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Consultancy on the Roles and Functions of Audit, Nomination and Remuneration Committees in connection with the Corporate Governance Review

Final Report

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EXECUTIVE SUMMARY

The objective of this consultancy brief is to examine the roles and functions of the audit, nomination and remuneration committees. We draw on agency theory, incomplete contracting theory and the associated problems of information asymmetry to provide a theoretical framework for understanding the role of these three board committees in a firm's corporate governance regime. Agency problems arise from the separation of ownership and control in modern corporations between the firm's financiers and the firm's management. The financiers as a result of information asymmetry face the risk that management can expropriate his/her capital. Thus, the objective of the firm is to design the contracts in such a way as to minimize contracting costs including the above agency costs. However, it is not possible to write complete contracts to cover every contingency and the monitoring of these contracts also becomes significant because of agency problems. The establishment of an independent board of directors and these three board committees are expected to alleviate the agency problems between shareholders and management and overcome some of the problems of incomplete contracts and information asymmetry.

However, the mere establishment of these committees is not expected to be effective unless the committees are made up of "truly" independent non-executive directors (INEDs). These INEDs play an important part in aligning the interests of managers and shareholders through their monitoring role in the board and its committees. The extent to which the three committees can fulfill their roles and functions effectively therefore depend to a large extent on the monitoring role played by the INEDs on these committees.

Before reviewing the legal and regulatory environments of the three board committees in the different jurisdictions, we provide by way of a background an overview of the legal institution, corporate ownership structures and the regulatory framework that underlie the overall corporate governance systems. Legal scholars have identified two distinct legal systems in the world namely common law and civil law systems and these systems form the basis for the legal framework including the laws and associated enforcement that provides the minimum standard for investor protection. Prior research studies show that investors are better protected by laws and related enforcement in common law jurisdictions than in civil law countries. Research also shows that there are wide variations in legal enforcement and judicial efficiency in different countries and these can affect corporate governance systems and the protection of shareholders and other stakeholders. Ownership structures also influence the system of corporate governance. For example, different forms of concentrated ownership may be used to distinguish three corporate governance systems, namely equity market, bank lending and family-based corporate governance systems. Hong Kong is an example of the family based corporate governance system which is characterized by a particular type of agency problem whereby family controlled companies may expropriate minority shareholder interests. The presence of "truly" INEDs in the corporate governance regime is seen as one way of mitigating this kind of agency problem often associated with concentrated family ownership.

The corporate governance regulatory framework in Hong Kong is derived from a number of sources including the Companies Ordinance, Securities Ordinance, Main Board Listing Rules, Growth Enterprises Market (GEM) Listing Rules and the Hong Kong Monetary Authority (HKMA). The Main Board Listing Rules require listed companies to report in their interim and annual reports their compliance with the Code of Best Practice, including the recommendation of setting up an audit committee comprised of at least two non-executive directors (NEDs) with a majority of them being independent, or disclose the reasons for any non-compliance. It also recommends that the principal duties of the audit committee should focus on the review and supervision of the financial reporting process and internal controls. There are no requirements for nomination and remuneration committees. On the other hand, the GEM Listing Rules require issuers to establish an audit committee with at least two directors, the majority of whom, including the chairman, are independent. There are other voluntary recommendations relating to the three board committees from the Hong Kong Society of Accountants (HKSA) and HKMA.

The above review of Hong Kong's common law legal system with the dominance of family owned listed companies forms the basis for understanding the establishment of effective board committees. Three different regulatory approaches to promote good corporate governance, namely prescriptive, non-prescriptive and balanced approaches have been identified in the literature and will be used as our analytical framework to understand the regulatory approaches to corporate governance in each of the jurisdictions under study. The prescriptive approach imposes specific corporate governance practices that must be followed by all companies. The non-prescriptive approach allows companies to set their own corporate governance practices while a balanced approach provides corporate governance practices in the form of "best practices", but allows companies to follow different practices, as long as appropriate disclosure is made. These three approaches will be used to make recommendations on the roles and functions of these three board committees in Hong Kong.

Four methods have been employed for our study. First, we conducted a comprehensive review of academic literature and board practice surveys on the roles and functions of audit, nomination and remuneration committees in the UK, the USA, Australia, Canada, Malaysia, Taiwan, Singapore 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 on the above committees was conducted. A review of the academic literature focusing on the effectiveness of these three committees including NEDs and INEDs was also conducted. Second, we interviewed the key regulators and representatives from government departments and prominent corporate governance experts from private sector institutes in different countries, namely the UK, the USA, Australia, Canada, Malaysia to shed light on their latest views on the key factors that contribute to effective board committees in their respective countries. Third, a questionnaire was developed to collect the opinions of the chief executive officers (CEOs) or Chairmen of Hong Kong listed companies towards the effectiveness of the three board committees. Our sample respondents are the CEOs or Chairmen of the Hang Seng 100 companies in Hong Kong for the year 1999. Fourth, relevant corporate governance information including information on audit committees from the annual reports of Hong Kong listed companies in 1999 was collected and empirical analyses were conducted on the relationship between board and audit committee characteristics and firm performance. Since auditors play a pivotal role in the monitoring process of firms, we also present the findings of a study that examine if audit committee characteristics are associated with audit fees.

Literature Review on Board Committees – Main Findings

Audit Committees

The number and quality of INEDs and their experience and expertise such as financial literacy have been identified as crucial elements for the effectiveness of audit and remuneration committees. The frequency of meetings is also a good indicator of the extent to which management relies on these committees and determines its effectiveness.

Remuneration Committees

Some prior research studies have investigated issues related to the effectiveness of remuneration committees and found that a higher proportion of outside directors on the board or on the remuneration committee would induce management to act more in the interests of the shareholders and would more likely promote the pay and performance linkage.

Nomination Committees

Prior literature on the effectiveness of nomination committee is scarce. One recent study found no evidence that the establishment of a nomination committee would have any impact on the determination of CEO pay levels.

Interview Findings

Our interview findings revealed that the most vital element in implementing effective audit, remuneration and nomination committees is the quality of INEDs. In general, interviewees were skeptical about the existence of qualified INEDs (in terms of independence, integrity, expertise and experience) as they are usually connected to the companies. Therefore, good quality INEDs are hard to come by in Hong Kong unless more incentives are provided in terms of compensation. Another alternative to finding good quality INEDs is to outsource the hiring function to professional recruitment agencies that recruit globally.

Interviewees were supportive of corporate governance reform in Hong Kong. However, they favored a disclosure-based approach over a regulatory-based regime in order to allow market participants to have more flexibility in conducting their businesses to enhance shareholders' values. They considered that an effective way to upgrade the quality of INEDs is to "professionalize" them through continuing education and training.

Questionnaire Results

Consistent with our interview findings, the results of our questionnaire survey revealed that the independence of the INEDs is the most important factor contributing to good corporate governance. Therefore, the appointment of INEDs should be regulated by the Listing Rules and the reasons for the resignation of INEDs should also be disclosed. These results also suggested that emphasis should be placed on the recruitment of quality directors, particularly INEDs. In addition, the disclosure of directors' benefits derived from exercising share options and/or warrants and detailed disclosure on directors' dealings with related parties are important factors contributing to good corporate governance practices.

On average, our sample respondents agreed that the establishment of audit committees (but not remuneration and nomination committees) should be made compulsory and audit committee meetings should be attended by the external auditor of the company. They agreed that all three committees should be chaired by INEDs and there should be at least three members in each of the committees.

Empirical Analyses

Annual reports of 566 Hong Kong listed companies in 1999 have been surveyed and the main findings are:

- Over half (60%) of the listed companies in 1999 disclosed that they have an audit committee (i.e., 342).
- Out of those companies with audit committees, disclosure of the number of audit committee meetings was rare (7% disclosing that they had two meetings a year).
- The majority of audit committees had at least two INEDs.
- Only 2% of Hong Kong companies reported remuneration committees and 1% reported nomination committees for the year 1999.

Further, an analysis of the Hang Seng 100 companies in 1998 and 1999 showed the following:

- There was an increasing trend of disclosure on the roles and functions of audit committees in 1999.
- There was a phenomenal increase in the number of companies with audit committees (from 28 in 1998 to 76 in 1999).
- There was no disclosure of remuneration committees for 1998 and two disclosures in 1999.
- There was one disclosure of nomination committee in 1998 and two disclosure in 1999.

Based on our analysis using 1998 and 1999 data collected from Hang Seng 100 annual reports, it is encouraging to note that Hong Kong listed companies have taken steps to improve their corporate governance practices. For example, there was a dramatic increase in the number of audit committees established in 1999 and more companies disclosed the work done by the audit committees during the year 1999.

Findings from regression analyses of 408 firm observations for 1999 showed that the existence of audit committees was positively associated (at a marginally significant level) with better performance. In addition, for firms with audit committees, it was found that more INEDs as committee members were associated with better performance. Further, a Hong Kong study showed that those companies with audit committees were associated with lower audit fees suggesting that the existence of audit committee reduced control risks. For companies with audit committees, the results showed that companies with larger audit committee membership were associated with higher audit fees due to increased audit scope. This finding is consistent with the view that audit committees with more independent and diligent members would be more concerned with discharging their monitoring role and would be more supportive of the external audit function.

Main Recommendations

Based on the literature review, interview findings, questionnaire results and empirical analyses, we provide the following main recommendations:

Audit Committees

- All listed companies should establish an audit committee with at least three NEDs, with the chairman and the majority of its members being independent.
- All the NEDs and INEDs on the committee should have some financial expertise either acquired through accounting or financial management qualifications or experience.

- The role of the audit committee is to assist the board of directors to monitor and oversee the financial reporting process, the external audit and internal controls including the audit function and risk management.

- A charter stipulating the terms of reference for this committee should be disclosed in order that all members understand their role and responsibilities in the committee.

- The annual report should disclose the composition of the audit committee, the number of audit committee meetings and how it has discharged its responsibilities.

In terms of implementation, we recommend that a balanced approach be adopted. The establishment of an audit committee with at least three NEDs as members, the chairman being an INED and the majority being independent should be incorporated in the Listing Requirements of the Main Board as well as the GEM Board. Other detailed recommendations should be incorporated in the Code of Best Practice.

Remuneration Committees

- The remuneration committee should be established and consist wholly of NEDs with the chairman and the majority being INEDs.

- The remuneration committee should be responsible for recommending to the board the compensation policy as well as all aspects of compensation for key executives including all the executive directors and the CEO. The compensation for NEDs and INEDs should be a matter for the board. Disclosure of the individual members' remuneration including all aspects of their remuneration packages should be made in the annual report.

- The terms of reference of the remuneration committee together with composition, number of meetings and work done should be disclosed in the annual report.

- Ideally, there should be at least one member who is knowledgeable in executive compensation. Otherwise, external professional advice should be sought.

- The principle that no executives or NEDs or INEDs should have a role to play in determining his/her compensation should be strictly adhered to.

- Composition, role and remuneration policy of NEDs should be disclosed and include:

    - an analysis of individual directors' remuneration including basic salaries, housing allowances, other allowances and benefits in kind.

- o an analysis of directors' remuneration between "performance-based" and "non-performance-based" compensation.
- o directors' share options including their individual benefits derived from the aggregate value realized on the exercised options during the year and the closing market price of shares at the balance sheet date.

We recommend that a balanced approach be adopted. The establishment of the remuneration committee/corporate governance committee with detailed requirements on the constitution of the committee should be incorporated in the Listing Requirements of the Main Board and GEM Board. Details of other recommendations should be incorporated in the Code of Best Practice.

Nomination Committees

- The nomination committee should be established with the chairman and a majority of its members being INEDs. This constitution is particularly important for Hong Kong because over 60% of listed companies are family owned or dominated by controlling shareholders and the quality of INEDs is the most critical element in corporate governance.
- The nomination committee should be responsible for making recommendations to the board on all new appointments including executives, NEDs and INEDs. It is also crucial that the CEO and Chairman should have some control/influence over the recommendations of executive directors to the board or its committees. However, the nomination of INEDs and NEDs should be the sole responsibility of this committee. One of the functions of this committee is to consider the best qualified candidates in terms of the skills and characteristics required for the membership of the board. Performance evaluation of individual directors should be undertaken by this committee on an on-going basis.
- There should be a charter stipulating the role and functions of this committee.
- Disclosures in the annual report should include: membership, terms of reference and responsibilities of members, procedures for recruiting and evaluating directors including executives, NEDs and INEDs.

In terms of implementation, a balanced approach should be adopted. The establishment of the nomination committee/corporate governance committee with detailed requirements on the constitution of the committee should be incorporated in the Listing Requirements of the Main Board and GEM Board. Details of other recommendations should be incorporated in the Code of Best Practice.

Corporate Governance Committees

If nomination and/or remuneration committees are not established, a corporate governance committee should be established as an intermediate step to formally establishing these committees. This is perhaps more appropriate for smaller companies where there may not be enough directors to formally constitute all recommended committees. The appointment of a corporate governance committee with the duties as outlined below, plus the duties of the remuneration and nomination committees would likely be a feasible undertaking for all but the smallest of listed companies. It is also a logical step to the long-term goal of establishing the other nomination and remuneration committees as the company grows in size.

The corporate governance committee may be chaired by the chairman of the board, if that person is not also the CEO. The duties of the committee should include:

- General responsibility for developing corporate governance policies;
- Proposing changes as necessary to conform with governance guidelines;
- Explaining the rationale behind the company's practices if they do not follow corporate governance guidelines; and,
- Forum for concerns of individual directors when the matters may not be appropriate for a full board meeting, such as individual performance of other directors, or the company's approach to governance.

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CHAPTER 1 INTRODUCTION

This introductory chapter provides an overview of the theoretical background for analyzing and understanding the role of the three board committees, namely the audit committee, the nomination committee and the remuneration committee. It also draws attention to the pivotal role that independent non-executive directors (INEDs) play in ensuring the effectiveness of these three board committees. The major objectives of this study are outlined in the last section of this chapter.

1.1 Theoretical Background

A starting point for a theoretical understanding of corporate governance in modern corporations is the economics of agency theory and incomplete contracting theory and the problem of information asymmetry. The agency problem arises from the separation of ownership and control in modern corporations between the firm's financiers on one hand, including holders of both equity and debt, and the firm's management on the other (Shleifer and Vishny, 1997). The manager requires the financier's funds, since he/she usually cannot supply the capital he/she requires on his/her own. The financier on the other hand, as a result of information asymmetry and the absence of a mechanism to prevent this, 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). An extension of the agency problem also arises when majority shareholders expropriate the interests of minority shareholders. A further dimension that may affect the severity or otherwise of the agency problems hinges on the idea that firms are a "nexus of contracts" and there are difficulties associated with incomplete contracting.

The firm is viewed as a set of contracts between a multitude of parties and individuals. The objective of the firm is to design the contracts in such a way as to minimize contracting costs including agency costs. The contracts are between the individuals and separate entities and there are myriad types of written and unwritten agreements among individuals in the firm. These contracts include formal contracts such as compensation and debt contracts and informal contracts such as informal working arrangements between managers such as organization charts and job descriptions. Accounting is also an integral part of the contracts that define the firm. The contracts themselves, and the enforcement and the monitoring of these contracts are costly and can affect the firm's profitability and survival. Unfortunately, it is not possible to write contracts that cover every contingency in the business environment and 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.

Agency problems arising from the separation of ownership and control allow managers to pursue opportunistic behavior by expropriating from investors or misallocating company funds. This is one of the major deterrents facing investors in their decisions to put up *ex ante* the resources to finance the firm (Williamson, 1991; Grossman and Hart, 1986). Corporate governance which offers a way of overcoming these problems in modern corporations may be defined as the mechanisms whereby suppliers of corporate finance can assure themselves of a return on their investment

(Shleifer and Vishny, 1997). Therefore, corporate governance mechanisms deal with the constraints that investors put on managers to decrease the *ex post* misallocation and induce investors *ex ante* to supply funds to the firm.

A plethora of corporate governance devices have surfaced in corporations, particularly in the USA, and they include increasing management ownership of shares, institutional investors, issues relating to INEDs on the boards of directors and the separate roles of the chairman and chief executive officer (CEO) and so on. Of interest in this study are three important committees which have been identified as essential corporate governance mechanisms by key international corporate governance reports. These are the committees of the board of directors, namely audit, nomination and remuneration committees. These committees are expected to alleviate the above agency problems between shareholders and management and overcome some of the problems of incomplete contracts. They are also viewed as the main mechanisms for good corporate governance practices by the regulators of the developed capital markets such as the USA and the UK.

The audit committee's principal functions are to diligently monitor the audit process, internal control systems including internal audit and the financial reporting process. The audit committee is viewed as the primary and foremost board committee charged with the responsibility of overseeing management and ensuring that the audit process by the external auditor is effective. Similarly, the remuneration committee is responsible for formulating the compensation policy and packages for executives including performance based components such as bonus, share options and other incentive schemes and other non-performance based components such as basic salary. It can also focus on the determination of remuneration policy for non-executive directors (NEDs) as well. The nomination committee is normally responsible for the appointment of executive directors and INEDs for the board and its committees such as the audit committee and the remuneration committee. This committee attempts to ensure that these outside directors are not only competent but also independent. In evaluating and considering the role and effectiveness of these committees, it is important not to lose sight of the role of INEDs.

1.2 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). Some academics point out that these INEDs bear the important function of an unbiased monitor (Klein, 1998). Apart from the above roles, 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 incentives exist for these outside directors to act independently from management (Perry, 1999). For example, they need to fulfill their fiduciary duties and to maintain their good reputation as astute executives and effective monitors. In the developed capital markets, these INEDs are provided with stock-based incentive plans to motivate them to perform their roles effectively. Though a number of empirical studies have been conducted to link the presence of INEDs to better firm performance, no conclusive evidence has been found to support this relationship. 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 open 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.

1.3 Objective and Structure of this Study

The major objective of this study is to examine the roles and functions of the audit, nomination and remuneration committees. Before doing this, we will first provide a discussion of the corporate and ownership structures in Hong Kong companies and an overview of the legal and regulatory requirements for corporate governance in Hong Kong. This is followed by a suggested analytical framework for analyzing the roles and functions of the three committees including a discussion of the role of INEDs and the methodology to be used. A comprehensive literature review on the roles and functions of the three committees with country analyses covering the legal and regulatory requirements and voluntary disclosures in each country is also conducted. The countries considered are the UK, the USA, Australia, Canada, Malaysia, Taiwan and Singapore. The report also includes a detailed survey of the key international corporate governance reports on the three committees and a literature review of the empirical evidence on the effectiveness of each of the three committees. Our findings from interviews with regulators and prominent corporate governance experts in the private sector on the effectiveness of the three committees in the different jurisdictions will be summarized in a separate chapter. The final chapter contains our recommendations and conclusions.

CHAPTER 2 BACKGROUND

2.1 Introduction

The roles, functions and effectiveness of board committees such as the audit, remuneration and nomination committees are likely to depend on the legal institution, corporate ownership structures and the regulatory framework that underlie the overall corporate governance system. This chapter provides an overview of the institutional and regulatory framework that is likely to have a bearing on the role and effectiveness of these board committees.

2.2 Legal Systems

In any corporate governance environment, the legal system including the laws and associated enforcement provides the minimum standard for investor protection. There are essentially two major distinct legal systems in the world, namely common law and civil law[1]. 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 forty-nine countries into common law countries such as Australia, Canada, Singapore, the UK, the USA, Malaysia and Hong

[1] 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).

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). They also found that common law countries have better law enforcement that protected investors against insiders' expropriation of the rights of minority shareholders. In addition, they found that more developed countries enforce laws better than less developed countries while controlling for differences in per capita income in each country. In a later study, La Porta *et al.* (1998) documented that common law countries provide better legal protection for shareholders than civil law countries. Legal protection includes both voting rights such as the one-share-one-vote rules and anti-director rights [2] 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 the establishment of effective board committees, ownership structures present different agency problems that are inherent in companies and thus need to be well understood in evaluating and understanding the role of the three board committees.

[2] According to La Porta *et al.* (1998), anti-director rights refer to rights of shareholders to object to management's proposal. One example is exemplified in the voting requirements for shareholders to show up in person at company meetings or can mail their proxy vote directly to the firm. Another one relates to mechanisms for more power for minority shareholders to put their representatives on the board e.g. cumulative voting for directors, proportional representation on the board etc.

2.3 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/or 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* (Gul, 1999). Dewenter and Warther (1998) compared dividend policies of US and Japanese firms. They found that Japanese firms, particularly keiretsu-member firms, i.e., firms that are closely held by large banks, faced less information asymmetry and fewer agency conflicts than US firms. This suggests that the interest of the management of Japanese firms are more in line with the shareholders.

One explanation for the above empirical results is the unique corporate landscape in Japan. It is not uncommon for banks to own over 20% of the outstanding common stock of nonfinancial firms in Japan. The concentrated ownership held by banks in Japan is associated with good corporate governance because they effectively act as "insiders" to firms. They have access to information about the firm's operations and have the ability to monitor and influence management (Prowse, 1990). Management is thus able to act independently whenever firm performance is satisfactory. However, in the event that firm performance is weak, bank intervention is expected (Aoki and Patrick, 1994; Berglof and Perotti, 1994). The banks themselves are influential shareholders who have reciprocal cross-shareholding ties between different companies. This is similar to the case in Germany, where it was found that banks exert a disciplinary function on management (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, namely Hong Kong, Indonesia, Japan, South Korea, Singapore, Malaysia, Philippines, Taiwan and Thailand for the year 1996. Using data obtained from the Worldscope data base, 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 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. A corporation at the base of the pyramid was controlled by another, which in turn was controlled by another, and so on with an ultimate owner at the end of the chain. The ultimate owners in their study were classified as family, state, widely held financial institutions, and widely held corporations. A company was classified as widely held if no ultimate owner controlled 20% or more of the shares in each link in the chain of control. Their study showed that, except for Japan, all the other countries 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".

2.3.1 Family Based System

Family control is a significant feature of Hong Kong listed companies with 66% being family owned (Claessens *et al*., 2000). 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 fifteen families in Hong Kong held shares with market capitalization accounting for 84% of 1996 Gross Domestic Product (SCMP, September 2000). It is not uncommon that the chief executive officer (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 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, in fact, 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. In Hong Kong, we can infer that the highly concentrated share ownership by families is associated with relatively poorer protection for minority shareholders. One way of mitigating the agency problems associated with concentrated family ownership such as the expropriation of minority interests is the presence of independent non-executive directors (INEDs) in the corporate governance regime.

2.3.2 Role of Independent Non-Executive Directors (INEDs)

There is a fundamental problem with concentration of control by substantial shareholders. It is expropriation of interests of outside or minority shareholders. Substantial shareholders try to treat themselves preferentially at the expense of other investors. The case is especially so when there is a substantial departure from the one-share-one-vote rule (Grossman and Hart, 1988). Morck *et al*. (1988) studied the relationship between cash flow ownership of the largest shareholders and firm profitability. They found that profitability increases for the range of ownership between 0 to 5 percent, and decreases above the 5% ownership limit. The quality of the INEDs is a key element not only for successful corporate governance practices, in general, but more specifically is indispensable for the effective functioning of the three board committees. The recommendation on the inclusion of quality INEDs on board committees is crucial to ensure that there is sufficient "check-and-balance" management. Klein (1998) showed a linkage between the composition of the boards of directors and firm productivity by examining the committee structures of boards for firms listed on the S&P 500. She found a positive relation between the percentage of outsiders on monitoring committees. This result suggests that outside directors increase productivity through better monitoring. The concept of the quality of INEDs becomes even more important and perhaps more difficult to implement within a family based corporate governance system. One problem is that family owned companies are more likely to appoint friends, distant relatives and the likes, as INEDs. In considering the role of the three board committees, it therefore behooves us to take into account both family ownership and the role of INEDs. Before we provide details on the roles and functions of the three board committees in the latter chapters, we discuss the legal and regulatory framework of corporate governance in Hong Kong with an emphasis on the voluntary disclosures as recommended by the different professional institutes in the next section.

2.4 Legal and Regulatory Framework of Corporate Governance in Hong Kong

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). The following sections briefly discuss these requirements.

2.4.1 Companies Ordinance and Securities Ordinance

Companies Ordinance (Cap. 32) spells out the basic requirement that financial statements of Hong Kong-incorporated companies have to be prepared and audited. The powers, duties and conduct of company directors as well as the disclosure requirements (such as the Tenth Schedule) are stated in the Ordinance. However, there are no specific requirements in the Companies Ordinance concerning the audit, remuneration or nomination committees.

Corporate governance of Hong Kong companies is also administered by the Securities and Futures Commission (SFC). For example, the Securities (Disclosure of Interests) Ordinance (Cap. 396) administered by SFC requires the directors and the major shareholders of the company to 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 SFC has unveiled a consultation paper on the 'Composite Securities and

Futures Bill' on 2nd April 2000. The bill consolidates all the ten securities and futures related ordinances into a single law, and it recommends that the investigative power for SFC should be widened, including their power to take civil or criminal action against market malpractice such as insider trading, as well as the rights of the investors to sue over misleading information. The aim of the bill is to establish a regulatory framework which meets with international best practice designed to enhance market efficiency and transparency. However, all of the above Ordinances are silent on the board committees.

2.4.2 Main Board Listing Rules

The Main Board Listing Rules stipulate a requirement of the appointment of at least two INEDs for each listed company since 1994. The Code of Best Practice, incorporated as an appendix to the Stock Exchange of Hong Kong Listing Rules (SEHK, 1998), contains a number of requirements concerning audit committees. Companies listed on the Main Board of the SEHK are encouraged to follow these guidelines. The Code requires listed issuers to report in their interim and annual reports their compliance with the recommendation of setting up an audit committee or the reasons for any non-compliance for accounting periods commencing on or after 1st January 1999. The principal duties of the audit committee "should be the review and supervision of the issuer's financial reporting process and internal controls" (SEHK, 1998). The audit committee should comprise of at least two non-executive directors (NEDs) with a majority of them being independent. Appendix 14 of the Code of Best Practice refers to the Hong Kong Society of Accountants' (HKSA, 1997b) "A Guide for the Formation of An Audit Committee" for detailed requirements on audit committees. However, remuneration and nomination committees are neither required nor recommended as best practice in Hong Kong.

2.4.3 Growth Enterprise Market (GEM) Listing Rules

The GEM Listing Rules require the listed issuers to set up an audit committee comprising of at least two directors, the majority of whom, including the chairman, should be INEDs. This differs from the Main Board Listing Rules, where issuers are encouraged, but not obliged to establish an audit committee. Remuneration and nomination committees are also not required under the GEM Listing Rules.

2.4.4 Hong Kong Monetary Authority (HKMA)

The statutory guideline in section 7(3) of the Banking Ordinance (Cap. 155) issued by the HKMA in September 2001 on Corporate Governance sets out the minimum corporate governance standards that locally incorporated authorized institutions (AIs) have to 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. Each bank should establish an audit committee with written terms of reference specifying its authorities and duties. The audit committee should be constituted with NEDs, the majority of whom should be independent. The AIs are recommended to establish remuneration and nomination committees. The remuneration committee should make recommendations to the board on the AI's remuneration policy and specific remuneration packages for each of the senior executives and key personnel. The nomination committee, comprising of a majority of NEDs, is responsible for making recommendations to the board on all new appointments of directors[3] and senior executives.

The above summarizes the regulatory requirements in Hong Kong with respect to the three board committees including the requirements for INEDs. Voluntary recommendations on corporate governance from professional institutes such as the HKSA and Hong Kong Institute of Directors (HKIoD) are discussed below.

2.4.5 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 six publications on additional disclosures on the three board committees 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), "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 boards 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 audit committees with defined functions in the Code of Best Practice of the SEHK Listing Rules. The HKSA

[3] This could include NEDs and INEDs as well.

considered that nomination and remuneration committees in the mid 1990s were not suitable for implementation in Hong Kong after reviewing the corporate governance climate in Hong Kong and the international best practice at that time.

The Second Report (HKSA, 1997a) provided further recommendations on board membership, finance directors and chief financial officers. It also reported on a survey which showed that there were only 2% of listed companies in Hong Kong disclosed the existence of an audit committee and that the levels of disclosures on directors were not satisfactory. It concluded that there is a gap on disclosures of family relationships between directors and whether the director is employed by or is a director of a substantial shareholder[4]. Additional disclosures on executive directors, NEDs, and INEDs and fees paid to INEDs were recommended. It was also recommended that details of family relationships between directors and substantial shareholders who are not directors be disclosed.

