The holders of 5% of shareholdings of the company may demand the directors to call a meeting; if the directors fail to do so, they may convene a meeting themselves (s113(2)).

- Section 168A entitles any member of the company to apply to the court for an order on the ground that the affairs of the company are being conducted in a manner which is unfairly prejudicial to the interests of the members.

- Shareholders have the right to apply to the court to cancel a resolution. For example, they can do so when they object to an alteration to the company's objects (s8(2)), or where a private company has approved a redemption or buy back out of capital (s8(4)).

- The minority shareholders have the right to have their shares bought out if they did not accept the offer in the event of a successful general offer to buy-back shares, under Schedule 13.
- A member may apply to the court for winding up the company (s177).

5.2.2.5 Companies (Amendment) Bill 2002

The Companies (Amendment) Bill 2002, which was introduced in the Legislative Council on 30 January 2002, was an attempt to improve corporate governance in Hong Kong (Yiu, 2002). The Bill covers 17 recommendations issued in the report by the SCCLR in February 2000 to amend the Companies Ordinance. They are classified into three categories, namely shareholders' rights, requirements regarding directorships, and technical matters.

On shareholders' rights, the Bill recommends that shareholders should be granted the right to enforce the terms of a company's memorandum and articles of association. According to the Secretary of Financial Services, "this will ensure that the shareholders can take appropriate action when the affairs of the company are not conducted constitutionally" (Ip, 2002). The Bill also proposes to reduce the threshold for circulating shareholders' proposals to 2.5% of voting rights (from 5%) or 50 shareholders. It also recommends that shareholders be allowed to remove directors by ordinary resolution (a simple majority of votes) instead of special resolution.

Regarding directorships, the Bill recommends a number of changes to clarify the definitions and responsibilities of the directors. It proposes that a director should be responsible for his alternate director's acts. The current definition of 'shadow director' is confined to Part IVA of the Ordinance. The Bill recommends applying the

definition to the whole Ordinance, and amending the definition to include "someone who can influence a majority of the directors". It also clarifies such issues as the extent to which a company may indemnify its officers or auditors, the extent and forms to which a company may provide loans or security for loans to directors, etc.

On other technical matters, the Bill recommends the prohibition of the incorporation of a company limited by guarantee with a share capital, and repealing the right of shareholders to apply to the court to annul amendments passed by the company to its objects, so as to "ensure that the business decisions of the public company will not be unnecessarily impeded" (Ip, 2002). Other recommendations include the removal of the directorial autonomy rule, and a new definition of the term 'manager'. They are largely proposals to enhance good corporate governance.

5.2.3 Securities Ordinance

The Securities (Disclosure of Interests) Ordinance (Cap. 396) administered by the Securities and Futures Commission (SFC) requires that the directors and the major shareholders of the company disclose their interests in the company shares to the other investors. The Hong Kong Code on Takeovers and Mergers (Takeovers Code) contains provisions to protect the interests of the shareholders during takeovers. Recently, the Securities and Futures Ordinance (Cap. 571) has been passed in March 2002. The legislation has not yet come into effect at the date of this report. The Ordinance consolidates all ten securities and futures related ordinances into a single law, and aims to establish a regulatory framework to meet with international best practice to enhance market efficiency and transparency. The following paragraphs discuss some of the recommendations in the Ordinance pertaining to enhancing corporate governance of Hong Kong.

The Ordinance widens the investigative and disciplinary power of the SFC. For example, a Market Misconduct Tribunal (MMT) will be formed, on the basis of the current Insider Dealing Tribunal, to handle insider dealing and other specified market misconduct (Part XIII of the Ordinance). The MMT will have the powers to (among others) order the disgorgement of related profits, order the payment of legal costs and investigation, and disqualify a director from being a director of any listed company for a period of up to five years. It also recommends that the SFC be entitled to seek explanations of the accounting records from the listed company or a member of its group, and it should have the right to access the working papers of the company's auditors (Part VIII of the Ordinance).

With respect to disclosure of shareholdings in a company, the Ordinance lowers the disclosure threshold from 10% to 5% and reduces the time limit for disclosure from five days to three business days (Part XV of the Ordinance) so as to provide investors with timely and accurate information for their investment decisions, including a notification to the listed company concerned and the Exchange about the interests he/she has (s324). On investor protection, the Ordinance stipulates a clear statutory right of persons who suffer losses as a result of market misconduct to take civil actions and claim compensation for loss (Part XIII and XIV of the Ordinance).

With these new additions to the Ordinance, it is expected that an effective regulatory framework would be created to protect investor interests, reduce market misconduct, and promote market confidence and corporate governance in Hong Kong.

5.2.4 The Main Board Listing Rules

In addition to the legislation above, the Listing Rules prescribe conditions and obligations relating to listing. Chapter 3 of the Stock Exchange of Hong Kong (SEHK) Listing Rules stipulates in detail the requirements of sponsors, authorized representatives and directors. Directors have fiduciary duties and shall comply with the code on their securities transactions as listed in Appendix 10 of the Listing Rules. In 1994, the Listing Rules stipulated the requirement of at least two independent non-executive directors (INEDs) to be appointed for each listed company. The SEHK may in certain circumstances stipulate more than two INEDs, higher than the minimum required.

In addition, The Code of Best Practice, which is not mandatory, is incorporated in Appendix 14 of the SEHK (1998) Listing Rules. Though the Code is intended to be a guideline that does not have to be strictly adhered to, companies listed on the Main Board of the SEHK are encouraged to follow it. The Code outlines the best practices in corporate governance in terms of board composition, directors' access to information, appointment and re-appointment of directors and the establishment of audit committee, etc.

5.2.5 Growth Enterprise Market (GEM) Listing Rules

The requirements on directors, authorized representatives and corporate governance matters for GEM companies are listed in Chapter 5 of the GEM Listing Rules. Similar to the Listing Rules of the Main Board, Chapter 5 of the GEM Listing Rules outlines the fiduciary duties of directors, and stipulates the requirement of the appointment of at least two INEDs to be appointed for each listed company. Similar

to the Main Board Listing Rules, the SEHK may stipulate more than the minimum number of INEDs required.

In order to enhance the adequacy and effectiveness of systems of internal control, the GEM Listing Rules require listed companies in GEM to designate an executive director as a compliance officer and a qualified accountant to supervise the accounting and financial reporting procedures and internal control. Another mandatory requirement is that GEM listed companies establish audit committees comprising of no less than two members. The majority of the committee and the chairman must be INEDs. In the case of a committee of two, both members must be INEDs. There are no such requirements in the Main Board Listing Rules. GEM Listing Rules also stipulate that the duties of the audit committee must at least include reviewing the company's reports (annual, half-year and quarterly) and accounts and supervising the company's financial reporting and internal control procedures.

5.2.6 Hong Kong Monetary Authority (HKMA)

The statutory guideline in section 7(3) of the Banking Ordinance (Cap. 155) issued by the HKMA (2001) on Corporate Governance sets out the minimum corporate governance standards that locally incorporated authorized institutions (AIs) must comply with. However, the guideline does not have the force of law. It suggests that at least three independent directors be appointed to a bank's board of directors in order to provide a sufficient pool of independent resources.

The above summarizes the legal and regulatory requirements of corporate governance in Hong Kong. Voluntary recommendations on corporate governance from

professional institutes such as the Hong Kong Society of Accountants (HKSA) and Hong Kong Institute of Directors (HKIoD) are discussed below.

5.2.7 Hong Kong Society of Accountants (HKSA)

Since 1995, the Corporate Governance Committee of the HKSA has responded to the debate in corporate governance in Hong Kong with seven publications, namely "First Report of the Working Group on Corporate Governance" (HKSA, 1995), "Second Report of the Corporate Governance Working Group" (HKSA, 1997a), "A Guide for the Formation of An Audit Committee" (HKSA, 1997b), "A Guide for Directors' Business Review in the Annual Report" (HKSA, 1998), "Directors' Remuneration – Recommendations for Enhanced Transparency and Accountability" (HKSA, 1999), "Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement" (HKSA, 2001) and "A Guide for Effective Audit Committees" (HKSA, 2002).

The First Report (HKSA, 1995) contained nineteen recommendations on the role and responsibilities of board of directors, financial reporting and audit, and other additional corporate governance disclosures such as the inclusion of a statement on internal control in the annual reports. One of the recommendations in 1995 was for companies to introduce a general statement on corporate governance in the annual report. The HKSA emphasized the importance of the concept of board independence and also recommended that the SEHK actively monitor to ensure that the INEDs meet the 'independence' criteria according to the Listing Rules, code of best practice, guidance notes, etc. It recommended that information on directors' duties, board procedures, recent issues of concern, the business and financial performance of the

company should be provided to non-executive directors (NEDs). In order to enhance the transparency and independence of the external auditor, non-audit fees paid to them should also be disclosed in the annual report.

The Second Report (HKSA, 1997a) provided further recommendations on board membership, finance directors and chief financial officers. In order to increase the effectiveness of the board, at least 50% of the directors on the board should be unrelated (non-family members). It specifically stated that there is a gap in disclosures of family relationships between directors and whether the director is employed by or is a director of a substantial shareholder[1]. Details of family relationships between directors and substantial shareholders who are not directors should be disclosed. Additional disclosures on executive directors, NEDs, and INEDs and fees paid to INEDs were recommended.

The third HKSA publication, "A Guide for the Formation of an Audit Committee" (HKSA, 1997b) was formally endorsed by the SEHK as recommended guidance on the establishment of an audit committee in its Code of Best Practice in 1998. A revision of this guide, "A Guide for Effective Audit Committees" (HKSA, 2002) has been recently published. The recommendations of this new publication are reviewed in more detail in Brief 3.

In 1998, the Directors' Business Review Task Force of the HKSA Corporate Governance Committee published "A Guide for Directors' Business Review in the Annual Report" (HKSA, 1998). This Guide provided a framework for company

[1] This disclosure gap has been rectified by Paragraph 12 of Appendix 16 of the Listing Rules in 2000 requiring the disclosure of family relationships between directors and whether the director is employed by another company which has an interest in the share capital of the company.

directors in formulating the Business Review section of the annual reports. The Business Review was regarded as an interpretation of the business with an assessment of future prospects. The Guide recommended that the Business Review should include two sections, namely the operating review and the financial review, and the nature of the company's business activities and the benefits expected from each area should be discussed, with particular emphasis on changes in the level of activity and management policy.

The HKSA conducted a comparative study on the disclosure requirements of directors' remuneration in Hong Kong, and other major capital markets including the USA, the UK, Singapore and Australia (HKSA, 1999). Detailed recommendations of this report titled "Directors' Remuneration-Recommendation for Enhanced Transparency and Accountability" are reviewed in Brief 3.

A comprehensive Guide entitled "Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement" (HKSA, 2001) was issued by the HKSA recently. This Guide summarized the findings from the previous four publications by the HKSA on corporate governance and focused on those recommendations which had not yet been adopted in the Listing Rules and made further recommendations on board structure and function, management discussion and analysis, board and executive remuneration, audit committee and related party transactions. These recommendations are expected to meet international standards in order for Hong Kong to maintain its status as a major international financial center and capital market. Listed companies and public corporations were encouraged to include a statement on corporate governance,

including the responsibilities of the board, the number of board meetings held, the attendance of individual directors and the contribution and role of NEDs, and present it separately in the annual report with the same prominence as, for example, the Directors' Report. This Guide continued to emphasize the importance of the transparency and independence of the external auditor with the recommendation that non-audit fees paid to them should be disclosed.

5.2.8 Hong Kong Institute of Directors (HKIoD)

The HKIoD issued the "Guidelines For Directors 1995", with the view to summarize the existing laws governing directors' duties and recommend good practice for directors in areas where the law is vague or unclear[2]. The Guideline (HKIoD, 1995) stated that "the board of directors should take responsibility for:

- Determining the company's strategic objectives and strategic policies;
- Appointing the company's top management;
- Monitoring progress towards the achievement of objectives and compliance with policies;
- Giving an appropriate account of the company's activities to the parties to whom an account is properly due."

The Guideline also dealt with the legal status of directors and the associated powers, duties and liabilities. It clearly stated that directors have fiduciary duties such as the duty to:

- Act honestly for the bona fide benefit of the company;
- Exercise their powers for a proper purpose; and,
- Not allow any conflict between their duties as directors and their personal interests to interfere in the performance of their duties.

[2] The Guideline reflected the law of Hong Kong as at 31st March 1995.

Other duties included compliance with the requirements of the Companies Ordinance, proper disclosure of information to the public, appointment of appropriate officers and auditors. The issues on eligibility, appointment, removal, disqualification, remuneration and compensation of directors have also been dealt with in the Guideline.

In an effort to further clarify the role and responsibilities of INEDs, the HKIoD issued a guideline in 2000. The Guideline (HKIoD, 2000) clarified NEDs' relationship with management by stating that "a NED should have no executive or management responsibility in the company." Further, the NED is deemed to be independent of management if he or she does not receive any benefits from the company other than his or her fees as a director. These descriptions are similar to those found in the Listing Rules of the SEHK. Apart from monitoring management and providing advice on the strategic direction of the company's business, an INED should also help to ensure that the interests of all shareholders are taken into account by the board of directors. This Guideline offered a basic benchmark for defining the roles of different types of directors, and also provided some guidance to directors on understanding their roles and functions on the board and as members in board committees.

5.2.9 Corporate Governance Review by the Standing Committee on Company Law Reform (SCCLR)

A comprehensive corporate governance review has been initiated by the SCCLR to identify and plug any gaps in the corporate governance regime in Hong Kong. The objective of the review is to enhance accountability, disclosure and transparency, and thereby further improve corporate governance standards in Hong Kong. This includes five consultancy projects, including this one, which focuses on the different corporate

governance systems in selected jurisdictions. Results and recommendations of the review are expected to lead to reforms in corporate governance in Hong Kong.

5.2.10 Proposals for Listing Rules Amendments by Hong Kong Exchanges and Clearing Limited (HKEx)

In the interest of raising the standards of corporate governance of Hong Kong to current best practices of international capital markets, HKEx published the Consultation Paper on Proposed Amendments to the Listing Rules Relating To Corporate Governance Issues in January 2002. The proposed amendments cover the following areas:

- Directors and board practices;
- Corporate transactions and shareholders' rights; and
- Corporate reporting and disclosure of information.

The key issues discussed in the above consultation paper are summarized below:

5.2.10.1 Directors and board practices

Directors composition

- Companies should assign an executive director with appropriate qualifications to be responsible for accounting and financial reporting; an announcement would be required if the position were vacant.

- An executive director with appropriate qualifications should be appointed to act as compliance officer; an announcement would be required if the position were vacant.

- Duties and responsibilities of NEDs should include:

    - Attending board meetings;
    - Protecting minority interests; and
    - Participating in audit and other committees.

- Separation of the roles of chairman and chief executive officer (CEO) as good practice.

- A report on corporate governance practices to be included in annual report.

- Annual report disclosure on directors' remuneration should include:

    - o Individual director's remuneration and compensation packages;
    - o Remuneration policy and long term incentive schemes;
    - o Policy for granting share options; and
    - o Basis of fees and other benefits for INEDs.

Board Practices

- Mandatory establishment of audit committee, comprised of at least three NEDs, with a majority being INEDs and a requirement for disclosure of non-compliance.

- Recommended establishment of remuneration committee; disclosure in annual report if no remuneration committee were established.

- Recommended establishment of nomination committee, the majority of members being INEDs and a requirement for disclosure in annual report if no nomination committee were established.

- All directors should be subject to rotation at regular intervals.

Independent Non-Executive Directors (INEDs)

- Number of INEDs should not be less than 1/3 of the board.

- Independence of INEDs may be questionable in the following situations:

    - o holding over 5% of shares;
    - o receiving stocks as gift or other financial assistance;
    - o being employed by the company;
    - o being the former or current director of related company;
    - o being the professional advisor of the company;
    - o having material interest in business activity of the company;
    - o owing 'allegiance' to a particular shareholder or group of shareholders;
    - o being the representative of certain parties whose interests are not the same as minority shareholders;
    - o being 'connected' to other directors or substantial shareholders; and
    - o receiving director remuneration as a major part of personal income.

5.2.10.2 Corporate transactions and shareholders' rights

Proposed amendments include revisions to the existing Listing Rules concerning the thresholds regarding "connected persons", "associates" and matters concerning voting by shareholders, among other things.

5.2.10.3 Corporate reporting and disclosure of information

Quarterly Reporting

Apart from the existing requirements on half-year and annual reporting, quarterly reports are proposed (which will come into effect from 1 January 2003, in both Main Board and GEM Listing Rules) that would have to be reviewed by audit committees and published within 45 days of their quarter-end. For the half-year and annual reports, the time limits of publishing these reports are proposed to be amended to two months and three months after the relevant period ends respectively.

Other Corporate Disclosure Matters

Apart from the timeliness and frequency of reporting, the proposed amendments also include changes regarding notifiable transactions announcements and circulars. For example, the Main Board Listing Rules will be amended to follow the GEM Rules such that a company shall include an accountants' report on the enlarged listed group in circulars for a very substantial acquisition. Both Main Board and GEM Rules will be amended to require companies to disclose additional information on all announcements and circulars of notifiable transactions and the Main Board Listing Rules will require companies to publish an announcement on any changes in directorship.

5.2.11 Accounting Practices

5.2.11.1 Regulation of the accounting profession

Incorporated by the Professional Accountants Ordinance, Chapter 50 on 1 January 1973, the Hong Kong Society of Accountants (HKSA) is the only statutory licensing body of professional accountants in Hong Kong responsible for the regulation of the accountancy profession. Qualified members are designated as professional accountants, and are entitled to use the designation Associate or Fellow of the HKSA. Only a person holding a Practising Certificate issued by the HKSA may hold out as a Certified Public Accountant (CPA) and sign the auditor’s report in Hong Kong. A CPA practicing under the name of a firm/corporate practice must apply to the HKSA for registration of the name of the firm/corporate practice.

A company incorporated under the Companies Ordinance must appoint an auditor who must be a professional accountant holding a practicing certificate issued by HKSA. Essentially, the HKSA is a self-regulatory body governing the professional conduct of professional accountants in Hong Kong. Professional Accountants Ordinance (Cap. 50) empowers the Disciplinary Committee of the HKSA to handle complaints against its members and impose disciplinary actions against them in case of negligence and misconduct.

5.2.11.2 Accounting standards and disclosure

The Companies Ordinance, the Statements of Standard Accounting Practice (SSAPs) issued by the HKSA and the Rules Governing the Listing of Securities issued by the

HKEx are the major sources that prescribe the mandatory accounting principles and disclosures for companies listed in Hong Kong.

The Companies Ordinance requires that annual accounts give a true and fair view of the state of affairs of the company as at the financial year-end and of its results for the year. The accounting disclosure requirements mainly stem from both mandatory and advisory sources, including:

- Statements of Standard Accounting Practice (SSAPs) issued by the HKSA (mandatory). Moreover, HKSA has issued Interpretations to provide authoritative guidance on the application of the SSAPs in order to give a true and fair view of the financial statements of the companies;
- Accounting Guidelines issued by the HKSA to give guidance on current best practice (advisory); and
- Technical Bulletins issued by the HKSA, with a view to assisting members in dealing with various accounting issues (advisory).

Most of the standards issued are closely in line with International Accounting Standards (IAS) in terms of measurement, recognition and disclosure. In 1993, HKSA delivered a policy change on the international harmonization of accounting standards and resolved that the basis for the development of all future SSAPs would be IAS. Therefore, the accounting requirements for disclosure in Hong Kong largely conform with IAS, and in the absence of guidance in Hong Kong SSAPs, a relevant IAS will be taken as the primary indicator of best practice.

Although Hong Kong SSAPs do not have statutory backing, they are the most authoritative source of Hong Kong General Accepted Accounting Principles (GAAP), and they are to be observed in financial statements intended to give a true and fair view, as required by the HKSA. Twenty-one (21) new/revised standards were issued as at 1 February 2002. The purpose of these statements is to cover specific issues and

areas which aim to improve the quality of financial reporting. For example, the new standard 2.125 "Interim Financial Reporting" improves the quality of the interim financial reports by establishing the minimum requirements on the form and content whereas the revised standard 2.126 "Segment Reporting" requires more extensive disclosures as compared to those recommended under the replaced accounting guideline. These new standards provide guidance in standardizing accounting treatments and improve the information to be disclosed.

5.2.12 Enforcement

The Companies Ordinance, the SFC and the HKEx form the main enforcement mechanism of corporate governance.