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. Since the Code of Best Practice of the SEHK (1998) Listing Rules only requires listed issuers to "establish an audit committee with written terms of reference which deal clearly with its authority and duties", this Guide provided more practical guidance for companies. It recommended that written terms of references covering the four aspects of responsibilities, namely financial and other reporting, internal control, internal and

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

external audit and any other needs of management be stated explicitly. Its major responsibility should include the review and supervision of the company's financial reporting process and internal controls, paying particular attention to the disclosure of related party transactions and any unusual items. Members of the audit committee should ensure that an adequate internal control environment is established and maintained. This would assist members assess the key areas of risk and its associated uncertainties. The audit committee should consist of a minimum of three NEDs with the majority being independent. This was a deliberate attempt by the HKSA to emphasize the importance of independence and the quality of members of the audit committee. For example, the HKSA (1997b, p. 4) emphasized that "the committee will only be as good as the people in them". The Guide (HKSA, 1997b) spelled out that the committee should consist of members who have some broad business background as well as the necessary skills and experience to carry out their duties and responsibilities. It also recommended that the chairman of the audit committee be appointed by the board with the company secretary acting as secretary of the committee. Disclosures on the composition, work and frequency of meetings of the audit committee should also be made in the annual report. It also suggested that the committee report to the board regularly on matters within its terms of reference. The communication should include recommendations on the appointment of the external auditor, conclusions on discussions with the external auditor on the audit process, conclusions on the internal audit function and the efficacy of the company's internal control system.

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. Their report (HKSA, 1999) "Directors' Remuneration-Recommendation for Enhanced Transparency and Accountability" recommended that there should be sufficient disclosure of directors' remuneration in order for their performance to be assessed. To this end, boards should establish a remuneration committee, with the majority of members being INEDs, to recommend the remuneration for executive directors. This requirement was recommended for incorporation in the Code of Best Practice of the SEHK Listing Rules. It also recommended that a statement on the company's policy on executive directors' remuneration and share options be disclosed along with additional disclosures on benefits for NEDs. Two separate categories of remuneration should be disclosed, namely performance-based and non-performance-based components to enable investors to assess the pay-performance linkage. Given the prevalence of share options as a key element of directors' remuneration, more details should be provided, such as the disclosure of aggregate value realized by directors on the exercise of options, the aggregate value of in-the-money, unexercised options at the end of the fiscal year and the aggregate gains made by the directors on the exercise of options.

A comprehensive Guide entitled "Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement" was issued by the HKSA (2001). 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 SEHK 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. Listed companies and public corporations were encouraged to include a statement on corporate governance 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 audit committee, and suggested disclosure on the independence and quality of its members. It recommended that the role and function of the audit committee be included in the corporate governance statement, whereas the composition of the committee should be included in the Directors' Report. A report of the work done and significant issues addressed by the audit committee on the review of financial reports and internal controls was also recommended. In order to enhance the transparency and independence of the external auditor, non-audit fees paid to them should also be disclosed.

Consistent with HKSA's earlier recommendations, this report continued to emphasize the importance of setting up remuneration committees comprised wholly or mainly of NEDs to make recommendations to the board regarding the remuneration of executive directors. The composition, role and functioning of the remuneration committee should be disclosed. The disclosure of the analysis of directors' remuneration between "performance-based" and "non-performance-based" compensation and the remuneration policy of NEDs continued to be emphasized. Disclosures of the analysis of individual directors' remuneration including basic salaries, housing allowances, other allowances and benefits in kind were also encouraged. Further, the report also recommended that directors' share options including their individual benefits derived from the aggregate value realised on the exercised options during the year and the closing market price of shares at the balance sheet date be disclosed.

In order to assess the effectiveness of the board of directors, additional information was recommended to be disclosed in the corporate governance statement, including the responsibilities of the board, the number of board meetings held, the attendance of individual directors and the contribution and role of NEDs. The HKSA's (2001) Guide made no recommendations on the nomination committee.

In February 2002, the Audit Committee Guide Review Task Force of the HKSA Corporate Governance Committee published "A Guide For Effective Audit Committees". This update to "A Guide for the Formation of an Audit Committee" issued in December 1997 places more emphasis on the effectiveness of the audit committee, and is intended to provide more guidance than the first publication with respect to how an audit committee should fulfill its role and responsibilities. There are several new recommendations in this Guide. They are (HKSA, 2002, pp. 2-3):

- "Audit Committee meetings should be adequately planned and prepared for, held at appropriate time and attended by relevant persons;
- The Audit Committee should understand the roles and responsibilities of parties involved in the financial reporting and audit process and should have good and independent communications with the management and the internal auditors as well as the external auditors;
- The Audit Committee should provide regular and informative reporting to the Board, and;
- A statement on corporate governance should be disclosed in the annual report which includes, inter alia, the composition, role (including reference to the frequency of its meetings), function and activities of the Audit Committee."

Although the recommendations are intended to be a broad outline, they appear to enhance the effectiveness of the audit committee in two ways. First, they recommend increased communication, which should have the effect of ensuring that everyone involved with the process knows and understands their roles and responsibilities. Second, the recommendation for disclosure increases transparency of the audit committee, which should lead to better monitoring. This Guide also spells out five guiding principles for effective audit committees[5] (HKSA, 2002, pp. 4-5):

- Oversight role – the audit committee should understand the financial reporting and audit process and the roles and responsibilities of all parties involved. It can then ensure that the process is operating effectively and all parties are accountable for their work;

- Independent communication with internal audit – appropriate channels of communication must exist between the internal auditor and the audit committee, independent of management. The audit committee and the internal and external auditors should also be able to meet independently of management;

- Independent communication with external auditor – the audit committee should be able to communicate with the external auditor independently of management. The audit committee should encourage objective and critical analysis of management and internal audit;

- Discussions with key parties on issues relating to judgments and quality – the audit committee must be able to have candid discussions with all parties to ensure that it is receiving quality information, and;

- Quality of membership – The board must ensure that there are systems in place to select and retain audit committee members that are dedicated and willing to devote the necessary time, and possess the diligence and knowledge required to contribute meaningfully to the committee.

Again, these recommendations focus on communication as being an important factor in the effectiveness of audit committees.

With respect to structure, the new Guide recommends that the chairman of the audit committee be an INED. This recommendation for an independent chairman is new, and is consistent with the emphasis on the chairman fulfilling a vital role in the success of audit committees. A description of duties the chairman should perform (HKSA, 2002, p. 8) is added. Specifically, the chairman should:

[5] These principles are adapted from the recommendations of the "Blue Ribbon Committee of Improving the Effectiveness of Corporate Audit Committees" published by the New York Stock Exchange and the National Association of Securities Dealers (1999).

- Maintain close contact with the chairman of the board to ensure the board is aware of the audit committee's activities;
- Establish a good working relationship with the finance director to enhance information exchange;
- Maintain direct contact with the external auditors, keeping informed of the progress of the audit and any findings or action required;
- Ensure a suitable level of communication between the internal auditor and the audit committee;
- Have a clear understanding of the audit committee's authority, responsibility, and activities, and;
- Monitor the audit committee to ensure that it is fulfilling its role as described in its terms of reference.

Another significant difference is a more formal recognition of risk management. A specific requirement for the audit committee is to ensure that management has systematically identified key areas of risk and maintained an appropriate control environment. The audit committee must understand the risks and uncertainties the company faces and assess whether the internal controls in place are adequate to ensure compliance with management policies, safeguarding of assets, prevention and detection of fraud and error, and accuracy and completeness of financial records and information.

Finally, in connection with the statement of corporate governance referred to earlier, the new Guide has additional recommendations on disclosures. In addition to previously described disclosures, the report should state (HKSA, 2002, p. 16):

- "The role and function of the audit committee;
- The work of the audit committee undertaken during the financial year, significant issues addressed including in respect of the review of financial reports, internal control and risk management, the conclusions and key findings, and;
- A statement on the independence of the audit committee".

In conclusion, the new Guide attempts to increase effectiveness of the audit committee primarily through enhancing transparency (via increased disclosure) and improving communication between all parties involved in the audit and internal controls/risk management process.

2.4.6 Hong Kong Institute of Directors (HKIoD)

In an attempt to enhance corporate governance of listed companies, the HKIoD issued a guideline for INEDs in 2000 to clarify their roles and duties. It suggested that "a NED should have no executive or management responsibility in the company" (HKIoD, 2000). The NED is deemed to be independent of management if he/she does not receive any benefits from the company other than his/her fees as a director. This is similar to the SEHK Listing Rules. Apart from supervising management and providing advice on the 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 serves to assist INEDs to understand their roles and functions in the context of the three board committees.

2.5 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 with a consultation paper published in July 2001. 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 the current one, which focuses on the three board committees. Results and recommendations of the review are expected to lead to reforms in corporate governance in Hong Kong.

2.6 Summary

This chapter began with a review of the two key elements of corporate governance practices, namely legal systems and ownership structure. Prior studies found that common law systems are by nature more conducive to investor protection and better law enforcement. Three corporate governance systems classified by ownership structure, namely equity market based system, bank lending system and family based system have been discussed. Hong Kong's family based ownership structure embedded in a common law legal system presents a different set of agency problems that form the basis for considering the roles and functions of the three board committees. A review of the legal and regulatory framework of corporate governance relating to the three board committees in Hong Kong is being conducted. Voluntary recommendations from the professional institutes on the three board committees are also discussed. The next chapter will review the methodology and framework for examining the roles and functions of the three board committees.

CHAPTER 3 ANALYTICAL FRAMEWORK AND METHODOLOGY

3.1 Introduction

In this chapter, we present a framework to facilitate our analysis and understanding of how the three board committees both individually and taken as a whole could be the main mechanism for Hong Kong's corporate governance regime. The chapter ends with an outline of our approach and methodology adopted in this study.

3.2 Analytical Framework

The establishment of the three board committees offers a way to overcome the problems arising from the separation of ownership from control in modern corporations and the difficulties in designing contracts to monitor the agents to ensure that they act in the interest of the principals. The extant literature clearly documents that differences in the legal and institutional environment including patterns in ownership structure also affect the extent and nature of the agency and incomplete contracting problems that exist in any one jurisdiction (La Porta *et al*., 1998). The legal and institutional environment in Hong Kong is characterized by the common law system and the dominance of family owned listed companies. These characteristics form the basis for understanding effective board committees. Apart from considering each committee individually in its roles and functions in each of the following three chapters, a common element that straddles these three committees is the quality of independent non-executive directors (INEDs). It is thus necessary to understand and appreciate the important role of the INED in each of these committees. In addition, the three board committees should be considered in aggregate as part of the overall corporate governance mechanism in any organization. This framework will form the basis for our analysis that follows in the following chapters.

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 specifies 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 these three committees could be adopted for good corporate governance in Hong Kong.

3.3 Methodology

The overall objective of this study is to critically review the roles and functions of audit, nomination and remuneration committees with a view to providing recommendations on appropriate regulations and/or policies for corporate governance reform in Hong Kong. More specifically, the detailed objectives of this study are:

- To obtain a better understanding of the roles and functions of the three committees.
- To ascertain how these committees can be effective in Hong Kong's unique institutional framework.
- To obtain empirical evidence relating to possible linkages between these committees and financial disclosure, corporate and market performance.
- To review the literature on the effectiveness of non-executive directors (NEDs) and INEDs in the board committees.

3.3.1 Comprehensive Literature Review

We conducted a comprehensive review of academic literature and board practice surveys on the roles and functions of audit, nomination and remuneration committees in the UK, the USA, Australia, Canada, Malaysia, Taiwan, Singapore 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 on the above committees has been conducted. A review of the literature focusing on the effectiveness of these three committees including NEDs and INEDs is 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 (additional details are provided in the bibliography sections):

3.3.1.1 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

3.3.1.2 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)
- Greenbury Report (July 1995)
- Hampel Report (January 1998)
- OECD Principles of Corporate Governance (April 1999)
- Blue Ribbon Committee Report (1999)
- General Motors Corporation Corporate Governance Guidelines (1994)

3.3.1.3 Professional literature and board practices surveys/studies

To appreciate the extent of enforcement and disclosures on the three committees, we review the surveys conducted by private sector organizations. They include:

- The 27th Annual Board of Directors Study conducted by Korn/Ferry International (2000)

- Audit Committees – Good Practices for Meeting Market Expectations published by PricewaterhouseCoopers (1999)

- 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)

3.3.2 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, Canada, Malaysia. A list of the interviewees is provided in Appendix 1. The objective of conducting in-depth interviews was to ascertain their latest views and comments on the key factors that contribute to effective board committees in their respective countries with possible applications for Hong Kong. The most up-to-date developments with respect to their country's experience were also obtained in the in-depth interviews. Attention was also given as to whether these committees should be mandatory or voluntary for listed companies in Hong Kong. Findings from the in-depth interviews are summarized in Chapter 7.

3.3.3 Questionnaire Survey

Based on the literature review, a questionnaire was developed. The objectives of the questionnaire survey are twofold. Firstly, since the objective of this study is to critically assess the roles and functions of audit, remuneration and nomination committee, i.e., the three board committees, it is important to gather the opinion of the chief executive officers (CEOs) or chairmen of Hong Kong listed companies towards the effectiveness of the three board committees. Secondly, it is also important to assess their views on the alternative arrangements that can promote good corporate governance practices in Hong Kong. The questionnaire is attached in Appendix 2. We have selected the CEOs or chairmen of the Hang Seng 100 companies in Hong Kong for the year 1999 as our sample respondents.

3.3.4 Empirical Tests

In order to provide some empirical insights on the effectiveness of the board committees, relevant corporate governance information from the annual reports of Hong Kong listed companies in 1999 was collected. Information for the variables collected are listed below:

CEO	:	whether the role of CEO and chairman of the board is separated
ED	:	number of executive directors on the board
NED	:	number of NEDs on the board
INED	:	number of INEDs on the board
INED Qual	:	number of other offices or directorships the INEDs hold
FAM	:	number of family members on the board
FAM SH	:	number of shares owned by family members of the board
AC	:	existence of an audit committee
ACNMEM	:	number of members in the audit committee
ACNINED	:	number of INEDs in the audit committee
ACNNED	:	number of NEDs in the audit committee
ACMTG	:	number of audit committee meetings held during the year
TR	:	whether the audit committee is established according to the terms of reference set out in the HKSA Guideline
RC	:	existence of remuneration committee
RCNMEM	:	number of members in the remuneration committee
RCNINED	:	number of INEDs in the remuneration committee
RCNNED	:	number of NEDs in the remuneration committee
RCMTG	:	number of remuneration committee meetings held during the year
NC	:	existence of nomination committee
NCNMEM	:	number of members in the nomination committee
NCNINED	:	number of INEDs in the nomination committee
NCNNED	:	number of NEDs in the nomination committee
NCMTG	:	number of nomination committee meetings held during the year

There were a total of 701 listed companies in Hong Kong as at 31 December 1999. However, financial information available in the Company Analysis database limited our sample to 607. Our sample was further reduced to 566 due to missing annual reports. The data on the above is summarized in Chapter 7. We have also compared the data collected for the Hang Seng 100 companies in 1999 with that in 1998[1] and results are presented in Chapter 7.

Statistical tools were then employed to analyze the data obtained from the annual reports and Company Analysis database on the possible linkages between relevant corporate governance variables relating to the three board committees and performance.

3.4 Summary

To achieve the objective of this study, four methods were outlined. They are comprehensive literature review, in-depth interviews, questionnaire survey and empirical tests of data obtained from Hong Kong annual reports. The comprehensive literature review covered the roles and functions of the three committees 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. The questionnaire survey was used to gather the opinion of the CEOs or chairmen of Hong Kong Hang Seng 100 companies towards the effectiveness of the three board committees and the alternative arrangements that can promote good corporate

[1] Relevant data in 1998 is extracted from Tsui and Gul (2000).

governance practices. Finally, empirical tests were conducted based on the collection of relevant corporate governance information disclosed in the annual reports. These three methods were expected to provide insights on the effectiveness of the board committees for Hong Kong.

CHAPTER 4 AUDIT COMMITTEES

4.1 Introduction

The audit committee is one of the most important developments in recent attempts to improve corporate governance. This chapter first reviews the key international corporate governance reports on audit committees. This is followed by a review of the role and functions, composition, disclosure issues and benefits of audit committees. The chapter also provides an overview of the legal and regulatory framework in the different countries, namely the UK, the USA, Australia, Canada, Malaysia, Taiwan and Singapore, followed by surveys on the extent of enforcement and disclosures. The next section reviews the literature on the effectiveness of audit committees. A summary of our recommendations is provided in the last section.

4.2 Key International Corporate Governance Reports

In this section, we summarize the recommendations of the key committees and organizations that consider issues relating to the audit committee. Some of the reports included are silent on the audit committee but make broad recommendations on other corporate governance issues which indirectly affect the role and functions of the audit committee. The reports/guidelines considered 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 Corporate Governance Guidelines (GMC Guidelines, 1994)
- "Directors Remuneration: Report of a Study Group chaired by Sir Richard Greenbury" (Greenbury Report, 1995)

- "Committee on Corporate Governance" (Hampel Report, 1998)
- "OECD Principles of Corporate Governance" (OECD, 1999)
- "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" (Blue Ribbon Committee Report, 1999)

The codification of principles of corporate governance began to appear after a series of unexpected failures of major companies in the UK in the 1980's such as Maxwell, Pollypeck and BCCI. The Financial Reporting Council, the London Stock Exchange, and the accountancy profession, under the chairmanship of Sir Adrian Cadbury, formed a committee in England to address the lack of a uniform code of corporate governance. The report of this committee, commonly referred to as the Cadbury Report, was the first private sector initiative to develop a corporate governance code of best practices that formed the basis of development of corporate governance in the UK.

The Cadbury Report (Cadbury), published in 1992, focused on the financial aspects of corporate governance such as financial reporting, and as such reviewed primarily the roles of boards 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 (Dey), published in Canada in 1994 was one of the first corporate governance reports that provided a full set of corporate governance guidelines that could be used as a requirement for a listed company on a stock exchange. Dey recommended that its corporate governance guidelines be adopted by the Toronto Stock Exchange (TSE), and that all TSE-listed companies provide an explanation of the differences between their own corporate governance approach and the Dey guidelines. This requirement for companies to explicitly address their corporate governance approach with reference to the guidelines effectively brought corporate governance issues into the public eye, and put pressure on companies to improve their own corporate governance practice. Since the publication of this report, there have been many similar reports in other jurisdictions such as the Bosch Report (1995) in Australia, Vienot Report (1995) in France, King Report (1994) in South Africa, and Peters Code (1997) in Holland.

The General Motors Corporation (GMC) in the USA, under growing criticism from shareholders for poor corporate performance and questionable board practices, introduced its own corporate governance guidelines in 1994 (GMC Guidelines, 1994). This self-imposed set of guidelines was developed in consultation with the board, shareholders, and corporate governance activists. The guidelines were welcomed by the industry and particularly institutional investors such as the California Public Employees' Retirement System (CalPERS), which challenged other large corporations to undertake a similar initiative. GMC Guidelines have since become a benchmark for individual corporate governance structures in the USA.

Fired by media and public disquiet over the remuneration of directors, particularly in some poor performing and privatized utilities, the Greenbury Report (Greenbury) on directors' remuneration was published in the UK in 1995. The Greenbury Committee was formed to review and identify good practices and develop a code of best practice for directors' remuneration. This report did not, however, have the same scope as Cadbury. It focused specifically on directors' remuneration policy and the role and functions of a remuneration committee.

In an effort to combine the recommendations of Cadbury and Greenbury, as well as to address some areas that these two reports did not cover, the Hampel Committee issued its final report in January in 1998. The Hampel Report (Hampel) examined the extent of the implementation of the recommendations of Cadbury and Greenbury. It also provided more explicit recommendations than the two previous reports in some areas, notably with regard to remuneration policy, accountability and audit. Hampel's focus on corporate governance was to enhance shareholders' long-term value. The report brought attention to the fact that "box ticking" is a serious issue and that form over substance would always remain a potential problem. A listed company could have a record of 100% compliance on paper but be the next corporate disaster. In the view of the committee:

"The true safeguard for good corporate governance lies in the application of informed and independent judgment by experienced and qualified individuals – executives and NEDs, shareholders and auditors."(Hampel Report, 1998, para 1.14).

Thus, good corporate governance goes beyond a matter of prescribing particular corporate structures and complying with a number of hard and fast rules. It 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 pay attention to directors' explanations and judge them on their merits.

Following the three key corporate governance reports in the UK, two other significant reports were published in 1999, namely the "OECD Principles of Corporate Governance" (OECD, 1999) and the "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" (Blue Ribbon Committee Report (Blue Ribbon), 1999). The OECD (1999) was published based on the findings of the Ad Hoc Task Force on Corporate Governance, and was intended to be a non-binding set of corporate governance principles for listed companies of OECD member countries. Blue Ribbon contained recommendations regarding the improvement of audit committees in listed companies in the USA.

In late November 2001, the Pacific Economic Cooperation Council (PECC) released the "Guidelines for Good Corporate Governance Practice". 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 Committees[1]. Though the OECD principles did not directly refer to board committees, PECC had specific recommendations on audit committees, and recommended that other committees (i.e., remuneration and nomination committees) consist mainly of independent non-executive directors (INEDs). We will review specific PECC recommendations that differ from other codes of best practice later in this chapter.

[1] 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, Vietnam, France (Pacific Territories), and Mongolia.

In general, these various committees and organizations made several recommendations and the following section attempts to crystallize the main issues regarding the functions of the audit committee and the role of the non-executive directors (NEDs) and inside directors as they relate to the audit committee.

4.2.1 Non-Executive Directors (NEDs)

An underlying theme that kept emerging in all the reports is the important role that NEDs play in bringing an independent voice to boards and in particular to committees. 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 examined the role of the NEDs in terms of accountability, Hampel adopted a broader "business-growing perspective". In essence, this meant that NEDs can add more value to the company and ultimately shareholders' wealth. Hampel suggested that more attention be paid to other characteristics of NEDs such as their diversity of backgrounds for bringing special expertise or experience to the company.

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

Experience since Cadbury has indicated that it is more difficult for smaller companies to find qualified independent non-executive directors (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 must be given 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 shareholders other than the significant shareholder.

4.2.2 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 chief executive officer (CEO), without fear of any reprisals.

A review of the reports suggests clearly that the success of the various committees must be seen as dependent on quality INEDs. There is also the view that NEDs should have expertise and experience and to this extent they can add value to a company. We now turn to the recommendations from key reports on audit committees.

4.2.3 Recommendations from Key Reports

Cadbury recommended the formation of an audit committee and Hampel explicitly recommended that guidelines on audit committees should be applicable for all companies regardless of size.

4.2.3.1 Membership

Cadbury suggested that the audit committee should consist of a minimum of three members. Further, the committee should consist solely of NEDs, with the majority of them being INEDs. Blue Ribbon went further than Cadbury and recommended that membership be confined solely to INEDs, similar to the GMC Guidelines. Dey also recommended that audit committee membership be confined solely to outside directors[2]. The PECC recommended that the audit committee consists mainly of INEDs.

Blue Ribbon was specific about the qualifications of the directors that should serve on the audit committee. It recommended that at least one member of the committee have *financial expertise*, while the others should be *financially literate*. Financially literate is defined by Blue Ribbon as having the ability to ask suitable questions and evaluate

[2] This suggests that the chairman should also be an outside director.

the responses, supplemented by a basic foundation of financial literacy that could be provided through an in-house training program. Financial expertise is acquired through past employment in a finance or accounting role, a professional certification in accounting, or some other relevant experience or background profile.

Blue Ribbon pointed out that all members of the audit committee should possess characteristics, namely integrity, accountability, a history of achievement, an ability to ask tough questions, combined with core competencies, such as financial literacy, experience with organizations, leadership and strategic thinking.

4.2.3.2 Meetings

Cadbury recommended that the audit committee should normally meet twice per year. The external auditor and finance director should attend these meetings. Any other board members who wish to attend should be permitted although the committee should be able to meet with the auditors at least once a year without any executive directors present. It may be appropriate to invite outsiders to attend a meeting if they have relevant skills and expertise that would otherwise not be found in the committee. GMC Guidelines recommended that the chairman of the audit committee set the number, agenda and length of the committee meetings. The PECC guidelines recommended the audit committees meet at least three times a year.

4.2.3.3 Duties and responsibilities

Blue Ribbon recommended that the audit committee have a written terms of reference. The audit committee's role flows directly from the board's oversight function, and there should be written documentation of this delegated responsibility in the form of a formal charter. The charter should describe the audit committee's role, responsibility, and processes. Whether a formal charter has been adopted and whether or not the terms of the charter were met should be disclosed at each annual general meeting. Dey also recommended that the roles and responsibilities be explicitly defined in order to provide adequate guidance to audit committee members. Appendix 3 provides an example of a charter.

Cadbury and Blue Ribbon specified a number of duties that the audit committee should fulfill. The duties fall into three main areas, namely financial accounting, internal controls, and external auditor relationship. These are discussed in detail in the next section. Blue Ribbon also pointed out that the audit committee must take necessary steps to evaluate and ensure the independence of the external auditor. Dey noted that the audit committee should have oversight responsibility for management reporting on internal controls. The recommendations of the PECC guidelines also reflected recommendations of earlier reports, but they also added that the audit committee should be a channel of communication between the board, internal auditors and general counsel.

As pointed out earlier, the application of corporate governance mechanisms must be viewed in terms of the legal and regulatory framework that exist in any one jurisdiction. This certainly also applies to the audit committee.

A summary of the detailed recommendations of these key corporate governance reports on audit committees is appended in Appendix 4a.

4.3 Role and Functions

Audit committees are expected to assist the board of directors to monitor and oversee the financial reporting process, internal controls including the internal audit function and the external audit function. It is a key corporate governance committee and may be described as the ultimate monitoring mechanism of the financial reporting process. The key role and functions of the audit committee normally cover the following four aspects namely:

4.3.1 Financial Reporting

The audit committee is responsible for reviewing financial statements to ensure their completeness, accuracy and fairness. There are several major areas that this responsibility encompasses (HKSA, 1997b):

- Significant accounting policies – the committee should consider whether accounting policies used in the company's financial reporting are in accordance with relevant best practices or recommendations in their jurisdiction. Where alternative policies are available, the committee should assess whether the particular policy selected is the most appropriate given the circumstances.

- Judgmental issues and estimates – there are often areas in financial reporting where exact numbers are not available, and estimates must be made. The audit committee should review such issues and estimates to ensure that the assumptions are reasonable, and whether alternative methods of calculation or estimation may be appropriate.

- Disclosures – the committee should consider whether all material items have been disclosed, and whether the disclosure is a fair view of the issues concerned.

- Inconsistencies – the audit committee should review all other statements and reports such as narratives (i.e., the chairman's report) to ensure that there is consistency with the financial statements.

- Unusual items – any material items which are outside the normal range of operations should be considered unusual, and the audit committee should ensure that they are given appropriate disclosure and prominence in the financial statements.

- Audit adjustments –significant audit adjustments should be reviewed.
- Auditor concerns – the committee should review any items that have resulted in disputes or discussions between management and auditors.

4.3.2 Internal Controls and Risk Management

Internal controls generally refer to controls that enhance the effectiveness and efficiency of the company's business, the reliability of financial reporting, and compliance with rules and regulations. In order to understand and assess the control environment, the audit committee must have a thorough understanding of the way the company operates, the industry it operates in, and all rules and regulations, both external and internal, that apply to its operations. The audit committee should review all reports from internal and external auditors, as well as minutes from meetings with the external auditor and management to review the findings of the auditor's work. There is an increasing emphasis on risk management. This involves ensuring that significant risk areas have been identified and that suitable internal controls (including internal audits, where appropriate) are implemented and enforced[3].

4.3.3 External Audit

The audit committee must play an important role in overseeing the external audit. To ensure that the external auditor remains independent, the audit committee should review the balance between audit and non-audit work performed by the external auditor. In particular, non-audit services such as the provision of management advisory services should be viewed with caution since it could affect third party

[3] In "A Guide for Effective Audit Committees" (HKSA, 2002), published by the Hong Kong Society of Accountants, there is an explicit recommendation that audit committees "obtain assurance that management systematically identifies key areas of risk and that an appropriate control environment is enforced and maintained". In order to do this, committee members must have adequate knowledge of the issues involved to challenge whether management has considered all associated risks and uncertainties.

perceptions of auditor independence[4]. The audit committee can also monitor the quality of work done, and assess whether the company is getting an appropriate level of service for the audit fees paid. The audit committee should also review and ensure that all key risk areas are covered by the external auditor. This would likely be achieved through a discussion of the current audit plans with the external auditor.

4.3.4 Other Requirements

The audit committee may be directed by the board to assume responsibilities beyond those discussed above. The additional responsibilities may vary from company to company, and they may be formalized in the terms of reference or be assigned on an *ad hoc* basis. These responsibilities may include compliance with listing rules or other industry or legal regulations, and investigation into stakeholder or community concerns.

4.4 Composition

The audit committee should be formally established with a written charter describing its terms of reference. It should have a minimum number of three members who are all NEDs, with the majority being independent and chaired by an INED. There are varying degrees of recommendations on the qualifications of members, but it is generally agreed that audit committee members should have a sufficient level of financial knowledge and experience to competently carry out their duties as members of the audit committee.

[4] Gul and Tsui (2001) in a study of Australian companies showed that investors attached lower levels of credibility to earnings of firms with higher non-audit services fees relative to audit fees. In some cases, the non-audit services fees were three times the audit fees.

4.5 Disclosures

Since the audit committee is established by the board and held accountable to the shareholders, it should have a formal written terms of reference that includes a clear description of the lines of communication from the committee to the board and the shareholders. Regular reports to the board could include the following:

- Conclusions on final discussions with the external auditors regarding the results of their review of the financial statements.

- Recommendations on the appointment of the external auditor, including discussions of fees and adequacy of services.

- Conclusions on the internal audit findings.

- Assessment of the adequacy of internal controls.

Reporting to shareholders could be achieved through disclosures in the Annual Report. These disclosures could include:

- Composition of the audit committee.
- Extent of work performed by the audit committee.
- Frequency of audit committee meetings.

4.6 Benefits

Cadbury provided a list of the potential benefits that is associated with the audit committee. They include:

- Improvement on the quality of financial reporting.

- Reduction of the opportunity for fraud through a climate of discipline and control.

- Creation of the environment for NEDs to contribute independent judgment.

- Support for the finance director.

- Provision for a channel of communication for the external auditor leading to a strengthening of independence of the external audit.

- Establishment of a framework for the external auditor to act independently.
- Strengthening the position of the internal audit function by increasing its level of independence.
- Increase in public confidence on the credibility of the financial statements and enhance the board's accountability to increase shareholders' values.

The above provides a general review of the role and functions of audit committees including a discussion of the constitution, size and qualification of its members, as well as communication links between the board and shareholders. At this stage, it is worthwhile to point out that the specific functions, size and composition of audit committees should be tailored to fit the size of the organization. The fully operational audit committee envisaged in Cadbury could perhaps be too cumbersome for small companies. Indeed, it may be necessary to consider whether audit committees are at all necessary for such small companies.

The following section outlines an overview of the legal and regulatory framework in different jurisdictions, namely the UK, the USA, Australia, Canada, Malaysia, Taiwan and Singapore and link these to the functions of audit committees. Section 4.14 summarizes survey findings in some of the above jurisdictions.

4.7 The United Kingdom

4.7.1 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 pieces of legislation governing companies are the Companies Act (1985) which applies to companies, and the Financial Services and Markets Act (2000) which is responsible for regulating deposit taking, insurance and investment businesses. Over the years, there have been many additions and amendments to existing laws, and the legal system has become quite complex. Until the recent establishment of the Company Law Review Steering Group (1998), it appears that no attempts have been made to streamline the structure or remove obsolete segments.

In March 1998, the Department of Trade and Industry (DTI), which is responsible for company law, insolvency, and investigation and prosecution under the Companies Act, launched a wide-ranging review of company law. The independent steering group was appointed to carry out the review and published a series of consultation documents with a final report in July 2001. The review contained a number of significant recommendations concerning corporate governance of which the following recommendations concerned directors:

- a statutory statement on directors' duties[5];
- clarification of the Companies Act dealing with directors' conflicts of interest;
- clarification of the common law where it concerns attribution, contributory negligence and contribution to ensure that companies also bear some responsibilities when their directors are at fault;
- a limit on the length of director contracts[6]; 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:

- measures to ensure the "real" or "beneficial" shareholders can exercise their rights;

[5] This should include a clear statement on directors' duties, an update of laws to reflect modern business practice and standards of behaviour, and reference to directors' duty to consider the importance of stakeholders.

[6] Recommended contracts of employment should be limited to three years for new appointments and one year for subsequent contracts, unless otherwise authorized by shareholders.

- requirement to circulate members' resolutions with AGM documents free of charge; and,
- greater transparency of how institutional investors exercise their votes.

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

- companies be required to publish an operating and financial review 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;
- 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 far less prescriptive than in the USA. There are, however, a number of rules that companies in the UK have to follow. Over the past decade, a number of reports on corporate governance discussed earlier have been published, including Cadbury, Greenbury, and Hampel reports. These reports all made recommendations on what the committee members believed should be adopted as corporate governance best practice in the UK. 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 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. Alongside developments on these fronts came the development of 'soft law' under the umbrella of corporate governance by private sector initiatives which have been discussed in the above section.

Publicly listed companies in the UK are traded on the London Stock Exchange (LSE). In keeping with the balanced[7] UK approach to corporate governance, the Listing Rules which are published under the authority of the Financial Services and Markets Act (2000) by the UK Listing Authority do not have extensive rules for listed companies. The Combined Code has been appended to, but does not form part of, the Listing Rules. In addition to the preamble, the Code comprises 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))

[7] Section 3.2 provides the explanation for different approaches to corporate governance.

- "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."(12.43A(b))

The company's auditors are required to review such compliance statements before publication in relation to certain Code provisions.

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, while at the same time 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.

4.7.2 Accountability, Internal Control and Audit Committees

There are three principles stipulated in the Combined Code that relate to the board's accountability for the company, the requirement for internal controls, and the role of the audit committee in assisting the board. These principles are:

- "The board should present a balanced and understandable assessment of the company's position and prospects" (D.1).

- "The board should maintain a sound system of internal control to safeguard shareholder's investment and the company's assets" (D.2).

- "The board should establish formal and transparent arrangement for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors" (D.3).

4.7.2.1 Accountability

The first of these principles is backed by basic provisions[8] requiring directors to explain their responsibility for preparing the accounts and by the auditors explaining their reporting responsibilities. The board's responsibility to present a balanced and understandable assessment extends to all reports namely, interim, price sensitive public reports, reports to regulators and those required by statutory requirements. These activities are facilitated by the existence of an effective audit committee.

4.7.2.2 Internal audit

The second principle covering this issue (D.2) is backed by, in particular, the provision that "directors should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management" (D.2.1). This was a considerable extension from the earlier recommendations such as Cadbury. The Cadbury Code of Best Practice, strictly speaking, only required a review of financial controls. The Rutteman Working Group later produced guidance on this called "Internal Control and Financial Reporting: Evidence for Directors of Listed Companies Registered in the UK" in 1994. It recommended that the directors publish an internal controls statement which would contain as a minimum:

- Acknowledgement that internal financial controls are the responsibility of the directors of the company;

[8] The "provisions" are contained in Part 2 of the Combined Code, the "Code of Best Practice" or a set of guidelines to assist in achieving the principles of the Code.

- Caution that the system provides only reasonable and not 100% assurance against material misstatement;

- Description of the main procedures that are in place to provide an effective system of internal controls;

- Statement that the directors have taken the necessary steps to assure that the system of internal financial controls is effective.

The recommendations of the Rutteman Working Group have been superseded by the Turnbull Report (1999).

It is in regard to this extended internal audit requirement that the Turnbull report is particularly relevant. The objective of the Turnbull Report, published by the ICAEW in September 1999, is to provide 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 four main responsibilities:

- Maintaining a sound system of internal control
  - Responsibility for internal controls is with the board.
  - The nature and extent of risks the company faces, which are acceptable for the company to bear, and the cost of controls relative to the benefit obtained from them should be considered.
  - The implementation of board policies on risk and control are the responsibility of management.

- Reviewing the effectiveness of internal control
  - Although management is responsible for monitoring the systems of internal control, the board must satisfy itself as to the effectiveness of the controls after careful enquiry and analysis.
  - As part of the board's enquiry and analysis, it may call upon committees such as the audit committee to carry out specific tasks.

- The board's statement on internal control
  - In addition to the disclosures recommended by Rutteman (1994), the statement should also consider the following:
    - Statement on *how* the company has applied the Combined Code principle D.2.
    - Disclosure of additional information that would assist understanding of the company's risk management processes and system of internal control.

- Internal audit
  - Periodic review of the need for an internal audit function should include scale, diversity, and complexity of the company's operations as well as changes that have occurred either inside or outside the structure that have increased or will increase exposure to risk.
  - Management will have to employ other methods of monitoring if the internal audit function is not utilized, and the board will have to ensure that these alternative methods are adequate.

4.7.2.3 Audit committees

Principle D.3 referred to above is backed by the Combined Code Provision D.3.1 which states that the board should establish an audit committee. The Cadbury Code of Best Practice set out the requirement that the audit committee should consist of at least three directors, all non–executives, with written terms of reference dealing clearly with its authority and duties. Provision D.3.1 has enhanced the Cadbury Code through recommending that a majority of the audit committee be INEDs. According to provision D.3.2 "the duties of the audit committee should include keeping under review the scope and results of the audit and its cost effectiveness and the independence and objectivity of the (external) auditors. Where the (external) auditors also supply a substantial volume of non-audit services to the company, the committee should keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money".

In 1997, the ICAEW published "Audit Committees: A Framework for Assessment" which helped to fill the gap in existing guidance often written on the assumption that the board wished to set up an audit committee and had a basic understanding of what it involves. A Framework for Assessment dealt with the assessment of audit committee performance and presented examples of good practice. In essence, the framework suggested that audit committees ask themselves a series of key questions and provided suggestions for resolving them. This publication draws on existing codes of best practice such as Cadbury and Greenbury, and provides guidance on how an audit committee could actually implement the recommendations. It could be looked upon as a “how to” guide for audit committees.

4.8 The United States

4.8.1 Legal and Regulatory 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 U.S. 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). 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.

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. 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 NYSE, and more than half of the 500 largest industrial companies in the USA are incorporated in Delaware.

Since Delaware incorporated companies predominate among publicly listed companies, we will examine some of the features of the Delaware General Corporation Law.

The Delaware General Corporation Law (DGCL) offers minimal regulation of corporate governance, leaving flexibility in the structure and management of the company. The DGCL states that directors manage all the aspects of the business of the company. The board may delegate some of its responsibilities, such as day-to-day management of the company, and appoint committees such as audit, remuneration, and nomination committees. It also allows anonymity of shareholders, whereas some other states require publication of this information as part of incorporation. The courts of Delaware have a reputation of supporting business, with a long history of significant court decisions. Because of this volume of case law, there is a high level of predictability as to the outcome of disputes. There are also special features of the law that allow the articles of incorporation of a company to excuse officers and directors from personal liability arising from the business of the company.

In terms of corporate governance, the USA follows a non-prescriptive[9] approach, relying on requirements for high levels of disclosure, rather than stipulating many rules and regulations attempting to control behaviour. In this manner, 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 Securities and Exchange Commission (SEC), a federal agency. The SEC oversees the

[9] Section 3.2 provides the explanation for different approaches to corporate governance.

key participants in the securities transactions, including stock exchanges, brokers, and investment advisors. The SEC's 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 of 1933 and the Securities Exchange Act of 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 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. As stated earlier, the 1934 Act created the SEC, and also focused on the purchase and resale of the securities already traded in the market. It deals with the continuous disclosure by issuers whose securities are registered under the 1933 Act. It was designed to prevent fraud and market manipulation.

The foregoing outlined the legal framework in which publicly traded companies operate. We now discuss the regulatory environment in which the securities of these companies are actually traded. We will confine our review to the largest exchanges, namely the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations (NASDAQ). Exchanges in the USA are classified by the SEC as "self-regulating organizations" (SROs), which 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 then will be approved by the SEC after amendments.

As stated earlier, 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 which will be discussed later, there are few "rules" on how a company must be structured. However, there are many requirements for disclosure of information such as board member biographical information, remuneration of directors including pension obligations and share options, composition and independence of audit committee, and information regarding contracts or transactions that could be considered as non arms-length.

Alongside the regulatory requirement, other Codes of Best Practice have been published by several key organizations or committees such as Blue Ribbon's (1999) "Improving the Effectiveness of Corporate Audit Committees", the American Law Institute's (1994) "Principles of Corporate Governance: Analysis and Recommendations" and The Business Roundtable's (1997) "Statement on Corporate

Governance". Institutional investors in the USA have also increasingly become one of the influential forces in shaping US board practices and corporate governance issues. The California Public Employees Retirement System (CalPERS) is perhaps the most well known of the institutional investors actively involved in corporate governance. Because of the relative size of their holdings, they are able to promote good corporate governance through informal and formal contact with boards of their investee companies. The following reviews the regulatory requirements on the audit committee and the INEDs in the USA.

4.8.2 Audit Committees

The SEC approved amendments to the listing standards of both the New York Stock Exchange (NYSE) and the North American Securities Dealers (NASDAQ) on audit committee and independent directors following the recommendations of "The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees" (1999).

Both the NYSE (Rule 303.01) and NASDAQ (Rule 4350(d)) now require that every listed company has a qualified audit committee that consists of at least three members and be comprised of independent directors only[10]. Other requirements for NYSE and NASDAQ on audit committees include the following:

- The audit committee must have a formal written charter, outlining the committee's responsibilities and role.
- Each member of the committee shall be financially literate, defined as an ability to ask and evaluate questions, supplemented by a basic financial literacy that could be provided through in-house training.

[10] Companies which are small business filers under the SEC rules are exempt from these requirements and are required to maintain an audit committee with a majority of independent directors.

- At least one member will have financial or accounting expertise, defined as having past employment in finance/accounting, professional certificate in accounting, or relevant experience/background.

"Independence" of every committee member is defined by NYSE Rule 303.01 and NASD Rule 4350(d) as follows:

- No relationship to the company that may interfere with the exercise of their independence from management and the company.
- Not an employee or executive officer of the company or any of its affiliates within previous three years.
- Not a partner, controlling shareholder, or executive officer of an organisation that has a business relationship with the company.
- Not employed as an executive of another corporation where any of the company's executives serves on that corporation's compensation committee.
- Not an immediate family member of an individual who is an executive officer of the company or any of its affiliates within previous three years.

4.9 Australia

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 the 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.

The responsibility for the regulation of the securities and investment industry lies with the Australian Securities and Investment Commission (ASIC), an independent government body established under the authority of the Australian Securities and Investment Commission Act of 1989. The ASIC reports directly to Parliament and is responsible for regulating and enforcing laws related to financial markets, products and services, and coordinates with other financial, consumer and law enforcement agencies, both domestically and internationally.

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 Australian Stock Exchange (ASX). It is responsible for developing and administering its Listing Rules, which are additional and complementary to existing legislation and common law. These Listing Rules are contractually enforceable, as well as being enforceable under the Corporations Act (Sections 777 and 1114). Once a Listing Rule is set or modified, it must be lodged with the ASIC, and is subject to disallowance by the Minister for Financial Services and Regulation. The ASX stipulates requirements for disclosure of corporate governance practices in its listed companies. The ASX rules on corporate governance take a non-prescriptive 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 (1995), and "Corporate Governance: A Guide for Investment Managers and Corporations and A Statement of Recommended Corporate Practice" by the Australian Investment Manager's Association (1997).

A Working Group formed by the Australian Institute of Company Directors, the Australian Society of Certified Practising Accountants, the Business Council of Australia, the Law Council of Australia, the Institute of Chartered Accountants in Australia and the Securities Institute of Australia under the chairmanship of Henry Bosch published "Corporate Practices and Conduct" (1995) (commonly called the Bosch Report). The Report states that:

"An audit committee should be set up in all companies with boards of four or more members. The committee should have a majority of non-executive members, preferably independent, a non-executive chairman, and have clear, written terms of reference. It should have access to the CEO/chairman, internal and external auditors, and all directors. As a delegated representative of the full board, the audit committee is responsible for issues of audit quality and effectiveness, coordination of the internal and external audit process, and should be the line of communication between the external auditor and management"

The ASX also 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 help the companies to prepare 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.

The following is the indicative list of corporate governance matters pertaining to audit committees that an entity may take into account when making the statement in its annual report under Listing Rule 4.10.3:

"The main procedures the entity has in place for the nomination of external auditors, and for reviewing the adequacy of existing external audit arrangements (particularly the scope and quality of the audit).

If a procedure involves an audit committee, set out, or summarise, the committee's main responsibilities and rights, and the names of committee members. If a member of the committee is not a member of the entity's governing body (e.g., director of the entity), state that person's position."

Although there is no statutory requirement for audit committees in Australian listed companies, evidence suggests that the largest companies (defined by sales) have voluntarily set up audit committees.

Recently, the Corporate Law Economic Reform Program (CLERP) was launched by the Australian Government in 1997 (which became the Corporate Law Economic Reform Program 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. Though the proposal did not recommend making the establishment of audit committees mandatory for Australian companies, it recognized the importance of audit committees in the corporate governance of the companies, and proposed that ‘ it may be desirable for the indicative list of corporate governance matters in the ASX listing rules to be appropriately enhanced to facilitate the disclosure by listed companies of their policies on audit committees.’ The Government believes a non-prescriptive approach on the question of audit committees is appropriate, and that it is preferable for Australian corporate governance practices, including the setting up of audit committees, to develop in response to competitive economic, commercial and international pressures, rather than in response to prescriptive rules mandated by the Government.

4.10 Canada

4.10.1 Legal and Regulatory Framework

Canada, with the exception of the province of Quebec, has a common law tradition and has been strongly influenced by the UK and the US law. Corporate governance in Canada largely follows a balanced approach, which prescribes only a few practices, and requires high levels of disclosure from companies.

Companies in Canada may be incorporated provincially (under provincial Company Acts) or federally (Canadian Business Corporations Act (CBCA), 1975), providing minor differences in requirements in terms of the regulatory environment under which they operate. The CBCA is the primary source of statutory requirements affecting corporations. According to the CBCA, a director must be an individual at least

18 years old with a sound mind (mentally competent) and "not an undischarged bankrupt". The majority of directors in any board must be residents of Canada.

Directors' duties and responsibilities are governed by the CBCA, provincial corporate law statutes and other federal statutes[11]. Both the Common Law and the Civil Code of Quebec impose fiduciary duties on company directors because they are in a position to subject others to the risk of loss of their investments. The most important director duty as described by the CBCA is the duty of care. Directors must act honestly, in good faith and in the best interests of the company. The level of care and diligence expected is that which a reasonable person would exercise in similar circumstances. Basically, this duty requires directors to act in the interests of the company, rather than their own personal interests. Directors relying on the work of other professionals, such as accountants, lawyers or engineers, are considered to have exercised a sufficient level of care and diligence.

A director may not be excused from liability because of ignorance of what was happening in the company. There is an obligation for each director to know what is going on in the company within the scope of his authority, and ensure it is legal and being done in the best interests of the company.

Canada and Singapore are the only jurisdictions in our survey with a statutory requirement for an audit committee. The CBCA requires a corporation to have an audit committee if the corporation is publicly listed on an exchange or if its securities are held by more than one person. It must comprise a minimum of three directors, with at least two of them being independent. In some circumstances, this requirement

[11] Other federal statutes under which a director may be held liable include: Canadian Environmental Protection Act, Fisheries Act, Bankruptcy and Insolvency Act, Excise Tax Act, Canada Labour Code, Unemployment Insurance Act, Income Tax Act.

may be waived if the interests of shareholders will not be prejudiced. No other committees are required by the CBCA or other statutes. The CBCA also requires companies to appoint an auditor, unless the requirement is waived by all shareholders.

Securities regulation is left to each provincial or territorial securities regulatory authority (SRA). Together, all the SRAs comprise the Canadian Securities Administrators, which is a forum for the coordination and harmonization of provincial/territorial securities regulation. Each province or territory has a Securities Act governing the securities of companies traded in that province/territory.

In addition, each stock exchange has additional listing rules that must be followed by companies listed on the particular exchange[12]. We will confine our review to the rules of The Toronto Stock Exchange (TSE) because it is the primary and largest exchange in Canada.

Canada has undergone major changes in corporate governance over the past ten years. Dey, published in 1994, established a set of corporate governance guidelines, which were subsequently adopted by the TSE. Dey recommendations are only guidelines, not prescribed corporate governance rules, and thus have no statutory power. The TSE Listing Rules require listed companies to describe their own corporate governance policies and explain how and why they differ from the Dey recommendations. An interesting requirement is for the board to specifically address corporate governance on an annual basis and this requirement has resulted in corporate governance being an increasingly important subject on the board agenda. However, there are concerns that

[12] There is also The Canadian Venture Exchange (venture capital) and the Montreal Stock Exchange (derivatives exchange).

changes that have been implemented are largely structural, without any substantial changes in the substance of good corporate governance practices.

Since the Dey recommendations are not mandatory, enforcement of good corporate governance practices is achieved mainly through the market; investors will presumably choose to buy or sell shares in a company based on their evaluation of the corporate governance disclosures made by the company.

Dey recommended that audit committees be composed entirely of outside directors. Although the CBCA requires an audit committee to be established statutorily, Dey went further by recommending that all members be independent, rather than only a minimum of two being INEDs. The report also provided the following recommendations on the role and responsibility of the audit committee:

- Should have direct communication with internal and external auditors;
- Should have oversight of management reporting on internal controls – even though internal controls are the responsibility of management, it is the audit committee's responsibility to ensure management has satisfactorily fulfilled its duty.

4.10.2 Recent Developments

A very recent publication by the Canadian Institute of Chartered Accountants (CICA), the Toronto Stock Exchange (TSE), and the Canadian Venture Exchange (CVE) (CICA *et al.*, 2001) made more recommendations on corporate governance with some specific recommendations on audit committees. It recommended that in addition to members of audit committees being outside directors, they should also be "unrelated" directors. The term "unrelated" has a special meaning under the TSE Guidelines (Sec. 474 (2)). It is defined as "a director who is independent of management and is 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". "Unrelated" specifically focuses on a director's ability to act in the best interests of the corporation, though Cadbury's definition of independence already specified that the director should be free from relationships which could interfere with independent judgment. This meaning of "unrelated directors" adds a new dimension to independence which includes the exercise of independent judgment as well as acting in the best interests of the corporation.

This report also adopted Blue Ribbon's recommendation that members of the audit committee be *financially literate*, and at least one member have financial expertise. Financial expertise is defined as having past employment in finance or accounting, a professional certificate in accounting, or relevant background/experience. The definition and criteria for *financial literacy* is left for the board to determine.

There should be formal written terms of reference for the audit committee that explicitly states the role and responsibility with respect to:

"its relationship with and expectations of the external auditors and the internal auditor function, its oversight of internal control, disclosure of financial and related information, and any other matters that the audit committee feels are important to its mandate or that the board chooses to delegate to it."

4.11 Malaysia

4.11.1 Legal and Regulatory Framework

Malaysia is a common law country where The Companies Act 1965, commonly referred to as "the Act" and the Companies Regulations 1966 are legislation governing companies incorporated in Malaysia. The Act is modeled on the English Companies Act 1948 and the Australian Uniform Companies Act (1961). 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 Rules. 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.

According to the Act, companies incorporated in Malaysia must have at least two directors without specifying any minimum qualification except that they have to be natural persons and of full age, i.e. have attained the age of eighteen with a maximum age limit of seventy. Generally, persons convicted of certain offences or undischarged bankrupts are prohibited from holding office as directors. The Act does not require a person to have a shareholding qualification in order to be qualified as a director.

Directors are generally elected for a term of three years and normally one-third of the board will retire at each annual general meeting. There is no provision under Malaysian law for employees to nominate a director to represent their interests. Similarly, NEDs are elected for a 3-year term as well and reappointment is not supposed to be automatic.

4.11.2 Independent Directors

Before the Asian Financial Crisis in 1997-8, board composition and independence from management were issues that had not received sufficient attention. In 1999, the publication of the Report of the Finance Committee on Corporate Governance spearheaded changes in corporate governance in Malaysia. It emphasized the need to have an independent board so as to avoid it being dominated by one or a group of controlling shareholders. It made the point that independent board members should be persons of good caliber, have credibility and possess relevant skill and expertise to handle board issues.

There is no provision in the Act prescribing the need for directors to be independent from substantial shareholders or management. However, the KLSE Listing Requirements [13] provide that every listed company on the KLSE must have at least two directors or one-third of the board, whichever is higher, to be independent. Independent directors are defined as directors who are independent of management

[13] The Listing Requirements were revised with effect from January 2001.

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.

4.11.3 Directors' Duties

Section 132(1) of the Act stipulates that "a director shall at all times act honestly and use reasonable diligence in the discharge of the duties of the office". Therefore, Malaysian law resembles other common law jurisdictions that specify directors to be fiduciaries and their fiduciary duties are owed to the company, i.e., not to individual shareholders.

4.11.4 Audit Committees

The current Malaysian Code on Corporate Governance (March 2000) (the Code) is backed up by the Listing Requirements of the KLSE. Listed companies have to comply with the Code and the Exchange may take action for non-compliance. The Code stipulates that there should be "a clearly accepted division of responsibilities between the chairman of a company and the CEO". It requires the establishment of the audit committee, which deals with internal controls and integrity of external audit.

As the recommendations of the Code have been accepted, the Listing Requirements require listed companies in Malaysia to establish an audit committee. An audit committee shall comprise of at least three members, a majority of whom, including the chairperson, should be independent directors. In order to address the issue of financial literacy, the Listing Requirements require at least one audit committee member be a member of the Malaysian Institute of Accountants. The Listing

Requirements also prescribe specifically the functions of an audit committee and require audit committees to alert the KLSE of any breaches of the Listing Requirements. The functions of the audit committee are specified as follows:

- Review the following with the external auditor: audit plan, audit report, internal audit programme, quarterly results and year-end financial statements, related party transactions, etc.

- Recommend the nomination of external auditors.

4.12 Taiwan

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 (1928) 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 which 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 and 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 5, 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 3, 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.

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 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 prevents investors from making investment decisions on the basis of corporate governance within individual companies.

There is no statutory or regulatory requirement for an audit committee for companies in Taiwan. However, the Company Law specifies that monitoring will be undertaken by supervisors as statutory auditors[14]. Although, in theory, this should provide adequate supervision by the supervisors, it is ineffective for two reasons. First, as discussed earlier, directors and supervisors are often appointed by the same dominant shareholder, and it is therefore difficult for a supervisor to question the actions of the director who acts on behalf of the shareholders. Second, private enforcement[15] of corporate and securities law is difficult under the civil law system. Some of the major obstacles to private enforcement are a court system that is not conducive to class actions, large court fees payable in advance, and high information costs to plaintiffs because of a lack of a civil discovery process.

4.13 Singapore

4.13.1 Legal and Regulatory Framework

Singapore is a common law country where companies are regulated by the Companies Act, (Cap. 50), commonly referred to as "The Act". In addition, listed companies are required to comply with the Listing Manual of the Singapore Exchange. 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 Singapore Exchange is the regulatory body responsible for imposing appropriate injunction on non-compliant listed companies. In addition, the Monetary Authority of Singapore is charged with the responsibility of regulating

[14] Because of the oversight responsibility for supervisors statutorily established by the Company Law, supervisors are sometimes referred to as statutory auditors.
[15] Private enforcement refers to enforcement through an individual shareholder, rather than enforcement by government or regulatory authority.

listed companies in the banking, insurance, securities and futures industries in Singapore.

The Companies Act requires every company to have a board of directors. It requires every company to have 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. The Act 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. The Act 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.

There is no statutory requirement prescribing the 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", which specifies corporate governance best practices but allows companies to depart from these practices subject to proper disclosure.

4.13.2 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[16] (the Code), recently adopted by the Singapore Exchange 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".

4.13.3 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.

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

[16] 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.

Directors also owe the 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.