The Companies Ordinance contains provisions that help to enforce corporate governance related rules. For example, the Ordinance requires every company to keep proper books of accounts which give a true and fair view of the company's financial statements. If the director fails to take all reasonable steps to ensure that the company keeps proper books of accounts, he commits an offence and may be liable to a fine and imprisonment. The Financial Secretary is also given the power to appoint Inspectors to investigate the affairs of a company in certain circumstances. More details are given in Section 5.2.2 of the Hong Kong Companies Ordinance.

The SFC could invoke its powers of investigation when requested to do so by the SEHK on more complex or controversial issues, or when the SFC notes a serious breach of the Listing Rules, a breach of the Takeovers Code and Share Repurchases

or other statutory misconduct under the Securities (Disclosure of Interests) Ordinance and/or the Securities (Insider Dealing) Ordinance.

The SEHK is responsible for the day-to-day supervision and regulation of listed companies, their directors and controlling shareholders. Though the SEHK does not have statutory power in disciplining listed companies, it relies on non-statutory rules such as the Listing Rules and the Takeovers Code. The Listing Rules require directors of a listed company to adhere to the fiduciary duties of skill and diligence to the standard established by common law in Hong Kong. In cases where there is a willful or persistent failure by the director to discharge their responsibilities under the Listing Rules, the SEHK may state publicly that the retention of the director is not in the best interests of investors. If that director remains in office after SEHK's public statement, the SEHK can suspend or even cancel trading of that company's shares. The SEHK may also require remedial actions to be taken within a certain period of time or require the appointment of an independent adviser for the minority shareholders.

5.3 The United Kingdom

5.3.1 Legal and Regulatory Framework

The UK's legal system developed indigenously and was based largely on judicial decisions (common law or case law). The main legislation governing companies is the Companies Act (1985), which applies to companies, and the Financial Services and Markets Act (2000), for regulating deposit taking, insurance and investment businesses. The Companies House[3] is responsible for incorporation and registration of companies and their associated filings, along with providing company information to

[3] Companies House became an executive agency of the Government on 3 October 1998. It took on a range of delegated powers from the Department of Trade and Industry, relating to finance, personnel and support services (www.companieshouse.gov.uk).

the public. Over the years, there have been many additions and amendments to existing laws, and the legal system has become quite complex. The Company Law Review Steering Group (1998) was established to streamline the structure or remove obsolete segments.

In March 1998, the Department of Trade and Industry (DTI), which is responsible for the enforcement of company law, insolvency, investigation and prosecution under the Companies Act, launched a wide-ranging review of company law. The independent steering group appointed to carry out the review published a series of consultation documents, with a final report in July 2001. Although there are mixed opinions on how effective and thorough the review was, it made a number of significant recommendations concerning corporate governance. Many of the recommendations concerned small and private companies, and they are not considered within the scope of this review. Among others, the review made the following recommendations concerning directors for listed companies:

- a statutory statement on directors' duties[4];
- clarification of the Companies Act dealing with directors' conflicts of interest;
- clarification of the common law where it concerns attribution and contributory negligence to ensure that companies also bear some responsibility when their directors are at fault;
- a limit on the length of directors' contracts[5]; and,
- more disclosure of directors' training and qualifications to enable shareholders to better evaluate directors' performance.

There were also recommendations on how to better facilitate shareholder rights:

[4] This should include a clear statement on directors' duties, an update of laws pertaining to directors, and reference to directors' duty to consider the importance of stakeholders.
[5] Recommended contracts of employment should be limited to three years for new appointments and one year for subsequent renewals, unless otherwise authorized by shareholders.

- measures to ensure that the “real” or “beneficial” shareholders can exercise their rights;

- requirement to circulate members’ resolutions with annual general meeting documents free of charge; and,

- greater transparency of how institutional investors exercise their votes.

The other major recommendations regarding corporate governance was on financial reporting. It recommended that:

- companies be required to publish an operating and financial review (OFR) as part of the annual report, reviewing the business, performance, plans and prospects, and any other information the directors feel is relevant for understanding the business[6];

- after release of information to the market, it should also be published on the company website; and,

- listed companies publish their annual reports on their websites within four months of the year-end.

The Steering Group also supported the ‘comply or explain’ approach of the Combined Code (explained later in this section), rather than converting the Code recommendations into requirements.

The UK approach to corporate governance has been relatively more prescriptive than in the USA since companies in the UK have to follow more rules. Over the past decade, a number of reports on corporate governance discussed earlier have been published, including the Cadbury (1992), Greenbury (1995), and Hampel (1998) Committee reports. These reports all made recommendations on what the committee members believed should be adopted as corporate governance best practice in the UK.

[6] The OFR is to be published by all public and very large private companies (suggested as those with an annual turnover in excess of £500 million). It is designed to address the need in a modern economy to account for and demonstrate stewardship of a wide range of business relationships and company resources, which are of vital significance to the success of modern business, but are not often included if at all, in traditional financial statements.

The culminating report was the Combined Code (1998), which was based essentially on the Hampel recommendations, and incorporated some of the earlier recommendations from Cadbury and Greenbury.

It is generally accepted that the responsibility for corporate governance rests squarely with the board of directors. Controls over directors operate over three basic levels. They begin from the recognition of the position and principles of trust with common law duties. The latter are supplemented by a variety of statutory provisions dealing with particular incidences such as duties of disclosure and conflicts of interests, rules in relation to directors' remuneration, loan arrangements and contract terms, insider dealing, directors' disqualification and fraudulent and wrongful trading to name but a few.

The common law imposes fiduciary duties on company directors to act in the best interests of the company and put their own interests aside because they are in a position to subject others to a risk of loss.

5.3.2. Listing Rules

Publicly listed companies in the UK are traded on the London Stock Exchange (LSE). In keeping with the balanced[7] approach to corporate governance in the UK, the LSE does not have extensive rules for its listed companies. Listed companies must comply with the "Rules of the LSE", as well as the Listing Rules, which are published by the UK Listing Authority, under the authority of the Financial Services and Markets Act

[7] Section 2.6 provides the explanation of different approaches to corporate governance.

(2000). The main rules that pertain to directors and the board, and to corporate governance in general are outlined below.

Listing Rule Chapter 3 “Conditions for Listing” lays down the requirements to be met in order for a company to be considered for listing. Paragraph 3.8 requires that directors and senior management of the company “have collectively appropriate expertise and experience for the management of the group’s businesses”. It also requires that such expertise and experience be disclosed in the documents prepared by the company to support its listing application. Another requirement is that directors be free of conflicts between their duty to the company and their duties to private or other interests, unless there is a mechanism to avoid the potential conflict from damaging the company (paragraph 3.9). Paragraph 3.12 defines a controlling shareholder as one who can exercise 30% or more of the votes at a general meeting, or can control the appointment of enough directors to exercise a majority of the votes at a board meeting. It states that the company must still be capable of running its business independently of a controlling shareholder, and that all transactions and relationships with the controlling shareholder must be on an arm’s length basis. It does not provide recommendations on how the company would run independently of the controlling shareholder.

Chapter 9 “Continuing Obligations” lists requirements of an ongoing basis, i.e., requirements that companies must satisfy at all times once the company has been listed on the exchange. Paragraph 9.34A continues the initial requirements of 3.8 and 3.9 (described above) relating to independence from a controlling shareholder, and arm’s length transactions.

Chapter 11 “Transactions with Related Parties” provides rules designed to protect the company from current or recent directors, or substantial shareholders from taking advantage of their positions with respect to certain types of transactions. The rules describe the procedures[8] that must be followed when the transaction is one that is not “of a revenue nature in the course of ordinary business”[9] (Chapter 11, Definition 11.1(a)(i)).

Chapter 16 “Directors” contains the remainder of the specific requirements of the Listing Rules with respect to directors. Some of the major points are summarized below:

- Directors responsibilities – directors are individually and collectively responsible for compliance with the Listing Rules;
- Service contracts – must be available for inspection by any individual at the registered offices of the company and at the annual general meeting;
- Board changes – the notification should be made without delay and before the end of the business day following the decision on appointment and resignation of directors stating the effective date of the change (for companies seeking listing);
- Disclosure of director details – details of each director including details of previous and current directorships (for companies seeking listing).

Beyond these very basic requirements, the Listing Rules have no other specific requirements relating to directors or the board. The approach to corporate governance, as discussed earlier is through the use of the Combined Code as an appendix to the Listing Rules.

[8] Prior approval from shareholders should be obtained and the related party and his associates should abstain from voting. There are a number of exceptions such as Clauses 11.7 and 11.8 stating that the rules are not applicable if the related party does not have any equity securities listed; or the related party is an overseas company with a secondary listing by the UK Listing Authority etc.

[9] A revenue nature refers to regular transactions that are a part of the day-to-day business activities of the corporation.

The Combined Code is comprised of two parts. The first part lays down *principles* of good governance in two sections, the first relating to companies and the second relating to institutional investors. Essentially, the Combined Code is a toothless "soft law". A little bite is added to the Code by Listing Rule 12.43A requiring a UK listed company to make a disclosure statement in two parts:

- "A narrative statement of how it has applied the *principles* set out in Section 1 of the Combined Code, providing explanation to enable its shareholders to evaluate properly how the principles have been applied." (12.43A(a))
- "A statement as to whether or not it (the company) has complied throughout the accounting period with the Code *provisions* set out in Section 1 of the Combined Code. A company that has not complied with the Code provisions, or complied with only some of the provisions or (in the case of provisions whose provisions are of a continuing nature) complied for only part of an accounting period, must specify the Code provisions with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any non-compliance."(12.43(b))

The company's auditors are required to review such compliance statements before publication.

Specific duties of the directors of the boards, the chairman and CEO are specified in the "Principles of Good Governance" section within the Combined Code. The section below examines the "Principles of Good Governance" and reviews their implications on the structure and operation of boards in the UK.

5.3.3 The Combined Code

5.3.3.1 Section 1 – Companies

A – Directors

A.1 - The Board – "Every listed company should be headed by an effective board which should lead and control the company".

The provisions state that the board should meet regularly (regularly is not defined), and should use a formal agenda. Board members should have access to the company secretary and to independent legal advice (at company expense) to assist as necessary in carrying out their duties. All new directors should receive appropriate training (not specified) upon joining the board, and on an ongoing basis for all directors. It is expected that all directors exercise independent judgment on all matters relating to their work for the company.

A.2 – Chairman and CEO – “There are two key tasks at the top of every public company – the running of the board and the executive responsibility for the running of the company’s business. There should be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision.”

On the surface, this principle appears to forbid combining the roles of CEO and chairman. However, the code provisions suggest that the roles may be combined as long as the rationale for such a decision is disclosed. Regardless of whether the roles are combined or not, there is a requirement for a strong independent non-executive element on the board, including an identified senior independent director (sometimes referred to as a lead director), through whom concerns may be relayed to the board.

A.3 – Board Balance – “The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board’s decision taking.”

This principle states the importance of having NEDs on the board as a check against executive directors acting in their own interests rather than the company's. The provisions provide more explicit recommendations on the balance of executive and NEDs. Provision A.3.1 recommends that at least one-third of the board should be NEDs. Provision A.3.2 recommends that the majority of NEDs be independent. Independent means that they are "free from any business or other relationship which could materially interfere with the exercise of independent judgment".

A.4 – Supply of Information – "The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties."

Although management is required to provide information to the board, it is unlikely that the information provided will be sufficient for the board to discharge its duties. Directors must ensure they make enquiries to obtain further information as required.

A.5 – Appointments to the Board – "There should be a formal and transparent procedure for the appointment of new directors to the board."

The provisions recommend that a nomination committee be used to make recommendations on board appointments in companies with larger boards. This is a recommendation, and it would presumably be up to the board to decide whether or not the committee was required.

A.6 – Re-election – “All directors should be required to submit themselves for re-election at regular intervals and at least every three years.”

This principle recommends against automatic reappointments, and the accompanying provisions recommend that all appointments be subject to shareholder election after initial appointment and for re-election at intervals of three years or less. Biographical information should also be provided so that shareholders can make an informed decision on the appointments.

B – Directors’ Remuneration

This part of the Code is concerned with directors’ remuneration and remuneration committees which are covered in Brief 3.

C – Relations with Shareholders

C.1 – Dialogue with Institutional Investors - “Companies should be ready, where practicable, to enter into dialogue with institutional shareholders based on the mutual understanding of objectives.”

C.2 – Constructive Use of the Annual General Meeting (AGM) – “Boards should use the AGM to communicate with private investors and encourage their participation.”

These principles and their accompanying provisions are aimed at increasing shareholder involvement and enhancing the effectiveness of the AGM. Increasingly, institutional investors are seeking contact and ongoing communication with their investee companies – C.1 specifically recommends that companies should cooperate

in this regard. Other recommendations include reporting the levels of proxy voting, the separation of substantially different issues into separate resolutions to be voted on, and adequate notice to shareholders of the AGM, including provision of related papers. Chairmen of the audit, remuneration and nomination committees should be present and available to answer questions at the AGM.

D – Accountability and Audit

D.1 – Financial Reporting – “The board should present a balanced and understandable assessment of the company’s position and prospects.”

The directors are responsible for preparing the accounts, and the auditors are responsible for reporting on the directors’ representation of the financial position of the companies. The directors’ responsibilities also extend to interim and price-sensitive reports to the public and to regulators. They should also make a statement that the company is a going concern[10] with assumptions and/or qualifications.

D.2 – Internal Control – “The board should maintain a sound system of internal control to safeguard shareholders’ investment and the company’s assets.”

An annual review of the effectiveness internal controls should be performed, and the results reported to shareholders. The review should include all controls, not just financial controls, but including operational and compliance controls, and the systems by which the company identifies and manages risk.

[10] The “going concern” concept is an assumption that the business will continue to be able to meet its financial and legal obligations over the next fiscal period.

Related to this is the internal audit function. If a company has not established an internal audit function, the need for one should be considered from time to time.

D.3 – Audit Committee and Auditors

This part of the Code is concerned with the roles of audit committees and external auditors which are covered in Brief 3.

Section 2 of Part 2 deals with the role of institutional investors. The recommendations largely echo the recommendations of C above, but from the perspective of the investor rather than the company. The three recommendations are that institutional investors should make considered use of their votes, be ready to participate in a dialogue with the company, and consider all relevant factors when evaluating a company's governance disclosures.

5.3.3.2 Internal control

As described under the Combined Code principle D.2 above, the directors have a responsibility for ensuring that an effective system of internal controls is maintained to safeguard company assets and ultimately the shareholders' investment. To assist directors in fulfilling this responsibility, The Turnbull Report, published by the The Institute of Chartered Accountants in England & Wales (ICAEW) in September 1999, provides guidance for directors of listed companies incorporated in the UK on the implementation of the internal control recommendations set out in the Combined Code. The Turnbull Report (1999) identified and provided guidance for four main responsibilities, namely maintaining a sound system of internal control, reviewing the effectiveness of internal control, the board's statement on internal control, and matters

related to internal audit. More detailed explanation of these responsibilities and the recommendations of the Turnbull Report is provided in Brief 3 as they relate more to the three board committees.

5.3.4 Accounting Practices

5.3.4.1 Regulation of the accounting profession

Amongst the professional accountancy bodies in the UK[11], ICAEW is the largest professional accountancy body with more than 120,000 members. These professional accountancy bodies are self-regulated professional organizations that educate and train professional accountants and maintain standards for professional conduct among their members. Created by Royal Charter, the ICAEW is required to operate in a manner consistent with the public interest. The ICAEW licenses its members to use the designations of ACA or FCA (an Associate or Fellow of the Chartered Accountants, respectively).

Unlike other jurisdictions such as Canada and Hong Kong, professional accountancy bodies in the UK are not responsible for setting accounting and auditing standards and regulating financial reporting including disclosures.

5.3.4.2 Accounting standards and disclosures

In the UK, the Financial Reporting Council (FRC) and its subsidiaries, the Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP) are responsible for promoting and ensuring good financial reporting. The FRC provides general policy guidance to the ASB and the FRRP, which are the two

[11] These include ICAEW, The Institute of Chartered Accountants in Ireland and The Institute of Chartered Accountants of Scotland.

operational bodies. The ASB sets, amends and withdraws accounting standards. It adopted all the "Statements of Standard Accounting Practice" (SSAPs), issued by the Accounting Standards Committee (the former accounting standards setting body). SSAPs have been gradually superseded by the Financial Reporting Standards (FRS) though some SSAPs still remain in force. It also collaborates with accounting standard-setters worldwide and the International Accounting Standards Board (IASB) to ensure that its standards are developed with due regard to international development. Most accounting standards in the UK are similar to IAS, and the principles of the IAS will normally be followed where there is no corresponding accounting standard applicable in the UK.

The FRRP was established to examine departures from the accounting requirements of the Companies Act (1985) and the accounting standards. In practice, FRRP can seek directors' explanations concerning departures from the accounting requirements. If FRRP is not satisfied with the explanations, it can persuade directors to adopt a more appropriate accounting treatment or may allow directors to correct the comparative figures in the next set of annual financial statements. The FRRP can even exercise its powers to secure the necessary revision of the original financial statements through a court order. Even though ASB and FRRP are subsidiaries of FRC, they are independent from each other in performing their respective roles. The Auditing Practices Board establishes and publishes statements of the principles and procedures with which auditors are required to comply.

Every company registered under the Companies Act is required to prepare a balance sheet and a profit and loss account that gives a true and fair view for each financial

year. If the company is a parent company, consolidated accounts must also be prepared (the Act contains certain circumstances where exemptions could be granted).

The Accounting Standards are applicable to the financial statements of a reporting entity and are intended to give a true and fair view of its state of affairs as at the balance sheet date and of its profit and loss for the period covered. The Urgent Issues Task Force (UITF) of the ASB issues Abstracts that are used to assist in areas where an accounting standard or Companies Act provision exists, but where unsatisfactory or conflicting interpretations have developed or are likely to develop. Though UITF Abstracts are not part of the accounting standards, they are applicable to financial statements of a reporting entity and form part of the basis of what constitutes a true and fair view.

5.3.5 Enforcement

The Department of Trade and Industry (DTI) is responsible for enforcement of the Companies Act, administration of insolvent companies, and has power of investigation, including prosecution under the Companies Act. The Financial Services Authority (FSA) is responsible for the enforcement of FSA rules and the Financial Services and Markets Act. FSA has the statutory authority to:

- cancel a firm's authorization to do business;
- discipline firms through public statements and financial penalties;
- impose penalties for market abuse;
- obtain injunctions against a firm;
- prosecute offenses; and
- force the return of money to consumers.

Within the FSA is the Regulatory Decisions Committee (RDC), which is responsible for fundamental regulatory decisions, including:

- refusal of authorization applications;
- cancellation of permission to carry out regulated activities;
- disciplinary cases; and
- decisions that would result in a fundamental change in what a firm is allowed to do.

As a Recognized Investment Exchange, the LSE is responsible to the FSA for the enforcement of its own rules and regulations. The LSE monitors listed companies' compliance with its rules, and may make preliminary investigations on matters which would be taken up by the FSA for prosecution. The LSE can take disciplinary action, including unlimited fines, against listed companies who are in breach of LSE rules.

5.4 The United States

5.4.1 Legal Framework

The US legal system is based primarily on English common law. The legal system in each of its states is also based on common law, with the exception of Louisiana, which inherited a civil code from France. The sources of law in the USA are the US constitution, state constitutions, federal and state statutes, ordinances, administrative agency rules and regulations, executive orders, and judicial decisions by federal and state courts (Cheeseman, 2000). Common law imposes fiduciary duties of loyalty and care on company directors to act in the best interests of the company and put their own interests aside because they are in a position to subject others to a risk of loss.

Corporation law is generally established by individual states, not the federal government. Since the relevant laws vary from state to state, there is the opportunity to incorporate in a particular state that may give the company certain rights that may be advantageous to it or its shareholders. For a smaller company, the preferred jurisdiction of incorporation is often the state in which it operates.

5.4.2 Model Business Corporation Act (MBCA)

5.4.2.1 Background

In order to rationalize corporation law among states, a uniform business corporation law called the MBCA has been prepared by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association. The MBCA has been amended many times and a complete revision was published in 1984. The Committee undertakes ongoing revisions to the MBCA to meet the changing business environment. "Twenty-four states[12] have adopted all or substantially all of the MBCA as their general corporation statute, and seven other jurisdictions[13] have statutes based on the 1969 version of the Act." (Committee on Corporate Laws of the Section of Business Law 1999 p.xix). Therefore, selected provisions of the MBCA will be discussed below.

Delaware and several other major commercial states such as New York and California do not follow the MBCA. However, Delaware has a long history of being the most popular jurisdiction of incorporation within the USA for holding companies and multi-state corporations due to favourable corporate laws. In fact, over 40% of the companies listed on the New York Stock Exchange (NYSE), and more than half of the 500 largest industrial companies in the USA are incorporated in Delaware. Since Delaware incorporated companies dominate the publicly listed companies, we examine some of the features of the Delaware General Corporation Law (DGCL).