4.13.4 Audit Committees

In Singapore, the audit committee is the only board committee mandated by the Act. Section 201B of the Act requires every listed company to establish an audit committee. It should comprise of at least three members. The majority of these members, including the chairman, cannot be executive directors of the company or any related company (including foreign companies) or relatives of such an executive director. It is expected to function independently of the executive directors and officers and to serve as a communication channel between the board and the external auditors on matters related to external audit. For the purposes of the appointment of audit committees, a NED is defined as "a director who is not an employee of and does not hold any other office of profit in, the company or in any subsidiary or associated company of the company in conjunction with his office of director and his membership of an audit committee" (Section 201B(10)). Section 201B(5) prescribes the functions of an audit committee as follows:

- "To review with the auditor, the audit plan, his evaluation of the system of internal accounting controls, and his audit report; the assistance given by the company's officers to the auditor; the scope and results of the internal audit procedures; and the balance sheet and profit and loss account, including the consolidated balance sheet and profit and loss account where relevant, before submission to the board of directors of the company or the holding company;

- To nominate a person or persons as auditor; and

- Such other functions as may be agreed to by the audit committee and the board of directors."

An overview and a detailed comparison of the legal and regulatory framework for audit committees in different jurisdictions are appended in Appendices 4b and 4c respectively.

4.14 Summary of Survey Findings

Appendix 4d contains the summary of the findings of various surveys conducted in the jurisdictions under review. In most cases, the surveys examined corporate governance practices on the whole, and were not limited to audit committees specifically. It should be noted that not all surveys had the same scope. Therefore, information obtained could not always be comparable across all jurisdictions.

Virtually all companies in the surveys had audit committees. In one US survey, audit committees were reported by 96% of the companies. The companies in this survey were not necessarily publicly listed companies, and therefore not subject to a mandatory requirement for audit committees. Another survey reported the existence of audit committees in 88% of UK companies. This survey did not give details on what kinds of companies were included in the sample. In summary, it should be no surprise that all companies are following legal or regulatory requirements in establishing audit committees.

Audit committee meeting frequency was consistent among jurisdictions, normally meeting four or five times per year. Meetings would be held more frequently when required.

The audit committees were typically composed of three or four members. About half of the surveys provided information on the executive/non-executive composition of the committees. Of those that provided the information, most committees had one executive director, and the remainder NEDs. Most audit committees had a majority of NEDs. The only information provided about the presence of INEDs on the board was in a US survey, which found that 50% of the companies in its sample had entirely INEDs. The survey in Malaysia showed that 100% of the companies surveyed indicated that their chairmen were NEDs.

In summary, almost all companies had audit committees because of regulatory or listing requirements. They normally met four or five times per year, and had three or four members, with a majority of them being NEDs. Little information was provided about audit committee chairs or independent status of members.

Having provided an overview of the legal and regulatory framework in each of the countries and a summary of survey findings, we now turn to a review of the literature on the effectiveness of audit committees. This review is expected to shed light on the recommendations for audit committees in Hong Kong.

4.15 Literature Review

The Kirk Panel (1994) argued that the audit committee is an important element in corporate governance and instrumental in ensuring the quality of financial statements. Recent irregularities at Cendant Corporation and Sunbeam in the USA underscore the importance of maintaining an active and independent audit committee[17]. The forefathers of agency theory research (e.g., Alchian and Demsetz, 1972; Fama and Jensen 1983) argued that effective audit committees enhance the credibility of annual audited financial statements and thus assist the board of directors. Other writers such as Pincus *et al.* (1989) have argued that audit committees are monitoring mechanisms that reduce information asymmetries between insiders (management) and outside (non-management) board members. In addition, the audit committee also benefits the external auditor and enhances the external auditor's independence and effectiveness (Gul, 2001, pp. 36-37).

This section reviews the literature regarding various issues related to audit committee effectiveness. We first review two studies that examine characteristics of firms that have audit committees under a voluntary regime and the factors associated with audit committee activities in terms of the frequency of meetings.

4.15.1 Audit Committee and Firm Characteristics

Pincus *et al.* (1989) investigated the firm characteristics associated with voluntary formation of audit committees by companies using a sample of 100 randomly selected NASDAQ firms in 1986. They found that firms which *voluntarily* set up audit committees tended to be larger in size and had a relatively higher level of leverage. For these companies, managerial ownership of the company's shares was lower while the proportion of outside directors in the board was higher. These firms also tended to have Big 8 auditors. It is worth noting that large firms, firms with high leverage and

[17] In April 1998, Cendant Corporation reported accounting irregularities to the SEC. The Company later announced that it had booked nearly $300 million in fictitious revenue. Sunbeam's accounting practices are the subject of SEC investigation. Both Cendant and Sunbeam were forced to restate earnings. More recently, the Enron debacle calls into question a lot of aggressive accounting techniques.

firms with low management ownership are normally associated with higher agency costs. Thus, this study suggests that firms with higher agency costs voluntarily set up audit committees to reduce agency costs.

Collier and Gregory (1999) investigated a sample of 142 major UK companies listed on the LSE in 1989-1990 and found that higher audit committee activity, measured by the number of meetings, was associated with the following:

- the employment of high quality auditors as measured by membership of the Big 6;
- the absence of CEO dominance (CEO being the same person as the chairman);
- the exclusion of insiders (executive directors) in the membership of the audit committees.

We next consider studies that deal more directly with issues related to the effectiveness of audit committees.

4.15.2 Effectiveness of Audit Committees

Deli and Gillan (2000) studied the role of audit committee in improving the credibility of accounting information and used the term "accounting certification" to describe better quality reporting. They assumed that firms with more active and independent audit committees would be associated with higher quality reporting or "accounting certification". They examined a sample of 1,150 US firms in 1998 and showed that the independence of audit committees (in terms of the number of independent outside directors on the committee) is related to the demand for higher quality reporting. They also showed that firms with low growth opportunities (more assets-in-place) and low managerial ownership are associated with independent and active (in terms of frequency of meetings) audit committees. They also found that large firms and firms with high leverage were associated with more independent and active audit committees.

Song and Windram (2000) evaluated the corporate governance reforms proposed by Cadbury in the UK. They reviewed a sample of 27 cases[18] dealt with by the Financial Reporting Review Panel (FRRP) for a ten-year period 1990-2000 and found that UK audit committees are crucial to the monitoring of financial reporting. More specifically, they found that financial literacy[19] was an important factor that affected audit committee effectiveness since audit committees with higher financial literacy were more likely to identify defects in financial reporting and therefore could ensure a higher quality of financial reports. Further, they found that low meeting frequency and outside directorship on audit committees could undermine audit committee effectiveness. Their conclusion that outside directorship was dysfunctional is at odds with other studies.

McMullen (1996) studied the relationship between the presence of audit committees and financial reporting reliability. Financial reporting reliability was measured by the incidence and occurrence of errors, irregularities and illegal acts, including shareholder litigation alleging management fraud, quarterly earnings restatements, SEC actions, illegal acts, and auditor turnover involving an accounting disagreement. The author examined 219 US firms during the period 1982-1988 and found that the presence of an audit committee in a company would enhance the quality of financial

[18] In their study, they compared the sample cases with a control sample of 27 firms that were not investigated by the FRRP.
[19] Financial literacy was measured by the total number of individuals with financial management experience and with formal qualification of accounting and auditing.

reporting, suggesting that audit committees would be an effective mechanism in governing the financial reporting process of a firm.

Defond and Jiambalvo (1991) investigated a sample of 41 corrections of earnings overstatements errors[20] from 1977 to 1988 based on 35 firms from The National Automated Accounting Research System (NAARS) and six firms from the Accounting Trends and Techniques (ATT) databases. They found that when firms voluntarily establish audit committees, they are less likely to overstate earnings.

4.15.3 Compositions of Audit Committees

Klein (2000a) examined 803 publicly traded US firms in 1992 and 1993 to study the relationship between audit committee independence and the expected growth measured in terms of market-to-book value of equity ratio and the market-to-book value of assets. Klein also examined the relationship between audit committee independence and CEO's bargaining power over the board in terms of the CEO's ability to place himself on the board's compensation committee. Audit committees are classified as independent when more than 50% of the audit committee members are outside directors. Results showed that expected growth opportunities[21] are positively associated with audit committee independence. Since mangers of high growth firms have more latitude and discretion in decision making, it is likely that these firms would seek out more independent audit committees to monitor managerial behavior. However, when the CEOs had more power over the board, audit committees were less

[20] Financial statement errors may be defined as items resulting 'from mathematical mistakes, mistakes in the application of accounting principles, or the oversight or misuse of facts that existed at the time the financial statements were prepared' (Accounting Principles Board (APB) Statement No. 20, para 13).

[21] High growth firms are generally small firms characterized by high risk, discretionary investment opportunities and high Research & Development spending.

likely to be independent in terms of membership of outside directors and the number of audit committee meetings declined. These findings suggest that audit committees are more effective when they are independent (i.e., more than 50% of the members are outside directors).

Klein (2000b) examined 683 firms that were listed on NYSE and NASDAQ (excluding financial firms) in 1991-1993 and found that there was a (non-linear) negative relation between audit committee independence and earnings management[22] measured in terms of the absolute value of discretionary accruals. Audit committee independence was measured in terms of the number of independent directors on the committee. Firms with membership of audit committees made up of less than a majority of independent directors were found to be associated with earnings management but as the membership of independent directors on the audit committee increased, the level of earnings management decreased. These results suggest that the independence of the audit committee is an important feature in monitoring corporate financial accounting reporting.

Carcello and Neal (2000) examined the relation between audit committee independence and audit reporting behavior. Audit committee independence was measured in terms of the percentage of audit committee members affiliated with the company (i.e., directors who lack independence) and audit reporting behavior was measured by the likelihood that the auditor would issue a going-concern report. They studied 223 US companies experiencing financial distress (with the probability of failure exceeding 28%, calculated from Zmijewski's (1984) financial distress

[22] "Earnings management" refers to management manipulations of reported earnings in a given period e.g., by over or understating discretionary accruals.

prediction model) in 1994, and found that the percentage of affiliated directors on the audit committee was negatively related to the probability the auditor would issue a going-concern report. Thus, the presence of independent directors on audit committees would enhance the auditor's independence and allow them to issue qualifications when necessary.

Vicknair *et al.* (1993) examined 100 US firms in 1980-1987 on the effects of 'grey' area directors on audit committee independence. 'Grey' area directors were those directors who, though not employed by the company, were affiliated with it or its management. They reviewed the proxy statements of these companies which reported board interlocks between inside and outside directors, consulting fees paid to directors, related party transactions between the firm and its directors, kinship relationship between management and outside directors, and other relationships which may indicate that director independence has been compromised. They found that the existence of 'grey' area directors on audit committees presented problems for audit committee independence. Moreover, the affiliation or background of many 'grey' area directors suggested that they enjoyed a direct or indirect financial interest in the firms, suggesting that these directors might be a potential source of violations of audit committee independence. The reason is that conflict of interest would exist if inside directors who have a financial interest in a company are members of audit committees. The independence of audit committees could be hindered because insider directors may be more willing to compromise with management on issues that are connected with their interests in the company.

Wright (1996) investigated the relationship between corporate governance characteristics and the quality of financial reporting for 151 US firms from the largest non-financial industry surveyed in the *Reports of the Association for Investment Management and Research Corporate Information Committee* (AIMR Reports) for the year 1989 (69 firms) and 1993 (82 firms). He examined the nature of the directors on the audit committee of these firms and its impact on financial reporting quality. He found that when the majority of a company's audit committee consists of inside or "grey area"[23] directors, the quality of financial reporting became lower, suggesting that the monitoring effect of an audit committee would be hampered by the existence of non-independent directors in the committee.

Menon and Williams (1994) noted the concerns of the SEC that an audit committee with inside directors would mislead shareholders into thinking that there was an effective monitoring mechanism in the company. Therefore, it is better not to have audit committees at all than to have audit committees with inside directors. The authors studied whether firms actually relied on audit committees by examining a sample of 200 randomly selected over-the-counter (OTC) firms for which information about their audit committees was available in 1986-1987. Reliance on audit committees was measured by the frequency of audit committee meetings. They found that the lower the proportion of outside directors in the board, the lower the frequency of audit committee meetings. Their results suggest that board composition affects management's reliance on audit committees.

[23] Grey directors are directors who have certain relationships with the firm. They are also known as "interlocking" directors.

The above studies are consistent with the notion that audit committees composed of independent directors are effective in improving the corporate financial reporting process and alleviating agency problems. However, other studies have found conflicting evidence.

Beasley (1996) studied 75 US firms that reported the existence of financial statement fraud[24] from 1980 to 1991. They compared these firms with 75 similar US firms (matched-pair analysis) to study whether a higher proportion of outside members on boards would reduce the probability of financial statement fraud. Results showed that the establishment of an audit committee does not affect the likelihood of financial statement fraud.

In a recent study, Peasnell *et al.* (2000) investigated the relationship between board monitoring and earning management (measured by both income-increasing and income-decreasing abnormal accruals) in the UK, with special focus on the roles of outside board members and audit committee. They used a sample of 1,271 UK firms from 1993 to 1995. Two proxies of board monitoring were examined – (1) the proportion of outside directors and (2) the presence of an audit committee. Results showed that the presence of audit committee had no impact in controlling earning manipulations. However, for firms that had audit committees, more outside directors were associated with lower likelihood of income-increasing earnings management.

[24] These are firms that had an occurrence of publicly reported financial statement fraud. The financial statement frauds investigated by the study were limited to two types: 1. occurrences where management intentionally issued materially misleading financial statement information to outside users; 2. occurrences of misappropriations of assets by top management such as the chairperson, vice chairperson, CEO, etc.

4.15.4 Summary

A review of these papers warrant a few conclusions. First, firms voluntarily set up audit committees when they are faced with higher agency costs such as low management ownership of shares or when they are large firms. Second, the effectiveness of audit committees relies heavily on the number of quality independent outside directors. Third, the expertise of the INEDs such as financial literacy also adds to the effectiveness of audit committees. Finally, the frequency of audit committee meetings is a good indicator of the extent to which management relies on the audit committee and determines its effectiveness.

4.16 Recommendations

The review of the (1) key international corporate governance reports; (2) legal and regulatory framework in the different jurisdictions, namely the UK, the USA, Australia, Canada, Taiwan, Malaysia and Singapore and (3) empirical studies provided us with a basis for some recommendations on the audit committees. The main recommendations are as follows:

- All listed companies should establish an audit committee with at least three NEDs, with the chairman and the majority of its members being independent.
- All the NEDs and INEDs on the committee should have some financial expertise either acquired through accounting or financial management qualifications or experience.
- The role of the audit committee is to assist the board of directors to monitor and oversee the financial reporting process, the external audit and internal controls including the audit function and risk management.
- A charter stipulating the terms of reference for this committee [25] should be disclosed in order that all members understand their role and responsibilities in the committee.

[25] We recommend that the specimen Terms of Reference for an Audit Committee contained in the publication – "A Guide for Effective Audit Committee" published by Hong Kong Society of Accountants in 2002 be followed.

- The annual report should disclose the composition of the audit committee, the number of audit committee meetings and how it has discharged its responsibilities.

These requirements should significantly increase the effectiveness of this committee.

In term of implementation, we recommend that a balanced approach be adopted. The establishment of an audit committee with at least three NEDs as members, the chairman being an INED and the majority being independent should be incorporated in the Listing Requirements of the Main Board as well as the GEM Board. Other detailed requirements should be incorporated in the Code of Best Practice.

CHAPTER 5 REMUNERATION COMMITTEES

5.1 Introduction

The second most popular board committee that is expected to enhance corporate governance is the remuneration committee. The importance and need for such a committee for Hong Kong firms is highlighted by recent reports of excessive directors' remuneration in Hong Kong for firms with poor business performance (see SCMP, 24 September 2001, p.1). For example, PCCW faced a loss of HK$6.9 billion but directors' remuneration went up nearly 55 times from the previous year to HK$768 million!

This chapter first reviews key international corporate governance reports on the role and functions of remuneration committees, followed by surveys on the extent of enforcement and disclosures. The next section reviews the literature on the effectiveness of remuneration committees. A summary of our recommendations is provided in the last section.

5.2 Key International Corporate Governance Reports

Chapter 4 considered the general background of the key corporate governance reports and the pivotal role of independent non-executive directors (INEDs) as an important element of board committees. The background of the key reports and role of INEDs also applies to remuneration committees and will not be repeated here. This section focuses on a review of the recommendations and guidelines of these key reports that relate to remuneration committee. The reports considered are:

- "Report of the Committee on the Financial Aspects of Corporate Governance" (Cadbury Report, 1992)

- "Directors Remuneration: Report of a Study Group chaired by Sir Richard Greenbury" (Greenbury Report, 1995)
- "Committee on Corporate Governance" (Hampel Report, 1998)
- "Where were the Directors? Guidelines for Improved Corporate Governance in Canada" (Dey Report, 1994)
- The General Motors Corporation Corporate Governance Guidelines (GMC Guidelines, 1994)

The Cadbury Report (Cadbury) provided some general guidance on remuneration committees and executive directors' remuneration. The report recommended that the remuneration committee consist wholly or mainly of non-executive directors (NEDs) with an overriding principle of openness that should be applied to the determination of executive directors' remuneration[1]. Detailed disclosures on separate amounts for salary and performance based compensation, criteria on which performance is measured, and other components of compensation, such as stock options and pension contributions were recommended. Directors' contracts should not exceed three years to give shareholders more control over the level of compensation for early termination of directors' contracts[2]. It also recommended that the level of remuneration should be determined by the market, i.e., high enough to attract qualified directors, but not excessively high to the detriment of the company.

The Greenbury Report (Greenbury) also focused on recommendations relating to directors' remuneration and advocated the establishment of a remuneration committee to handle issues relating to executive director compensation, but also observed that

[1] The remuneration of NEDs should be the responsibility of the board and not the remuneration committee because directors should not be involved in the discussion of their own pay.
[2] Compensation for early termination is often based on time remaining in the employment contract. If there is a long, or open-ended contract, the potential compensation may be considerably higher than for a short contract that is terminated early.

compensation of non-executive members should be a matter for the board as a whole. Subsequently, the Hampel Report (Hampel) made additional recommendations on remuneration policy that will be discussed later in this section. The following section reviews the detailed recommendations regarding remuneration committees from the above key reports.

5.2.1 Recommendations from Key Reports

5.2.1.1 Membership

Greenbury (and later Hampel) recommended that members should be exclusively non-executives, with additional requirements on independence and relevant experience. An INED is defined as one having no potential financial benefit from decisions that he/she may be involved in (other than as a shareholder), as well as freedom from any cross-directorships that would offer a potential for conflict of interest. However, Greenbury relaxed the minimum size for the committee to two for small companies as a large membership requirement may be too onerous or impractical. The membership of the remuneration committee should also be disclosed in the annual report.

5.2.1.2 Remuneration policy

Both Greenbury and Cadbury recommended that remuneration packages be designed to attract, retain and motivate quality directors, without being excessive. The remuneration committee should judge where to position the company's remuneration policy relative to other companies, assess the wider pay situation, both within and outside the company, and construct a remuneration package. Hampel recommended full disclosure of director remuneration packages such as share option and pension benefits. This would enable directors to compare their remuneration to that in other companies. With such disclosures, directors are then in a position to demand what others are receiving if their own remuneration is not comparable. This may result in companies having to offer more costly packages than their competitors to attract their directors. This disclosure could potentially put an upward pressure on director remuneration levels. Hampel, however, warned against an "upward ratchet" of increasing remuneration without a corresponding improvement in company performance. The Dey Report (Dey) commented that remuneration "should reflect the responsibility and commitment" that the director undertakes and should strike a balance without being too low or too high. Salaries that are too low are likely to adversely affect the director's motivation and salaries that are too high could affect a director's ability to remain independent.

Greenbury was more specific on the details of the remuneration package, and offered a number of recommendations. In general, performance related components of remuneration should be designed to align the interests of directors with the interests of shareholders. There is no set formula, but a balance between the fixed and performance-related components of pay must be determined. The GMC Guideline on board remuneration suggested that a meaningful portion of common shares should be held by directors. Unfortunately, what constitutes "meaningful" portion was not discussed. Like GMC Guideline, Dey recommended that directors hold shares in the company, but did not suggest the percentage of the recommended shareholding. On the other hand, Cadbury warned against the use of share options for NED compensation, citing a loss of independence as the reason. While Greenbury did not comment on the subject, Hampel saw no difficulty in the use of shares as a component of non-executive compensation (but not share options). Hampel felt that the leverage inherent in share options (but not shares themselves) offered a large potential benefit that may impair independence[3]. Dey did not object to the granting of stock options as remuneration, but recommended their value be reasonable, and conditions should be attached to discourage short-term exercise and encourage long-term holding. This could overcome the problem of the non-executives focusing on short-term gains at the expense of shareholders' long-term value.

5.2.1.3 Service contracts and compensation

Cadbury advised keeping directors' contracts to three years or less while Greenbury recommended reducing contract periods to one year or less. It may be necessary to offer longer initial terms, but subsequent terms should be reduced. The problem with longer-term contracts is that poorly performing directors are more difficult to remove, and the cost of early termination is potentially high. Hampel addressed the costs of termination by recommending that provision for termination payments be made explicitly in the directors' written contracts. This removes the difficulty in quantifying the damages should termination occur, and enables shareholders to have a better idea of the potential liabilities the company may or has incurred in the event of dismissals. However, Hampel agreed with Greenbury and recommended reducing the terms to one year. Dey did not recommend a term limit, but suggested that the nomination committee should monitor and propose changes as required.

[3] Independence may be impaired if directors fear the loss of their options or loss of participation in a share option plan. Granting of shares outright does not pose such a threat to independence.

5.2.1.4 Disclosures

Cadbury recommended that the remuneration committee prepare a report to shareholders disclosing details on compensation policy, levels, and components (in total, and details by director), performance criteria and measurement, contracts, and pension and other commitments. Hampel's view was that some of the previous reports to the shareholders were overly detailed, to the point where they became difficult to understand and not useful for a non-expert reader. It recommended moving to a simpler disclosure, with remuneration policy statements that would describe the particular remuneration environment in which the company operates. This report may be integrated as part of the annual report, or it could be an attachment to the annual report. Service contracts beyond one year should be disclosed, along with the rationale for long-term contracts.

A summary of the detailed recommendations of these key corporate governance reports on remuneration committees is appended in Appendix 5a.

5.3 Role and Functions

The remuneration committee's role is to provide recommendations on matters of director compensation[4]. The main functions of a remuneration committee are to develop remuneration policy for the company and set remuneration packages for executive directors. Formality and transparency are the basic principles that should be followed to fulfill its role and functions. The committee should be formally established by the board and there should be transparent procedures for fixing remuneration packages. Under no circumstances should any director be involved in

[4] Unless otherwise specified, director compensation refers to compensation for all directors including executive and NEDs.

setting his or her own remuneration package. It follows from this principle that NED/INED compensation is not the responsibility of the remuneration committees (which would be comprised of NED/INEDs), but that of the board as a whole (Greenbury Report, 1995).

The National Association of Corporate Directors (NACD)'s (2000) report "Blue Ribbon Commission on Executive Compensation" specified the responsibilities of the remuneration committees. They fall into three main areas namely:

- establishing and overseeing executive compensation policy,
- individual pay decisions, and
- incentive plan administration.

In establishing executive compensation policy, the committee must first review the company's performance and how the past and current compensation is related to performance. This review should include statistics on the number of share options, price and number of outstanding options, and a calculation of the present value of current commitments relating to these options. The remuneration committee must be sensitive to pay and employment conditions in other similar companies, particularly when determining annual increases. In setting individual compensation packages, the committee must also consider all components including basic salary, bonuses, benefits, and incentive schemes, such as stock options or grants[5]. Incentive plan administration includes developing criteria for top executive performance-related compensation. To align directors' interests with those of shareholders, there should be compensation components that are contingent on achieving certain goals, such as corporate growth, sales, or profitability among others. The committee should monitor

[5] Stock options are options to purchase company stock in the future while stock grants are outright granting of company stocks.

the total personnel costs, and changes in management's ownership of company shares. The remuneration committee should review management's recommendations for incentive plan programs including performance targets and criteria and ensure that overall compensation levels are appropriate and that the plans are consistent with the company's strategy and enhancement of shareholder value.

We now turn to the regulatory frameworks that are in place in the different jurisdictions under study, namely the UK, the USA, Australia, Canada, Malaysia, Taiwan and Singapore. Section 5.11 summarizes survey findings in some of the above jurisdictions.

5.4 The United Kingdom

Regulatory Framework

There is no legal or regulatory requirement for a remuneration committee to be established in listed companies in the UK.

As discussed in Chapter 4, every listed company must disclose in a statement how it applies corporate governance principles, and whether or not the company is in compliance with the recommendations of the Combined Code (1998). The Combined Code (1998) recommends that the company's annual report contain a statement of remuneration policy and the details of each director's remuneration packages including share options schemes and pension entitlements. It emphasizes the need for remuneration committees to be responsible to shareholders by warning against excessive remuneration.

The Combined Code's (1998) detailed recommendations on remuneration are summarized as follows:

- A remuneration committee should be used for making recommendations to the board on matters of executive director remuneration.
- Committee should comprise solely of INEDs.
- Committee should consult with chief executive officer (CEO)/chairman on executive remuneration, and seek professional advice inside and outside the company where appropriate.
- The board, or a specially delegated sub-committee should set the remuneration of NEDs.
- Remuneration should be linked to company performance in order to align shareholder and board interests.
- No director is to be involved in deciding his or her own remuneration.

An interesting question is whether UK companies have voluntarily complied with the Combined Code. A recent survey commissioned by the European Commission found that only 9% of UK listed companies had fully complied with all the recommendations of the Combined Code (Financial Times, April 8, 2002). This is clearly an area that warrants further study to determine why compliance is not being achieved with certain parts of the Code.

5.5 The United States

Regulatory Framework

Companies in the USA are not required by law, the SEC rules or the Listing Rules of NYSE and NASDAQ to establish remuneration committees. The NYSE Listing Rules 203.01(D) only recommend listed companies to include the identification of directors in the audit committee and other major committees of the main board in their annual reports. However, if companies registered under the Security Exchange Act of 1934 have established remuneration committees, the SEC regulation requires additional disclosures. Specifically, the company must disclose any committee member who is, at any time during the preceding fiscal year, an officer or director of the company or any of its subsidiaries (or formerly an officer of the company or its subsidiaries) or who had certain transactional relationships with the company (Regulation S-K Item 402(j)). In addition, the remuneration committee is required to issue a report that discusses the remuneration policy applicable to the company's executive officers, the basis for determining the CEO's compensation, and how the remuneration of executives and the CEO are related to company performance in the annual proxy statement (Regulation S-K Item 402(k)). On the other hand, the regulation does not have any requirement on the composition of the remuneration committee.

Though the SEC rules and NYSE Listing Rules do not require the establishment of remuneration committees, the SEC rules require extensive disclosure on remuneration matters. If a company had a remuneration committee, these disclosure requirements would form part of the committee's responsibilities. The requirements (under SEC Regulation S-K Item 402 and Schedule 14A Item 8) include the following:

- All compensation of:
    - CEO;
    - Four most highly compensated executive officers other than the CEO;
    - up to two additional individuals (NEDs) if there were fewer than the four executive officers described above.

- All compensation paid to directors under pension obligations.

- Compensation for any services provided as a director, including any additional amounts payable for committee participation or special assignments.
    - Any employment contract between the company and a named executive officer;
    - Any compensatory plan or arrangement relating to early termination of a director.

- Compensation committee's compensation policies applicable to executive officers including the specific relationship of corporate performance to executive compensation;
- Analysis of pension benefits earned currently, and total company liability for future pension payments.

Although there is no statutory or regulatory requirement for publicly held corporations in the USA to set up a remuneration committee, the American Law Institute's (ALI) (1994) "Principles of Corporate Governance: Analysis and Recommendations" recommends each publicly held corporation establish a remuneration committee. The ALI's Principles 3A.05 recommends a remuneration committee comprising of only outside independent directors. This committee has the task of reviewing and determining, or recommending to the board, the annual salary, bonus, stock options and other benefits, direct and indirect, of senior executives. They should also review on a periodic basis the company's executive compensation programmes and ensure that they reasonably relate to executive performance. The committee should also establish and periodically review policies in the area of management perquisites.

5.6 Australia

Regulatory Framework

As discussed in Chapter 4, the ASX Listing Rules require a listed company to provide a statement of the main corporate governance practices in place during the reporting period to allow investors to make their own assessments and conclusions about a company's corporate governance. The Bosch Report (1995) suggested that it is good practice to set up a remuneration committee to allow independent judgment to be exercised with respect to remuneration matters. Such a committee would be especially important if there were a large or powerful executive presence on the board. The committee should be led by an independent non-executive chairman, and consist of at least a majority of INEDs.

Guidance Note 9 of the ASX Listing Rules provides the indicative list of 'corporate matters' that should be reported in the statement regarding corporate governance in its annual report (Rule 4.10.3). These include the procedures for establishing and reviewing the compensation arrangements for the CEO, other senior executives and NEDs of the board. It should also summarize the committee's main responsibilities and rights, and the names of committee members.

5.7 Canada

Regulatory Framework

Remuneration committees are not mandatory in Canada, but are referred to in Dey as a committee that many companies find useful. Dey echoed the warnings of the Combined Code in the UK on executive remuneration that remuneration should be sufficient enough to attract directors, but not so excessive that directors' independence could be adversely affected. Dey contained no recommendations on how a remuneration committee should be constituted or the details on its duties and responsibilities.

5.8 Malaysia

Regulatory Framework

The Malaysian Code of Corporate Governance (2000)[6] recommends a remuneration committee to be made up wholly or mainly of NEDs. They should not participate in decisions concerning their own compensation packages. Therefore the board as a whole should determine the compensation packages for NEDs and INEDs. All listed companies should have a formal and transparent procedure for developing a policy on compensation. These general principles should apply to determine the level and composition of executive remuneration namely: a significant part of executive directors' remuneration should be based on company performance and the remuneration of non-executives should reflect their experience and level of responsibility in the company.

5.9 Taiwan

Regulatory Framework

There are no legal or regulatory requirements on remuneration committees and related matters in Taiwan. There does not appear to be any code of best practice or similar guideline in Taiwan.

5.10 Singapore

Regulatory Framework

Currently, there is no general guideline on the requirement of a remuneration committee and how it should operate. However, the Singapore Code of Corporate Governance (2001) recommends that every company should establish a remuneration

[6] Listed companies with financial years ending after June 30, 2001 are required to make a statement of compliance in accordance with the Malaysian Code.

committee comprising a majority of independent directors and chaired by an independent director in order to minimize the risk of any potential conflict of interest. At least one member of the remuneration committee should be knowledgeable in the field of executive compensation. Otherwise, the committee should obtain expert advice inside and/or outside the company on remuneration matters. The objectives of establishing remuneration committees are to facilitate appropriateness, transparency, accountability on the issue of executive remuneration and link individual executive director's and senior managers' performance to corporate performance in the remuneration setting process. The main function of remuneration committees is to recommend to the board a framework for remuneration for the board and key executives, and to determine the specific compensation packages for each executive and independent director. The committee covers all aspects of compensation, including directors' fees, bonuses, options, allowances, salaries, benefits-in-kind, etc.

A comparison of the regulatory requirements on remuneration committees in different jurisdictions is appended in Appendix 5b.

5.11 Summary of Survey Findings

Appendix 5c contains the summary of the findings of various surveys conducted in the jurisdictions under review. In most cases, the surveys examined corporate governance practices on the whole, and were not limited to remuneration committees specifically. It should be noted that not all surveys had the same scope. Therefore, information obtained could not always be comparable across all jurisdictions.

Remuneration committees were found in companies in all of the surveys, but the extent of their use as a corporate governance device varied. They were most common in the more developed markets such as the USA, the UK, and Australia, and less common in the Asian markets. The USA had the highest use of remuneration committees, with as many as 100% of the companies having one. Singapore had the lowest use of remuneration committees, at about 15% among the listed companies.

Most remuneration committees had three or four members and most of them had a majority of NEDs, with many having all NEDs as members. Only Malaysia had indicated that their chairmen were NEDs. Remuneration committees met between two to five times per year, with US companies meeting most frequently. Executive director remuneration usually consisted of a base salary, plus bonuses and stock options. Many forms of non-cash remuneration were employed in the various jurisdictions.

The surveys generally revealed a wide variety of practices regarding remuneration committees across the different jurisdictions. In general, there was support for the need to manage and monitor senior management remuneration in a more transparent and effective way. Having considered the regulatory framework as well as the various surveys regarding remuneration committees, we now turn to a review of the literature on the effectiveness of remuneration committees.

5.12 Literature Review

The most critical factor affecting the effectiveness of remuneration committee as a key corporate governance mechanism is the independence of its members (Evans and

Evans, 2001). Independence can be proxied by the number and quality of INEDs. Some prior research studies have investigated issues related to the effectiveness of remuneration committee.

Conyon and Peck (1998) analyzed data on large, publicly traded UK companies collected from 1991 to 1994 from the UK *Financial Times* top 100 companies by market value. It was found that management pay and company performance were more aligned when there was a higher proportion of outside directors on the main board or on the remuneration committee, thus inducing management to act more in the best interests of the shareholders.

Anderson and Bizjak (2000) used two compensation measures to measure CEO pay. First, they included salary and bonus as fixed portion of total compensation. Also, they measured the value of new options grants and the value of the full option portfolio that make up the total CEO compensation. They employed both an accounting measure and a market measure for firm performance. The accounting measure of performance was earnings before interest, tax, depreciation and amortization divided by the book value of total assets for the prior year and the market measure of performance was the annual return on common stock for the prior year. They examined situations where the CEO was a member of the compensation committee, and subsequently resigned from their position on the committee. Analysis of 50 US firms between 1985 and 1994 showed that there were no changes in pay levels, pay incentives, or ownership when a *non*-founder/*non*-family CEO resigned from the compensation committees. However, there were increases in levels of pay and sensitivity of pay to performance for founder/family members who left compensation committees. The increase in the sensitivity of pay to performance suggested that remuneration committees with CEOs who were family or founder members were less effective. Overall, there was no support for the notion that CEOs who sat on the compensation committee acted opportunistically in pay decisions. On the other hand, compensation committees with greater outsider representation were associated with lower fixed pay, greater option-based pay and more sensitive pay to performance relationship. This suggests that independent compensation committees are more likely to promote the pay and performance linkage which is one of the objectives of remuneration committees.

Vafeas (2000) also examined the determinants of compensation committee composition. After analyzing 576 of the largest US publicly traded firms that reported having a standing compensation committees and 6,607 directors in 1994, he found that members of compensation committees generally had a smaller percentage of share ownership, were older, had been with the firm longer, and held more directorships in other companies than directors who were not members. Weak evidence was found that firms are more likely to appoint independent outside directors on their compensation committees.

On the other hand, Evans and Evans (2001), using 214 companies listed on the Australian Stock Exchange in 1997, studied the relationship between the remuneration structure of NEDs and the CEO pay levels. It is argued that as the equity holdings of NEDs increase, there is a closer alignment of the NEDs interests with the company's long-term performance, thus providing restraints on the annual CEO cash pay. Although the paper did not specifically focus on the effectiveness of remuneration committee, it could be inferred that there would be more effective monitoring of executive remuneration when NEDs have more equity holding in the company.

5.13 Recommendations

Based on the key international corporate governance reports and the legal and regulatory framework in the different jurisdictions under study, namely the UK, the USA, Australia, Canada, Taiwan, Malaysia and Singapore on remuneration committees, we provide some recommendations on remuneration committees.

- Remuneration committees should be established and consist wholly of NEDs with the chairman and the majority being INEDs.

- The remuneration committee should be responsible to recommend to the board the compensation policy as well as all aspects of compensation for key executives including all the executive directors and the CEO. The compensation for NEDs and INEDs should be a matter for the board. Disclosure of the individual members' remuneration including all aspects of their remuneration packages should be made in the annual report.

- The terms of reference of the remuneration committee together with composition, number of meetings and work done should be disclosed in the annual report.

- Ideally, there should be at least one member who is knowledgeable in executive compensation. Otherwise, external professional advice should be sought.

- The principle that no executives or NEDs or INEDs should have a role to play in determining his/her compensation should be strictly adhered to.

- Composition, role and remuneration policy of NEDs should be disclosed and include:

    - analysis of individual directors' remuneration [7] including basic salaries, housing allowances, other allowances and benefits in kind.

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[7] While we did not consider the issue of remuneration for a company as a whole, it is worth noting that some experiences in the USA suggest that a more cautious approach towards the policy for employee share ownership as part of pension plans is warranted. For example, when Enron recently collapsed the employees suffered great losses since more than half the of the assets in Enron's employee retirement plan were in company shares that the beneficiaries were not allowed to sell. The issue here is the risk to employees of such non-diversification. Other US companies that have employees holding a high percentage of company shares as a percentage of 401(k) assets include Proctor and Gamble (94.7%), Coca-Cola (81.5%) and Pfizer (85.5%) (See The Economist, 2001, December 15, p. 62).

- analysis of directors' remuneration between "performance-based" and "non-performance-based" compensation.

- directors' share options including their individual benefits derived from the aggregate value realised on the exercised options during the year and the closing market price of shares at the balance sheet date.

We recommend that a balanced approach be adopted. The establishment of the remuneration committee/corporate governance committee[8] with detailed requirements on the constitution of the committee should be incorporated in the Listing Requirements of the Main Board and GEM Board. Details of other requirements should be incorporated in the Code of Best Practice.

[8] Corporate governance committee is discussed in Chapter 6, Section 6.13.

CHAPTER 6 NOMINATION COMMITTEES

6.1 Introduction

The nomination committee owes much of its importance to the fact that it is expected to ensure the appointment of quality independent non-executive directors (INEDs) for the board and its committees. This chapter first reviews the recommendations from key corporate governance reports on the nomination committee. This is followed by a discussion of the role and functions of this committee. This chapter also provides a brief description of the regulatory framework for the operation of the nomination committee and an overview of the surveys conducted by private sector organizations on the nomination committee in the different jurisdictions under study. The next section reviews the literature on the effectiveness of the nomination committee, followed by a brief introduction on corporate governance committee. A summary of our recommendations is provided in the last section.

6.2 Key International Corporate Governance Reports

This section summarizes the main recommendations of key corporate governance reports as they relate directly or indirectly to nomination committees. The reports 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 Guidelines, 1994)
- "Committee on Corporate Governance" (Hampel Report, 1998)
- "The Final Report of the Joint Committee on Corporate Governance" (Canadian Institute of Chartered Accountants, the Toronto Stock Exchange and the Canadian Venture Exchange, 2001)

A central theme running through all the reports is the important role non-executive directors (NEDs) play in bringing an independent voice to boards, and in particular, committees. NEDs should be able to take the lead where potential conflicts arise between management and the board. The Cadbury Report (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. Cadbury recommended that a nomination committee be composed of a majority of NEDs, and that the chairman of the nomination committee should be the chairman of the board[1] (if he/she is not the chief executive officer (CEO)), or a NED. The Dey Report (Dey) recommended that the nomination committee be composed solely of NEDs, the majority of whom are unrelated[2]. The Hampel Report (Hampel) stated that the NEDs should be of such a caliber that they command the respect of the executive directors, which is essential to running the business in a cohesive manner. The GMC Guidelines (1994) recommended that the criteria for the assessment of suitable board members should include judgment, diversity, age, skills, and international experience. 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/interest of other shareholders. The CEO duality (non-separate roles for CEO and board chairman) problem was recognized by Cadbury which recommended that if the roles are not separated, then there should be a strong independent element on the board. Hampel went further and recommended that there

[1] Cadbury did not specify whether the chairman must be an INED.
[2] 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.

should be a strong independent element in any event and there should be a senior INED through whom concerns can be conveyed to the board. This director should be identified in the annual report. This position is sometimes referred to as a "lead director". A recent report on corporate governance, "The Final Report of the Joint Committee on Corporate Governance" (CICA *et al.*, 2001), by the Canadian Institute of Chartered Accountants (CICA), the Toronto Stock Exchange (TSE) and the Canadian Venture Exchange (CVE) has gone so far as to recommend that an "independent board leader" be appointed as a condition of listing[3].

Dey also suggested a number of responsibilities for the nomination committee including the responsibility for proposing new nominees for board membership, assessing directors on an ongoing basis, and setting policies such as director term limits and maximum number of directorships to be held by NEDs.

Experience since Cadbury 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. Hampel further stated that the governance arrangements for smaller companies must be considered with flexibility and due regard to the company's circumstances.

A summary of the detailed recommendations of these key corporate governance reports on nomination committees is appended in Appendix 6a.

[3] They further stipulated that if the chairman of the board is an INED, then he/she should be the independent board leader. If the CEO is also the chairman, then an INED should be appointed as the independent board leader.

6.3 Role and Functions

The nomination committee serves as a more independent source for the identification of candidates for membership on the board and its committees. It should provide guidance on directorship issues such as director term limits and director assessment. The presence of a nomination committee with INEDs is an integral part of enhancing corporate governance in a company as well as the public's perception of a company's transparency and accountability.

The importance of such a committee becomes apparent if one considers the perceived problems with the appointment of NEDs in the UK and the USA in the 1980s and early 1990s. For example, in many cases it was felt that too many appointments were on the recommendation of the CEO/chairman who already had his own informal contacts in mind. There was no written and clear job/candidate profile which was in turn exacerbated by a lack of clarification of the INEDs' role. It is in this context that the role of the nomination committee can be a very useful one and help prevent stacking the board with 'yes' men or women.

The use of a nomination committee can prevent the board, or individuals on the board, from selecting new directors that may help the board pursue individual's interests. For example, in boards without a nomination committee the most common source of candidate recommendations is the CEO. If the CEO is able to personally select new directors, he/she can perpetuate a board that supports his/her views, rather than working in the best interest of the company. For a nomination committee to be effective in this regard, it must have some degree of independence. To ensure this, there is usually a recommendation that the composition of the committee be made up of NEDs as well as a non-executive chairman. Although the responsibility for identifying candidates is removed from the CEO, he/she along with the inside directors should be fully consulted during the selection process. The nomination committee will not have the delegated power to act upon its recommendations but will have to take its recommendations to the board for consideration, approval and implementation.

The nomination committee should first examine the composition of the board and identify competencies and characteristics of the individual directors and the board as a whole. These competencies and characteristics should then be compared against the board charter and terms of references to assess whether the current mix of directors is adequate for the board to discharge its duties. If vacancies exist, or if additional skills are needed, the nomination committee is responsible for identifying candidates to fill the positions, and making its recommendations to the board.

Beyond selection of director candidates, the nomination committee is often responsible for the ongoing evaluation of the board as a whole and of individual directors, including the CEO and chairman. Assessment of the CEO should occur at least annually and there should be ongoing evaluation of the board as a whole and individual directors as well. The assessments should be carried out against individuals' job descriptions, the board charter, and the stewardship of the company.

It is clear that nomination committees have the potential to ensure appointments are in the best interest of the company and provide monitoring of the various executive functions. We now turn to a description of the regulatory framework for the operation of nomination committees in the different jurisdictions under study, namely the UK, the USA, Australia, Canada, Malaysia, Taiwan and Singapore. Section 6.11 summarizes survey findings in some of the above jurisdictions.

6.4 The United Kingdom

Regulatory Framework

There are no legal or regulatory requirements for nomination committees in companies in the UK. However, the Combined Code recommends the establishment of a nomination committee as best practice. The Combined Code principle A.5 states that there should be a formal and transparent procedure for the appointment of new directors to the board, and the best practice guide states that a nomination committee should be established to make recommendations to the board on all new board appointments. If the board is small, the provision implies that such a committee is not necessary. A majority of the members of this committee should be NEDs and the chairman should be either the chairman of the board[4] or a NED.

6.5 The United States

6.5.1 Regulatory Framework

Companies in the USA are not required by law, the SEC rules or the Listing Rules of NYSE and NASDAQ to appoint nomination committees. The American Law Institute's (1994) "Principles of Corporate Governance: Analysis and Recommendations" principle 3A.04, however, recommends that each publicly held corporation establish a nomination committee composed exclusively of outside independent directors. This committee has the task of recommending candidates for

[4] The Combined Code did not specify whether or not the chairman should be an INED.

all directorships to the board. In addition, two recent developments in the USA to allow the nomination committee to fulfill its role and functions more effectively are "out-sourced recruitment" and director education. These are discussed in the next section.

6.5.2 Out-sourced Recruitment

A recent trend in the way directors (including executive, NEDs and INEDs) are recruited is through the use of executive recruitment agencies. A major executive search firm based in the USA with offices around the world reported a threefold increase in the number of searches for executive directors, NEDs and INEDs in 2001 as compared to 1995. Two advantages of using executive recruitment agencies to assist a nomination committee in recruiting members to the board have been identified. Firstly, these recruitment firms can increase the pool of director candidates through its global database and search process. Secondly, they could also have a higher level of independence identifying more qualified INEDs than those identified by members of nomination committee. This is particularly relevant for developing capital markets where the pool of local INEDs is restrictive. The "out-sourced recruitment" strategy could be an efficient way of recruiting highly qualified and experienced INEDs with a global perspective.

6.5.3 Director Education

Another issue related to director recruitment is the director's initial and continuing education. Best practice in the developed capital markets recommends initial training and ongoing education for directors. Although there are no mandatory requirements for director education in the USA, the National Association of Corporate Directors

(NACD), a private sector establishment, offers research, training and continuing education to enhance the effectiveness of its members. According to the NACD's official homepage, it has 3,000 members and 8,000 clients representing boards ranging from Fortune 100 and NASDAQ companies to smaller private and closely held firms. It is the only membership association for boards, directors, director-candidates and board advisors in the USA.

NACD promotes high professional board standards, and aims to enhance the effectiveness of directors by conducting research and providing training and continuing education to boards and directors. It offers a wide range of courses that cater to the different needs of its members. It runs specialized courses, such as "CEO's Role In Board Leadership", that are designed for seasoned CEOs and board chairmen, as well as CEO candidates and new directors. It also offers seminars that deal with other technical and specific issues, such as "Audit Committee: Improving Quality, Independence and Performance" that are designed for a specific group of its members like chairmen and members of audit committees in public companies.

6.6 Australia

6.6.1 Regulatory Framework

There are no legal or regulatory requirements for nomination committees in Australia. However, as discussed in Chapter 4, the ASX Listing Rules require 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 Bosch Report (1995) states that it is good practice to set up a nomination committee for nomination of candidates to the board, and for assessing performance of the CEO, the board, and individual directors. The committee should be led by an independent non-executive chairman, and consist of at least a majority of INEDs.

Guidance Note 9 of the ASX Listing Rules gives the indicative list of "corporate matters" that should be reported. Those that relate to nomination committees when making the statement in its annual report are as follows (Rule 4.10.3):

- The main procedures for:
  - devising criteria for membership of the board;
  - reviewing its membership; and
  - nominating representatives.

- If a procedure involves a nomination committee, set out, or summarise, the committee's main responsibilities, the names of committee members and their positions in relation to the entity (e.g., director of the entity).

6.6.2 Director Education

The Australian Institute of Company Directors (AICD) coordinates training and education of directors including executive directors, NEDs and INEDs in Australia. AICD has a leadership position in the Australian business community with over 13,000 members in industry, commerce, the professions, government and non-profit organizations. It is a professional body that offers board level professional training and development and provides director specific information services to its members.

In order to promote better quality directors, AICD provides professional development and education services to its members. The key objective is to offer practical training to assist directors in understanding their roles, duties and responsibilities and to provide guidance on ways to improve board, company and director performance.

Director specific information is also provided including a personal copy of "Duties and Responsibilities of Directors and Officers", a personal copy of the monthly "Company Director" journal, director-specific publications; and opportunities to attend Directors Briefings and other board level training (source: AICD's homepage). The training programs are broadly divided into induction and training levels.

Induction level programs are designed for newly appointed directors. The programs cover a broad range of topics from the duties and role of a director to technical topics such as the "Fundamentals of Financial Statements for Directors" course. The latter is a 6-hour program that is offered in two 3-hour sessions. It covers the role of the board, profit and loss statement, balance sheet, statement of cash flows, case studies and audit, etc., with the objective to educate directors on their duties with respect to their company's financial statements and accounts.

Training level programs are designed for experienced directors who need to develop specific skills and knowledge that help them to improve company and board performance. A good example is the "Implementing a Compliance Program" course which covers legal updates, identifies integrated compliance programs, with the objective of helping directors and officers to understand why compliance is a core corporate practice and to provide directors and officers with an overview of changes to the core laws that affect them (www.companydirectors.com.au).

6.7 Canada

Regulatory Framework

There are no legal or regulatory requirements for nomination committees in Canada. Dey recommended the establishment of a nomination committee as best practice. The Dey Committee advocated that a nomination committee was central to enhancing good governance since the quality of the board and its committees are solely dependent on how the directors are identified, recruited and appointed. It is well recognized that the quality of the board is related to the quality of the individual members. They recommended that the nomination committee should comprise entirely of NEDs, with a majority of them independent. The nomination committee's responsibilities are to propose new members to the board and its committees, and assess directors on an ongoing basis. Although the committee recommended nominations of new directors, it is the full board that approves the recommendation and appoints the new directors.

6.8 Malaysia

6.8.1 Regulatory Framework

There are no legal or regulatory requirements for a nomination committee in Malaysia. However, the Listing Rules of the Kuala Lumpur Stock Exchange (KLSE) require compliance with the Malaysian Code of Corporate Governance (2000). The Malaysian Code of Corporate Governance recommends a nomination committee be established and made up exclusively of NEDs, with the majority of them independent. It would make recommendations to the board and not be delegated the power to implement its own recommendations. The full board, through its nomination committee, should annually review its required mix of skills, experience and other qualities, including core competencies that NEDs should bring to the board. This should be disclosed in the annual report. The duties of the nomination committee are:

- Recommending candidates for directorships;
- Considering candidates proposed by the CEO; and
- Recommending directors for board committees.

There are certain skills and experience which are so strategic and fundamental to the company's success that they should exist at the board level itself and in particular amongst the independent directors. The board should implement a process to be carried out by the nomination committee for assessing the effectiveness of the board as a whole, its committees, and the contribution of each individual director on annual basis. In respect of the latter function, companies should identify the criteria for individual contributions and should be willing to provide feedback to directors in respect of their individual performance. This should, in theory, enhance each director's contribution. The process may also provide constructive input to each individual director, including NEDs as to how he or she may better contribute to the functioning of the board.

6.8.2 Director Education

Unlike Australia and the USA, there is a Listing Requirement (Paragraph 15.09) stipulating that all directors (executive, NEDs, and INEDs) in Malaysia "must attend training programs that are prescribed by the KLSE from time to time". Supplementing this Listing Requirement is the recently revised Practice Note No. 5/2001 [5], which prescribes training programs and requirements for directors of companies listed on the KLSE and that directors must attend the Mandatory Accreditation Program (MAP) and the Continuing Education Program (CEP) on a

[5] This Note dated 31 January 2001 is effective from 15 February 2001.

yearly basis. MAP's key objective is to make directors of listed companies in Malaysia aware of their duties and responsibilities. It comprises nine modules that contain ten training hours in total. The first two modules require one and half training hours each and the remaining seven modules are one training hour each. More advanced training and education of directors is provided by the CEP. All directors, including executive, non-executive and independent directors are required to attend the CEP to maintain their accreditation from year to year.

Paragraph 5.1 of Practice Note 5/2001 stipulates that a director who does not attend the MAP or the CEP will be in breach of the Listing Requirements. The KLSE would take enforcement actions that range from the issuance of a caution letter to the issuance of a private or public reprimand to de-listing (paragraphs 16.16 and 16.17 of the Listing Requirements).

Apart from the MAP and the CEP as prescribed, there are other opportunities through which corporate directors and senior executives can obtain training and education on corporate governance. Recently, the Malaysian Institute of Corporate Governance (MICG)[6] and the Association of Chartered Certified Accountants (ACCA) signed a memorandum of agreement in October 2001 to offer two diploma courses in corporate governance. The first course being planned is the ACCA Diploma in Corporate Governance, which is offered on a worldwide basis while the second is the MICG Diploma in Corporate Governance, which is for the Malaysian market. The diploma courses are designed for middle to senior management in the private and public

[6] MICG was formed in March 1998 with the objective to promote good corporate governance practices in Malaysia (www.micg.net).

sectors. The objective of these courses is to enhance knowledge of good corporate governance practice and thus help to shape and improve practices in Malaysia.

6.9 Taiwan

Regulatory Framework

There are no legal or regulatory requirements for nomination committees in Taiwan.

6.10 Singapore

Regulatory Framework

There are no legal or regulatory requirements for nomination committees in Singapore listed companies. However, listed companies are required to provide a statement of corporate governance that either acknowledges compliance with the Singapore Code of Corporate Governance (CCG) (2001), or explains instances of non-compliance. The CCG recommended a nomination committee of at least three directors, with a majority including the chairperson being independent for companies listed in Singapore Exchange. The objective of establishing nomination committees is to make the process of board appointments transparent and to assess the effectiveness of the board.

The nomination committee should have written terms of reference that describe the duties and responsibilities of its members, and its membership should be disclosed annually (Yeo and Koh, 2001). It is charged with making recommendations to the board on all board appointments, including independent directors, re-nomination of directors, performance evaluation of independent directors with particular attention on independence and performance of his/her duties as an independent director of the company.

A comparison of the regulatory requirements on nomination committees in different jurisdictions is appended in Appendix 6b.

6.11 Summary of Survey Findings

Appendix 6c contains the summary of the findings of various surveys conducted in the jurisdictions under review. In most cases, the surveys examined corporate governance practices on the whole, and were not limited to nomination committees specifically. It should be noted that not all surveys had the same scope. Therefore, information obtained could not always be comparable across all jurisdictions.

Nomination committees were found in companies in all the surveys, but the extent of their use as a corporate governance device varied. They were most common in the more developed markets such as the USA, the UK, and Australia, and less common in the Asian markets. The USA had the highest use of nomination committees, with as many as 74% of the companies having one. In jurisdictions such as Malaysia and Singapore, the use of nomination committees was as low as 1%. Many surveys found that companies had intentions of establishing nomination committees in the near future.

Most nomination committees had three members, although Singaporean companies tended to have bigger committees, with an average of five members. Few surveys outside of those in the USA indicated whether the membership was independent, but there appeared to be a majority of NEDs comprising the nomination committees. The only exception to this was in Singapore, where one survey indicated a majority of executive directors. However, another survey, performed a year later, indicated that this situation had reversed. Only Malaysia had indicated that their chairmen were NEDs. Nomination committees typically met two or three times per year. Despite the presence of nomination committees, the surveys found that CEOs and shareholders often were the dominant force in the nomination of directors to the board. However, nomination committees were not the most influential or frequent source of nominations to the board.

Having reviewed the regulatory framework of nomination committee and its existence in the different jurisdictions, we review the literature that examined the effectiveness of nomination committee in the next section.

6.12 Literature Review

Prior literature on the effectiveness of nomination committee is scarce. Evans and Evans (2001)'s recent study analyzed 214 of the top 500 companies in the Australian Stock Exchange [7]. In theory, the establishment of nomination committee should facilitate the recruitment of properly qualified and independent directors and thus would influence the determination of CEO pay levels. However, this study found no evidence that the establishment of a nomination committee would have any impact on the determination of CEO pay levels.

[7] Only companies with 30 June year-end were selected for this study.

6.13 Corporate Governance Committees

Dey introduced the concept of having a committee responsible for corporate governance matters in the company. It stated that each board must expressly assume responsibility for the company's corporate governance, but may do this by delegating the responsibilities to an existing committee, such as the nomination committee, or to a specifically appointed corporate governance committee. It was suggested that the nomination committee was central to good governance. The duties of the committee (whether it be nomination committee or a specifically appointed corporate governance committee) should include:

- General responsibility for developing corporate governance policies;
- Proposing changes as necessary to conform with governance guidelines;
- Explaining the rationale behind the company's practices if they do not follow corporate governance guidelines;
- Forum for concerns of individual directors when the matters may not be appropriate for a full board meeting, such as individual performance of other directors, or the company's approach to governance;

The corporate governance committee may be chaired by the chairman of the board, if that person is not also the CEO. "The Final Report of the Joint Committee on Corporate Governance" (CICA *et al.*, 2001) supported Dey's existing recommendations regarding corporate governance committees.