[12] They include Alabama, Arizona, Arkansas, Connecticut, Florida, Georgia, Idaho, Indiana, Iowa, Kentucky, Mississippi, Montana, Nebraska, New Hampshire, North Carolina, Oregon, South Carolina, Tennessee, Utah, Vermont, Virginia, Washington, Wisconsin, and Wyoming.

[13] They include Alaska, the District of Columbia, Hawaii, Maine, New Mexico, Rhode Island, and South Dakota.

5.4.2.2 Roles of the board

Traditionally, the fundamental duty of board of directors is to manage the business and affairs of the company. However, as the business environment changes and many large publicly held companies emerge, it is very difficult for directors to manage the company by themselves. As a result, Delaware imposes the duty by statute: "The business and affairs of every corporation shall be managed by or under the direction of a board of directors" (DGCL, Code 141(a)). The MBCA imposes a similar duty but makes it clear that the business and affairs of the company is managed under the direction of its board of directors. In other words, the board of directors may delegate some of its responsibilities to committees (i.e., the executive committee) and to the management of the company. However, under the MBCA, some important decisions such as declaring dividends, filling vacancies on the board, adopting and amending bylaws, and approving issuances and repurchases of the corporation's shares still require the approval by the board as a whole (Mallor *et al.*, 1998 p.861).

5.4.2.3 Size of the board and terms of its members

Both the MBCA (section 8.03(a)) and the DGCL (Code 141(b)) allow the boards of directors to consist of a minimum of one member. The number of directors shall be stated in bylaws or the articles of incorporation. Directors usually are elected by the shareholders at the annual general meeting and hold office for only one year. The MBCA (section 8.06) and DGCL (Code 141(d)) allow staggered terms for directors[14]. The maximum term for directors is three years. The purpose of staggered terms is to allow continuity of management so as to promote stability in the company's business

[14] Under the MBCA, a corporation with a board of nine or more members may divide the directors into either two or three classes. The term of office of those of the first class will expire at the next annual meeting, the second class will expire at a year later and so on.

and affairs. Delaware has a similar statute but it does not impose a minimum number of directors on the board to be subjected to staggered terms.

5.4.2.4 Duties and liabilities of individual board members

Directors owe fiduciary duties of care and loyalty to the company. "The duty of loyalty requires that a director make decisions based on the best interests of the corporation and not on any personal interest (Varallo and Dreisbach, 1996, p. 30)". In addition to the director's duty of care under common law, the MBCA Section 8.30 explicitly states the following standards of care that must be exercised by directors when discharging their duties:

- To act (1) in good faith, and (2) in a manner that the director reasonably believes to be in the best interests of the corporation;
- With the care that a person in a like position would reasonably believe appropriate under similar circumstances.

5.4.3 Business Judgement Rule (BJR)

The BJR is a tool used by the courts to avoid excessive examination of directors' decisions. In principle, directors will not be held personally liable for business decisions. As long as they have acted in good faith, based on sufficient information about the decision, and honestly believed that the decision was made in the best interests of the company, the courts will accept the director's decision and not try to "second-guess" it. However, a director is always liable for his or her own torts or crimes even if they were committed on behalf of or for the interests of the company.

5.4.3.1 Directors' meetings

Both the MBCA and DGCL permit action by the board without the holding of a meeting if all the directors consent in writing to the action taken.

5.4.4 The Securities and Exchange Commission (SEC)

In terms of corporate governance, the USA follows a non-prescriptive[15] approach, relying on requirements for high levels of disclosure, rather than stipulating many rules and regulations to control behavior. Investors are better able to judge a company on the merits of its disclosures, rather than relying on complex (and often costly) laws and regulations to protect the investor. The responsibility for overseeing publicly traded companies in the USA is that of the SEC, a federal agency. The SEC oversees the key participants in the securities transactions, including stock exchanges, brokers, and investment advisors. Their main concerns are the promotion of disclosure of important information, enforcement of securities laws and protection of investors. The key to the power of the SEC is its enforcement authority which is established through federal statute. Although the SEC enforcement of statutes is a matter of civil law, it works with criminal law enforcement agencies to bring criminal charges where the misconduct is more serious.

The Securities Act (1933) and the Securities Exchange Act (1934) are the two principal laws that provide the basic framework for the federal regulation of the sale of securities in interstate commerce. The 1933 Act and the 1934 Act are divided into sections which constitute the law. The SEC was created by the 1934 Act, and it is through these acts that it has the power to administer the federal securities laws and carry out provisions of the law by promulgating rules and regulations.

[15] Section 2.6 provides the explanation of different approaches to corporate governance.

The 1933 Act requires that securities offered to the public should be registered before they can be sold. It deals with the original distribution of securities by the issuing corporations, and ensures that investors receive financial and other information regarding the security being offered. It also specifically prohibits misrepresentation and other fraud related to the sale. The 1934 Act focuses on the purchase and resale of the securities already traded in the market. It is designed to prevent fraud and market manipulation and deals with the continuous disclosure by issuers whose securities are registered under the 1933 Act, traded on a national stock exchange or traded in interstate commerce with more than 500 shareholders and company's total assets of US$5 million or greater. Section 13 of the 1934 Act requires reporting companies to file the following periodic reports:

- Annual reports on Form 10-K, including audited financial statements, a detailed analysis of the company's performance (management's discussion and analysis - MD&A), the nature of the firm's business, the current status of its securities and a listing of all directors and executive officers and their compensation (such as salary and stock options);
- Quarterly reports on Form 10-Q, including summarized, unaudited condensed financial statements and MD&A of financial condition and results of operations;
- Monthly reports on Form 8-K must be filed when material events occur such as a change in control of the company.

Under the 1934 Act, a reporting company is only required to send the annual reports to its shareholders. Other reports are required to file with the SEC only.

The SEC has developed two regulations, Regulation S-X and S-K, as standard instructions for filing forms under the 1933 and 1934 Acts. Regulation S-X covers the requirements for the form and content of financial statements included in registration

statements and periodic reports under both filings. Regulation S-K governs the non-financial information in filings under either the 1933 or 1934 Act. (Please refer to Appendix 5 for detailed disclosure).

5.4.5 Regulatory Framework – the Exchanges

5.4.5.1 Background

Exchanges in the USA are classified by the SEC as "self-regulating organizations" (SROs). They are responsible for developing rules and policies for disciplining their own members/participants, and establishing rules that will ensure market integrity and investor protection. Rules established by exchanges must first be published for consultation, and will then subsequently be approved by the SEC after amendments.

Most of the publicly listed companies are traded on the NYSE and the National Association of Securities Dealers Automated Quotations (NASDAQ). Therefore, our review will be confined to these two largest exchanges. The corporate governance environment in the USA depends heavily on disclosure, and the rules of the NYSE and NASDAQ reflect this. Except for the requirements for an audit committee, there are few rules on how a company must be structured and governed.

5.4.5.2 Corporate governance

Section 303 of the NYSE Listed Company Manual contains details for corporate governance standards. It emphasizes the policy, requirements, composition and independence of the audit committee (already discussed in Brief 3). The NASDAQ Marketplace Rule 4350 addresses corporate governance requirements for:

- Distribution of Annual and Interim Reports;
- Independent Directors;
- Shareholder Meetings;

- Quorum Requirements;
- Solicitation Proxies;
- Conflicts of Interest;
- Shareholder Approval;
- Stockholder Voting Rights;
- Auditor Peer Review.

The requirements relevant for this brief are discussed below (others are given in Appendix 5).

5.4.5.3 The board

Both the NYSE and NASDAQ Listing Rules require that each listed company establish an audit committee with at least three directors, all of whom are independent. In other words, each listed company is required to have at least three independent directors on its board in order to satisfy the audit committee requirement. There are no other requirements on the board composition such as the role of CEO or chairman or the appointments to the Board.

5.4.5.4 Conflicts of interest

The exchanges believe that the review and oversight of related party transactions is best left to the discretion of listed companies. Given the independent nature of the audit committee, companies shall utilize the audit committee to review the potential conflict of interest situations on an ongoing basis where appropriate (NASDAQ Marketplace Rule 4350 (h) and the NYSE Listing Rule 307).

5.4.5.5 External audit

The exchanges require that all financial statements contained in annual reports of listed companies be audited by independent public accountants. Companies listed in the NYSE are required to publish and distribute to shareholders an annual report containing financial statements of the company and its subsidiaries at least 15 days in

advance of the annual general meeting whereas companies listed in the NASDAQ are required to distribute to shareholders an annual report within a reasonable period of time prior to the company's annual general meeting.

5.4.6 Accounting Practices

5.4.6.1 Regulation of the accounting profession

The most influential accounting body in the USA is the American Institute of Certified Public Accountants (AICPA)[16]. The AICPA is the national professional organization for all Certified Public Accountants (CPAs). It provides certification and licensing to public accountants in the USA, and licenses the CPA designation. Its mission is to provide members with the resources, information, and leadership that enable them to provide valuable services in the highest professional manner to benefit the public as well as employers and clients. In fulfilling its mission, the AICPA works with state CPA organizations and gives priority to those areas where public reliance on CPA skills is most significant. It also serves as the national representative of CPAs before governments, regulatory bodies and other organizations in protecting and promoting members' interests. The Institute has its own bylaws ('AICPA Bylaws' as amended October 28, 1997), which contain all the rules and conditions regarding the admission to, and retention of, membership, structure of the Institute, and also on termination of membership as well as disciplinary sanctions.

In order to maintain the high standard of the profession, the AICPA launched the AICPA Peer Review Program. The Program is dedicated to enhancing the quality of accounting, auditing and attestation services performed by AICPA members in public

[16] Its predecessors have a history dating back to 1887, when the American Association of Public Accountants was formed. After a series of restructurings, the Institute finally took its current shape in 1936.

practice. The Peer Review Board (Board) is responsible for maintaining, furthering and governing the activities of the Program, including the issuance of peer review standards, and peer review guidance, while being mindful of the profession's covenant to serve the public interest with integrity and objectivity. It is committed to conducting, in cooperation with state CPA societies, a globally preeminent Program that monitors the quality of services provided by over 30,000 AICPA firms.

The Public Oversight Board (POB) is an independent private sector body responsible for overseeing the accounting profession in the USA. It was established in 1977 to oversee the SEC Practice Section created by AICPA. In February 2001, a Charter for the POB was announced which extends POB's oversight to the Auditing Standards Board and the Independence Standards Board. The independence of POB is assured by its power to set its own budget, composition and policy.

5.4.6.2 Accounting standards and disclosure

The laws concerning accounting standards and disclosures vary from state-to-state and often have substantial differences. The Securities Exchange Act (1934) has a requirement for keeping books and records which accurately and fairly reflect the transactions of listed companies.

The Financial Accounting Standards Board (FASB) is established to set financial accounting standards. It develops broad accounting concepts and accounting standards for financial reporting, and also provides guidance on the implementation of standards[17]. These are achieved through publishing their own alerts (called Action Alerts) to trends in financial reporting. In developing accounting standards that are

[17] Prior to the establishment of the FASB in 1973, financial accounting and reporting standards were set by the Committee on Accounting Procedure of the AICPA (1936 – 1959) and then by the Accounting Principles Board, also a part of the AICPA (1959 – 1973).

acceptable, the FASB also consults the public, other interested organizations, and other professional bodies such as the Emerging Issues Task Force (EITF), the Accounting Standards Executive Committee and Auditing Standards Board of the AICPA (AcSEC), the International Accounting Standards Board (IASB), and the appropriate committees of such organizations as the Association for Investment Management and Research (AIMA), Financial Executives International (FEI) and the Institute of Management Accountants (IMA).

The FASB's structure is independent of all other business and professional organizations. The Financial Accounting Standards Advisory Council (FASAC) has the responsibility to consult with the FASB on technical issues. The Financial Accounting Foundation (FAF) is responsible for selecting the members of the FASB and its advisory council, determining funding for FASB's activities and exercising general oversight. The FASB has absolute power to decide all the technical issues. The EITF of the FASB has the role of identifying, discussing and resolving accounting issues in a timely manner.

The regulatory framework for accounting standards setting in the USA is summarized below:

1. FASB Statements of Financial Accounting Standards (SFAS), FASB Interpretations, AICPA Accounting Principles Board (APB) Opinions, and AICPA Accounting Research Bulletins;

2. FASB technical bulletins, AICPA industry audit and accounting guides, and AICPA Statements of Position;

3. AICPA Practice Bulletins;

4. AICPA Accounting Interpretations, FASB Implementation Guides;

5. other accounting literature, such as APB statements, AICPA issue papers, concept statements from FASB, International Accounting Standards (IAS), pronouncements of other professional associations or regulatory agencies, and accounting textbooks and articles.

While this list is non-exhaustive, it highlights the significant sources of GAAP affecting publicly traded corporations. It is worth noting from the list that IAS does not rank highly in this list.

The FASB has stated that it will continue to actively participate in the IASC process, and will consider IAS (along with other foreign national standards) when developing its own projects. Although the IASC is currently regarded as the focal point of developing harmonization with international standards, FASB will also look to other sources (i.e., foreign accounting pronouncements) for increasing comparability of financial statements with those of other jurisdictions.

5.4.7 Enforcement

Corporation laws in the USA are established and administered by individual states, and the specifics of each differ from one state to another. Enforcement is also the responsibility of the state, and it varies by state. Common law imposes fiduciary duties of loyalty and care on company directors to act in the best interests of the company and put their own interests aside because they are in a position to subject others to a risk of loss.

The responsibility for overseeing publicly traded companies in the USA is that of the SEC, a federal agency. The Securities Act (1933) and the Securities Exchange Act (1934) are the two principal laws that provide the basic framework for the federal regulation of the sale of securities in interstate commerce. The 1933 Act and the 1934

Act are divided into sections which constitute the law. The SEC was created by the 1934 Act, and it is through these Acts that it has the power to administer the federal securities laws and carry out provisions of the law by promulgating rules and regulations. The SEC oversees the key participants in the securities transactions, including stock exchanges, brokers, and investment advisors. Their main functions are to promote disclosure of important information, enforce securities laws and protect investors. The enforcement power of the SEC is established through federal statute. Although the SEC's enforcement of statutes is a matter of civil law, it works with criminal law enforcement agencies to bring criminal charges where the misconduct is more serious (i.e., embezzlement, theft).

As discussed previously, exchanges in the USA are self-regulating, and therefore responsible for enforcing their own rules and policies.

5.5 Australia

5.5.1 Legal and Regulatory Framework

Australia is one of the common law countries in which companies are incorporated and operated under the Corporations Law (1989) and the common law. The common law, the Corporations Law and the Australian Securities Commission Law govern corporate governance of Australian companies. Section 221 of the Corporations Law requires at least three directors to be appointed in a public company, and the director should not be a bankrupt, or a person convicted of certain offences (s229). Sections 231 and 232 of the Corporations Law stipulate that directors have the duty to avoid a conflict of interest, and the duty to act honestly in the exercise of his or her powers at all times. Directors are also liable to penalties and may be subject to derivative actions

(s246, s461, s1324). Other than the above sections of the Corporations Law, the duties and liabilities of the directors and other officers are set out in common law. The two major duties of the directors include the duty to act in the interests of the company and the duty to exercise care and skill.

5.5.2 The Australian Stock Exchange (ASX)

Corporate governance in Australia has been influenced by the existence of institutional investors and globalization, resulting in fairly high standards of corporate governance. Currently, the major promoter of corporate governance is the ASX which stipulates requirements for disclosure of corporate governance practices in its listed companies. The ASX rules on corporate governance take a non-prescriptive [18] approach by not requiring listed companies to follow specific practices. It acknowledges that different solutions to corporate governance may be appropriate for different companies, and that a "one size fits all" approach to corporate governance would be inappropriate. Instead, the ASX encourages companies to refer to guides of best practice for implementation of corporate governance practices. In the ASX Listing Rules, there is a requirement for a listed company to provide a statement of the main corporate governance practices in place during the reporting period, allowing investors to make their own assessments and conclusions about a company's corporate governance. The ASX names several general guides to best practice including: the "Code of Conduct" developed by the Australian Institute of Company Directors (AICD, 1995), and "Corporate Governance: A Guide for Investment Managers and Corporations and A Statement of Recommended Corporate Practice" by the Australian Investment Managers' Association (AIMA, 1997).

[18] Section 2.6 provides the explanation of different approaches to corporate governance.

Moreover, a Working Group formed by the AICD, the Australian Society of Certified Practising Accountants (ASCPA), the Business Council of Australia, the Law Council of Australia, the Institute of Chartered Accountants in Australia (ICAA) and the Securities Institute of Australia under the chairmanship of Henry Bosch published the Bosch Report (1995) titled "Corporate Practices and Conduct". Recommended practices related to corporate governance are addressed in the Report, such as recommending the separation of roles between chairman and CEO, separate meetings attended only by NEDs and INEDs, formation of a corporate governance committee, etc.

The ASX provides an indicative list of matters that it considers relevant to corporate governance as guidance to companies, although it is not intended to be a guide to best practice itself. In September 2001, the ASX introduced Listing Rule 4.10 which requires listed companies to include a separate statement detailing the corporate governance practices in place. In order to assist companies in preparing this declaration, the ASX also published Guidance Note 9 of the Listing Rules on the Disclosure of Corporate Governance Practices, giving the indicative list of "corporate matters" that should be reported, including the identification of status of the directors (whether they are executive or non-executive), the existence of proper procedures for appointing and compensating directors, the existence and maintenance of appropriate ethical standards, and the existence of properly working board sub-committees, etc.

5.5.2.1 Corporate Law Economic Reform Program (CLERP)

The CLERP was launched by the Australian Government in 1997 (which subsequently became the Corporate Law Economic Reform Program (CLERP) Act in 1999), with an aim to improve Australia's business and company regulation so as to promote business, economic development and employment. Corporate governance issues have also been addressed in the proposal. The proposal states that: "While the (Australian) Government should seek to encourage public corporations to adopt appropriate governance structures, it should avoid unnecessary prescription which could lead to inflexibility and inhibit innovation…it is considered preferable for Australian corporate governance practices to develop in response to competitive economic, commercial and international pressures, rather than in response to prescriptive rules mandated by Government." (CLERP, 1997) Therefore, according to the Proposal Paper No. 3 published in 1997, though "the establishment and maintenance of effective corporate governance practices by Australian companies is essential to Australia's international competitiveness and economic growth" (CLERP, 1997), it was stressed that:

> "Corporate governance practices should, as far as practicable, be continuously monitored by the ASX, relevant industry and professional bodies who promote best practice, investors and Government to maintain investor confidence in Australia's capital markets. The Government will not impose additional mandatory legislative requirements unless there is a failure of the current requirements or these regulatory mechanisms." (CLERP, 1997)

Thus, it could reasonably be expected that the work of maintaining corporate governance in Australian companies would continue to be largely monitored by the regulatory bodies (such as ASX) instead of legal institutions even after recent reforms have been undertaken.

5.5.3 Accounting Practices

5.5.3.1 Regulation of the accounting profession

There are three major professional accounting bodies in Australia, namely the Institute of Chartered Accountants in Australia (ICAA)[19], Certified Practising Accountants (CPA) Australia[20] and the National Institute of Accountants. Both the ICAA and CPA Australia are responsible for the licensing of professional accountants.

The National Institute of Accountants[21] is self-regulating, and has about 14,000 members working in industry, commerce, government, academia and private practice. It is consulted by business, government and public bodies on issues affecting the accounting profession, including representation on Federal Government committees.

5.5.3.2 Accounting standards and disclosures

Accounting standards and disclosures in Australia arise from requirements under the Corporations Law, Australian Accounting Standards (AAS) issued by the Australian Accounting Standards Board (AASB), Listing Rules of the ASX, and the Australian Securities and Investments Commission (ASIC). The Corporations Law stipulates that financial statements be prepared on an annual and semi-annual basis in accordance with standards issued by the AASB.

The CLERP Act (1999) establishes the basis for the new standard setting arrangements as part of the government's Reform Program with the new arrangements effective 1 January 2000. These include the introduction of a business

[19] Constituted by Royal Charter in 1928, it now operates under a Supplemental Royal Charter granted by the Governor-General on behalf of Queen Elizabeth II on 23 August 2000.
[20] Formerly named the Australian Society of Accountants, it is the nation's largest professional body with more than 90,000 members in Australia and overseas.
[21] One of Australia's oldest representative professional bodies, began as the Institute of Factory and Cost Accountants in 1923.

judgement rule and derivative actions into the Corporations Law, clarification of directors' obligations and liabilities in the Corporations Law, and the establishment and maintenance of effective corporate governance practices of Australian Companies by the ASX.