A corporate governance committee may be a viable intermediate step instead of requiring full remuneration and nomination committees. This is perhaps more appropriate for smaller companies where there may not be enough directors to formally constitute all recommended committees. The appointment of a corporate governance committee with the duties as outlined above, plus the duties of the remuneration and nomination committees would likely be a feasible undertaking for all but the smallest of listed companies. It is also a logical step to the long-term goal of establishing the other nomination and remuneration committees as the company grows in size.

6.14 Recommendations

Based on the key international corporate governance reports and the legal and regulatory framework in the different jurisdictions under study, namely the UK, the USA, Australia, Canada, Taiwan, Malaysia and Singapore on nomination committees, we provide some recommendations on nomination committees.

- The nomination committee should be established with the chairman and a majority of its members being INEDs. This constitution is particularly important for Hong Kong because over 60% of listed companies are family owned or dominated by controlling shareholders and the quality of INEDs is the most critical element in corporate governance.

- The nomination committee should be responsible to make recommendations to the board on all new appointments including executives, NEDs and INEDs. It is also crucial that the CEO and chairman should have some control/influence over the recommendations or executive directors to the board or its committees. However, the nomination of INEDs and NEDs should be the sole responsibility of this committee. One of the functions of this committee is to consider the best qualified candidates in terms of the skills and characteristics required for the make up of the board. Performance evaluation of individual directors should be undertaken by this committee on an on-going basis.

- There should be a charter stipulating the role and functions of this committee.

- Disclosures in the annual report should include: membership, terms of reference and responsibilities of members, procedures in recruiting and evaluating directors including executives, NEDs and INEDs.

- The nomination committee should assume the roles and responsibilities of the corporate governance committee as described in 6.13.

- If nomination and/or remuneration committees are not established, a corporate governance committee should be established as an intermediate step to formally establishing these committees.

In terms of implementation, a balanced approach should be adopted. The establishment of the nomination committee/corporate governance committee with detailed requirements on the constitution of the committee should be incorporated in the Listing Requirements of the Main Board and GEM Board. Details of other requirements should be incorporated in the Code of Best Practice.

CHAPTER 7 INTERVIEW, QUESTIONNAIRE AND EMPIRICAL FINDINGS

7.1 Introduction

This chapter discusses our empirical findings. First, findings from interviews with key personnel from regulatory and government agencies and prominent corporate governance experts in the different jurisdictions will be summarized. This will be followed by a discussion of the results from our questionnaires sent to company secretaries and chief executive officers (CEOs). The chapter ends with a discussion of empirical findings based on the collection of corporate governance information from 1999 Hong Kong company annual reports.

7.2 Interview Findings

Interviews with key personnel of regulatory and government agencies, representatives from local corporate governance organizations and institute of directors from the USA, the UK, Australia, Malaysia and Hong Kong were conducted[1]. While these interviews covered general issues related to corporate governance, they also focused on the roles and functions as well as the effectiveness of the three board committees, namely audit, remuneration and nomination committees. Interview findings are discussed below.

7.2.1 Effectiveness of the Three Committees

A constant theme that emerged from all the interviewees is that the **most vital element in implementing effective audit, remuneration and nomination committees is the quality of independent non-executive directors (INEDs)**.

[1] Due to time constraint, 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 the interview findings as reported.

Interviewees pointed to the fact that the mere existence of board committees would do "more harm than good". It is the quality of membership that really matters. Quality refers to the experience and expertise that the members possess, e.g., the number of years served as board members, financial literacy, business expertise, etc. More importantly, quality also refers to the independence and integrity of the members. Quotes from interviewees were as follows:

- "Independent mental attitudes of directors is considered to be the key factor."
- "As far as the effectiveness of board committees is concerned, the ability to identify good quality of INEDs is very important."
- "The effectiveness of the board committees depends on the independence of the INEDs."
- "It is not difficult to understand that the effectiveness of audit committees rests on the quality of INEDs."
- "The key for successful board committees is independence and quality of INEDs."
- "We need to stress on the quality but not the mere existence of INEDs."
- "Effectiveness is really dependent upon the quality and composition of the committees members."

7.2.2 Approach to Corporate Governance Practices

Most of the interviewees believed that **corporate governance reforms including the establishment and detailed requirements on the three board committees should not be legislated**. They favored a disclosure-based corporate governance regime over a regulatory-based regime (i.e., voluntarily practiced by market participants) where investors are allowed to exercise their own judgment on business transactions. They believed that companies should have more flexibility in conducting their business activities and organizing their internal governance to enhance shareholders' values. Therefore, codes of best practices with disclosure to allow investors to understand the corporate governance practice of each company could be the solution to better corporate governance.

Quotes from interviewees were as follows:

- "(in Australia) Regulatory requirements on specific corporate governance practices, for example, the establishment of board committees are never in the law."
- "(in the USA) The SEC adopted the recommendations made by the Blue Ribbon Committee Report i.e., companies listed in the US stock exchanges have to have audit committees. They must comprise entirely INEDs."
- "(in the UK) Generally speaking, corporate governance (including board committees) 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."
- "(in Hong Kong) It is agreed that the three board committees, i.e. audit, nomination and remuneration committees should not be made as mandatory requirements."
- "(in Hong Kong) But, it is certain that there is a strong case to make for these committees to be an integral part of best practices as far as listed companies are concerned."

7.2.3 Training and Education of Executive and Non-executive Directors (NEDs)

Most of the interviewees believed that **training and education of directors is another crucial element in assisting directors to be effective in board committees**. They asserted that many NEDs, including INEDs do not 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 executive and NEDs.

Quotes from interviewees were as follows:

- "The Australian Institute of Company Directors offers continuous training courses to directors (both executive and non-executive) so as to provide more information and education for them. The objective is to make them aware of what their fiduciary duties are and what their legal liabilities are."

- "To 'professionalize' companies' directors so as to make them aware of their roles and responsibilities."

- "Education of directors will lead to effective board committees."

- "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'."

7.2.4 Difficulties for Hong Kong

Though the interviewees **all agreed that the quality of INEDs is important, many 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 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**.

Quotes from interviewees were as follows:

- "Family owned businesses in Australia are not common, that is, say less than 10% of Australian Annual GDP, as opposed to some 80% of GDP in Hong Kong. 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."

- "People are skeptical about the effectiveness of the board committees in Hong Kong. They exist only in form but not in substance because members of these committees are often friends or connected persons of the chief executive officer."

- "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."

7.2.5 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 corporate governance practices 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. Regarding the difficulties in the recruitment of good quality INEDs, many interviewees suggested that **companies can outsource this hiring function to professional recruitment agencies**[2]. With their worldwide networks, they can possibly recruit good quality candidates abroad.

Quotes from interviewees were as follows:

- "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 shareholders about the candidates, especially for independent non-executive directorship."
- "It is necessary to change the corporate culture and mindsets of management towards corporate governance."

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

7.3 Questionnaire Results

We have employed a set of questionnaires to gather the opinions of the CEOs or chairmen of Hong Kong Hang Seng 100 companies regarding the effectiveness of the three board committees and the alternative arrangements that can promote good corporate governance practices. The response rate is 32% (with 32 respondents' information received and summarized).

7.3.1 Opinion towards the Effectiveness of Three Board Committees

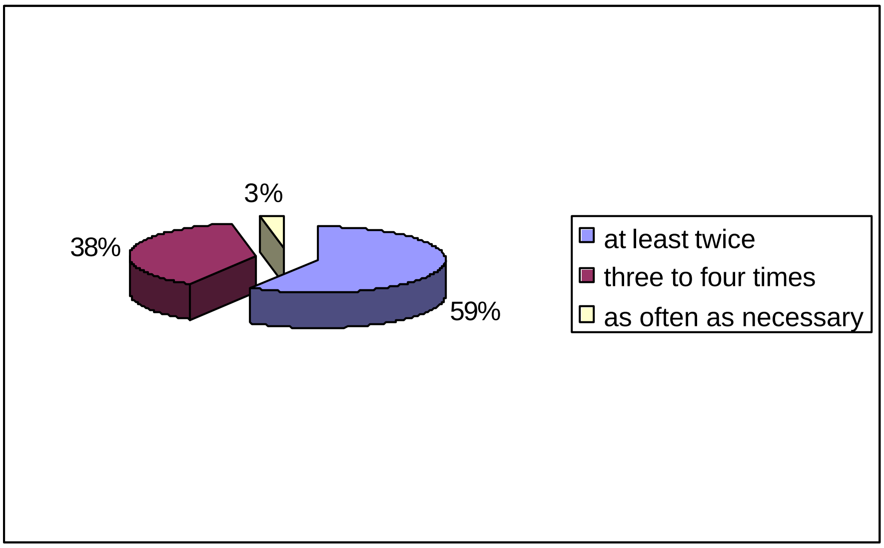
The sample respondents' opinion towards the effectiveness of audit, remuneration and nomination committees in Hong Kong is summarized below (please refer to Appendix 7 for details on scores).

7.3.1.1 Audit committees

On average, most of the respondents strongly agreed that the establishment of audit committees should be made compulsory and audit committee meetings should be attended by the external auditor of the company. The respondents agreed that audit committees should be chaired by INEDs and there should be at least three members. They agreed that all members in the audit committee should be NEDs and they should possess adequate financial experience/expertise.

Fifty-nine percent (59%) of our sample respondents considered that there should be at least two audit committee meetings per year while 38% revealed that it should be three to four times a year. Only 3% considered that audit committee meetings should be held as often as necessary (see Chart 7.1).

Chart 7.1 Number of Audit Committee Meetings Required Each Year

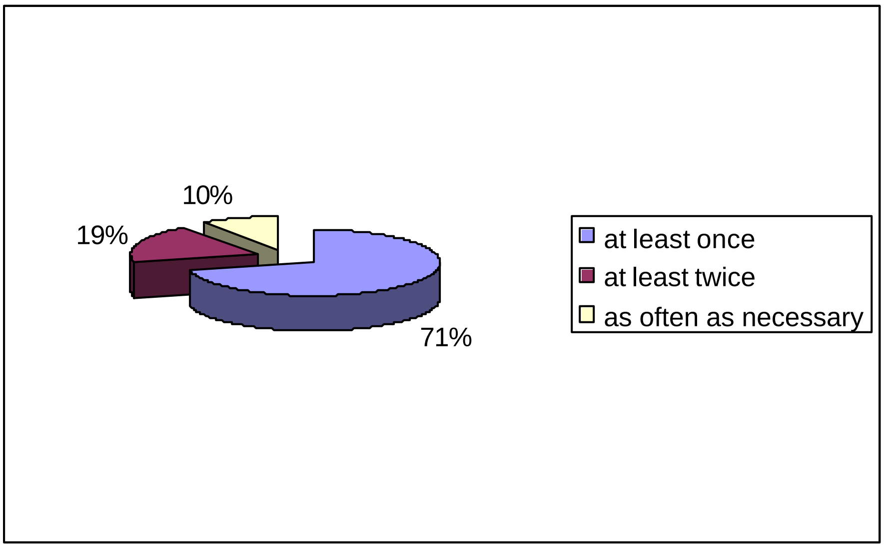


7.3.1.2 Remuneration committees

In general, 68% of our respondents agreed that remuneration committees should be chaired by INEDs and there should be at least three members. However, there was no strong agreement that the establishment of remuneration committees should be made compulsory.

Amongst our sample respondents, 71% considered that there should be at least one remuneration committee meeting per year; 19% revealed that it should be at least twice a year. Only 10% considered that remuneration committee meetings should be held as often as necessary (see Chart 7.2).

Chart 7.2 Number of Remuneration Committee Meetings Required Each Year

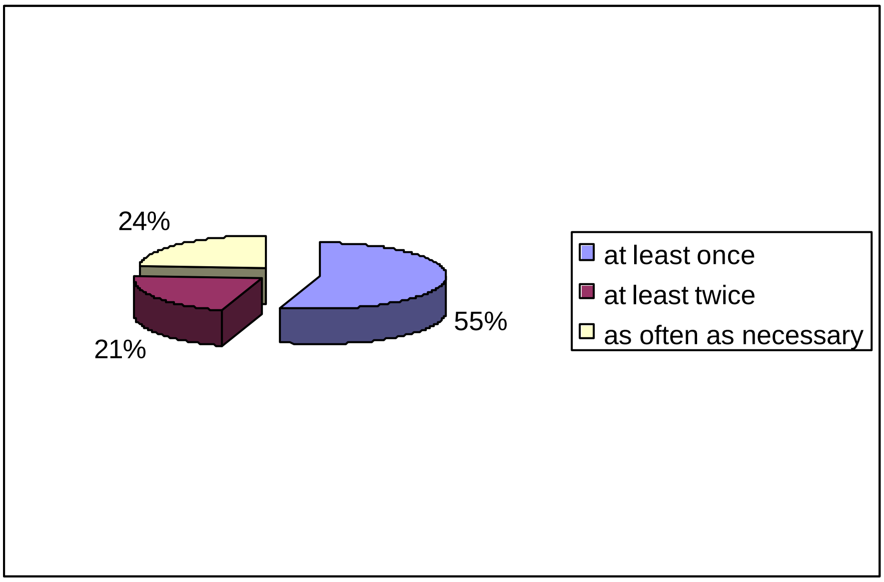


7.3.1.3 Nomination committees

Similar to the responses for remuneration committees, there was no strong agreement that the establishment of nomination committees should be made compulsory. Fifty percent (50%) of our respondents agreed that nomination committees should be chaired by INEDs and there should be at least three members.

Fifty-five percent (55%) of our sample respondents considered that there should be at least one nomination committee meeting per year while 24% considered that nomination committee meetings should be held as often as necessary. Only 21% were of the view that there should be two nomination committee meetings per year (see Chart 7.3).

Chart 7.3 Number of Nomination Committee Meetings Required Each Year



7.3.2 Corporate Governance Mechanisms

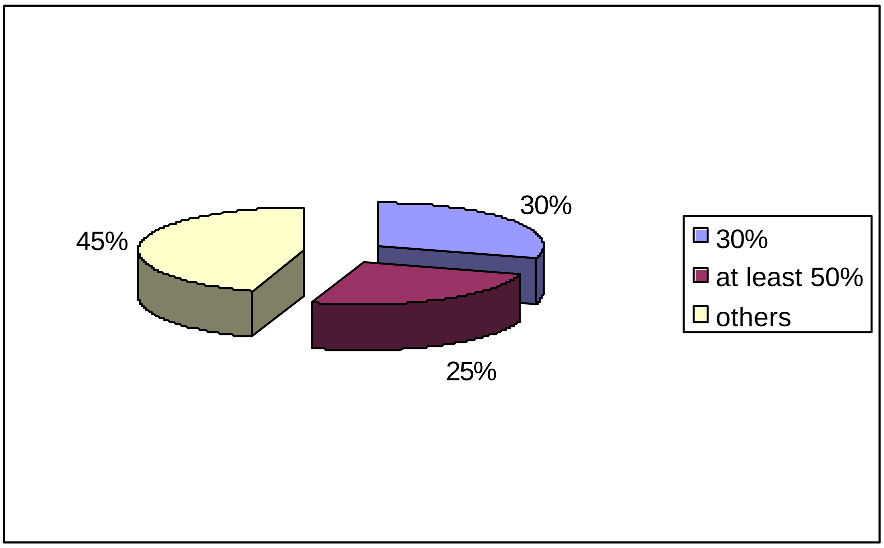
The following summarizes the key factors that contribute to good corporate governance practices (please refer to Appendix 7 for detailed scores):

7.3.2.1 Quality of independent non-executive directors (INEDs)

On average, the respondents considered the independence of the INEDs to be the most important factor contributing to good corporate governance. Moreover, they agreed that the **appointment of INEDs should be regulated by the Listing Rules of the Stock Exchange and the reason(s) for the resignation of INEDs should be disclosed**.

Regarding the optimal percentage of INEDs in a board of directors, 30% of the sample respondents considered the optimal percentage to be 30%, while 25% of the respondents suggested the majority of the board members should be INEDs (i.e., 50% of board members) (see Chart 7.4).

Chart 7.4 Optimal Percentage of INEDs in a Board of Directors



7.3.2.2 Board structure and practices

Respondents revealed that it is important to place emphasis on the recruitment of quality directors, especially INEDs. They also considered that the Board should draw up a code of ethics or statement of business practice to facilitate the standard of conduct expected of directors and employees. Moreover, they tended to agree that the roles of chairman and CEO should be separated.

7.3.2.3 Annual report disclosures

In general, respondents indicated that disclosure of directors' benefits derived from exercising share options and/or warrants and detailed disclosure on directors' dealings with related parties are important factors contributing to good corporate governance practices. They considered a separate section or general statement on corporate governance and business risk in the annual report to be important as well.

7.3.2.4 Investor Protection

Respondents considered the one-share-one-vote principle to be important for good corporate governance practices. Nevertheless, they did not suggest that institutional investors should have nominee directors on boards of investee companies.

7.3.2.5 Regulatory enforcement

Respondents generally considered that it was important to have heavier penalties and sanctions imposed on insider trading. Fifty-three percent (53%) of our respondents agreed that the Securities and Futures Commission (SFC) should have more power of enforcement.

7.3.2.6 Others

On average, respondents agreed that the introduction of corporate governance rating of individual Hong Kong listed company could enhance the standard of corporate governance in Hong Kong.

The next section summarizes findings from empirical analyses using corporate governance data collected from annual reports in 1999.

7.4 Empirical Analyses

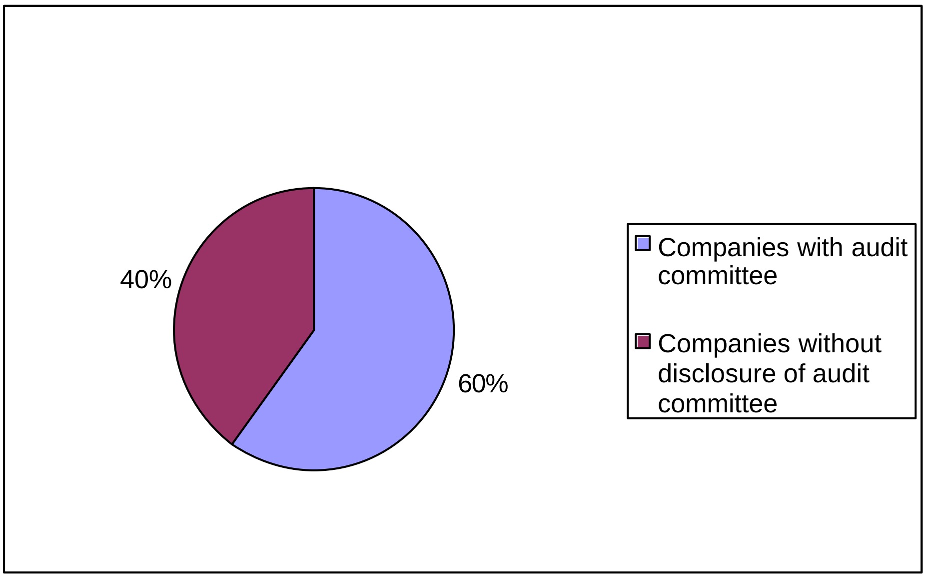
The empirical analyses discussed in this section are based on the collection of corporate governance data from annual reports of Hong Kong listed companies for the year 1999. The objective of this analysis is to examine the current establishment of the three board committees for Hong Kong listed companies. A total of 566 annual reports of listed companies have been surveyed. The analyses are summarized in two sections covering first the full sample of 566 listed companies for 1999 and then followed by Hang Seng 100 companies for 1998[3] and 1999. The results on corporate governance data relevant for the three committees are as follows:

7.4.1 Findings

7.4.1.1 Audit committees

In 1999, 60% of the listed companies (a total of 342) in Hong Kong disclosed that they had established an audit committee (see Chart 7.5).

Chart 7.5 Presence of Audit Committee



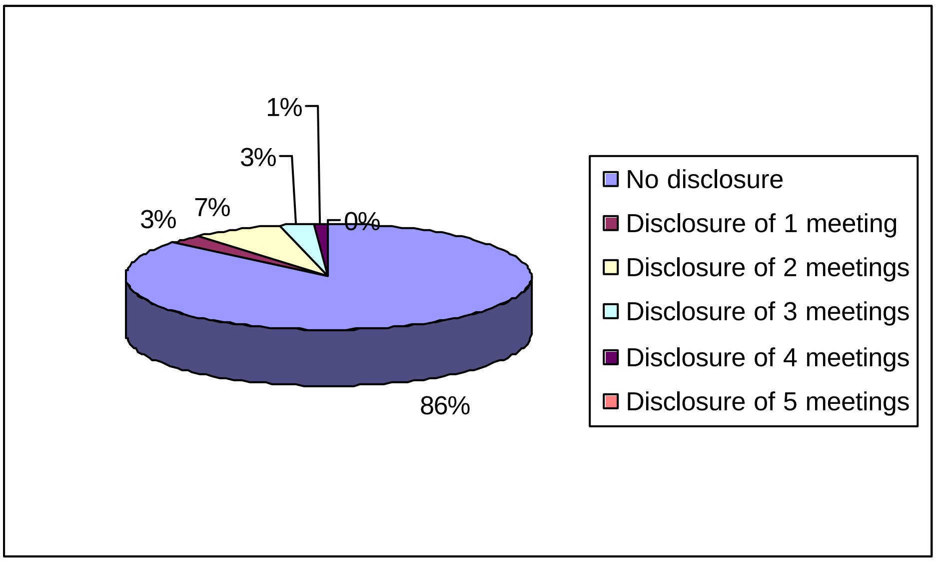
When we compare Hang Seng 100 companies in 1998 and 1999, it is very encouraging to note that there was a phenomenal increase in the number of companies with an audit committee, from 28 in 1998 to 76 in 1999.

When the number of audit committee meetings held were surveyed, only 14% (i.e. 48 companies out of the 342 companies with audit committees) had disclosed the number

[3] The data for 1998 are extracted from Tsui and Gul (2000).

of audit committee meetings held in 1999. Out of the 48 companies with such disclosure, the majority of the companies had on average only two meetings a year. About 294 companies did not disclose any information on the number of meetings held (86%) (see Chart 7.6).

Chart 7.6 Number of Audit Committee Meetings Held in 1999



Similar results were found when we compared 1998 and 1999 Hang Seng 100 companies.

For companies (286 companies) that disclosed membership of the audit committees in their annual reports, there were on average three members in the audit committee, with two of them being INEDs and one being a NED.

The same average figures were found for the Hang Seng 100 companies in 1998 and 1999. There were 115 (34% of 342 companies which reported an audit committee on board during 1999) companies that disclosed chairmanship of the audit committee in their annual report. Most of them (71%) were INEDs and some of them (about 24%) were NEDs. It should be noted that 5% of the audit committee chairmen were executive directors of the companies. When compared with Hang Seng 100 companies in 1998, 28 companies disclosed chairmanship of audit committee in their annual reports in 1999 (only 10 in 1998). Sixty-four percent (64%) of these companies (18 out of 28) have an INED as chairman of the committee (50% in 1998), 29% of them were chaired by a NED (50% in 1998), and 7% led by an executive director (0% in 1998).

Eighty-nine (89%) companies (out of 342) disclosed the work done by the audit committees during the year in the 1999 annual reports[4], with 30 of them being Hang Seng 100 companies. In 1998, only four Hang Seng 100 companies disclosed this information.

In addition, 205 companies (out of 342) with an audit committee disclosed either the roles and functions of the audit committee or the fact that the audit committee was being established according to the Guidelines provided by the Hong Kong Society of Accountants (HKSA), with 39 of them being Hang Seng 100 companies. Only 14 Hang Seng 100 companies in 1998 disclosed this information in the annual reports.

An extract from an annual report of a listed Hong Kong company which contained disclosure of an audit committee is provided in Appendix 8.

[4] This represents only 26% of the companies with an audit committee.

7.4.1.2 Remuneration committees

Our survey found that only 2% (10 out of 566) of the listed companies in Hong Kong had established remuneration committees with only one company disclosing the number of meetings held in 1999.

There were on average four members in the remuneration committee, with two of them being INEDs, one being a NED and one executive director. For Hang Seng 100 companies, there was a meagre increase of one company with a remuneration committee from four in 1998 to five in 1999. Details are shown below:

	Average number of members	Average number of INEDs	Average number of NEDs	Average number of outsiders
1998 Hang Seng 100	4	2	1	1
1999 Hang Seng 100	5	2	2	1

Only three companies in 1999 disclosed in the annual reports the work done by the remuneration committees during the year[5], with two of them being Hang Seng 100 companies. There was no such disclosure noted in 1998 annual reports.

An extract from an annual report of a listed Hong Kong company which contained disclosure of a remuneration committee is provided in Appendix 8.

7.4.1.3 Nomination committees

Nomination committees are even more rare in Hong Kong listed companies than remuneration committees. We found only six companies (out of the total 566 companies) that had a nomination committee in 1999, and none of them disclosed the number of meetings held during the year. Out of the six companies above, two of

[5] This represents only 30% of the companies that have established a remuneration committee during the year.

them were Hang Seng 100 companies as compared to only one Hang Seng 100 company in 1998.

Only one of the six companies disclosed the composition of nomination committee in 1999 annual reports. There were three members in that nomination committee including one INED, one NED and one executive director. Though the number of members in the committee dropped by one in 1999 (four in 1998), the committee in 1999 had one INED.

Only one company in 1999 has disclosed the work done by the nomination committee during the year in the annual report. There was no such disclosure in 1998 annual reports.

7.4.2 Summary of Major Findings

Annual reports of 566 Hong Kong listed companies in 1999 have been surveyed and the results are summarized below:

- Over half (60%) of the listed companies in 1999 disclosed that they have an audit committee (i.e., 342).
- Out of those companies with audit committees, disclosure of the number of audit committee meetings was rare (7% disclosing that they had two meetings a year).
- The majority of audit committees had at least two INEDs.
- Only 2% of Hong Kong companies reported remuneration committees and 1% reported nomination committees for the year 1999.

Further, an analysis of the Hang Seng 100 companies in 1998 and 1999 showed the following:

- There was an increasing trend of disclosure on the roles and functions of audit committees in 1999.
- There was a phenomenal increase in the number of companies with audit committees (from 28 in 1998 to 76 in 1999).
- There was no disclosure of remuneration committees for 1998 and two disclosures in 1999.
- There was one disclosure of nomination committee in 1998 and two disclosure in 1999.

7.4.3 Regression Analysis

7.4.3.1 Introduction

Regression analysis is a commonly used statistical method to quantify the relationship between a set of independent variables (those having effects on the variable of interest) and the dependent variable (variable of interest). In our study, we are interested in quantifying the relationship between independent variables (such as the existence and size of audit committees, number of INEDs in the audit committees) and the dependent variable, firm performance (measured by return on equity (ROE), return on assets (ROA) and Tobin's Q. Control variables such as firm size, leverage are added in the regressions to control for their differential effects on the dependent variable.

To interpret the regression results, we focus on the sign and magnitude of the coefficient of the independent variable on the dependent variable to determine whether the relationship is as predicted. In our study, we expect that there is a positive relationship between the existence and the number of INEDs on firm performance. Therefore, the coefficient on the existence of the audit committee and the number of INEDs should be positive and significant (as denoted by an asterisk).

7.4.3.2 Regression results - audit committees and firm performance

Using 1999 Hong Kong data, we investigated whether there was any association between the existence of audit committee and the number of INEDs on audit committee with firm performance. Since only a few listed companies disclosed remuneration and nomination committees in 1999, we were unable to investigate the relationship between the effectiveness of these two committees and firm performance.

We measure performance of individual Hong Kong listed companies by ROE, ROA and Tobin's Q[6].

Complete data for analysis was available for 408 out of 566 sample companies[7]. A regression analysis with control variables for firm size, debt-to-total-asset ratio, industry differences, etc., showed that companies with audit committees were positively associated with better firm performance at a marginally significant level as measured by ROE and ROA only. Details are reported in Appendices 9a to 9c.