The institutional arrangements for accounting standard setting involves the Financial Reporting Council (FRC) with the oversight responsibility for the AASB, which deals with standard setting in the private and public sectors[22].

The FRC is a statutory body established under the Australian Securities Commission Act 1989[23]. The FRC is responsible for overseeing the operations of the AASB, monitoring the development of international accounting standards and accounting standards that apply in major international financial centers, and promoting the adoption of international best practice accounting standards in the Australian accounting standard setting process.

The Act expressly limits the FRC's ability to be involved in the technical deliberations of the AASB. It provides that the FRC does not have power to direct the AASB in relation to the development, or making, of a particular standard, or to veto a standard formulated or recommended by the AASB. This provision is designed to ensure the independence of the standard setter.

The AASB standards apply to "reporting entities", which are listed corporations, borrowing corporations, and subsidiaries of foreign listed companies where there are

[22] This replaces the Australian Accounting Research Foundation.
[23] Now re-enacted as the Australian Securities and Investments Commission Act 2001 (ASIC Act).

no intermediate Australian holding companies. A Directors' Report must also be prepared, in which directors will state whether they are of the opinion that compliance with AAS results in a true and fair view or not. If not, they must provide sufficient information and explanation in the notes to the financial statements.

The AASB issued a policy on international harmonization (Policy Statement 6 "International Harmonisation Policy") in 1996 which states that it is their intention, in conjunction with IASC and other standard-settings bodies, to follow a program of harmonization of accounting standards in Australia with international standards. Although it is recognized that achieving a set of internationally accepted accounting standards is likely a long term objective, the "interim objective is to work towards ensuring that compliance with Australian accounting standards results in compliance with IASs" (Policy Statement 6, para 2.2). Currently, compliance with IAS will not necessarily result in compliance with AAS.

5.5.4 Enforcement

The ASIC is responsible for enforcing the laws (primarily the Corporations Act 2001 and the Australian Securities and Investment Commission Act 2001) relating to securities of publicly listed companies. The ASIC investigates breaches of the Corporations Act and the Australian Securities & Investment Commission Act, based on consumer/market participant complaints, referrals from the ASX (see below), or through their own inquiries. The ASIC may seek civil or administrative action, or may alternatively seek enforceable undertakings [24]. When cases proceed to civil,

[24] Enforceable undertakings are court enforceable undertakings from individuals or companies, and may include an agreement to pay a fine or to cease a prohibited activity.

administrative, or criminal actions, the range of penalties are provided in the relevant Acts and Codes.

The ASX is responsible for supervision of trading activity and market participants, as well as investigation and enforcement of ASX rules under the Corporations Act. While the surveillance and enforcement department of the ASX is concerned primarily with breaches of ASX rules, it works closely with the ASIC to identify matters that may require further investigation. Where there are violations of the Corporations Act, the ASX would provide details to the ASIC for further action. It has the authority to impose a range of disciplinary actions, including:

- a warning letter;
- a request for explanation;
- suspension of trading rights (for serious breaches of trading rules and regulations);
- a fine; and,
- prosecution by ASIC (for serious cases).

Since directors in Australia have the common law fiduciary duties of loyalty and care, under the Corporations Act, they could be subjected to penalties in common law and as well as statutes.

5.6 Malaysia

5.6.1 Legal and Regulatory Framework

Malaysia is a common law country where The Companies Act (1965), and the Companies Regulations (1966) are legislation governing incorporated companies. The Act is modeled on the English Companies Act (1948) and the Australian Uniform Companies Act (1961) (Arjunan and Low, 1995). Additional statutes governing listed

companies include the Securities Commission Act (1993) and the Securities Industry Act (1983).

The regulatory bodies that are chartered with securities regulations include the Securities Commission and the Kuala Lumpur Stock Exchange (KLSE). The Securities Commission was established in 1993. Its primary function is to advise the Minister of Finance on all matters relating to the securities and futures industries. It also supervises and monitors the activities of any exchange, clearing house, or custodian, and suppresses illegal and improper practices in dealings in securities, trading in futures, etc.

The KLSE, which was formed in 1976, is a self-regulatory organization to administer and enforce rules with respect to the conduct of its members in securities dealings. It is responsible for the maintenance of an efficient market, surveillance and enforcement of the Listing Requirements[25]. It is also charged with the responsibility of ensuring that relevant disclosure requirements and appropriate corporate conduct expected of publicly listed companies are properly maintained.

Like many other jurisdictions, the Listing Requirements in Malaysia form the regulatory basis to regulate companies listed on the KLSE. After the Asian financial crisis in late 1997, there were a number of initiatives proposed by policy makers and private sectors, the major one being the Malaysian Code on Corporate Governance issued by the Finance Committee Report on Corporate Governance ("the Code") in March 2000. This Code was adopted and backed up by the Listing Requirements of

[25] In Malaysia, KLSE is responsible for both "Main Board Listing Requirements" and "Second Board Listing Requirements", collectively referred to as "Listing Requirements".

the KLSE. All KLSE listed companies are required to state in their annual reports how they have applied the principles and complied with the best practices. Listed companies have to comply with the Code and the KLSE may take action for non-compliance. Malaysia's approach to corporate governance is best described as being a prescriptive approach[26] (Gul, 2002).

5.6.2 The Kuala Lumpur Stock Exchange (KLSE)

All companies seeking public listing on the KLSE and existing public listing companies in Malaysia are required to follow the Listing Requirements of the KLSE. Chapter 3 "Admission" Part E "Other Requirements" states that applicants are required to have independent directors and an audit committee. This part provides that every applicant has to have at least two directors or one-third of the board, whichever, is higher, being independent. Independent directors are defined as directors who are independent of management and free from any business or other relationship which could interfere with the exercise of independent judgment or the ability to act in the best interests of the company. The requirements on audit committee have been discussed in Section 4.11.4 of Brief 3.

Chapter 8 "Continuing Listing Obligations" prescribes that listed companies should submit to the KLSE semi-annual returns as prescribed by the KLSE from time to time. Listed companies shall also supply information to the KLSE concerning financial condition, level of operations, minimum shareholding spread, etc. in order to warrant continued trading.

[26] Section 2.6 provides the explanation of different approaches to corporate governance.

Chapter 9 "Continuing Disclosure" requires companies to disclose to the public all material information necessary for informed investing and should take reasonable steps to ensure that all investors, who invest in their securities, have equal access to such information. This chapter also outlines specific policies concerning insider trading, disclosure of material information and quarterly and annual reports, etc.

Chapter 15 "Corporate Governance" covers mainly issues relating to directors, audit committees, external auditors and corporate governance disclosure that all listed companies must comply with. They are similar to the requirements in Chapter 3 "Admission" above. However, Section 15.09 of Listing Requirements requires every director, including independent directors of a listed company to ensure that he or she undergoes continuous training so as to equip him or herself to effectively discharge his or her duties as a director. Roles and functions of audit committees in Malaysia have been discussed in Section 4.11.4 of Brief 3.

Chapter 15 of the Listing Requirements also gives external auditors the right to demand meeting(s), through the chairman of the audit committee, to consider any matter the external auditor believes should be brought to the attention of the directors or shareholders. Finally, all listed companies should prepare a narrative statement of how they have applied the principles set out in the Code according to their particular circumstances and also a statement on the extent of compliance with the Best Practices in Corporate Governance of the Code, explicitly identifying and giving reasons for any areas of non-compliance.

5.6.3 Malaysian Code on Corporate Governance (the Code)

5.6.3.1 Principles of the Code (2000)

Below is a summary of the main areas covered in Part 1 – Principles of the Code.

The Board

An effective board, which should include a balance of all directors, including INEDs, should head every listed company so that no individual(s) can dominate decision making of the board. The board should be supplied with timely and quality information in order to enable it to discharge its duties. There should be a formal and transparent procedure for the appointment of new directors to the board and all directors should be required to submit themselves for re-election at regular intervals and at least every three years. The recommendations regarding nomination committee are described in section 6.8.1 of Brief 3.

Directors' Remuneration

The recommendations regarding directors' remuneration and remuneration committee are described in Section 5.8.1 of Brief 3.

Shareholders' Communication

Companies and institutional shareholders should have open dialogue and each be ready to have communication based on the mutual understanding of objectives. Companies should use the annual general meeting (AGM) to communicate with private investors and encourage their participation.

Accountability and Audit

The board should present a balanced and understandable assessment of the company's position and prospects in their financial reporting. The board should also maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. It should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors.

5.6.3.2 Best practices in corporate governance

Below is a summary of the main areas covered in Part 2 – Best Practices of the Code.

Risk Management and Internal Control

The board should explicitly assume the responsibilities of reviewing and adopting a strategic plan for the company; overseeing the conduct of the company's business; identifying principal risks and implementation of systems to manage these risks; succession planning; developing and implementing an investor relations program and reviewing the adequacy and integrity of the company's internal control systems.

CEO Domination and Director Training

There should be a clearly accepted division of responsibilities at the head of the company, who will ensure a balance of power and authority. A decision to combine the roles of chairman and CEO should be publicly explained and at least one third of the membership of the board should be INEDs. NEDs should be persons of high caliber, possessing the credibility and the necessary skills and experience to bring

independent judgment to board issues. In this regard, it is recommended that directors, including INEDs should receive training through a proper course of induction into the company's affairs backed up by an ongoing internal and external training program to keep abreast of new laws and regulations, and changing commercial risks. Details concerning directors' training and education in Malaysia have been included in Section 6.8.2 of Brief 3.

The board should disclose on an annual basis whether one third of the board is independent and in circumstances where the company has a significant shareholder (defined as a shareholder with the ability to exercise a majority of votes for the election of directors), whether it satisfies the requirement to fairly reflect through board representation the investment of the minority shareholders.

Meetings

The Code requires that boards meet regularly on issues supported by the relevant paperwork, and record its decisions and conclusions. Board meetings should have a formal schedule of matters reserved for decision. The schedule is to be kept up to date and provided to new directors on appointment. The governance report must disclose the number of meetings held each year so that shareholders may determine if they are frequent enough.

Bearing in mind the responsibility of the chairman for the provision of information, and that the quality of information is crucial to the deliberations of the board, access to information concerning the company's performance was regarded as critical by the committee. Such information should go beyond mere quantitative performance and

include performance factors such as customer satisfaction, product and service quality, market share, market reaction and environmental performance. These information needs require procedures to be in place to ensure the board is supplied with information in a timely fashion. The board should not simply rely on management but be proactive in demanding information where appropriate. Directors should have access to all information collectively or individually. They should also be entitled to take independent professional advice at the company's expense if considered necessary.

Shareholders

Boards must maintain a communications policy that enables both the board and management to communicate effectively with the shareholders and general public. The system must effectively analyze company operations, and must accommodate feedback from shareholders. The AGM is seen as a crucial mechanism for shareholder communication, and to improve its value, companies should observe the following:

- Each item of special business included in the notice should be accompanied by full explanation;
- Notice of meetings should include which directors are standing for election or re-election;
- The chairperson should provide reasonable time for discussion;
- Information regarding the effects of proxy voting should be disclosed immediately after each vote;
- A summary of discussion at the AGM should be provided to shareholders upon request.

5.6.4 Accounting Practices

5.6.4.1 Regulation of the accounting profession

The Malaysian Institute of Accountants (MIA)[27] is a self-regulating professional body promoting and regulating professional and ethical standards of professional accountants in Malaysia, and enhancing competency through continuing education and training. The Council of the MIA is represented by the Accountant General, the Registrar of Companies and accountants in public practice, private sector and academia.

5.6.4.2 Accounting standards and disclosure

In Malaysia, the Companies Act and the Malaysian Accounting Standards (MAS) issued by the Malaysian Accounting Standards Board (MASB) are the two major sources that prescribe the mandatory accounting principles and disclosures for companies listed in Malaysia.

The MASB was established in 1997 under the Financial Reporting Act, and is the sole statutory authority for setting and issuing accounting standards in Malaysia. In 1998, the MASB initiated a comprehensive review of the financial reporting regime. Existing accounting standards issued by the Malaysian accountancy profession as approved accounting standards (known as IAS or MAS) are considered by MASB as approved accounting standards until they are revised or replaced under the review. In essence, Malaysia follows IAS with variations that accommodate local economic and business environment. Malaysian Approved Standards on Auditing (MASA) are incorporated from International Standards on Auditing and International Auditing Practice Statements, which are approved by the Council of the MIA. MIA members

[27] Established under the Accountants Act, 1967.

who assume responsibilities as independent auditors are required to observe these MASA.

The Companies Act requires incorporated companies to comply with all its provisions regarding the maintenance of proper accounting records and the preparation and submission of audited accounts for statutory purposes.

5.6.5 Enforcement

Malaysian law follows the common law treatment of directors' fiduciary duties. Enforcement of director's duty is difficult due to Malaysian law which does not allow class actions. Furthermore, lawyers cannot act based on contingency fees, so the potential costs involved with individuals' enforcement of their rights can be potentially high as the individual may have to invest considerable sums of money just to initiate an action (Nathan, 2001).

Both the KLSE and the Securities Commission enforce listing rules through a range of disciplinary actions as described below. Recent amendments to the Securities Industry Act (1983) provide for recourse against individual directors, rather than the company only, in cases of non-compliance with listing requirements (Nathan, 2001). The types of disciplinary actions the KLSE can impose are provided in their own Listing Rules, as well as in the Securities Industry Act. These disciplinary actions include the issuance of private/public reprimands, fines, suspension of listing, and de-listing of a company.

5.7 Taiwan

5.7.1 Legal and Regulatory Framework

Historically, Taiwan has evolved as a civil law jurisdiction, and therefore its Company Law is based on the models of civil law jurisdictions, particularly those of Germany and Japan. More recently, there has been a stronger influence from common law jurisdictions, particularly the USA. This influence from common law has helped shape Taiwan's current Company Law (1929) and Securities and Exchange Law (1968), both of which form the legal framework underlying corporate governance. Only companies limited by shares are traded on the Taiwan Stock Exchange (TSE).

Taiwanese companies follow the two-tiered board models common in some continental European countries such as Germany. There is a board of directors, comprising of members elected from shareholders who manage the company, and a number of supervisors who perform an oversight role. The board of directors in a two-tiered model assumes a greater management role than the board of directors in a unitary board company. It is responsible for running the business of the company while supervisors are individually responsible for performing their duties and functions (as opposed to a group) of overseeing the management (the board of directors) of the company.

The Company Law stipulates statutory requirements with respect to duties and responsibilities of directors and supervisors and the constitution of boards of directors. Each company must have a minimum of three directors and one supervisor. Rather than prescribing qualifications that a director should have, the Company Law and TSE Listing Rules provide guidance on conditions that would preclude someone from being a company director.

The Company Law bars individuals from serving as directors if they have records of financially related crimes, bankruptcy, infirmity through age or mental illness, or other misconduct that may have a bearing on his or her ability to act as a director. The TSE Listing Rules expand on the Company Law requirements by adding a "violation of the principle of good faith" test for disqualifying individuals from being supervisors or directors of listed companies. Violations that would disqualify someone from becoming a director or supervisor include:

- Having written dishonoured cheques;
- Delinquency in repaying a loan;
- Criminal violation of labour laws or tax evasion within the preceding two years;
- Having made false representations or violated laws and regulations which resulted in material damage to the interest of the company and/or the rights and interests of its shareholders/public;
- Having been convicted of corruption, malfeasance, fraud, breach of trust or theft;
- Having committed a malicious insolvency or other improper conduct in another company;
- Committed other acts in serious violation of laws and regulations or of the principle of good faith.

The Company Law specifies the requirements for directors and supervisors to attend meetings, their liabilities for damages or illegal acts within their scope of business, and responsibilities in exercising due care. Directors serve the company under a contract, and under civil law have a duty to exercise due care in carrying out their responsibilities. However, fiduciary duty has not been an important principle in Taiwan until recently (Liu, 2001). Fiduciary duty is not stressed in the Civil Code or Company Law, but directors may still be held criminally responsible for breach of trust.

Directors are usually either the dominant shareholders or appointees of dominant shareholders since most companies in Taiwan are family controlled. The supervisors are often appointed by the same shareholders. This creates a situation where it is difficult for supervisors to object to actions of a director that are really the desire of the shareholder who appointed them both. Compounding this lack of independence is the fact that chairmen of Taiwanese companies are rarely independent of management, as they are often founders of the company and remain involved with the day-to-day running of the business.

The TSE Listing Rules require a company applying for a listing to have an independent director, but does not give a clear definition on what is meant by "independence". The Listing Rules provide some guidance as to what would constitute a lack of independence in Article 15 of the TSE Supplementary Provisions:

- "On the part of the board of directors: Where the total number of directors is less than five, or any of the following relationships exists among more than 2/3 of the members of the board of directors:
    - Spouse;
    - Linear relatives by blood within the second degree of relationship;
    - Lateral relatives within the third degree of relationships;
    - The representatives of the same juristic person; or
    - Related persons.

- On the part of supervisors: Where the total number of supervisors is less than three, or any of the following relationships exists among the supervisors or between a supervisor and any of the directors:
    - Spouse;
    - Linear relatives by blood within the third degree of relationship;
    - Lateral relatives within the fourth degree of relationships;
    - The representatives of the same juristic person; or
    - Related persons."

It should be noted that these independence rules only apply to companies seeking listing for the first time, and they are under no legal or regulatory obligation to maintain "independent" directors after their initial terms are over (Liu, 2001).

Taiwan's civil law history has emphasized rules and codes rather than standards of behaviour. This has resulted in companies and individuals complying with existing law in form, rather than in substance. Rather than allowing market mechanisms to control behaviour, there have been attempts to generate rules to cover all situations. This type of codification has resulted in rules that are not flexible enough to adapt to the changing business environment. The Securities and Futures Commission is attempting to improve disclosure quality, particularly with respect to unusual transactions, related party transactions, and the "moral turpitude" of dominant shareholders. The presence of so many rules and market intervention may prevent investors from making investment decisions on the basis of corporate governance within individual companies.

There does not appear to be a code of practice or guidelines for corporate governance such as those found in most other jurisdictions (i.e., Singapore, Malaysia, and the UK) in Taiwan. Many of the other codes and guidelines in Asia were developed and published after the Asian financial crisis of the late 1990s, but "Taiwan's prudent macroeconomic policy has steered it clear of the Asian financial crisis" (Liu, 2001). This avoidance of a recession cushioned Taiwan's corporate sector and banking system from the downturn in the regional business cycle, resulting in less pressure for corporate governance reform than in other Asian countries (Asian Corporate Governance Association, 2000). This reduced pressure may have resulted in less drive

devoted to develop a code of best practice or guidelines for corporate governance in Taiwan. The corporate governance approach is best described as a prescriptive approach due to the existence of many rules and regulations imposed by law.

Another factor lacking in Taiwan that is present in some other jurisdictions is a high level of institutional ownership. In some countries, there has been pressure from institutional investors to improve corporate governance. In the USA, the California Public Employees' Retirement System (CalPERS) is a good example. In Taiwan, since family ownership is very common and the majority of stock transactions are incurred by individual investors, such a motivational force does not exist (Gul, 2002).

Some companies have taken a lead in developing practices that promote good corporate governance. Generally, these companies are larger companies with an international focus, such as high technology and computer companies. Because they are competing on a global basis, they must measure up to international standards and expectations in order to attract investment (Asian Corporate Governance Association, 2000).

5.7.2 Listing Rules

As most rules regarding directors and supervisors are contained in the law, there is very little in the TSE Listing Rules applicable to boards, directors or supervisors.

The Listing Rules state that a company applying for listing will not be eligible "where the board of directors or supervisors of the company applying for listing cannot independently perform their functions" (Listing Rules Article 9, Item 12). The board of directors or individual supervisors is defined to be unable to independently perform

their functions if any of the following conditions exist (Supplementary Provisions, Article 17):

- For board of directors:
  - Total number of directors is less than five; or
  - More than 2/3 of the directors are related (spouse, close relatives, or representatives of these).
- For supervisors:
  - Total number of supervisors is less than three; or
  - Any of the supervisors, or a supervisor and a director are related (spouse, close relatives, or representatives of these).

It should be noted that these requirements for independent directors apply only to companies seeking listing. Liu (2001) reported that many family-owned businesses will appoint independent directors for the purpose of listing, then replace them with family members or other non-independent directors at the first election.

5.7.3 Accounting Practices

5.7.3.1 Regulation of the accounting profession

Professional accountants in Taiwan are licensed by the Ministry of Finance through examination and/or professional experience, and all professional accountants must register as a member of the Taiwan Provincial CPA Association.

The Taiwan Provincial CPA Association has a disciplinary committee to investigate and discipline misconduct with the power to issue warnings to CPAs. In case of

serious misconduct, the committee will transfer the case to the Ministry of Finance, which has the power of suspending or even removing the licence of the CPAs. This authority is contained in the Accountancy Law (Sections 40 and 42).

5.7.3.2 Accounting standards and disclosure

The Commercial Accounting Law and the Company Law provide the basic legal requirements for accounts to be prepared on an annual basis. The Commercial Accounting Law rules relating to financial disclosure include chapters on accounts and financial statements, basis of accounting entry, recognition of profit and loss and auditing. The Company Law stipulates the legal requirement for companies to provide shareholders with annual financial statements within six months of the fiscal year-end, and for larger companies to have their statements audited. The Company Law contains additional requirements on contents of reports and accounting for equity accounts.

Statements of Financial Accounting Standards are published by the Accounting Research and Development Foundation of the Republic of China, and these statements are the authoritative source of recommendations in Taiwan. New Statements are developed with reference to IAS and US accounting standards for a background on international practice on the particular issue.

The Securities and Futures Commission (SFC) imposes additional rules for companies traded on a stock exchange, largely related to additional disclosure requirements. It ensures compliance by review of interim and annual reports for failures to comply with accounting standards or disclosure requirements.

5.7.4 Enforcement

Taiwan has a civil law legal framework, and there is an abundance of rules and regulations governing most aspects of business. The Company Law has many rules pertaining to the management of companies, and provides authority to shareholders and supervisors to act when these rules are being violated. The actions may include requests to terminate certain acts, removal of directors, and limits on self-trading. However, in the case of a lawsuit being filed under these provisions, the process is very slow and time consuming, due to high information and court costs, and a legal system that discourages the use of group litigation (SFI, 2001).

Enforcement action of Company Law and Securities and Exchange Law often takes place by regulators, with civil and/or criminal actions being "piggy-backed" onto the regulatory enforcement action (Liu, 2001). In cases where there are multiple victims, the company can be charged under the Criminal Code (Liu, 2000).

Though there are no provisions for class actions in Taiwan's civil law system, foundations are formed as a coordinating body to pursue collective action. For example, the Securities and Futures Market Development Institute (SFI), funded partially by grants from the SFC, acts as a representative of individual shareholders who have claims against companies (Liu, 2000).

The TSE carries out market surveillance through its Market Surveillance Department, which regularly publishes unusual trading behavior in the form of alerts to investors. The TSE may take disciplinary action against the company, in the form of warnings to

the companies, a fine, temporary or permanent suspension of trading, and/or referral to the Ministry of Economic Affairs where there are breaches of Company Law provisions.

5.8 Singapore

5.8.1 Legal and Regulatory Framework

Singapore is one of the common law countries where companies are regulated by Companies Act, (Cap. 50). In addition, listed companies are required to comply with the Listing Manual of the Singapore Exchange (SGX). Even though the Listing Manual does not have legislative power, the Securities Industry Act (Cap. 289) requires listed companies to comply with its provisions and other rules contained in the Listing Manual. The SGX is the regulatory body responsible for imposing appropriate injunction on non-compliant listed companies. In addition, the Monetary Authority of Singapore (MAS) is charged with the responsibility of regulating listed companies in the banking, insurance, securities and futures industries in Singapore.

The Companies Act requires every company to have a board of directors with at least two directors. A director is defined as any person who occupies the position of a director regardless of whether he or she is formally appointed so long as he or she purports to act as a director. It does not define "executive director". In essence, the Act imposes statutory duties and obligations on directors, including NEDs and the company secretary, and any other persons employed in an executive or managerial position. It does not state any minimum qualification for a director except that he or she be of sufficient mental capacity and 21 years or older. It stipulates that persons who have been persistently in default, have undergone bankruptcy in Singapore or

overseas, etc., are unsuitable for appointment as directors. The Act does not prescribe that directors of a company must hold shares in the company even though the articles of the company may require that they subscribe to a certain number of shares so as to qualify as directors (Gul, 2002).

There is no statutory requirement prescribing board composition. Therefore, selection criteria, quality and composition of boards vary significantly among listed companies in Singapore. The legal and regulatory framework regarding corporate governance follows a balanced approach[28] (Corporate Governance Committee, 2001), which specifies corporate governance best practices but allows companies to depart from these practices subject to proper disclosure.

5.8.1.1 Independent directors

Though there is no legal requirement for companies to have independent directors, there is a distinction between NEDs and independent directors in the Code of Corporate Governance[29] (the Code), recently adopted by the SGX in April 2001. The Code defines independent director as "one who has no relationship with the company or its affiliates that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgment with a view to the best interests of the company".

[28] Section 2.6 provides the explanation of different approaches to corporate governance.
[29] The Code is contained in the consultation paper prepared by the Corporate Governance Committee in Singapore. This is one of the three committees set up by the Ministry of Finance, the Monetary Authority of Singapore and the Attorney-General's Chambers to review the corporate regulatory framework, disclosure standards and corporate governance in Singapore.

5.8.1.2 Directors' duties

In Singapore, directors' duties are prescribed by the laws, i.e. a combination of statutes and case law. Directors are expected to carry out their duties with reasonable care, skill and diligence. Yeo and Koh (2001) summarized three broad propositions of what is expected of a director in relation to these duties:

- A director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.
- A director is not bound to give continuous attention to the company's affairs, i.e. his or her duties are of an intermittent nature.
- A director is entitled to trust an official to perform such duties as can be properly entrusted to him or her in accordance with the articles.

A director is required by law to use reasonable diligence in the discharge of his/her duties of the office. He/she will face both civil liability and penal sanctions if he or she is found in breach of these duties.

Directors also owe fiduciary duties to the company:

- To act "in good faith and in the best interests of the company";
- Not to restrain their action because of the wishes or direction of another person;
- To avoid conflicts or potential conflicts of interests;
- Not to make "secret" profits out of one's position as a director; and
- To utilize directorial powers for proper purposes.

Singapore's regulatory environment has undergone substantial change since the outbreak of the Asian financial crisis in late 1997. The Singapore Government realized the importance of meeting international standards of disclosure and corporate

governance, given the globalization of business and Singapore's aim of becoming an international financial center (Mak, 2001).

Amongst the regulatory bodies in Singapore, the MAS drives the major regulatory changes. Regulatory reforms in Singapore started from its financial sector. The Singapore Government formed the Financial Sector Review Group, which is chaired by the MAS and Deputy Prime Minister of Singapore, with the aim of making Singapore the dominant financial center in South East Asia.

The Financial Sector Review Group also formed committees such as the Committee on Banking Disclosure, the Corporate Finance Committee and the SGX Review Committee to make improvements in corporate disclosures and move from a merit-based regulation philosophy to a disclosure-based regulation philosophy.

5.8.2 Listing Manual of Singapore Exchange (SGX)

The only requirement in the Listing Manual regarding board composition of listed companies is stated in Appendix 1a "Guidelines for Listing on Main Board" which requires the directors and officers to have the appropriate experience and expertise to manage the group's business. The SGX would consider the character and integrity of the directors, management and controlling shareholders of the applicant for listing purposes. Since there is no statutory requirement prescribing board composition, the selection criteria, quality and composition of boards vary significantly among listed companies in Singapore.

Chapter 7 “Local Equity Securities – New Listing Application” requires applicants to ensure that all information that is material to the SGX’s decision on the application is made available in a timely manner. Directors (including independent directors), and executive officers occupying a managerial position or above who is a relative of any director or controlling shareholder should make declarations regarding their moral integrity, e.g. whether the directors have been convicted in Singapore or elsewhere of any offence in connection with the information or management of any corporation (Appendix 15 of the Listing Manual).

Chapter 9 “Continuing Listing Requirements” describes conditions that a listed company should immediately disclose to the SGX for public release. Such conditions would include information known to the listed company concerning itself or any of its subsidiaries or associated companies that could cause the establishment of a false market in its securities or which would be likely to materially affect the price of its securities, and information concerning appointment and resignation of directors, CEOs, general managers or other executive officers of equivalent rank, company secretary, registrar or auditors of the company. Listed companies, which hold their annual general meetings on or after 1st January 2003 should describe their corporate governance practices with specific reference to the Code in their annual reports. They should disclose non-compliance with any aspect of the Code together with an appropriate explanation in the annual reports.

Chapter 9A “Interested Person Transactions” requires listed companies to obtain shareholders’ approval and immediate disclosure to SGX for *transactions* between an *entity at risk* and an *interested person*. Transactions are prescribed under this Chapter

as (but not limited to) the provision of financial assistance, provision or receipt of services, issuance of securities, acquisition, realization or leasing of assets. An entity at risk is defined as the listed company itself, its subsidiary or associated company, which is not listed on a foreign stock exchange, i.e., listed in SGX. Interested persons include directors, CEOs or substantial shareholders of the listed company, or associates of such directors, CEOs or substantial shareholders.

Chapter 12 "Corporate Disclosure Policy" states that a listed company shall keep the SGX and its shareholders and other holders of its listed securities informed as soon as reasonably practicable of any material information relating to the group which is necessary to enable them and the public to appraise the position of the group. There are also specific disclosure requirements on unusual trading activities, and policies on insider trading, thorough public dissemination, etc.

5.8.3 Code of Corporate Governance (the Code)

5.8.3.1 Background

The Code, which was recently adopted by the SGX in April 2001, is not meant to unduly restrict corporate governance policies and practice (paragraph 7, the Code). The objective is to encourage each listed company to decide which corporate governance practices are relevant to investor decision-making and make disclosure accordingly. Below is a summary of the key elements of the Code.

5.8.3.2 Board matters

The Code is inclined towards having a dual leadership structure, i.e., a separate CEO and chairman on the board. The aim is to ensure an appropriate balance of power and

increase accountability. Such a separation is important because it enhances the independence of the board in monitoring management. Boards should also have at least one-third of the board members being independent directors. Setting up a nomination committee is recommended by the Code and details of the recommendation have been discussed in Section 6.10.1 of Brief 3.

5.8.3.3 Remuneration matters

Details of the recommendations on remuneration have been discussed in Section 5.10.1 of Brief 3.

5.8.3.4 Audit and accountability

In order to increase the accountability of management to the board and shareholders, the Code recommends quarterly reporting to enable investors to have access to more timely information on the stewardship functions of management. The Code emphasizes and discusses the importance of the independence of audit committee and the internal control function being independent of the management. Details of the role and functions of audit committees have been discussed in Section 4.13.4 of Brief 3.

5.8.3.5 Communications with shareholders

It is important to have regular, fair and effective communications with shareholders. Thus, the Code encourages shareholders to play a more active role in voting at annual general meetings (AGM).

5.8.4 Accounting Practices

5.8.4.1 Regulation of the accounting profession

The Institute of Certified Public Accountants of Singapore (ICPAS)[30], was established under the Accountants Act of Singapore in June 1963. It is the national organization of the accounting profession in Singapore responsible for setting Statements of Accounting Standards, Provisional Statements of Accounting Standards, Statements of Recommended Accounting Practice and Auditing Standards.

Another statutory body, the Public Accountants Board (PAB), was set up by the Ministry of Finance under the authority of the Accountants Act. It is responsible for controlling and regulating public accountants and accounting firms, and determining and developing standards of professional conduct and ethics for the accountancy profession. Currently, the composition of PAB includes representatives of ICPAS, the President of the SGX and the Director of Ministry of Finance.

5.8.4.2 Accounting standards and disclosure

In Singapore, the Companies Act, the Statements of Accounting Standard (SAS) issued by the ICPAS and the Listing Manual of SGX are the three major sources that prescribe the mandatory accounting principles for companies listed in Singapore.

[30] Formerly known as the Singapore Society of Accountants.

The Act requires companies incorporated in Singapore to prepare financial statements annually in accordance with the accounting requirements of the Act. Companies are also required to keep proper accounting records for no less than seven years.

All members of ICPAS are required to observe the SAS issued by the ICPAS when they prepare or audit financial statements. In Singapore, International Accounting Standards are adopted as SAS with minor modifications in some cases (Mak, 2001).

Recently, the ICPAS embarked on a program of full alignment of SAS to IAS. The Singapore Government has accepted all the recommendations suggested by the Disclosure and Accounting Standards Committee in their final consultation paper issued in October 2001 by adopting IAS. The standards that are adopted would be the prescribed accounting standards and be termed "Financial Reporting Standards (Singapore)" (FRS(S)) on or after 1 January 2003.

5.8.5 Enforcement

Listing rules are found in the Listing Manual, and while the Manual does not have legislative force, the Securities Industry Act requires listed companies to follow the provisions of the Manual. Injunctions against companies that are not in compliance with listing requirements can be applied for by the SGX or the MAS. Additionally, an individual who has been affected by a company's non-compliance may apply for an injunction against the company (Yeo and Keoh, 2001). Injunctions will require a company to cease doing the non-compliant activity, and/or require the company to take some other action.

Under common law, directors in breach of their duties are liable for damages for losses suffered by the company. Directors' fiduciary duties are subject to enforcement through civil actions under the common law. In addition to payment of damages, directors will be required to return any profits they personally received as a result of the breach. Enforcement of directors' duties is usually carried out by the regulatory authorities by way of a criminal prosecution. These are usually initiated after allegation of negligence or fraud of a director, and are often initiated by the company's liquidators where the collapse is related to the negligence or fraud. Civil actions by shareholders are uncommon, largely due to the absence of a mechanism for derivative actions, non-contingency fee based legal fee structure, and high costs of initiating legal actions (Yeo and Keoh, 2001). Injunctions may be obtained to stop or prevent further breaches. Similar provisions are found in the Companies Act, with additional provisions for statutory fines and/or incarceration for criminal offences. The Companies Act also provides a default fine for breaches that are not specifically addressed. Directors may be disqualified from holding office in the future if they have been found guilty of certain specific breaches (Yeo and Keoh, 2001). In cases of "white-collar" crimes, and violations of the Companies Act, the Commercial Affairs Department is the authority responsible for investigation and prosecution.

5.9 Comparison of Related Party Transactions

In the above sections on accounting standards for each country, we noted that country-specific accounting standards are similar to IAS. In this section, we single out related party transactions because of their significance in corporate governance. Transactions between a company and its related parties are often the way influential

shareholders can receive benefits at the expense of the company and/or minority shareholders. We will examine IAS 24 concerning related party disclosures, and explain how the requirements of each of the jurisdictions varies from the IAS. Unlike the earlier section which provides a country-by-country description, in this section we discuss related party similarities and differences across countries.

5.9.1 Definition of Related Party

According to IAS 24 "Related Party Disclosures", parties are considered to be related if one party has the ability to control the other party or to exercise significant influence over the other party in making financial and operating decisions. This includes:

- Entities that control, or are controlled by, or are under common control with, the reporting entity, e.g., holding companies, subsidiaries and fellow subsidiaries;
- Associates;
- Individuals owning an interest in the reporting enterprise that gives significant influence over it, and close family members of any such individual;
- Key management personnel, and their close family members; and enterprises in which a substantial interest is owned by any of the individuals included above, or over which such an individual is able to exercise significant influence.

This definition has been widely adopted in the accounting standards of the various jurisdictions selected in this consultancy review including Hong Kong, the UK, the USA, Australia, Malaysia, Taiwan and Singapore. The slight differences are listed below:

Hong Kong, in addition to the IAS definition, includes parties subject to common joint control or common significant influence as related parties in its SSAP 20.

In UK FRS 8, it is further stipulated that where the relationship refers to an individual who is able to exercise significant influence, the definition of related party is narrowed to consider whether one of the parties might be inhibited or has actually subordinated its own interests. Joint ventures and entities under common significant influence, pension funds of any related party, and each person able to exercise control or significant influence over the entity are regarded as related parties.

In Malaysia (MASB 8) and in US SFAS 57, influence is further defined as being to an extent that one or more of the parties might be prevented from fully pursuing its own interests.

5.9.2 Exclusions from the Definition of Related Party

IAS 24 excludes the following from the definition of 'related party':

- Two companies simply because they have a director in common;
- Providers of finance, trade unions, public utilities, government departments and agencies in the course of their normal dealings with an enterprise; and
- A single customer, supplier, franchiser, distributor or general agent with whom an enterprise transacts a significant volume of business merely by virtue of the resulting economic dependence.

Again the above exclusions are widely adopted by the various jurisdictions, except in the USA and Australia. According to SFAS 57 in the USA, only certain transactions in the normal course of business, such as compensation arrangements, expense allowances and similar items, are specifically excluded from the definition; while AASB 1017 in Australia excludes an entity from the definition of related party where the relationship results solely from normal dealings of financial institutions, authorized trustee corporations, fund managers, trade unions, statutory authorities, government departments, and local governments.

5.9.3 Disclosures Required

The disclosure requirements of IAS 24 regarding related party transactions include:

- The nature of the relationship;
- The types of transactions; and
- The elements of the transactions necessary for an understanding of the financial statements, i.e., an indication of volume, outstanding items, pricing policies.

Taiwan, Hong Kong and Singapore have provisions similar to IAS, but the Companies Ordinance and Listing Rules in Hong Kong and Singapore contain additional disclosure requirements in relation to directors' remuneration and loans, and connected party transactions. Malaysia also has similar requirements except that additional disclosures are specified as to the identities of related parties, and the terms and conditions of each different type of related party transaction must be disclosed. SFAS 57 in the USA, although similar to IAS, additionally requires the disclosure of any change in the established terms for related party transactions, and if not otherwise apparent, the manner of settlement of outstanding balances due to/from related parties.

According to AASB 1017 in Australia and UK FRS 8, disclosure is required of material transactions analyzed by type of transaction, and the terms and conditions for each type. In addition to the requirements of IAS 24, FRS 8 further requires the disclosure of the names of related parties, the amount involved, the balances outstanding at year-end and any provisions for doubtful debts, and the amounts written off in the period in respect of debts due to or from related parties.

5.10 Comparison of Regulatory Requirements on Board Practices Between Hong Kong and Other Jurisdictions

Compared to other jurisdictions, the regulatory requirements on board practices in Hong Kong are generally comparable with the international standard (details are presented in Appendix 6). For example, directors in Hong Kong, the UK, Malaysia and Singapore must have access to outside professional advice at the company's expense. As with the UK and Singapore, all directors in Hong Kong are entitled to have access to board papers and materials. Furthermore, the disclosure of directors' and senior managers' biographical details is required in Hong Kong, as in most of the other jurisdictions (except for Taiwan). Hong Kong companies have to disclose whether a director is an executive or non-executive director and this requirement also exists in the UK, Australia, Malaysia and Singapore.

In some areas, requirements in Hong Kong are even more clearly stipulated than in other countries. For example, the Main Board Listing Rules in Hong Kong require the minimum annual number of board meetings to be two (four under GEM Board Listing Rules), while other jurisdictions generally have no similar requirements (i.e., US Listing Rules only require the disclosure of the number of meetings and attendance of directors). Hong Kong Listing Rules also require newly appointed board members to have appropriate briefings. Except for Singapore, this requirement is not found in the other jurisdictions.

However, there are other aspects where the regulatory requirements on board practices in Hong Kong are not as stringent or as clearly stipulated as in the other jurisdictions studied. While most of the other jurisdictions (except Australia) require at least one-third of the board to be composed of non-executive directors, Hong Kong

requires only a minimum of two. Other jurisdictions have regulatory requirements on issues such as the number of members on the board, the chairman of the board should be an INED, director term and age limits, and access to company secretary (for details please refer to Appendix 6).

5.11 Surveys

Professional corporate governance surveys were reviewed for countries where available. Detailed findings from the surveys are provided in Appendix 8. The following section outlines some of the findings of these surveys.

5.11.1 CEO Duality

There was a wide range of practices with respect to combining the roles of CEO and chair of the board. The lowest frequency of CEO duality was in Australia, where approximately 11% of the boards had combined the roles in 2000, and the highest frequency was in Singapore and the USA, where combined CEO and chair roles were found in nearly three out of four boards in 2000. One other survey in Malaysia in 1998 reported that when the roles were separate, the chair was a NED in 62% of the cases. Surveys in the USA reported that when the roles were combined, a lead director was sometimes formally designated from among the NEDs.

5.11.2 Board Size

Board sizes ranged from seven to over thirty, but the vast majority of them were in the range of eight to twelve. Smaller boards, of fewer than ten directors, were found in companies in Asian countries, and the larger boards were found in companies in the

USA and the UK. Surveys in both the USA and the UK showed the largest boards in companies in the banking and finance sector.