Further, detailed analysis of companies with audit committees showed that companies with larger audit committee membership were positively associated with firm performance measured in terms of ROE, ROA and Tobin's Q. However, there was no significant association between the number of INEDs in the audit committees and firm performance. The results are reported in Appendices 10a to 10c. One possible

[6] These three measures are generally accepted proxies for firm performance in the academic literature. ROE is measured by the ratio of net profits to average shareholders' fund; ROA is measured by the ratio of net profits to average total assets and Tobin's Q is measured by the summation of market value of equity on the ending balance sheet date, closing book value of long-term debt, short-term debt and preferred shares, divided by the reported closing book value of total assets (Tsui and Lynn, 2001)

[7] There was missing data for 158 sample companies.

reason for this lack of association is that the INEDs of our sample companies are not effective in helping the boards to achieve better performance, either because they are not competent and / or not independent. This is of course an empirical question, which warrants further empirical testing. The insignificant result is surprising since intuitively, we would expect that more INEDs on audit committees should lead to better firm performance.

The above results suggest that the presence of audit committees and the size of audit committees are associated with better firm performance for Hong Kong listed companies in 1999.

7.4.3.3 Regression results - audit committees and audit fees

Gul (2002) used another way to evaluate the effectiveness of audit committee by examining how auditors assess the contribution of audit committee variables to reduce overall control risk. Gul used the audit fee regression model (see Gul, 1999; Gul and Tsui, 1998; 2001) which captures the variables that affect the size of the audit fees paid by the client to the auditor; the higher the control risk[8], the higher the audit effort and the higher the audit fee after controlling for other variables such as size of the client, debt levels, current ratio, number of subsidiaries etc. Thus, if the audit committee variables contribute to higher board diligence and independence, then the existence of these variables could indeed reduce control risk. A reduction in control risk will reduce the auditor's effort which will result in lower audit fees. This reasoning should lead to a negative association between the audit committee variables and audit fees. On the other hand, a positive association between these audit

[8] Control risk is an important component of the overall audit risk model; Audit risk = inherent risk x control risk x planned detection risk (see Gul and Tsui, 1998 or Gul, 2001 for a discussion of the audit risk model).

committee variables and audit fee could mean that the existence of audit committee or the existence of a larger audit committee membership is more supportive of the external audit function and encourage the auditor to do more audit work and increase the scope of the audit thus increasing the audit fee.

Gul (2002) used the above audit fee model and rationale to investigate the association between audit committee variables and audit fees. The audit committee variables were measured in terms of the following:

- the existence or non-existence of audit committees; and
- the size of audit committee membership for listed companies that have audit committees.

Complete data for analysis was available for 355 out of 566 sample companies[9] and a regression analysis with control variables for company size, debt-to-total asset ratio, current ratio, Big 5/non-Big 5 firms, audit opinion etc. showed that companies with audit committees were negatively associated at a marginally significant level with audit fees. The results are reported in Appendix 11a. These results are consistent with the broader agency explanation suggesting that firms with audit committees have better monitoring and have lower overall control risks and hence auditors charge lower fees.

Further, analysis of companies with audit committees showed that companies with larger audit committee membership in audit committees were positively associated with audit fees. The results are reported in Appendix 11b. This positive relationship is, however, not consistent with agency theory since larger audit committee

[9] There was missing data for 211 sample companies.

membership should be associated with higher monitoring and lower control risk. The results are, however, consistent with the argument that increased board vigilance could lead to increased audit scope. For example, Carcello *et al*. (2000) suggested that an audit committee that is more concerned with fulfilling its monitoring role (as proxied by the size of membership and the number of INEDs in audit committees) may support an enhanced audit scope by the external auditor. The increased audit scope thus results in higher audit fees.

The results in the Gul (2002) study suggested that for Hong Kong listed companies in 1999, the presence of audit committees is negatively associated with audit fees, i.e., lower control risks. However, for firms with audit committees, larger membership is associated with enhanced audit scope and hence higher audit fees.

Gul (2002) also examined the role of firm size on the association between audit committee variables and audit fees based on an important strand of the management literature which suggested that the effectiveness of board composition (including audit committee) could be affected by firm size. Dalton *et al*. (1998) for example, pointed out "that the scale of complexity of the large firm would cloud any relationship between board composition and structure and performance" (p. 273). Further, the ability of the board to monitor the firm's activities is also affected by the scale and complexity of the firm. In other words, the complexity of large firms was expected to compromise the boards' ability to dispatch this responsibility. Thus, smaller firms may facilitate better board monitoring.

To test the above reasoning, Gul (2002) divided the sample into large and small firms on the basis of the median score for total assets and re-ran the audit fee model. The results (not reported here) were consistent with expectations and showed that the negative association between the existence of audit committee variables and audit fee is more significant for small firms, but insignificant for large firms. Further, the positive association between audit committee membership and audit fee is more significant for small firms but insignificant for large firms.

7.5 Summary

In this study, we have reviewed the roles and functions of audit, remuneration and nomination committees. We have also used the descriptive and analytical research approaches to investigate the effectiveness of these three board committees.

Our interview findings revealed that the effectiveness of the three committees hinges on the quality of the members. In general, interviewees were skeptical about the effectiveness of the board committee in Hong Kong. This is because in Hong Kong, the business community is small and many companies are family controlled. Therefore, qualified INEDs (in terms of expertise and experience) are usually connected to the companies. One must recognize that it is not easy to recruit good quality INEDs in the territory.

Interviewees were supportive of a corporate governance reform in Hong Kong. However, they favored a disclosure-based approach in order to allow market participants to have more flexibility in conducting their businesses. They considered that an effective way to upgrade the quality of INEDs is to “professionalize” them.

Consistent with our interview findings, the results of our questionnaire survey revealed that the independence of the INEDs is the most important factor contributing to good corporate governance. These results also suggested that emphasis should be placed on the recruitment of quality directors, particularly INEDs.

On average, our sample respondents, i.e., CEOs or chairmen of Hang Seng 100 companies in 1999, agreed that the establishment of audit committees (but not for remuneration and nomination committees) should be made compulsory and audit committees meetings should be attended by the external auditor of the company. They agreed that the three committees should be chaired by INEDs and there should be at least three members in each of the committees.

From our analysis using 1998 and 1999 data collected from annual reports, it is encouraging to note that Hong Kong listed companies have taken steps to improve the corporate governance practices. For example, there was a dramatic increase in the number of audit committees in 1999 and more companies disclosed the work done by the audit committees during the year 1999.

Apart from the above methods, we have also used regression analyses of 408 firm observations to investigate, in a more objective manner, the association between the effectiveness of the audit committee variables and firm performance. Results showed that the existence of audit committee was positively associated at a marginally significant level with better performance. In addition, for firms with audit committees, it was found that more INED committee membership was associated with better performance. Further, a Hong Kong study showed that these companies with audit committees were associated with lower audit fees suggesting that the existence of audit committee reduced control risks. For companies with audit committees, the results showed that companies with larger audit committee membership were associated with higher audit fees due to increased audit scope. It was found that the relationship between the above audit committee variables and audit fees are significant for small firms and not for large firms. This suggests that firm size could affect the extent to which auditors, in developing the scope of audit works, are affected by audit committee variables.

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

CHAPTER 8 SUMMARY, RECOMMENDATIONS AND LIMITATIONS

8.1 Summary

Agency theory and the theory of incomplete contracting provide a framework for understanding the role of corporate governance mechanisms that have surfaced in modern corporations. These mechanisms include the establishment of the three board committees, namely the audit, remuneration and nomination committees. The objective of this study is to examine the roles and functions of these three committees.

Chapter 1 draws attention to the pivotal monitoring role of the independent non-executive directors (INEDs) in the effective functioning of these three committees. Since the roles and functions of these three committees depend on the legal institutions, corporate ownership structures and regulatory framework, Chapter 2 provides an overview of the institutional and regulatory framework that would impact on the effectiveness of these committees. It also includes a comprehensive review of the legal and regulatory framework of corporate governance in Hong Kong including the Companies Ordinance, Securities Ordinance, Main Board Listing Rules, Growth Enterprise Market (GEM) Listing Rules and Banking Ordinance of the Hong Kong Monetary Authority (HKMA). Recommendations on corporate governance practices in Hong Kong from private sector organizations such as Hong Kong Society of Accountants (HKSA) and Hong Kong Institute of Directors (HKIoD) are also reviewed. Chapter 3 presents a framework for analyzing and understanding how the three committees individually and collectively could contribute to effective corporate governance in Hong Kong. In addition, three regulatory approaches, namely the prescriptive, non-prescriptive and balanced approaches to promote good corporate governance are reviewed. These three approaches are used as an analytical framework for evaluating key recommendations for the three board committees in Hong Kong. Chapter 3 ends with an outline of the methodology adopted for this study, namely a comprehensive literature review, in-depth interviews, questionnaire survey and a battery of empirical tests.

Chapters 4 to 6 are devoted to a detailed discussion of the roles and functions of the audit, remuneration and nomination committees respectively in the context of the different legal and regulatory jurisdictions on a country-by-country basis. The countries examined are the UK, the USA, Australia, Canada, Malaysia, Taiwan and Singapore. This includes a detailed review of the key international corporate governance reports as they relate to each of the committees. To shed light on the status of the three committees in the different jurisdictions, surveys conducted by private organizations are also summarized. The chapters end with a review of the academic literature on the effectiveness of each committee.

Chapter 7 summarizes all the findings from the interviews, questionnaires and empirical tests. Our interview and questionnaire findings reveal that the effectiveness of the three committees depends on the quality of the INEDs who should dominate the committees' membership. The findings also emphasize that education is the best way to professionalize the INEDs and encourage more independent judgment. Interviewees express some skepticism about the quality of INEDs in Hong Kong as they are usually connected to family controlled companies or are really not willing nor capable to be independent in their judgment. The majority of our questionnaire respondents supports the compulsory establishment of the audit committee with the requirements that it be chaired by an INED, with at least three members and the external auditor present at meetings. They do not recommend that the nomination and remuneration committees be required.

Findings from data collected in 1999 show a dramatic improvement in the number of audit committees being established by listed companies with more disclosures on the work done by the audit committees. Our regression analyses of observations from a sample of Hong Kong listed companies for 1999 show that companies with audit committees are associated with better performance. Moreover, audit committees with larger membership are also associated with better performance. This is persuasive empirical evidence that audit committees are effective in not only monitoring management but also are associated with better firm performance. Findings from another recent paper (Gul, 2002) shows that companies with audit committees are associated with lower audit fees suggesting that audit committee can reduce control risks. However, larger audit committee membership is related to higher audit fees due to increased monitoring and vigilance. The finding is more significant for small firms than for large firms. This could be because the complexity of large firms may have clouded the relationship between audit committee membership and audit fees.

8.2 Recommendations

Chapter 7 draws attention to some discernable improvements in the corporate governance landscape of Hong Kong listed companies. This is, however, still far from satisfactory if corporate Hong Kong wishes to reap the full benefits of what effective corporate governance can offer. Based on the recommendations made in the academic and professional literature and taking into consideration Hong Kong's unique corporate environment, we provide below some broad recommendations that might be helpful in enhancing corporate governance, particularly the effectiveness of the three board committees in Hong Kong.

8.2.1 Quality of Independent Non-Executive Directors (INEDs)

As discussed in Chapter 7, the effectiveness of the three board committees hinges on the quality of INEDs. Quality is a generic term that refers to a multitude of desirable traits including integrity, business experience, acumen, financial literacy and independence to name a few. A useful way of improving the quality of INEDs in Hong Kong is to place emphasis on the recruitment, training, continuing education and "licensing" of INEDs. These programs are also likely to inject a much needed sense of professionalism amongst INEDs.

Given that most of the listed companies in Hong Kong are closely held or family owned businesses and Hong Kong is a small territory, it is not surprising to find that many good INED candidates are connected with the companies. To overcome this problem, it is suggested that Hong Kong companies may consider looking overseas for a source of

INEDs who can not only be independent but also bring an international experience to companies in Hong Kong. The nomination committees (if any) or the boards of directors of companies could work with international professional recruitment agencies to recruit such INEDs. Since these recruitment agencies have extensive international networks and expertise in executive searches, they could facilitate the appointment of higher quality INEDs in Hong Kong.

It may also be advisable to set up a "licensing" mechanism to "professionalize" INEDs within the territory. One of the criticisms leveled at many INEDs in Hong Kong is that they do not have the competence and expertise required to perform their duties. It is asserted that some of them do not even understand clearly their roles and responsibilities as INEDs. One way of overcoming this problem is to introduce systematic training and continuous education programs for them. Indeed, this is already a common practice for solicitors and professional accountants. These training and education programs should be organized, promoted and supervised by a professional body, possibly the Hong Kong Institute of Directors. Such training and education programs could lead to an award or certificate.

8.2.1.1 Reasons for setting up a licensing mechanism to "professionalize" INEDs

Considering the roles and functions of INEDs in modern business, their contributions and importance to the public at large are similar to other professionals such as solicitors and accountants. In addition, higher quality INEDs are demanded in order to give impartial and professional advice to the board and serve as a better monitoring device to safeguard the interests of shareholders. Such INEDs fulfill a similar role as other professionals. Therefore, a self-regulated professional body of INEDs can maintain the quality of their members. More importantly, this body may be established to assume responsibility for disciplining members where appropriate.

Upgrade the "Quality" of INEDs

The quality of INEDs comprises a number of traits including personal traits such as integrity and independence. It is also important for INEDs to have sound professional competence. If there is a full scale licensing system in place, the designated professional body could assist INEDs to upgrade and maintain their professional knowledge by implementing training programs including continuing professional development (CPD) programs and examinations.

Perceived Quality

Similar to the other professions, when there is an established and self-regulated licensing system in place (provided that the professional body is able to attract good members, administer training and accreditation programs properly and maintain discipline) the general public is likely to gradually build up confidence in the perceived quality of INEDs. The quality of INEDs will help to promote the standard of corporate governance in Hong Kong.

Overseas Benchmark

Though there is no empirical evidence showing that there is a relationship between an active directors' association and good corporate governance practices, anecdotal evidence supports the idea that countries having active directors' association are relatively better in terms of corporate governance, e.g., the National Association of Corporate Directors in the USA (See Section 6.5.3 above), and the Australian Institute of Company Directors in Australia (See Section 6.6.2 above). Based on this evidence, it is recommended that Hong Kong promotes the image of "professionalism" of corporate directors in order to be perceived as an active promoter of corporate governance in the international arena.

8.2.2 Board Committees Structure and Practices

Recommendations applicable to each of the three board committees have been discussed in Chapters 4, 5 and 6. To sum up, we recommend that a balanced approach be adopted and that the following be incorporated in the Listing Requirements of the Main Board as well as the GEM Board:

- Audit, remuneration and nomination committees be established.
- Each committee should have at least three INEDs as members.
- The chairman of each of the committees should be an INED.
- The majority of members of the committees should be INEDs.
- Establishment of a corporate governance committee as an interim measure to establishing the full remuneration and nomination committees as recommended above (for smaller companies or where the establishment of full committees is not practical)

Other detailed requirements should be incorporated in the Code of Best Practice.

Our recommendations are intended to provide a basis for discussion only. Details regarding the procedures and time-table on how and when these recommendations could be implemented should be further considered.

8.3 Limitations

Like all studies. this study is subject to some limitations. We covered as many of the key reports and the academic/professional literature as possible within the short time span and there could be other materials that we have not been able to review. In any case, we believe that we have comprehensively covered the more important literature in the area. The survey findings conducted by private organizations should be evaluated and taken on board with some caution since it is not entirely clear if the surveys were conducted in a scientific and objective manner. In some cases, no information was provided as to how the surveys were conducted. We also conducted in-depth interviews with a wide variety of individuals involved in corporate governance in different countries and in some situations, individuals were unwilling to be interviewed. This is not a serious limitation since we managed to interview enough individuals from various jurisdictions to obtain a good "spread" of opinions. Finally, we were disappointed with the low response rate for our questionnaire surveys and this poor response rate could limit the interpretation and generalization of our findings.

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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 constraint, 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

Questionnaire on Effectiveness of Board Committees

Section I Audit, Remuneration and Nomination Committees

A. Audit Committee

Please indicate your level of agreement with the following statements:

	Disagree		Neutral		Agree
▪ Establishment of audit committee should be made compulsory	1	2	3	4	5
▪ One of the roles of the audit committee is to prevent fraud	1	2	3	4	5
▪ Audit committee should be chaired by an independent non-executive director	1	2	3	4	5
▪ Audit committee members should comprise all non-executive directors	1	2	3	4	5
▪ All members in the audit committee should be independent non-executive directors	1	2	3	4	5
▪ There should be a minimum of three members in the audit committee	1	2	3	4	5
▪ Members of the audit committee should have adequate financial experience	1	2	3	4	5
▪ Disclosure in the annual report:					
• Number of audit committee meetings	1	2	3	4	5
• Attendance list of audit committee meetings	1	2	3	4	5
▪ Audit committees should be attended by the external auditor	1	2	3	4	5

- Number of audit committee meetings should be stipulated at:
  - at least once per year
  - at least twice per year
  - 3-4 per year
  - as often as necessary

- Please comment on any other aspects which you think are important for audit committees to function effectively as a corporate governance mechanism:

____

____

Appendix 2 (cont' d)

B. Remuneration Committee

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
▪ Establishment of remuneration committee should be made compulsory	1	2	3	4	5
▪ If the Board or the company is too small for establishing a remuneration committee,					
• external professional advisers should be hired to perform its functions	1	2	3	4	5
• additional disclosures should be made on the basis of directors' remuneration	1	2	3	4	5
▪ Remuneration committee members should comprise all non-executive directors	1	2	3	4	5
▪ Remuneration committee should be chaired by an independent non-executive director	1	2	3	4	5
▪ All members in the remuneration committee should be independent non-executive directors	1	2	3	4	5
▪ There should be a minimum of three members in the remuneration committee	1	2	3	4	5
▪ Disclosure in the annual report:					
• Number of remuneration committee meetings	1	2	3	4	5
• Attendance list of remuneration committee meetings	1	2	3	4	5

▪ Number of remuneration committee meetings should be stipulated at:

- at least once per year
- at least twice per year
- 3-4 per year
- as often as necessary

▪ Please comment on any other aspects which you think are important for remuneration committees to function effectively as a corporate governance mechanism:

Appendix 2 (cont' d)

C. Nomination Committee

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
▪ Establishment of nomination committee should be made compulsory	1	2	3	4	5
▪ If the Board or the company is too small for establishing a nomination committee,					
• external professional advisers should be hired to perform its functions	1	2	3	4	5
• additional disclosures should be made on the basis of directors' nomination	1	2	3	4	5
▪ Nomination committee should be chaired by an independent non-executive director	1	2	3	4	5
▪ Nomination committee members should comprise all non-executive directors	1	2	3	4	5
▪ All members in the nomination committee should be independent non-executive directors	1	2	3	4	5
▪ A representative from minority shareholders should be appointed as a member of the nomination committee of the company	1	2	3	4	5
▪ There should be a minimum of three members in the nomination committee	1	2	3	4	5
▪ Disclosure in the annual report:					
• Number of nomination committee meetings	1	2	3	4	5
• Attendance list of nomination committee meetings	1	2	3	4	5

- Number of nomination committee meetings should be stipulated at:
  - at least once per year
  - at least twice per year
  - 3-4 per year
  - as often as necessary

- Please comment on any other aspects which you think are important for nomination committees to function effectively as a corporate governance mechanism:

Appendix 2 (cont' d)

Section II Alternative Arrangements for Corporate Governance

Other than the audit, remuneration and nomination committees described above, how important are the following factors in contributing to good corporate governance?

A. Quality of Independent Non-executive Directors

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
▪ Independence of independent non-executive directors is most important	1	2	3	4	5
▪ The appointment of independent non-executive directors should be regulated by the Listing Rules of the Stock Exchange	1	2	3	4	5
▪ A majority of the independent non-executive directors should have an understanding of finance or accounting	1	2	3	4	5
▪ Reasons for the resignation/termination of independent non- executive directors should be disclosed	1	2	3	4	5

- What is the optimal percentage of independent non-executive directors in a board of directors?

B. Board Structure and Practices

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
▪ Chairman of the Board should not occupy the position as the CEO or Managing Director or President	1	2	3	4	5
▪ Restrictions on the number of family members who can sit on the Board	1	2	3	4	5
▪ Chairman of the Board should be an independent non-executive director	1	2	3	4	5
▪ Majority of the Board should be independent non-executive directors	1	2	3	4	5
▪ A member on the Board should represent minority interests	1	2	3	4	5
▪ The Board should draw up a code of ethics or statement of business practice to facilitate the standard of conduct expected of directors and employees	1	2	3	4	5
▪ Emphasis on the recruitment of quality directors, especially independent non-executive directors	1	2	3	4	5

Appendix 2 (cont' d)

C. Annual Report Disclosures

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
▪ Disclosure of directors' benefits derived from exercising share options and/or warrants	1	2	3	4	5
▪ More disclosure on directors' dealings with related parties	1	2	3	4	5
▪ A separate section or general statement on corporate governance in the annual report	1	2	3	4	5
▪ A general statement of business risk in the annual report e.g. foreign exchange exposure	1	2	3	4	5
▪ Quarterly financial reporting	1	2	3	4	5

D. Investor Protection

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
▪ Class actions against companies	1	2	3	4	5
▪ One-share-one-vote principle	1	2	3	4	5
▪ Institutional investors should have nominee directors on Boards of investee companies	1	2	3	4	5

E. Regulatory Enforcement

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
▪ Heavier penalties and sanctions imposed on insider trading	1	2	3	4	5
▪ Securities and Futures Commission should have more power of enforcement	1	2	3	4	5

F. Others

Please indicate your level of agreement with the following statements:

	Disagree 1	2	Neutral 3	4	Agree 5
Introduction of corporate governance rating of individual HK listed company e.g. Standard & Poor's Rating	1	2	3	4	5

Appendix 3

Sample Charter for an Audit Committee

(adapted from the Cadbury Report)

Constitution

1. The Board hereby resolves to establish a Committee of the Board to be known as the Audit Committee.

Membership

2. The Committee shall be appointed by the Board from amongst the Non-Executive Directors of the Company and shall consist of not less than three members. A quorum shall be two members.

3. The Chairman of the Committee shall be appointed by the Board.

Attendance at meetings

4. The Finance Director, the Head of Internal Audit, and a representative of the external auditors shall normally attend meetings. Other Board members shall also have the right of attendance. However, at least once a year the Committee shall meet with the external auditors without executive Board members present.

5. The Company Secretary shall be the Secretary, of the Committee.

Frequency of meetings

6. Meetings shall be held not less than twice a year. The external auditors may request a meeting if they consider that one is necessary.

Authority

7. The Committee is authorised by the Board to investigate any activity within its terms of reference. It is authorised to seek any information it requires from any employee and all employees are directed to co-operate with any request made by the Committee.

8. The Committee is authorised by the Board to obtain outside legal or other independent professional advice and to secure the attendance of outsiders with relevant experience and expertise if it considers this necessary.

Duties

9. The duties of the Committee shall be:

   a. to consider the appointment of the external auditor, the audit fee, and any questions of resignation or dismissal;
   b. to discuss with the external auditor before the audit commences the nature and scope of the audit, and ensure co-ordination where more than one audit firm is involved;
   c. to review the half-year and annual financial statements before submission to the Board, focusing particularly on:
      (i.) any changes in accounting policies and practices
      (ii.) major judgemental areas
      (iii.) significant adjustments resulting from the audit
      (iv.) the going concern assumption
      (v.) compliance with accounting standards
      (vi.) compliance with stock exchange and legal requirements.

   d. to discuss problems and reservations arising from the interim and final audits, and any matters the auditor may wish to discuss (in the absence of management where necessary);

   e. to review the external auditor's management letter and management's response;

   f. to review the Company's statement on internal control systems prior to endorsement by the Board;

   g. (where an internal audit function exists) to review the internal audit programme, ensure co-ordination between the internal and external auditors, and ensure that the internal audit function is adequately resourced and has appropriate standing within the Company;

   h. to consider the major findings of internal investigations and management's response;

   i. to consider other topics, as defined by the board.

Reporting procedures

10. The Secretary shall circulate the minutes of meetings of the Committee to all members of the Board.

Appendix 4a
Detailed Recommendations of Key Corporate Governance Reports on Audit Committees

	UK Cadbury Report (1992)	UK Greenbury Report (1995)	UK Hampel Report (1998)	USA Blue Ribbon Committee Report (1999)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(1994)	Canada Dey Report (1994)
1. Establishment	All listed companies should establish an AC.	See Note 1	Listed companies are recommended to establish an AC.	• Listed companies with a market capitalization above US$200m should have an AC. • The AC should (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the AC charter on an annual basis.	There is currently an AC. See Note 2	Listed companies are recommended to establish an AC.
2. Composition	There should be a minimum of three NEDs and a majority of them should be independent.	---	There should be at least three NEDs and a majority of them should be independent.	• The AC should comprise solely of independent directors. • The AC should comprise a minimum of three directors, who should be financially literate or become financially literate within a reasonable period of time after his/her appointment, and at least one member should have accounting or related financial management expertise.	The AC consists only of independent directors.	The AC should be composed only of outside directors.

AC: Audit committee
NED: Non-executive director

Notes: 1. The Greenbury Report is a set of Best Practice in determining and accounting for directors' remuneration, but does have some recommendations relating to internal control and audit.

2. The GM Code does not make recommendations on which specific committees should be used. It states that committees should be formed or disbanded depending on circumstances.

3. The OECD Principles is a set of general corporate governance standards and guidelines for members' countries. It is meant to be very broad in scope and therefore does not have recommendations on committees.

Appendix 4a (cont' d)

	UK Cadbury Report (1992)	UK Greenbury Report (1995)	UK Hampel Report (1998)	USA Blue Ribbon Committee Report (1999)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(1994)	Canada Dey Report (1994)
3. Role and functions						
3.1 External Audit	• Make recommendations to the board on the appointment of the external auditor. • Discuss with the external auditor about the nature and scope of the audit. • Review external auditor' s management letter.	---	• Safeguard auditor independence and objectivity. • Review the overall financial relationship between the company and the external auditor. • Keep the nature and extent of non-audit services by the external auditor under review, seeking to balance the maintenance of objectivity with value for money.	• Discuss with the external auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor. • Recommend the full board to take appropriate action to ensure the independence of the external auditor. • The AC charter for every listed company should specify that the external auditor is ultimately accountable to the board and the AC, as representatives of the shareholders, and that these shareholders have the ultimate authority and responsibility to select, evaluate and replace the external auditor.	---	• Have direct communication channels with the internal and external auditors to discuss and review specific issues as appropriate.
3.2 Financial Reporting	Review half-year and annual financial statements before submission to the board.	---	---	Discuss with the external auditor their judgments about the quality of the company' s accounting principles as applied in its financial reporting.	---	---
3.3 Internal Control	---	• Review company' s statement on internal control system • Review any significant findings of internal investigations.	---	---	• Oversight responsibility for management reporting on internal control. • Ensure that management has designed and implemented an effective system.	---

Appendix 4a (cont' d)

	UK Cadbury Report (1992)	USA Blue Ribbon Committee Report (1999)	Canada Dey Report (1994)
3.4 Others	• The chairman of the AC should be available to answer questions about its work at the AGM. • The AC should have explicit authority to investigate any matters within its terms of reference, the resources which it needs to do so, and full access to information. • The AC should be able to obtain external professional advice and to invite outsiders with relevant experience to attend if necessary.	The AC charter should also specify that the AC is responsible for ensuring its receipt from the external auditor of a formal written statement delineating all relationships between the auditor and the company.	The roles and responsibilities of the AC should be specifically defined so as to provide appropriate guidance to AC members as to their duties.
3.5 Internal Audit	UK Greenbury Report (1995) • Where an internal audit function exists, the AC should ensure that it is adequately resourced and has appropriate standing within the company. The AC should review the internal audit programme.		
4. Disclosure	USA Blue Ribbon Committee Report (1999) • Disclose in the company' s proxy statement for its annual meeting of shareholders whether the AC has adopted a formal written charter, and, if so, whether the AC satisfied its responsibilities during the year in compliance with its charter. • Annual report should include a statement of whether or not management has reviewed the audited statements with the AC, including a discussion about the quality of principles and judgments.		