5.11.3 Board Composition

Boards in most jurisdictions reported having a majority of non-executive members on their boards. Most commonly, boards had two or three executive members, with the remainder being NEDs. Information on how many of the NEDs were independent was not always clear, but suggested that approximately half of the NEDs were independent.

5.11.4 Board Meetings

Normally scheduled full board meetings occurred between four to ten times per year. Extra meetings occurred as required. Companies in the UK demonstrated the most frequent board meetings, almost monthly.

5.12 Summary

The primary objective of this chapter is to compare the legal and regulatory requirements and recommendations of corporate governance including accounting standards and disclosures such as issues on related party transactions in various jurisdictions. They covered three broad aspects of corporate governance, namely board characteristics, disclosure of corporate governance policies and practices and the definition of independence. The second aspect involves disclosure with specific reference to the kinds of disclosures of corporate governance practice and policy that are required by regulators. The third aspect that is critical to good corporate

governance is the definition of 'independence' with reference to INEDs. This section will highlight some of the common recommendations in these three areas.

5.12.1 Board Characteristics

The first common element of corporate governance is board characteristics, including composition, directors' education and training, CEO duality, access to information and outside advice.

5.12.1.1 Board composition

Non-Executive Directors (NEDs)

Specific recommendations vary on how many NEDs should be present on the board, but generally the emphasis is on ensuring that no individual or group can dominate decision making on the board. The Combined Code of the London Stock Exchange goes a little further by stating that NEDs should make up a minimum of one-third of the board.

Independent Non-Executive Directors (INEDs)

Generally, the recommendations on INEDs are more specific than those for NEDs. Either a specific number of INEDs is required, typically three (such as in the USA), or a portion of the board is required to be independent. The majority of the jurisdictions specify that a minimum portion, usually one-third, of the board be INEDs. Taiwan is the exception since it requires a company to have at least one INED at the time it is first listed with no corresponding requirement to continue having an INED on the board.

5.12.1.2 Directors' education and training

Apart from Malaysia, there is no specific requirement for directors' education and training. However, in Australia and the USA, directors' education and training are facilitated by the Australian Institute of Company Directors and the National Association of Corporate Directors respectively.

5.12.1.3 Chairman and CEO

CEO duality (one person filling the roles of both CEO and chairman) is common practice in the USA, but discouraged (though not prohibited) in other jurisdictions such as the UK, Australia, Malaysia and Singapore. The rationale is that the chairman, as head of the board, should be independent of management. It would be difficult for the chairman to perform his role well if he is also the head of the management. Some believe that the running of the company and the running of the board are two distinct jobs, and that one individual should not be responsible for both. In the USA, CEO duality is commonplace, and the attitude is that it has worked well until now, so there is no need to change it. If the roles are combined, some jurisdictions have a requirement to disclose the reasoning behind such a decision. Presumably, the combined role may have advantages particularly for small high growth firms that require strong direction and leadership.

5.12.1.4 Access to information

In order to perform their responsibilities, directors must have access to all relevant information pertaining to the company. It is often the case that NEDs do not receive the same information as the executive directors because they are not so intimately involved with the day-to-day business of the company. It is essential that all directors receive as much accurate and up-to-date information as is available in order to make

sound decisions. Failure to ask for and receive appropriate information may expose directors to liability under their fiduciary duties to exercise due care. Most jurisdictions explicitly state that all directors should have equal access to relevant information.

5.12.1.5 Outside advice

Director access to outside legal or other professional advice in carrying out their duties at company expense is a common requirement. This assists directors in ensuring they perform their duties in accordance with the law and regulatory standards, without having to be dependent on the company.

5.12.2 Disclosures

Most jurisdictions require a statement on the corporate governance practices in place during the reporting period to be disclosed in the annual report, and give details as to whether or not the company has complied with mandatory corporate governance requirements (if applicable). If they have failed to comply with mandatory requirements, they must disclose the reasons for non-compliance. This kind of a statement may take the form of a separate statement, included in the annual report, or form part of the financial statements.

Extensive disclosure requirements relating to the board are common. As a minimum, names and qualifications of directors, as well as their status as NEDs or INEDs, as well as other biographical information that would enable shareholders to better evaluate the directors' ability to fulfill their responsibilities should be disclosed. Less common is a requirement to disclose details of individual directors' service contracts.

5.12.3 Definition of Independence

Although the term "independence" is commonly used, the definition is not always exactly the same across jurisdictions. The general definition is that a director who is independent is free from relationships with the company, companies related to the company, or the company's officers, or any other relationship that could be seen as interfering with a director's independent judgment. Where the rules differ, it is in the details as to exactly what relationships would compromise independence, and what time frames would apply. For example, the Australian Stock Exchange specifies in a guidance note that an independent director should not have been employed in an executive capacity by the company or a related company in the previous three years. Malaysia and the USA also have a three-year requirement for previous employment in an executive capacity. Another condition is to restrict the percentage holding held by the director to be no more than 1% of issued capital to prevent impairing independence.

In all the jurisdictions reviewed, the definition of independence is very similar, differing only in wording or in details. In most cases, a director who is considered independent in one jurisdiction will meet the criteria for independence in all other jurisdictions.

In general, we also find that the definition of related party is widely adopted in all the jurisdictions and the disclosure requirements for all jurisdictions are also fairly similar. The last section of this chapter reviews corporate governance surveys in the various countries. The results suggest that there is some diversity in the practices of CEO duality, board size, board composition and board meetings across the jurisdictions with the UK and the USA leading the way with larger board size.

CHAPTER 6 INTERVIEW FINDINGS

6.1 Introduction

This chapter presents findings obtained from interviews with key personnel of regulatory and government agencies and prominent corporate governance experts in different jurisdictions.

6.2 Findings

Interviews were conducted with key personnel of regulatory and government agencies, representatives from local corporate governance organizations and institutes of directors from the USA, the UK, Australia, Malaysia and Hong Kong on general issues related to corporate governance. Since there is considerable overlap in the comments of interviewees, we have summarized the findings under one section without identifying the country origin of the interviewees. The findings are summarized below:

6.2.1 Approach to Corporate Governance Reform

Most of the interviewees believed that corporate governance reform should adopt a balanced approach that clearly specifies corporate governance best practices but allows companies to deviate from these stated practices with explanations and appropriate disclosures. They generally disagreed with the contention that corporate governance measures should be legislated.

The interviewees were inclined towards supporting the disclosure-based philosophy. They argued that with more quality disclosures, investors could exercise their own

business judgment on their investment decisions. They also subscribed to the view that companies should also have more flexibility and autonomy in conducting their business activities and organizing their internal governance to enhance shareholders' values.

Quotes from interviewees are as follows:

- "It is not appropriate to legislate any rules on corporate governance."
- "(in Australia) The Government has been mobilizing resources to facilitate, but not to regulate, good corporate governance practice."
- "Generally speaking, corporate governance may be more appropriate if it is left to the companies to implement voluntarily the mechanisms that suit their circumstances. The government's role is to facilitate but not to legislate or regulate too extensively because there is a danger that companies emphasize form over substance."
- "It is agreed that more disclosures on financial statements would help investors in general to make informed investment decisions."
- "For example, in Australia, the disclosure of non-audit service fees paid to auditors for their management advisory services, to a great extent, must have impact on investors."
- "Financial reporting, disclosure and legal protection are important factors contributing towards good corporate governance practices."
- "To conclude, the major underlying principles to good corporate governance are: quality disclosure (reduce agency costs associated with information asymmetries) and shareholders' access to companies' meeting records."
- "It is considered that the most effective way to have good corporate governance practice is to let market participants decide and voluntarily disclose because legislation can never be comprehensive."
- "If the bottom line is to improve corporate transparencies, corporate governance should be to a great extent, left to the "market participants" to decide the best way to disclose and disseminate "private" information to the public."

6.2.2 Requirements on Training and Education of Directors

Most of the interviewees believed that training and education of directors is a crucial element in enhancing corporate governance practices. This would improve the quality (in terms of their integrity and competence) of directors, including independent non-executive directors (INEDs). They asserted that many directors including executive, non-executive (NEDs) and INEDs do not fully appreciate and understand their roles and responsibilities as members of board committees. The objective in directing resources to directors' training and education is to enhance the quality of directors in general.

Quotes from interviewees are as follows:

- "Australian Institute of Company Directors (AICD) offers continuous training courses to directors so as to provide more information and education for them (directors). The objective is to make them aware of what their fiduciary duties are and what their legal liabilities are."
- "One point worth noting is that AICD has a 10-hour annual continuous professional education requirement for its members who are directors of major listed companies."
- "Resources should be directed to training and education of corporate directors so that they understand the benefits of having good corporate governance and teach them how to become good 'corporate citizens'."
- "(in Malaysia) There is a mandatory accredited programme organized by the Research Institute of Investment Analysts in Malaysia offered to all corporate directors. The objective is to "professionalize" companies' directors so as to make them well aware of their roles and responsibilities."

6.2.3 Difficulties for Hong Kong

Though it is commonly agreed that the quality of INEDs is important, many of our interviewees were skeptical about the existence of "truly independent" INEDs in Hong Kong. It is very difficult for Hong Kong to have truly independent INEDs because the business community is relatively small and many companies are family

controlled. Hence, INEDs, who are well qualified in terms of business expertise and experience, are usually connected to the company's chairman or chief executive officer (CEO). In addition, most of the interviewees mentioned that it is becoming more and more difficult to recruit good quality INEDs unless more incentives are provided in terms of compensation.

Some interviewees commented that Hong Kong lacks the influence of powerful institutional investors like TIAA-CREF in the USA to act as an external monitoring device to oversee corporate management. They believed that the Hong Kong SAR Government should impose more stringent measures (including heavier penalties) and implement more effective enforcement measures in order to deter non-compliant behavior of management.

Quotes from interviewees are as follows:

- "Family-owned businesses in Australia are not common. Most of the listed companies here (Australia) are widely held corporations."
- "The ethics culture in Australia does not exist in these places (Singapore, Hong Kong and Malaysia). While in Hong Kong, family-owned companies dominate the corporate scene."
- "However, it is difficult to recruit good quality (non-executive) directors."
- "It is getting more and more difficult to recruit good directors."
- "With regard to the quality of INEDs in Hong Kong, it is very difficult, if not impossible, to recruit quality INEDs given that Hong Kong is a compact jurisdiction."
- "Usually, people with strong business background are connected directly or indirectly with the controlling family."
- "In Hong Kong, one of the big issues is that Hong Kong is lacking some strong "monitoring" devices, e.g., TIAA-CREF in the USA, to oversee the operations of corporate management."

- "Voluntary disclosures would only be effective if a minimum level of legislation and regulation on investors' protection has been achieved. Apparently, Hong Kong's legislation towards investors' protection has not achieved the minimum level."

6.2.4 Possible Opportunities

Most of the interviewees agreed that the Hong Kong SAR Government has taken a keen interest in corporate governance reform. The Government should take the lead to legislate and regulate the basic elements of corporate governance such as connected party transactions in order to set a "level playing field" for investors. They realized that corporate governance reform is a long-term process that involves changing the mindsets and culture of corporate management. In order to overcome the difficulties in the recruitment of good quality INEDs, it was suggested by many interviewees that companies can outsource this hiring function to professional recruitment agencies[1]. With their worldwide networks, they can possibly recruit good quality candidates abroad. Some interviewees believed that the introduction of class actions in Hong Kong could help to protect the interests of investors, particularly the minority shareholders. However, others cautioned against it since this may affect the overall litigation environment in Hong Kong with potentially high social costs.

Quotes from interviewees are as follows:

- "It is necessary to change the corporate culture and mindsets of management towards corporate governance."
- "It would be a creative idea to look for good quality INEDs or NEDs globally. Perhaps, it could be an effective measure as well."
- "Professional recruitment agencies may play an important role in looking for directors with good qualities worldwide. They are considered to be effective because they would be able to provide impartial advice to the board or even the

[1] The Lead Consultant would like to declare that her spouse is the managing partner of one of the international executive recruitment agencies.

shareholders about the candidate, especially for independent non-executive directorships."

- "There are rooms for improvement regarding our (Hong Kong) corporate governance in terms of legal and regulatory enforcement. The objective of strengthening legal and regulatory enforcement is to introduce "fear" and "discipline" to corporate management and let them (directors who might want to commit opportunistic or even fraudulent acts) factor in the "total" costs of non-compliance, i.e., penalties."

- "In the longer run, the introduction of Mandatory Provident Funds may probably resemble the pension fund groups in the USA, and contribute positively to corporate governance in Hong Kong."

- "For Hong Kong, class actions should be (at some stage) brought into the territory so that the interests of investors (especially the minority shareholders) could be protected."

6.3 Summary

The general comments obtained from the interviewees, both foreign and local, are consistent with the results of the Credit Lyonnais Securities Asia's (CLSA, 2002) study and Standard & Poor's (S&P, 2001) study regarding the standard of corporate governance in Hong Kong in the context of the Asian countries including Australia[2]. That is, it is one of the best corporate governance jurisdictions among Asia-Pacific region countries (commonly being ranked behind Australia and Singapore). However, it is perceived as a little backward if it is being benchmarked against the system in the USA and the UK.

In order to upgrade the standard of corporate governance in Hong Kong to the current best practices of these leading international capital markets, there is certainly an urgent need to reform the corporate governance practices of Hong Kong[3]. Reforms must take into account the unique institutional factors and corporate landscape of

[2] Details are discussed in Section 4.2.3.6.
[3] Details of analysis and recommendation are discussed in Chapter 7.

Hong Kong, for instance, concentration of share ownership, CEO domination, family ownership, lack of quality INEDs, etc. Considering these features, it is not difficult to conclude that the prescriptive approach of corporate governance reform, i.e., requiring companies to adopt specific corporate governance practices may not be advisable because the assumption behind the approach - "one size fits all" is not appropriate for Hong Kong. Almost all interviewees disagreed with the contention that corporate governance measures should be legislated and rigidly prescribed. Instead, they were inclined to favor the disclosure-based philosophy, i.e., a balanced approach to corporate governance. They believed that companies should be given flexibility in conducting their business activities and organizing their internal governance to enhance shareholders' values.

Most of the interviewees believed that corporate governance reform should be a "concerted" effort. They considered that training and education of directors is a crucial element in enhancing corporate governance practices. In countries like Australia and the USA, local activists such as the AICD and the National Association of Corporate Directors (NACD) have been actively involved in improving and maintaining the quality of corporate directors, including INEDs through training and continuous education.

Even though there are many hindrances as mentioned above (e.g., concentrated ownership, lack of quality INEDs, etc.), interviewees are supportive of corporate governance reform in Hong Kong. Some of the interviewees revealed that corporate governance reform is a "long-term" objective, particularly in Hong Kong because it is

necessary to change the corporate culture and mindsets of corporate management towards good corporate governance practices.

We will present the summary and recommendations and discuss the limitations of this study in the next chapter.

CHAPTER 7 SYNOPSIS AND RECOMMENDATIONS

7.1 Introduction

This concluding chapter attempts to encapsulate the more important issues and features gleaned from our review of the literature and prior studies regarding the corporate governance regimes in different jurisdictions in the context of the legal and institutional environments. We draw on three approaches to corporate governance regimes identified in the methodology chapter to offer insights for corporate governance reform in Hong Kong.

7.2 Analysis and Recommendations

In order to evaluate the different corporate governance systems across the jurisdictions, it is necessary to recognize that these systems have evolved in response to the legal and political infrastructures in each of those environments. The countries examined and reviewed are all embedded in the common law system except for Taiwan. However, there are deep-rooted fundamental legal and institutional differences that should also be recognized. A case in point is that the USA has a very active market for corporate control with diverse shareholdings and powerful institutional investors. In particular, the USA has a more litigious environment with class actions being available and the US Securities and Exchange Commission plays a pivotal regulatory role by monitoring the corporate disclosures of companies. Unlike the USA, Asian markets do not have an effective market disciplinary device such as an active market for corporate control. Corporate ownership structures are characterized by family ownership and in some cases, like

Malaysia, ownership also includes political parties. Institutional investors are also not active in corporate governance. Needless to say, any contemplated reform of corporate governance must take into account the legal and institutional frameworks including the different patterns of ownership that could affect the nature and extent of agency problems in any one jurisdiction.

Using Rajan and Zingales' (1998) classification of corporate governance into relationship-based versus market-based systems, one can classify the USA, the UK, and Australia as having a market-based corporate governance system, where the financiers are protected by explicit contracts and the market becomes a more important medium for governing the terms of the transactions. Further, market-based systems require more transparency. Asian countries such as Singapore, Taiwan, Malaysia, however, belong more to the relationship-based corporate governance system, characterized by dominant shareholders, bank ownership and connections, and less transparency. Against this backdrop, the following provides a comparative review of the corporate governance regimes in different jurisdictions, spanning the continuum from the market-based system to the relationship-based system.

Before reviewing the different jurisdictions, it is useful to note the three different approaches to enhance good corporate governance identified in the literature, namely the prescriptive approach, the non-prescriptive approach and the balanced approach. A prescriptive approach is one in which specific rules regarding corporate governance practices are put into place and enforced. At the other end of the spectrum is the non-

prescriptive approach which permits companies to determine their own corporate governance practices subject to appropriate disclosure of the practices adopted. Finally, a balanced approach is a "middle-of-the-road" approach that specifies corporate governance best practices but allows companies to depart from these practices, subject to proper disclosures. The approach that is prevalent in any given jurisdiction is largely dependent on the current state of economic development, the existing legal and regulatory framework as well as patterns of ownership.

In emerging markets where laws are typically less well-defined or inadequately enforced, investor protection becomes more of a concern. This is particularly true in the case of the rights of minority shareholders when there are dominant shareholders exerting significant influence over companies. Dominant shareholders are known to expropriate the wealth of minority shareholders through improper transactions. This is not uncommon in Asian companies, where the company's founding families often still retain substantial ownership and control (in some cases through a complex web of cross listings and pyramid holdings) over the company. In some cases, companies are also under the influence of political parties. In order to provide some protection to investors, regulators will often impose extensive rules and regulations regarding corporate governance on listed companies. Without this, it is very difficult for corporations to attract additional capital, especially foreign investment. This may be described as a prescriptive approach to corporate governance. Malaysia and Taiwan (perhaps partly due to its civil law heritage which stresses codification of rules) are good examples that have adopted a more prescriptive approach as compared to the other regimes. Although Taiwan does not have

an equivalent of a code of best practice, the corporate governance culture is very prescriptive in terms of the rules and regulations pertaining to directors and boards. This prescriptive approach is also discernible in Singapore, though to a much lesser extent than Malaysia or Taiwan. The Report of the Corporate Governance Committee in Singapore (2001) specifically recommended that Singapore should move away from a prescriptive approach and adopt a balanced approach tilted towards a disclosure-based system.

Swinging to the other extreme approach, the non-prescriptive approach gives freedom to the companies to determine the specific corporate governance practices that would suit their circumstances subject to appropriate disclosures. The USA is a good example with its developed economy and markets, a long business history, well-defined and predictable common law, and strong enforcement (i.e., class action suits) available to investors for protecting their rights as shareholders. Since shareholders can exercise power in monitoring management (including the board) to ensure that the business is run effectively and profitably, there is no need to have extensive rules on corporate governance. The market effectively takes care of this. There may be codes of best practices published by various professional bodies or interested private institutions, but there is no compulsory requirement to follow these codes. Companies may follow these codes, and that may work in their favor through the market seeing them as being "responsible" corporations with respect to corporate governance. It has been noted in our literature review that investors will pay a premium for well-governed companies who voluntarily comply with codes of best practice which ultimately benefit them. This

situation best typifies the non-prescriptive approach to corporate governance. The other country in our study that follows a predominantly non-prescriptive approach is Australia. Companies are required by the Listing Rules of the Australian Stock Exchange to make a statement of the corporate governance policies they practice. The policies are not stipulated, and the companies are free to follow established guides to best practice or develop their own.

The third approach to corporate governance is the balanced approach. This approach relies on the publication of a code of best practice, or corporate governance recommendations that are to be addressed by all companies. Typically, a regulator will specify recommended practices and would encourage a listed company to comply with a code of best practice. It is acceptable for a company to follow a practice that is not in compliance with the recommendation or code, but it must disclose the reason for deviation. This approach achieves a balance between prescribing rules while at the same time giving the company freedom to establish its own corporate governance practices. The UK perhaps best exemplifies this "comply or explain" approach. The London Stock Exchange Listing Rules require companies to state how they apply the principles of the Combined Code and disclose if they are not in compliance and the rationale for their non-compliance.

A non-prescriptive approach is clearly not practical or effective in an emerging market, or even a developed market where there are still dominant shareholders. It works in the USA because of a well-established legal system, sophisticated investors, and extensive

disclosure requirements stipulated by the regulatory agency. A prescriptive approach is often ineffective because it tries to prescribe a "one-size fits all", when in reality companies of different sizes operate in different circumstances, and what may be good for one might not necessarily be good for another. However, the recent financial scandals in the USA such as Enron, WorldCom and Xerox is a concern since it raises some questions about the effectiveness of US non-prescriptive mode of corporate governance. The balanced approach gives freedom to companies to adopt the practices that are the most suitable at any particular time, but enhances accountability to investors through the requirements to explain their corporate governance practices when they differ from accepted best practice.

In Hong Kong, the situation is not identical to any of the other jurisdictions we have examined, but does bear strong similarities in some areas. Although family ownership is very common in Hong Kong as with countries such as Malaysia and Singapore, the market is better developed due in no small part to the presence of multinational companies that have to meet internationally accepted standards of best practice. From a legal perspective, Hong Kong directors have similar responsibilities and obligations of directors in the USA, but the mechanisms for enforcement of their duties and remedies for the breach of their responsibilities are not nearly as powerful as those in the USA (e.g., class actions). Clearly, standards of corporate governance in Hong Kong need to be improved, and it is our recommendation that this be done through a two-pronged approach:

(1) A set of fundamental rules needs to be mandated as minimum requirements, preferably through the Listing Rules of the Exchange. This would include the number of

independent non-executive directors (INEDs), the proportion of INEDs on the board, a more comprehensive definition of independence and better quality disclosures such as related party transactions. These rules would be mandatory for all listed companies.

(2) A comprehensive code of best practice should be established whereby listed companies are encouraged to comply with the code or explain their non-compliance. The code can include matters relating to chief executive officer (CEO) duality, board composition, disclosures of corporate governance practices, and possibly the formation of a corporate governance committee. The corporate governance committee would be an umbrella corporate governance mechanism designed to evaluate, implement and monitor corporate governance policies in an organization depending on the size and circumstances of the organization. It could assume some of the responsibilities of the remuneration and nomination committees as an intermediate step to a longer term goal of formally establishing those committees. The code should also include a requirement for training and continuing education for directors[1].

The implementation of (1) and (2) is essentially a balanced approach, and would be very similar to the situation in the UK, but with additional rules mandated due to the need to enhance Hong Kong's international image. The basic rules will provide fundamental protection against some of the "major" corporate governance problems, while a code of best practice will bring increased public awareness and investor scrutiny to companies who choose not to follow good practice. This essentially is compatible with the disclosure-based philosophy.

Based on our analysis of the enforcement mechanisms across different jurisdictions, Hong Kong needs to pay more attention to increase the powers of the Securities and Futures Commission to investigate breaches of related laws and regulations[2]. This can act as a deterrent to offenders who flout the minimum laws and regulations designed to

[1] Refer to Sections 6.6.2 and 6.8.2 of Brief 3 regarding details of director education in Australia and Malaysia respectively.
[2] The issue as to whether the disciplinary and investigation powers should rest with Hong Kong Exchanges and Clearing Limited or SFC should be further examined.

protect shareholders and as a complement to the balanced approach to corporate governance.

7.3 Conclusion

It is important to note that the effective implementation of any corporate governance reform is likely to falter if, as pointed out by the Credit Lyonnais Securities Asia (CLSA) and Standard & Poor's (S&P) survey (see Section 4.2.3.6, pp. 61-62), the quality of financial reporting and the enforcement mechanism are not given serious attention. The quality of financial reporting is crucial for providing reliable, accurate, relevant and timely information for the market to make informed and efficient decisions. An effective enforcement mechanism with sufficient sanctions has to be in place to back up any corporate governance reform. Though our recommendation hinges on the minimum mandatory requirements with voluntary compliance according to a code of best practice, it is important to ensure that all these efforts will lead to changes in mindsets, behavior and corporate culture as a whole. Bearing this in mind, the training and education of directors including non-executive (NEDs) and INEDs is another crucial element in the overall broad picture of good corporate governance in the long run (see Section 5.12.1, p. 161). It is our belief that reforms along these lines would ultimately elevate Hong Kong's status as an international financial centre that is poised to face the challenges of the ever changing dynamic and competitive global environment.

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Appendix 1
List of Interviewees

Name of Institution

Hong Kong SAR

1 The Hong Kong Institute of Directors
2 The Companies Registry of the HKSAR
3 Securities and Futures Commission
4 The Hong Kong Institute of Company Secretaries
5 Hong Kong Monetary Authority
6 Hong Kong Exchanges and Clearing Limited
7 Asian Corporate Governance Association

The United Kingdom

1 Accounting Standards Board
2 Financial Reporting Council
3 Financial Services Authority, Listing Authority

The United States

1 The Conference Board, Global Corporate Governance Research Center
2 National Association of Corporate Directors
3 United States Securities and Exchange Commission
4 Korn/Ferry International

Australia

1 Australian Stock Exchange
2 Australian Institute of Company Directors
3 CPA Australia
4 The Treasury, Corporate Governance and Accounting Policy Division

Malaysia

1 Kuala Lumpur Stock Exchange
2 Malaysian Institute of Corporate Governance

Note
1. We would like to acknowledge and thank the interviewees from the respective organizations.

2. Due to time constraints, we were unable to schedule meetings with corporate governance experts in Taiwan and Singapore. Our literature search does not suggest that their interview results (if conducted) would be different from our interview findings.

Appendix 2
Detailed Comparison on the Recommendations of Key International Corporate Governance Reports

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
1. The Board					
1.1 Board composition	All boards will require a minimum of three NEDs, one of whom may be the chairman of the company provided he or she is not also its executive head. Additionally, two of the three should be independent.	The board should include a balance of executive directors and NEDs including INEDs such that no individual or small group of individuals can dominate the board's decision taking. To be effective, NEDs need to make up at least one third of the membership of the board. A majority of NEDs should be independent.	There should be a majority of independent directors on the board.	The board of directors should be constituted with a majority of individuals who qualify as unrelated directors.	Sufficient number of NEDs should be on board.
1.2 Board size	---	---	The board in recent years has averaged fifteen members. The board will go to a larger size if necessary.	Every board should examine its size and, with a view to determining the impact of the number upon effectiveness, undertake where appropriate, a program to reduce the number of directors to a number which facilitates more effective decision-making.	---

NEDs = Non-executive directors
INEDs = Independent non-executive directors

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
1.3 The Chair	Responsible for: • The working of the board • Its balance of membership subject to board and shareholders' approval • Ensuring that all relevant issues are on the agenda • Ensuring that all directors play their parts in their activities.	Responsible for: • The working of the board • Its balance of membership subject to board and shareholders' approval • Ensuring that all relevant issues are on the agenda • Ensuring that all directors play their parts in their activities.	---	Responsible for: • Setting the agenda for directors' meetings. • Organizing the information necessary for the board to deal with the agenda and for providing this information to the directors on a timely basis.	The chairman plays a central role in ensuring the effective governance of the enterprise and is responsible for the board's effective function.
1.4 CEO duality	The chairman's role should in principle be separate from that of the chief executive. If two roles are combined in one person, it represents a considerable concentration of power. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognized senior member.	Separation of the roles of chairman and CEO is to be preferred. Companies should justify a decision to combine their roles. A senior INED should be identified in the annual report.	The board does not have a policy, one way or the other, on whether or not the role of the chairman and CEO should be separate or combined and, if it is to be separate, whether the chairman should be selected from the non-employee Directors or be an employee.	An appropriate structure to ensure that the board can function independently of management would be to • appoint a chair of the board who is not a member of management with responsibility to ensure that the board discharges its responsibilities or • adopt alternate means such as assigning this responsibility to a committee of the board, such as the governance committee, or to a director, sometimes referred to as the lead director.	In unitary board systems, the separation of the roles of the CEO and Chairman is often proposed as a method of ensuring an appropriate balance of power, increasing accountability and increasing the capacity of the board for independent decision making.

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
1.5 Roles and functions	• Retain full and effective control over the company and monitor the executive management. • Present a balanced and understandable assessment of the company's position. • Prevent and detect fraud and other illegal acts.	• Effectively lead and control the company. • Preserve and enhance shareholders' investment. • Determine the broad strategy of the company and to ensure its implementation.	• Manage the corporation in owners' interest. • Monitor the effectiveness of management policies and decisions.	Assume responsibility for the stewardship of the corporation: • Adoption of a strategic planning process. • The identification of the principal risks of the corporation's business and ensuring the implementation of appropriate systems to manage these risks. • Succession planning, including appointing, training and monitoring senior management. • A communications policy for the corporation. • The integrity of the corporation's internal control and management information systems. • Each board should assume responsibility for, or assign to a committee of directors the general responsibility for developing the corporation's approach to governance issues.	• Review and guide corporate strategy, major plans of action, risk policy, annual budgets and business plans. • Set, monitor and implement performance objectives. • Oversee major capital expenditures, acquisitions and divestitures. • Select, compensate, monitor and replace key executives and oversee succession planning. • Review key executive and board remuneration and ensure a formal and transparent board nomination process. • Manage potential conflicts of interest of management, board members and shareholders. • Ensure the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place.

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
1.5 Roles and functions	---	---	---	• The board should approve, or develop with the CEO, the corporate objectives which the CEO is responsible for meeting.	• Monitor the effectiveness of the governance practices under which it operates and make changes as needed. • Oversee the process of disclosure and communications.
1.6 Liability and duties	All directors are equally responsible in law for the board's actions and decisions.	The basic legal duties of directors are to act in good faith in the interests of the company and for a proper purpose and to exercise care and skill. The duties are owed to the company, meaning generally the shareholders collectively.	---	The Dey committee accepts that imposing personal liability on directors can be an effective tool for influencing corporate conduct; it is also concerned with the impact of excessive personal liability on the constitution of effective boards of directors. Directors and officers are required to act honestly and in good faith with a view to the best interests of the corporation and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.	Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
1.7 Board performance	---	---	The committee on director affairs is currently responsible for reporting annually to the board an assessment of the board's performance.	The board is required to have its own mechanism for assessing its effectiveness as a board and the contribution of individual directors.	Independent board members can bring an objective view to the evaluation of the performance of the board.

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
1.8 Board meetings and attendance	The board should meet regularly.	The board can only fulfil its responsibilities if it meets regularly and reasonably often.	The board welcomes the regular attendance at each board meeting of senior management.	The board should meet regularly without management present.	---
1.9 Appointment of directors					
Policy	---	There should be a formal and transparent procedure for the appointment of new directors to the board.	The board should be responsible for selecting its own members.	---	---
Term limits	Executive directors' service contracts should not exceed three years without shareholders' approval.	All directors should be required to submit themselves for re-election at regular intervals and at least every three years.	No need to establish term limits. A rotation of board members to various committees is suggested every 5 years but such a rotation should not be mandated as a policy.	The proposal for a maximum term for directors is artificial and unnecessary. The nomination committee can propose changes to the board composition which can result in the injection of a fresh approach to the board.	---
Age limits	---	No age limit is recommended as individuals' capacities and their enthusiasm for the work of the company vary widely.	The current retirement age of 70 is appropriate.	---	---
1.10 Other directorships	---	---	---	A specific guideline for limiting the number of board appointments an individual can hold is unnecessary.	Board members should devote sufficient time to their responsibilities. Service on too many boards can interfere with the performance of board members.

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
1.11 Orientation for new directors	Newly appointed board members are entitled to expect a proper process of induction into the company's affairs. It is then up to individual directors to keep abreast of their legislative and broader responsibilities.	Newly appointed board members should receive induction into the responsibilities of a director.	The board and the company have a complete orientation process for new directors that includes background material, meetings with senior management and visits to company facilities.	Every corporation should provide an orientation and education program for new recruits to the board. The program should include the opportunity to discuss with experts the responsibilities of a director and of the board as a whole as well as the opportunity to visit facilities and to meet with corporate officers to discuss and better understand the business.	---
1.12 Directors' training	Directors should all undertake some form of internal or external training. The training and development of directors is of importance to good governance.	Directors should receive further training from time to time, particularly on relevant new laws and regulations and changing commercial risks.	---	---	It may be beneficial for directors to receive training on relevant new laws, regulations and commercial risks and engage in voluntary self-evaluation.
1.13 Outside advice	There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.	---	---	The board should implement a system which enables an individual director to engage an outside adviser at the expense of the corporation in appropriate circumstances.	---

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
1.14 Access to information	NEDs should have the same right of access to information as the executive directors. The board should regularly review the form and the extent of the information which is provided to all directors.	The board should be supplied with quality information in a timely fashion.	Board members have complete access to management. Information and data that is important to the board's understanding of the business should be distributed in writing to the board before the board meets.	---	Board members should have access to accurate, relevant and timely information in order to fulfil their responsibilities.
1.15 Access to company secretary	All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with.	---	---	---	---
2. The Board – Disclosure					
2.1 Reporting responsibility	• A brief statement of directors' responsibilities should appear in the report and accounts next to a statement by the auditors about their responsibilities. • The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.	• A narrative statement of how companies apply the relevant principles to their particular circumstances should be included in their annual report.	---	A statement of corporate governance practices should be made in the corporation's annual report or information circular. Discussion includes: • Duties and objectives of the board; • The composition of the board;	Timely and accurate disclosure is made on all material matters: • The financial and operating results of the company; • The company's objectives; • Major share ownership and voting rights;

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
2.1 Reporting responsibility	• Listed companies should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance.	---	---	• If the board does not have a chair separate from management, the structures and processes which are in place to facilitate the functioning of the board independently of management; • Description of the board committees; • Description of decisions requiring prior approval by the board; • Procedures in place for recruiting new directors and other performance enhancing measures; • Measures for receiving shareholder feedback and measures for dealing with shareholder concerns; • The board's expectations of management.	• Members of the board and key executives, and their remuneration; • Material foreseeable risk factors; • Material issues regarding employees and other stakeholders; • Corporate governance structures and policies.
2.2 Directors' interests	Information about the relevant interests of directors should be disclosed in the directors' report.	---	---	---	---

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
3 (Independent) non-executive directors					
3.1 Definition of independence	Independent means: • Independent of management, and • Free from any business or other relationship that could materially interfere with the exercise of their independent judgement. It is for the board to decide in particular cases whether this definition is met.	Independent means: • Independent of management, and • Free from any business or other relationship that could materially interfere with the exercise of independent judgement.	GM's By-law 2.12 defines independent directors. GM's By-law 2.12 (c) provides: Independent directors shall mean a director who: • Is not and has not been employed by the corporation or its subsidiaries in an executive capacity within the five years immediately prior to the annual meeting at which the nominees of the board of directors will be voted upon; • Is not (and is not affiliated with a company or a firm that is) a significant advisor or consultant to the corporation or its subsidiaries; • Is not affiliated with a significant customer or supplier of the corporation or its subsidiaries; • Does not have significant personal services contract(s) with the corporation or its subsidiaries;	An unrelated director: • Independent of management, and • Free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding.	Independent means: • Not employed by company. • Not closely related to company or management (economic, family or others). • Does not mean they cannot be shareholders.

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
3.1 Definition of independence	---	---	• Is not affiliated with a tax-exempt entity that received significant contributions from the corporation or its subsidiaries; and, • Is not a spouse, parent, sibling or child of any person described by any of the above.	---	---
3.2 Roles and functions	NEDs shall: • Review the performance of the board and of the executive. • Take the lead where potential conflicts of interest arise when at times the specific interests of the executive management and the wider interests of the company may diverge such as during takeovers, boardroom succession, or directors' pay. • Bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.	NEDs shall: • Have a strategic and a monitoring function. • Contribute to the development of the company's strategy. • Contribute valuable expertise not otherwise available to management. • Act as mentors to relatively inexperienced executives. • Command the respect of the executives and should be able to work with them in a cohesive team to further the company's interests.	Independent directors shall: Make decisions on matters of corporate governance.	Unrelated directors shall: Exercise independent judgement.	INEDs shall: • Contribute significantly to the decision-making of the board. • Bring an objective view to the evaluation of the performance of the board and management. • Play an important role in areas where the interests of management, the company and shareholders may diverge such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisitions and the audit function. • Provide additional assurance to market participants that their interests are defended.

Appendix 2 (cont'd)

<table>
<tr><td>3.3 Others</td><td>UK – Cadbury Report

<u>Appointment and retirement</u>

NEDs should be appointed for specified terms and reappointment should not be automatic.
The appointment of NEDs should be a matter for the board as a whole.
The selection process is recommended to be carried out by a nomination committee.

<u>Other</u>

If NEDs remain on a board too long, they may lose something of their independent edge. Therefore, NEDs should be appointed for specified terms.

Canada – Dey Report

<u>Disclosure</u>

Corporations are obligated to disclose whether the board has a majority of unrelated directors and if the corporation has a significant shareholder, the corporation will be obligated to disclose whether the board is constituted with the appropriate number of directors who are not related to either the corporation or the significant shareholder.</td></tr>
</table>

Appendix 2 (cont'd)

	UK Cadbury Report (1992)	UK Hampel Report (1997)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(2001)	Canada Dey Report (1994)	OECD Principles of Corporate Governance (1999)
4. Internal Control	Directors are required to ensure that a proper system of internal controls are in place. The board should report on the effectiveness of the company's system of internal control.	The board should maintain a sound system of internal controls to safeguard shareholders' investment and the company's assets.	---	---	---
5. External Auditor	The board should ensure that an objective and professional relationship is maintained with the auditors. Full disclosure of fees paid to audit firms for non-audit work is suggested. A periodic change of audit partners should be arranged to bring a fresh approach to the audit.	The board should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors. The external auditors should independently report to shareholders and assure the board on the discharge of their responsibilities in accordance with statutory and professional requirements. The company's audit committee should review the non-audit services provided by the external auditor.	---	---	An annual audit should be conducted by an independent auditor in order to provide an external and objective assurance on the way in which financial statements have been prepared and presented.
6. Others					
Financial reporting	The board should state in the report and accounts that the business is a going concern with supporting assumptions or qualifications as necessary.	The board should present a balanced and understandable assessment of the company's position and prospects.	---	---	---

Appendix 3
Voluntary Disclosure Attributes Used in Gul & Leung's (2002) Study

Background Information
A statement of corporate goals is provided
General statement of corporate strategy is provided
Actions taken during the year to achieve the corporate goal discussed
Actions to be taken in future year discussed
Competitive environment discussed
Impact of competition on current profit discussed
General description of business provided
Principal products produced identified
Specific characteristics of products described
Principal markets discussed
Specific characteristics of markets described
Performance Information
ROA or sufficient information provided to compute
Net profit margin or sufficient information provided to compute
Asset turnover or sufficient information provided to compute
ROE or sufficient information provided to compute
Financial highlights
Comparison of previous earnings forecast to actual earnings
Comparison of previous sales forecast to actual sales
Future profits forecasted
Future sales forecasted
Change in sales
Change in operation income
Change in gross profit
Change in gross profit as % of sales
Change in selling and administration expenses
Change in interest expense or interest income
Change in net income
Change in inventory
Change in capital expenditures or R&D
Non Financial Information
No. of employees
Staff training
Corporate operation calendar
Operation details
Efficiency measures
Products segment analysis
Geographical segment analysis
Treasury management
Taxation management
Financial analysis
Pension valuation
Environmental measures
ISO or other awards
Y2K issue
Project progress
Impact of opportunities available to future sales/earnings discussed
Impact of risks facing the firm on future sales/earnings discussed

Appendix 4
A Survey of Legal and Regulatory Frameworks Across Jurisdictions

	Hong Kong	UK	USA	Australia	Malaysia	Taiwan	Singapore
Companies							
Relevant Legislation	Companies Ordinance	Companies Act (1985)	Individual state corporation laws	Corporations Act 2001	Companies Act (1965) Companies Regulations (1966)	Company Law (1929)	Companies Act (1994)
Issuing/Policy Authority	Companies Registrar	Department of Trade and Industry (DTI) Companies House	Individual states	Australian Securities and Investment Commission (ASIC)	Registrar of Companies (ROC)	Ministry of Economic Affairs	Registrar of Companies and Businesses
Enforcement Agency	Companies Registrar	DTI Companies House	Individual states	ASIC	ROC	Ministry of Economic Affairs	Commercial Affairs Department
Listed Companies							
Relevant Legislation	Securities and Futures Ordinance (SFC) Listing Rules of the Hong Kong Exchanges & Clearing Ltd (HKEx)	Financial Services and Markets Act (FSMA) (2000) Listing Rules of the UK Listing Authority, applicable to the London Stock Exchange (LSE)	Securities Act of 1933 Securities Exchange Act of 1934	Australian Securities Commission Act 2001	Securities Commission Act (1993) Securities Industry Act (1983) Futures Industry Act (1983)	Securities and Exchange Law (1968) Enforcement Rules of the Securities and Exchange Law (1988)	Securities Industry Act (1986) Securities and Futures Act (2001)
Issuing/Policy Authority	SFC HKEx	Financial Services Authority (FSA)	Securities and Exchange Commission (SEC)	Australian Securities and Investment Commission (ASIC) Corporate Governance and Accounting Policy Division of the Treasury (policy advice)	Securities Commission (SC)	Securities and Futures Commission (Ministry of Finance)	Monetary Authority of Singapore (MAS)
Listing Authority	HKEx	UK Listing Authority (role assumed by FSA)	NYSE, NASDAQ, AMEX each responsible for its own listing rules	Australian Stock Exchange (ASX)	Kuala Lumpur Stock Exchange (KLSE) responsible for Listing Rules	Taiwan Stock Exchange Corporation (TSE) responsible for Listing Rules	Stock Exchange of Singapore (SES) responsible for Listing Manual, compliance required under the Securities Industry Act.
Exchange(s)	HKEx	LSE	NYSE, NASDAQ, AMEX	Australian Stock Exchange (ASX)	KLSE	TSE	SES
Enforcement Agency	HKEx SFC	FSA (for FSMA and FSA rules) DTI (for Companies Act)	SEC	ASIC ASX	SC KLSE	TSE	SES

Appendix 5
Regulatory Requirements on Corporate Governance Disclosures Across Different Jurisdictions

COMMON LAW JURISDICTIONS	
Hong Kong	Stock Exchange of Hong Kong Main Board Listing Rules Appendix 14 – Code of Best Practices requires listed companies to include a statement in their annual reports to indicate whether they have complied with the Code of Best Practices. Companies are required to give reasons for any non-compliance.
UK	London Stock Exchange Listing Rule 12.43A requires a listed company to include a narrative statement of how it has applied the principles set out in Section 1 of the Combined Code, providing explanation which enables its shareholders to evaluate how the principles have been applied, and a statement on the extent of compliance and as to whether or not it has complied throughout the accounting period with the Code provisions set out in Section 1 of the Combined Code and give reasons for any non-compliance.
USA	No requirements.
Australia	Australian Stock Exchange Listing Rule 4.10.3 requires listed companies to include a statement of the main corporate governance practices that the companies had in place in the annual report.
Malaysia	Kuala Lumpur Stock Exchange Listing Rule 15.26 requires a listed company to include a narrative statement of how it has applied the principles set out in Part 1 of the Malaysian Code on Corporate Governance (MCCG); and a statement on the extent of compliance with the Best Practices set out in Part 2 of the MCCG and give reasons for any non-compliance in its annual report.
Singapore	Singapore Exchange Listing Rule 912 (4) requires: (a) A listed company which holds its AGM before 1 January 2003, unless it complies with paragraph (b) below, to state in its annual report whether and how it has complied with the Best Practices Guide, with respect to Audit Committee, and provide sufficient disclosure of its corporate governance processes and activities. (b) A listed company, which holds its AGM on or after 1 January 2003 to describe its corporate governance practices with specific reference to the Code of Corporate Governance in its annual report. It should disclose non-compliance with any aspect of the Code together with an appropriate explanation in the annual report.
CIVIL LAW JURISDICTIONS	
Taiwan	No requirements.

Appendix 6
Comparison of Regulatory Requirements on Board Practices in Different Jurisdictions

		Hong Kong	UK	USA	Australia	Malaysia	Taiwan	Singapore
1	Board composition	Main Board & GEM Board Minimum 2 INEDs.	Minimum 1/3 NEDs, majority of whom are independent. (LR)	Not specified, but there is an audit committee requirement of a minimum of 3 independent directors. (LR)	---	Minimum 2 directors or 1/3 INEDs. (LR)	Minimum 1/3 INEDs at time of company becoming listed. (LR)	Minimum 1/3 INEDs. (CCG)
2	Board size	---	---	---	---	---	-Minimum 2 directors. -Minimum 2 supervisors. (required by law)	Minimum 2. (required by law)
3	Chairman	---	---	---	---	---	---	Independent of management. (CCG)
4	CEO duality	---	A decision to combine the roles should be publicly explained. (LR)	---	---	A decision to combine the roles should be publicly explained. (CCG)	---	Roles should be separate. (CCG)
5	Board meetings and attendance	Main Board Minimum 2 annually. GEM Board Minimum 4 annually.	---	Disclosure of number of meetings and attendance of directors is required. (LR)	---	---	---	---
6	Director term limits	---	Maximum 3 years between election/re-election. (LR)	Maximum 3 years between election/re-election. (LR)	Disclose if any. (LR)	-Maximum 3 years between election/re-election of individuals -Elections shall take place annually. (LR/CCG)	Maximum 3 years between election/re-election. (LR)	Maximum 3 years between election/re-election. (CCG)

NED	Non-executive director	CCG	Code of Corporate Governance (Singapore and Malaysia) (Listed companies must comply with these recommendations, or explain why they are not in compliance)
INED	Independent non-executive director		
HKMA	Hong Kong Monetary Authority	SEC	Securities and Exchange Commission (USA)
LR	Listing Rules		

Appendix 6 (cont'd)

		Hong Kong	UK	USA	Australia	Malaysia	Taiwan	Singapore
7	Director age limits	---	---	---	Disclose if any. (LR)	---	---	70 years. (required by law)
8	Orientation for new directors	Newly appointed board members should receive an appropriate briefing. (LR)	---	---	---	---	---	Newly appointed board members should receive appropriate training. (CCG)
9	Outside advice	INEDs must have access to outside professional advice at company expense. (LR)	Directors must have access to outside professional advice at company expense. (LR)	---	---	Directors must have access to outside professional advice at company expense. (LR/CCG)	---	Directors must have access to outside professional advice at company expense. (CCG)
10	Access to information	All directors, executive and non-executive, are entitled to have access to board papers and materials. Where queries are raised by NEDs, steps must be taken to respond as promptly and fully as possible. (LR)	The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. (LR)	---	---	---	---	-Board members should be provided with complete, adequate and timely information prior to board meetings and on an on-going basis. -Management has an obligation to supply the board with complete, adequate information in a timely manner. (CCG)
11	Access to company secretary	---	All directors should have access to the advice and services of the company secretary. (LR)	---	---	---	---	All directors should have access to the advice and services of the company secretary. (CCG)

NED Non-executive director
INED Independent non-executive director
HKMA Hong Kong Monetary Authority
LR Listing Rules

CCG Code of Corporate Governance (Singapore and Malaysia)
(Listed companies must comply with these recommendations, or explain why they are not in compliance)
SEC Securities and Exchange Commission (USA)

Appendix 6 (cont'd)

		Hong Kong	UK	USA	Australia	Malaysia	Taiwan	Singapore
12	Disclosure of directors' and senior managers' biographical details	-Names and qualifications. -Brief biographical details. -Disclose whether any directors are related. (required by law and LR)	Names of directors standing for election or re-election, with biographical details. (LR)	-Names and ages of all directors. -Business experience. -Disclose whether any directors are related. (SEC/LR)	-Age. -Qualifications and experience. -Whether directors act as nominees or representatives of particular shareholders. (LR)	-Name, age, nationality, qualification. -Experience and occupation. -Date first appointed to the board. -Board committees served on. -Directorships held in other public companies. -Any family relationship with any director and/or major shareholder. -Any conflict of interest with the company. -List of convictions for offences within the past 10 years (other than traffic offences), if any. (CCG)	---	-Academic and professional qualifications. -Shareholding in the company and its subsidiaries. -Board committees served on. -Date of first appointment. -Date of last re-election. -Directorships or chairmanships held within past 3 years in listed companies. (LR)
13	Disclose whether directors are executive or non-executive	Disclose whether directors are executive or non-executive, and which are independent. (required by law)	Disclose whether directors are executive or non-executive, and which are independent. (LR)	---	Disclose whether directors are executive or non-executive, and which are independent. (LR)	Disclose whether directors are executive or non-executive, and which are independent. (LR)	---	Disclose whether directors are executive or non-executive, and which are independent. (CCG)

NED Non-executive director
INED Independent non-executive director
HKMA Hong Kong Monetary Authority
LR Listing Rules
CCG Code of Corporate Governance (Singapore and Malaysia)
(Listed companies must comply with these recommendations, or explain why they are not in compliance)
SEC Securities and Exchange Commission (USA)

Appendix 7
Comparison of the Regulatory Framework of the Accounting Profession Across Jurisdictions

Countries/Region	Hong Kong	UK	USA	Australia	Malaysia	Taiwan	Singapore
Main Professional Institutes	The Hong Kong Society of Accountants	• Institute of Chartered Accountants in England & Wales • The Institute of Chartered Accountants in Ireland • The Institute of Chartered Accountants of Scotland	The American Institute of Certified Public Accountants	• The Institute of Chartered Accountants in Australia • Certified Practising Accountants Australia	Malaysian Institute of Accountants	The ROC National Federation of CPA Associations	Institute of Certified Public Accountants of Singapore
Establishment	Professional Accountants Ordinance	Royal Charter	Not applicable	Royal Charter	Accountants Act of Malaysia	Revised Accountancy Law	Accountants Act of Singapore
Self Regulated?	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Standards Setting	The Hong Kong Society of Accountants	• Accounting Standards Board • Auditing Standards Board	Financial Accounting Standards Board	Australian Accounting Standards Board	Malaysian Accounting Standards Board	Financial Accounting Standards Committees	Institute of Certified Public Accountants of Singapore
Oversight Bodies	Not applicable	Financial Reporting Review Panel	Public Oversight Board	Financial Reporting Council	Not applicable	Not applicable	Public Accountants Board

Appendix 8
Summary of Surveys

Country	Australia		Malaysia		Singapore	Taiwan
Survey name	Korn/Ferry International "Board of Directors Study in Australia and New Zealand 2000"	Ernst & Young: "Corporate Governance Survey"	PricewaterhouseCoopers/ KLSE "Corporate Governance: 1998 Survey of Public Listed Companies"	PricewaterhouseCoopers Malaysia "Board of Directors: A Survey on Remuneration and Practices 2001"	Singapore Institute of Directors/Egon Zehnder International "Singapore Board of Directors Survey 2000"	Chen (2000): "Study of Effective Exercise by Exterior Directors and Supervisors of Listed Companies"
Year	2000	1999	1998	2001	2000	1998 data
Sample size	238	112	304	114	102	403
Sample source	Publicly listed, unlisted	Top 200 listed companies	KLSE listed companies	KLSE listed companies and individual directors	SGX listed companies	TSE listed companies
Types of companies in sample	All sectors and sizes	All industries	All industries	All industries	All industries	N/A
Participation	Voluntary	N/A	Voluntary	Voluntary	Voluntary	N/A
Response rate	N/A	N/A	42%		26%	N/A
CEO Duality	11%	N/A	40%	13%	71%	N/A
If no CEO duality, Chairman was independent	N/A	N/A	38%	N/A	N/A	N/A
Board size	N/A	N/A	8	8	7	N/A
Number of ED	N/A	N/A	3	3	3	N/A
Number of NED or INED	N/A	N/A	5	5	4	N/A
Number of INED	N/A	N/A	2-3	3	N/A	N/A
Existence of INEDs on board	N/A	N/A	N/A	N/A	N/A	68%
Board meetings per year	N/A	N/A	4	N/A	N/A	N/A

N/A: Information not available

Appendix 8 (cont'd)

Country	Australia		Malaysia		Singapore	Taiwan
Other	Ranking of backgrounds of directors: -accounting (17%) -financial & IT (11%) -banking/ engineering (10%) Ranking of objectives: -long term strategy -responsibility to shareholders -performance -review and selection of CEOs	ASX requires CG disclosure. All companies provided some kind of disclosure, but the extent of the disclosures varied greatly.	N/A	Ranking of backgrounds of directors: -lawyer (40%) -engineers (34%) -accountants (16%) -finance (15%)	In-house training was provided to new directors in 44% of the surveyed companies.	N/A

N/A: Information not available

Appendix 8 (cont'd)

Country	UK		USA		
Survey name	Korn/Ferry International "European Board of Directors Study 1998"	Heidrick & Struggles International "Is Your Board Fit for the Global Challenge"	Korn/Ferry International "26th Annual Board of Directors Study"	Korn/Ferry International "27th Annual Board of Directors Study"	Korn/Ferry International "28th Annual Board of Directors Study"
Year	1998	1999	1999	2000	2001
Sample size	450 (157 UK)	N/A	N/A	917	902
Sample source	N/A	Top 40 of FTSE 100	Fortune-listed corporations	Fortune-listed corporations	Fortune-listed corporations
Types of companies in sample	N/A	N/A	N/A	N/A	N/A
Participation	N/A	N/A	N/A	N/A	N/A
Response rate	N/A	N/A	N/A	N/A	N/A
CEO Duality	28%	N/A	N/A	N/A	N/A
If CEO duality, lead director is appointed	N/A	N/A	30%	30%	32%
Board size		14	11	11	11
Number of ED	52%		2	2	2
Number of NED or INED	48%	N/A	9	9	9
Number of INED	N/A	Min. of 1/3 of the board	N/A	N/A	N/A
Existence of INEDs on board	N/A		N/A	N/A	N/A
Board meetings per year	N/A	10	N/A	N/A	N/A
Other	Large number of companies indicated plans to split roles of CEO/Chairman in the next 5 years.	Standards of CG were better than European average, but still needed some improvement. Large companies were usually entirely in compliance with the Combined Code.	N/A	N/A	Retired CEOs from other companies were present in 91% of the boards.

N/A: Information not available

Appendix 8 (cont'd)

Country	USA	
Survey name	The Conference Board "Director's Compensation and Board Practices in 2000"	Russell Reynolds Associates and the Investor Responsibility Research Center "1999-2000 Board Practices Survey – The Structure and Compensation of Boards of Directors of US Public Companies"
Year	2000	2000
Sample size	2322 individuals/754 companies	1202
Sample source	American Society of Corporate Secretaries members	S&P Super Composite 1500 Index
Types of companies in sample	Companies in manufacturing, financial and service sectors.	All industry sectors
Participation	Voluntary	N/A
Response rate	N/A	N/A
CEO Duality	68%	75%
If CEO duality, lead director is appointed	4%	2%
Board size	9-12	4-32, most were 5-16
Number of ED	2	72% had one or two EDs, remainder had three or more
Number of NED or INED	7-10	N/A
Number of INED	N/A	N/A
Existence of INEDs on board	N/A	80% had majority of INEDs on the board.
Board meetings per year	6	N/A
Other	N/A	N/A

N/A: Information not available

Appendix 9
Recent Developments in Corporate Governance Across Jurisdictions

Jurisdiction	Recent Developments	Section Reference
Hong Kong	2002 • The Hong Kong SAR government announced plans to adopt the recommendations of the Standing Committee on Company Law Reform. Recommendations include a range of issues in corporate governance. (Dow Jones Newswires, October 2001) • Hong Kong Exchanges and Clearing Limited published the Consultation Paper on Proposed Amendments to the Listing Rules Relating to Corporate Governance Issues in January 2002. • The Securities and Futures Commission proposed to increase penalties for misstatements made by executives. (Financial Times, March 2002a) • The Hong Kong Society of Accountants announced measures to improve accountability and transparency of their regulation of the accounting profession in Hong Kong. Measures include allowing public and media to attend disciplinary hearings, and an agreement with the Hong Kong Stock Exchange on regulation of auditors and other accounting issues. (SCMP, April 15, 2002)	5.2.9 5.2.10
UK	2001 The Department of Trade and Industry completed its review and issued final recommendations on company law reform in 2001, including: • Recommendations concerning directors and their duties, and shareholders and their rights; and, • Supported the existing "comply or explain" of the Listing Rules' approach to the Combined Code. 2002 • In January 2002, the Government adopted the proposal made by professional bodies including the Association of Chartered Certified Accountants, the Chartered Institute of Management Accountants, the Chartered Institute of Public Finance and Accountancy, the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants in Ireland and the Institute of Chartered Accountants of Scotland (which are members of the Consultative Committee of Accountancy Bodies) regarding a new framework of oversight mechanism. The essence of the new framework is to give responsibility for the supervision of members of professional accountancy bodies, the setting of ethical standards and disciplinary functions to new independent bodies, namely The Accountancy Foundation (which has been proposed to contain no practicing accountants), the Review Board (which has been proposed to have a limitation on the number of members who are practicing accountants so as to preserve independence), the Ethics Standards Board, the Auditing Practices Board and the Investigation and Discipline Board (which has been proposed to have a restriction on the number of members who are professional accountants to less than 40% in each of these Boards). The objective of the above organization is to establish an independent system of regulation overseeing the accountancy profession in order to increase the independence and transparency of the profession (For details, Accountancy Foundation homepage http://www.accountancyfoundation.com). • In October 2002, the Department of Trade and Industry published a consultation document – "Review of the Regulatory Regime of the Accountancy Profession" that invited comments regarding the issues contained the consultation paper. On 24 July 2002, the Government published the interim report of the Co-ordinating Group on Accounting and Auditing issues (CGAA). The CGAA was set up in response to the corporate failures of Enron in the United States. An immediate review of the regulatory arrangements for the accountancy and auditing professions was called for. The purpose of the review is to review the way the accountancy and audit professions are currently regulated, and to consider whether any improvements should be made to make the system more effective. The review is considering the followings: 1. What regulatory functions are needed, who should carry them out, and how they are funded, including the scope for simplifying the current arrangements;	5.3.1 5.3.1

	2. Whether the existing balance between professional self regulation and independent regulation is the right one, and whether there should be a statutory basis for regulation; 3. The case for taking a different approach to the regulation of the accountancy profession in general and to the regulation of auditors in particular.	
USA	2001 • Role of the Public Oversight Board expanded to include the Auditing Standards Board and Independence Standards Board. 2002 • SEC proposed more timely disclosure of certain items, including immediate disclosure of related party transactions, material write-offs, and trading of shares by directors • SEC approved a new rule requiring more extensive disclosure of stock option schemes that have not yet been approved by shareholders. • NYSE plans to impose new corporate governance rules, including requirements that listed companies have at least three independent board members, and the audit, compensation and nomination committees be comprised solely of outside directors, boards appoint an independent director as either the chairman or lead director and boards meet regularly without executive management present (Dow Jones Newswires, June 2002). • NASDAQ requires that related party transactions be supported by a company's audit committee; stock options schemes need shareholders' approval (Financial Times, May 2002b). • American Bar Association (ABA) formed a Task Force on Corporate Responsibilities to examine the effectiveness of the governance and disclosure systems applicable to public companies in the USA and proposed that the NYSE and NASDAQ jointly develop nonbonding corporate guidelines regarding best practices. Such guidelines would not be mandatory, but companies that do not comply with the recommendations must disclose why they do not. • On 30 July 2002, President George W. Bush signed the Sarbanes-Oxley Act into law. Amongst other provisions, the new law mandates the establishment of a strong independent board i.e., Public Company Accounting Oversight Board to oversee audits of public companies, and gives it the power to investigate and fine auditors. The law also addresses growing pubic perceptions that lucrative consulting services can compromise auditor integrity by banning auditors from providing a laundry list of nearly a dozen services to their corporate clients – if they are at the same time auditing them. Most of the services, including bookkeeping, appraisal or valuation services, management functions, actuarial services and investment advice or investment banking services, were already prohibited, but the law added two new categories to the list – internal audit outsourcing and financial information system design. The law also requires that lead audit partners for each client be rotated every five years and that auditors obtain pre-approval from the company's audit committee for the audit and non-audit services that they provide (HKSA, 2002).	5.4.6.1
Australia	2001 • The Australian Stock Exchange issued a new listing rule requiring companies to make a statement about their corporate governance practices. • The Corporate Law Economic Reform Program continued to emphasize the non-prescriptive approach to corporate governance. 2002 • Powers of Australian Securities and Investments Commission to be expanded, giving more power to police and penalize instances of non-compliance. (Australian Financial Review, February 2002)	5.5.2 5.5.2.1
Malaysia	2000 • Code of Corporate Governance 2002 • New rule in the Companies Act prohibits directors convicted of fraud or other offences from serving on any board for five years. (The New Straits Times, January 2002)	5.6.3

Taiwan	No recent developments.	
Singapore	2001 • The Code of Corporate Governance was adopted by the Singapore Exchange in 2001, effective for all listed companies on Jan 1, 2003. • Singapore Institute of Directors will establish a firm to assist companies in searching for qualified independent non-executive directors. (The Straits Times, November 2001a) • Listed companies will be required to provide quarterly reporting effective Jan. 1, 2003. (The Straits Times, October 2001b)	5.8.3