Appendix 4b
An Overview of the Legal and Regulatory Framework for Audit Committees in Different Jurisdictions

COMMON LAW JURISDICTIONS	
Countries with Legal Requirements	
Singapore	Company Act Section 201 **requires** every listed company to establish an audit committee comprising **of at least 3 directors**, a **majority** of whom are **independent** directors.
Canada	Canadian Business Corporations Act requires listed corporations or companies with securities held by more than one person to appoint an audit committee comprising of **at least 3 directors**, with **at least two** of them being **independent**.
Countries with Listing Requirements	
United States	Each company must have a qualified audit committee. Each audit committee **shall consist** of **at least 3 directors**, **all** of whom are **independent** directors. Each member of the audit committee shall be financially literate. At least one member of the audit committee must have accounting or related financial management expertise. [NYSE 303.01 & NASD 4350(d)]
Malaysia	Listing Rule of KLSE 15.10 (1) states that a listed company must appoint an **audit committee** which consists of *at least 3 members* with a **majority** of **independent** directors.
Hong Kong	Listed companies in the GEM Board are required to establish an audit committee with **at least two non-executive directors**, the **majority** of whom are **independent**. An audit committee is required to be **chaired by an independent non-executive director**.

Appendix 4b (cont' d)

COMMON LAW JURISDICTIONS	
Countries with Listing Rules / best practice requirement (not required directly by Listing Rules but indirectly through reference in Listing Rules to Code of Best Practice)	
Hong Kong	Listed companies in the Main Board are encouraged, but not obliged, to establish an audit committee. Listing Rule Appendix 14 (14) Code of Best Practice recommends each listed company establish an audit committee with at least two NEDs, the majority of whom are independent.
Australia	Listed companies in the Australian Stock Exchange are encouraged, but not obliged, to establish an audit committee according to Listing Rules 4.10.2.
United Kingdom	Listing Rule 12.43A requires listed companies to comply with the Code provisions set out in Part 2, Section 1 of the Combined Code. For non-compliance, companies are required to provide justifications. The Combined Code S1.D.3.1 recommends that each board establish an audit committee of at least three NEDs, the majority of whom are independent non-executive directors.
CIVIL LAW JURISDICTION	
Taiwan	There is no statutory or regulatory requirement for listed companies in Taiwan to establish an audit committee.

NED Non-executive director

United States

NYSE The Listing Requirements of the New York Stock Exchange

NASD The Listing Requirements of NASDAQ

Reg. S-K U.S. Securities and Exchange Commission (SEC) – Regulation S-K contains the requirements for non-financial statement information in filings under the Securities Act of 1933 and the Securities Exchange Act of 1934

Malaysia

KLSE Kuala Lumpur Stock Exchange

Appendix 4c
Comparison of the Legal and Regulatory Requirements on Audit Committees in Different Jurisdictions

		Hong Kong	Australia	Singapore	Malaysia	United Kingdom	United States	Canada	Taiwan
1.	Establishment	**Main Board** – recommended **GEM Board** – required **HKSA** – recommended	Recommended by LR.	Required by law.	Required by LR.	Required by LR to have AC or explain why no AC is established.	Required by LR.	Required by law.	Not required.
2.	Composition (as required by the establishing authority shown in 1. above unless otherwise specified.)	**Main Board (recommended) & GEM Board (required)** -minimum 2 NEDs -only NEDs and INEDs -majority INEDs **HKSA** -members should be NEDs -majority INEDs	-majority NEDs, preferably independent.	-minimum 3 members -NEDs -majority independent (LR/CCG) -members should be appropriately qualified -at least two should have accounting or related financial management expertise or experience (CCG)	-minimum 3 members -majority INEDs -at least one member must be a member of the Malaysian Institute of Accountants, or be otherwise appropriately qualified	-minimum 3 members -majority INEDs	-minimum 3 directors -all INEDs -each member shall be financially literate -at least one member must have accounting or related financial management expertise	-only outside directors (LR)	Nil

NED	Non-executive director	INED	Independent non-executive director
AC	Audit committee	LR	Listing Rules
CCG	Code of Corporate Governance (Singapore)	BPG	Best Practices Guide (Singapore)
HKSA	Hong Kong Society of Accountants		

Appendix 4c (cont' d)

		Hong Kong	Australia	Singapore	Malaysia	United Kingdom	United States	Canada	Taiwan
3.	Chairman (as required by the establishing authority shown in 1. above unless otherwise specified.)	**Main Board** -not required **GEM Board** -INED	-INED (as long as not also the chairman of the board)	-INED	-INED	Nil	Nil	Nil	Nil
4.	Independence	Disclosure should be made of AC independence (HKSA).	Nil	A majority of members should be independent of management (BPG).	Nil	Nil	Nil	Nil	Nil
5.	Disclosure (as required by the establishing authority shown in 1. above unless otherwise specified.)	**GEM Board** -composition -work done -number of meetings Attendance of AC members at meetings during the year (HKSA). The role and function of the AC (HKSA).	Nil	-composition -work done -number of AC meetings during the year -attendance of directors at meetings (CCG)	-composition -work done -number of meetings -attendance of directors at meetings -summary of the activities -existence of an internal audit function	-composition	Nil	Nil	Nil

NED	Non-executive director	INED	Independent non-executive director
AC	Audit committee	LR	Listing Rules
CCG	Code of Corporate Governance (Singapore)	BPG	Best Practices Guide (Singapore)
HKSA	Hong Kong Society of Accountants		

Appendix 4c (cont' d)

Hong Kong	
HKSA	Hong Kong Society of Accountants. 2001. "Corporate Governance Disclosure in Annual Reports: A Guide to Current Requirements and Recommendations for Enhancement"
Australia	
LR	The Listing Rules of the Australian Stock Exchange
Singapore	
BPG	The Singapore Exchange (SGX) - Best Practices Guide
CCG	The Singapore Exchange – Code of Corporate Governance
Malaysia	
LR	Listing Requirements of Kuala Lumpur Stock Exchange (KLSE)
United Kingdom	
LR	The Listing Rules of London Stock Exchange (LSE)
United States	
LR	The Listing Requirements of the New York Stock Exchange The Listing Requirements of NASDAQ
Canada	
CBCA	Canadian Business Corporations Act
LR	Toronto Stock Exchange (TSE) Company Manual (i.e., the listing requirements)

Appendix 4d
Summary of Surveys on Audit Committees

Country	Australia		Canada	
Survey name	Korn/Ferry International "Board of Directors Study in Australia and New Zealand 2000"	Ernst & Young: "Corporate Governance Survey"	Patrick Callaghan & Associates and Korn/Ferry International: "Corporate Board Governance and Director Compensation in Canada – A Review of 2000"	Toronto Stock Exchange and Institute of Corporate Directors: "Report on Corporate Governance 1999"
Year	2000	1999	1999 data	1999
Sample size	238	112	324	635
Sample source	Publicly listed, unlisted	Top 200 listed companies	Publicly listed companies in Canada	TSE listed companies
Types of companies in sample	All sectors and sizes	All industries	All industries	N/A
Participation	Voluntary	N/A	N/A	N/A
Findings:				
Response rate	N/A	N/A	N/A	51%
Existence of AC	100%	N/A	100%	100%
Average no. of meetings per year	5	N/A	N/A	N/A
Average no. of members	4	N/A	N/A	N/A
Average no. of NEDs	3	N/A	N/A	N/A
Chairman as NED	N/A	N/A	N/A	N/A
Existence of procedures for auditor appointment	N/A	45%	N/A	N/A
Exclusively NED membership	N/A	N/A	N/A	69%

N/A: information not available

Appendix 4d (cont')

Country	Malaysia			Singapore	
Survey name	PricewaterhouseCoopers/ KLSE "Corporate Governance: 1998 Survey of Public Listed Companies"	PricewaterhouseCoopers Malaysia "Board of Directors: A Survey on Remuneration and Practices 2001"	OECD/World Bank/ADB: Third Asian Roundtable on the Role of Boards and Stakeholders in Corporate Governance: "A Comparative Review of Board Committees in Asia 2001"	Singapore Institute of Directors/Egon Zehnder International "Singapore Board of Directors Survey 2000"	OECD/World Bank/ADB: Third Asian Roundtable on the Role of Boards and Stakeholders in Corporate Governance: "A Comparative Review of Board Committees in Asia 2001"
Year	1998	2001	1999 data	2000	1999 data
Sample size	304	114	290	102	271
Sample source	KLSE listed companies	KLSE listed companies and individual directors	KLSE listed companies	SGX listed companies	SGX listed companies
Types of companies in sample	All industries	All industries	N/A	All industries	N/A
Participation	Voluntary	Voluntary	N/A	Voluntary	N/A
Findings:					
Response rate	42%	N/A	N/A	26%	N/A
Existence of AC	100%	100%	100%	100%	100%
Average no. of meetings per year	>2	4	N/A	N/A	N/A
Average no. of members	N/A	N/A	3	4	3
Average no. of NEDs	N/A	N/A	N/A	3	N/A
Chairman as NED	N/A	100%	N/A	N/A	N/A
Existence of procedures for auditor appointment	N/A	N/A	N/A	N/A	N/A
Majority NED membership	N/A	N/A	78%	N/A	79%

N/A: information not available

Appendix 4d (cont')

Country	Malaysia			Singapore	
Others	● 68% of the companies had established an internal audit function ● 65% of the companies stated that the internal audit function reported to the audit committee, and 25% reported to the managing director or CEO with the remainder reporting to the finance director, chairman of the audit committee or other board members	● one or more EDs were present in 60% of the committees, and two or more INEDs were present in 86% of the committees. While there are a substantial number of INEDs on the committee, the number of entirely independent committees is in the minority	N/A	N/A	N/A

N/A: information not available

Appendix 4d (cont' d)

Country	UK	USA				
Survey name	Korn/Ferry International "European Board of Directors Study 1998"	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"	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	1998	1999	2000	2001	2000	2000
Sample size	450 (157 UK)	902	917	902	2322 individuals/754 companies	12,139 directors/1202 companies
Sample source	N/A	Fortune-listed corporations	Fortune-listed corporations	Fortune-listed corporations	American Society of Corporate Secretaries members	S&P Super Composite 1500 Index
Types of companies in sample	N/A	N/A	N/A	N/A	Companies in manufacturing, financial and service sectors.	All industry sectors
Participation	N/A	N/A	N/A	N/A	Voluntary	N/A
Findings:						
Response rate	N/A	N/A	N/A	N/A	N/A	N/A
Existence of AC	88%	100%	100%	100%	96%	100%
Average no. of meetings per year	N/A	4	4	4	4	N/A
Average no. of members	N/A	4	4	4	N/A	N/A
Average no. of NEDs	N/A	N/A	N/A	N/A	N/A	N/A
Chairman as NED	N/A	N/A	N/A	N/A	N/A	N/A
Exclusively INED membership	N/A	N/A	N/A	N/A	N/A	50%
Majority NED membership	N/A	N/A	N/A	N/A	N/A	85%

N/A: information not available

Appendix 5a
Detailed Recommendations of Key Corporate Governance Reports on Remuneration Committees

	UK Cadbury Report (1992)	UK Greenbury Report (1995)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(1994)
1. Establishment (see Notes 2 and 3)	Each board should establish a RC.	Each board should set up a RC.	Listed companies should establish a RC.	There is currently an executive compensation committee. See Note 1
2. Composition	The RC should consist wholly or mainly of NEDs and chaired by a NED.	The RC should consist exclusively of NEDs with no personal financial interest other than as shareholders in the matters to be decided, no potential conflicts of interest arising from cross-directorships and no day-to-day involvement in running the business.	The RC should be made up wholly of independent non-executive directors.	The RC will consist only of independent directors.

RC: Remuneration committee
NED: Non-executive director

Notes: 1. The GM Code does not make recommendations on which specific committees should be used. It states that committees should be formed or disbanded depending on circumstances.

2. The Dey report suggests that the establishment of a RC is not important as long as the functions of the RC have been performed by the full board. The RC will function as a means for examining the compensation issues of the board and for preparing recommendations for full board action. Hence, the structural establishment of the RC may not be necessary depending on the company's particular circumstances.

3. The OECD Principles is a set of general corporate governance standards and guidelines for members' countries. It is meant to be very broad in scope and therefore does not have recommendations on committees.

Appendix 5a (cont'd)

	UK Cadbury Report (1992)	UK Greenbury Report (1995)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(1994)
3. Role and functions	The RC should recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary.	The RC should determine within agreed terms of reference the company's policy on executive remuneration and specific remuneration packages for each of the executive directors. The board itself should determine the remuneration of the NEDs, including members of the RC within the limits set in the Articles of Association.	The RC should establish a policy on the remuneration of executive directors and as appropriate, other senior executives, and to set remuneration packages for the individuals concerned. The determination of NEDs, including non-executive chairmen, should be a matter for the board as a whole.	Changes in board compensation should come at the suggestion of the Committee on Director Affairs, with full discussion and concurrence by the board.
	Executive directors should play no part in decisions on their own remuneration.	The RC should consider what compensation commitments their Directors' contracts of service, if any, would entail in the event of early termination, particularly for unsatisfactory performance.	---	---
4. Disclosure	Membership of the RC should appear in the Directors' Report.	The RC should make a report each year to the shareholders on behalf of the board. The report should form part of, or be annexed to, the company's annual report and accounts.	The reports to shareholders on remuneration should be made in the name of the board as a whole.	---
	• Directors' total emoluments including the chairman and highest-paid UK director. • Separate figures should be given for their salary and performance-related elements. • Criteria on which performance is measured. • Relevant information about stock options, stock appreciation rights and pension contributions.	The report should set out the Company's policy on executive remuneration, including levels, comparable groups of companies, individual components, performance criteria and measurement, pension provision, contracts of service and compensation commitments on early termination.	---	---
	---	The report should include full details of all elements in the remuneration package of each director.	---	---

Appendix 5b
Comparison of the Legal and Regulatory Requirements on Remuneration Committees in Different Jurisdictions

		Hong Kong	Australia	Singapore	Malaysia	United Kingdom	United States	Canada	Taiwan
1.	Establishment	No requirement, but HKMA recommends the establishment of RC.	Not required	Not required, but recommended in CCG, listed companies must comply or explain.	Not required, but recommended in MCCG, listed companies must comply or explain.	Not required, but recommended in CC, listed companies must comply or explain.	Not required	Not required	Not required
2.	Composition	---	-majority NEDs -preferably INEDs (LR)	-majority INEDs Should have at least one member who is knowledgeable in the field of executive compensation (CCG).	-mainly or entirely NEDs (MCCG)	-exclusively INEDs.	---	---	---
3.	Chairman	---	-independent (LR).	-INED (CCG).	---	-INED	---	---	---
4.	Independence	---	---	Should be independent of management and free from business relationships which could impair independence (CCG).	---	Independent (all members must be INEDs).	---	---	---

RC	Remuneration committee	NED	Non-executive director
INED	Independent non-executive director	CCG	Code of Corporate Governance (Singapore)
MCCG	Malaysian Code of Corporate Governance	LR	Listing Rules
HKMA	Hong Kong Monetary Authority	SEC	Securities and Exchange Commission (USA)
CC	Combined Code		

Appendix 5b (cont' d)

		Hong Kong	Australia	Singapore	Malaysia	United Kingdom	United States	Canada	Taiwan
5.	Disclosure	-composition, role and functioning -number of meetings -attendance at meetings -work undertaken -significant issues addressed -details of directors' remuneration -policy on remuneration -share option arrangements (HKMA)	---	-composition -details of directors' remuneration -details of remuneration policy -other benefit arrangements (CCG)	-composition -details of directors' remuneration -other benefit arrangements (LR/MCCG)	-composition -details of directors' remuneration -policy on remuneration -share option arrangements (LR)	SEC requires disclosure if RC is established: -RC members who are not independent -details of directors' remuneration -policy on remuneration -share option arrangements	Details of share compensation programs (LR).	---

Hong Kong
HKMA Hong Kong Monetary Authority – Statutory guideline on Corporate Governance of locally incorporated authorized institutions

Australia
LR The Listing Rules of the Australian Stock Exchange

Malaysia
LR Listing Requirements of Kuala Lumpur Stock Exchange (KLSE)

United Kingdom
LR The Listing Rules of London Stock Exchange (LSE)

Canada
LR Toronto Stock Exchange (TSE) Company Manual (i.e., the Listing Requirements)

RC Remuneration committee
INED Independent non-executive director
MCCG Malaysian Code of Corporate Governance
HKMA Hong Kong Monetary Authority
CC Combined Code
NED Non-executive director
CCG Code of Corporate Governance (Singapore)
LR Listing Rules
SEC Securities and Exchange Commission (USA)

Appendix 5c
Summary of Surveys on Remuneration Committees

Country	Australia		Canada	
Survey name	Korn/Ferry International "Board of Directors Study in Australia and New Zealand 2000"	Ernst & Young: "Corporate Governance Survey"	Patrick Callaghan & Associates and Korn/Ferry International: "Corporate Board Governance and Director Compensation in Canada – A Review of 2000"	The Conference Board: "Top Executive Compensation: Canada, France, the United Kingdom, and the United States"
Year	2000	1999	1999 data	1999
Sample size	238	112	324	102
Sample source	Publicly listed, unlisted	Top 200 listed companies	Publicly listed companies in Canada	Publicly traded companies in Canada
Types of companies in sample	All sectors and sizes	All industries	All industries	Included 70% manufacturing, 15% banking and utilities
Participation	Voluntary	N/A	N/A	N/A
Findings:				
Response rate	N/A	N/A	N/A	51%
Existence of RC	80%	69%	93%	N/A
Average no. of meetings per year	4	N/A	N/A	N/A
Average no. of members	4	3-4	N/A	N/A
Average no. of NEDs	3	N/A	N/A	N/A
Chairman as NED	N/A	N/A	N/A	N/A
Majority NED membership	N/A	96%	N/A	N/A
Exclusively NED membership	N/A	57%	N/A	N/A

N/A: information not available

Appendix 5c (cont' d)

Country	Australia		Canada	
Others	• 50% of the companies used a shareholder-approved pool for board compensation i.e. shareholders approved a total amount of compensation, leaving the board to decide how it is to be allocated • 9% of the companies used an incentive scheme, including cash and stock options	• 60% disclosed procedures for establishing and reviewing compensation for CEO and NEDs	• Almost 2/3 of the companies had a stock component in the compensation package • 87% of the directors owned shares in the company • 8% of the companies provided a guideline for requirements of director shareholding, and 95% of them required directors to maintain a minimum level of shareholding	• 87% paid an annual incentive to EDs in 1998, and the average annual incentive was about 26% of base salary • 85% offered long-term incentives, such as stock options, granted shares

Appendix 6a
Detailed Recommendations of Key Corporate Governance Reports on Nomination Committees

	UK Cadbury Report (1992)	UK Hampel Report (1998)	USA General Motor Corporation Guidelines on Significant Corporate Governance Issues(1994)	Canada Dey Report (1994)
1. Establishment	A NC is recommended.	Companies should set up a NC.	There is currently a Director Affairs committee. See Note	The board should appoint a NC.
2. Composition	A NC should have a majority of NEDs and be chaired either by the chairman of the Board or a NED.	---	The Director Affairs committee will consist only of independent directors.	The NC should be composed exclusively of outside directors, a majority of whom are unrelated directors.
3. Role and functions	Responsible for proposing appointments of executive directors or NEDs.	Make recommendations to the board on all new board appointments.	Responsible for reviewing with the board, on an annual basis, the appropriate skills and characteristics required of board members in the context of the current make-up of the board.	Responsible for proposing to the full board on new nominees to the board and for assessing directors on an ongoing basis.
	---	---	The Director Affairs committee after consultation with the chairman of the board and with consideration of the desires of individual board members is responsible for the assignment of board members to various committees.	Every board of directors should implement a process to be carried out by the NC or other appropriate committee for assessing the effectiveness of the board as a whole, the committees of the board and the contribution of individual directors.
	---	---	---	The NC removes from the CEO the general responsibility for constituting the board. The NC seeks to ensure the true independence of those recruited and an appropriate separation from management.
	---	---	---	A director who feels that he/she "owes" the CEO for the director's position will have difficulty acting independently, at least in assessing management. The NC is designed to apply criteria, recommend board composition, and establish inter-director relationships which facilitate board decisions.

NC: Nomination Committee
NED: Non-executive director

Note: The GM Code does not make recommendations on which specific committees should be used. It states that committees should be formed or disbanded depending on circumstances.

Appendix 6b
Comparison of the Legal and Regulatory Requirements on Nomination Committees in Different Jurisdictions

		Hong Kong	Australia	Singapore	Malaysia	United Kingdom	United States	Canada	Taiwan
1.	Establishment	No requirement, but HKMA recommends the establishment of NC.	Not required	Recommended in CCG, listed companies must comply or explain.	Recommended in MCCG, listed companies must comply or explain.	Recommended, listed companies must comply or explain (LR).	Not required	Not required, but listed companies are encouraged to establish the NC (LR).	Not required
2.	Composition	-majority of NEDs (HKMA)	-if established, majority of NEDs (LR)	-minimum of 3 directors -majority INEDs (CCG)	-all NEDs -majority INEDs (MCCG)	-majority NEDs (LR)	---	-exclusively outside directors (NEDs) -majority unrelated (INEDs) (LR)	---
3.	Chairman	---	-INED (LR)	-INED (CCG)	---	Should be either chairman of the board or a NED (LR).	---	---	---
4.	Independence	Membership should ensure independence (HKMA).	---	---	---	---	---	---	---
5.	Disclosure	---	---	-methods of assessing director performance -terms of reference	---	-membership of the NC (LR).	---	-presence of NC -methods of assessing director performance (LR)	---

NC	Nomination committee	NED	Non-executive director
INED	Independent non-executive director	CCG	Code of Corporate Governance (Singapore)
MCCG	Malaysian Code of Corporate Governance	LR	Listing Rules
HKMA	Hong Kong Monetary Authority		

Appendix 6b (cont' d)

Hong Kong	
HKMA	Hong Kong Monetary Authority – Statutory guideline on Corporate Governance of locally incorporated authorized institutions
Australia	
LR	The Listing Rules of the Australian Stock Exchange
United Kingdom	
LR	The Listing Rules of London Stock Exchange (LSE) and the Combined Code (June 1998) (annex to the LR)
Canada	
LR	Toronto Stock Exchange (TSE) Company Manual (i.e., the listing requirements)

Appendix 6c
Summary of Surveys on Nomination Committees

Country	Australia		Canada	
Survey name	Korn/Ferry International "Board of Directors Study in Australia and New Zealand 2000"	Ernst & Young: "Corporate Governance Survey"	Patrick Callaghan & Associates and Korn/Ferry International: "Corporate Board Governance and Director Compensation in Canada – A Review of 2000"	Toronto Stock Exchange and Institute of Corporate Directors: "Report on Corporate Governance 1999"
Year	2000	1999	1999 data	1999
Sample size	238	112	324	635
Sample source	Publicly listed, unlisted	Top 200 listed companies	Publicly listed companies in Canada	TSE listed companies
Types of companies in sample	All sectors and sizes	All industries	All industries	N/A
Participation	Voluntary	N/A	N/A	N/A
Findings:				
Response rate	N/A	N/A	N/A	51%
Existence of NC	33%	32%	26% (but 65% reported a corporate governance committee without any indication of how many of these had nomination committee responsibilities)	33%
Average no. of meetings per year	2	N/A	N/A	N/A
Average no. of members	4	3-4	N/A	3-5
Average no. of NEDs	3	N/A	N/A	N/A
Chairman as NED	N/A	N/A	N/A	N/A
Majority NED membership	N/A	91%	N/A	N/A
Exclusively NED membership	N/A	64%	N/A	>66%
Others	● 24% of NEDs selected through formal input from directors, 23% recommended by major shareholders, 22% recommended through nomination committees, and 19% through executive search or other means	N/A	N/A	● chairmen were most commonly responsible for the selection of new board members (40%), which is followed by nomination committees (33%)

N/A: information not available

Appendix 6c (cont' d)

Country	Malaysia		Singapore	
Survey name	PricewaterhouseCoopers Malaysia "Board of Directors: A Survey on Remuneration and Practices 2001"	OECD/World Bank/ADB: Third Asian Roundtable on the Role of Boards and Stakeholders in Corporate Governance: "A Comparative Review of Board Committees in Asia 2001"	Singapore Institute of Directors/Egon Zehnder International "Singapore Board of Directors Survey 2000"	OECD/World Bank/ADB: Third Asian Roundtable on the Role of Boards and Stakeholders in Corporate Governance: "A Comparative Review of Board Committees in Asia 2001"
Year	2001	1999 data	2000	1999 data
Sample size	114	290	102	271
Sample source	KLSE listed companies and individual directors	KLSE listed companies	SGX listed companies	SGX listed companies
Types of companies in sample	All industries	N/A	All industries	N/A
Participation	Voluntary	N/A	Voluntary	N/A
Findings:				
Response rate	N/A	N/A	26%	N/A
Existence of NC	15%	1%	7%	4%
Average no. of meetings per year	2	N/A	N/A	N/A
Average no. of members	N/A	3	N/A	5
Average no. of NEDs	N/A	N/A	N/A	N/A
Chairman as NED	100%	N/A	N/A	N/A
Majority NED membership	100%	N/A	N/A	N/A
Others	• 50% indicated an interest in setting up nomination committee in the future	N/A	• nomination committee included 52% EDs and 48% NEDs • nomination committee was slightly involved (6%) in making the final decision as to board appointments	• nomination committee included 70% NEDs and 30% EDs

N/A: information not available

Appendix 6c (cont' d)

Country	UK	USA				
Survey name	Korn/Ferry International "European Board of Directors Study 1998"	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"	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	1998	1999	2000	2001	2000	2000
Sample size	450 (157 UK)	902	917	902	2322 individuals/754 companies	12,139 directors/1202 companies
Sample source	N/A	Fortune-listed corporations	Fortune-listed corporations	Fortune-listed corporations	American Society of Corporate Secretaries members	S&P Super Composite 1500 Index
Types of companies in sample	N/A	N/A	N/A	N/A	Companies in manufacturing, financial and service sectors.	All industry sectors
Participation	N/A	N/A	N/A	N/A	Voluntary	N/A
Findings:						
Response rate	N/A	N/A	N/A	N/A	N/A	N/A
Existence of NC	54%	74%	74%	73%	46%	67%
Average no. of meetings per year	N/A	3	3	3	2	N/A
Average no. of members	N/A	3	3	3	N/A	N/A
Average no. of NEDs	N/A	3	3	3	N/A	N/A
Chairman as NED	N/A	N/A	N/A	N/A	N/A	N/A
Exclusively INED membership	N/A	N/A	N/A	N/A	N/A	40%
Majority INED membership	N/A	N/A	N/A	N/A	N/A	88%

N/A: information not available

Appendix 6c (cont' d)

Country	UK	USA				
Others	• 82% of EDs nomination and 72% of NEDs nomination was made by CEO or chairman • 62% of CEO position was filled by internal succession	• 10% had term limits on NED directorships (on average 5.5 years) • 77% used mandatory retirement age (age not specified)	• 10% had term limits on NED directorships (on average 5.5 years) • 77% used mandatory retirement age (the age not specified)	• on identification of NEDs, CEO/chairman and nomination committee had the greatest influence (63% and 55% respectively), followed by the chairman (when not also the CEO) or lead director and the full board (33% and 27% respectively) • CEO and the board had the most responsibility (65% and 35% respectively) for the appointment of a CEO successor • 10% had term limits on NED directorships (on average 5.5 years) • 77% used mandatory retirement age (age not specified)	N/A	N/A

N/A: information not available

Appendix 7

CEOs or Chairmen's Opinion towards the Effectiveness of Board Committees

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Section I Various Committees

D. Audit Committee

Factors	Average Score (5 = Agree)
▪ Establishment of audit committee should be made compulsory	4.78
▪ One of the roles of the audit committee is to prevent fraud	3.84
▪ Audit committee should be chaired by an independent non-executive director	4.77
▪ Audit committee members should comprise all non-executive directors	3.84
▪ All members in the audit committee should be independent non-executive directors	3.39
▪ There should be a minimum of three members in the audit committee	4.47
▪ Members of the audit committee should have adequate financial experience	4.06
▪ Disclosure in the annual report:	
• Number of audit committee meetings	3.66
• Attendance list of audit committee meetings	3.19
▪ Audit committees should be attended by the external auditor	4.71

Appendix 7 (cont' d)

E. Remuneration Committee

Factors	Average Score (5 = Agree)
▪ Establishment of remuneration committee should be made compulsory	3.47
▪ If the Board or the company is too small for establishing a remuneration committee,	
• external professional advisers should be hired to perform its functions	3.06
• additional disclosures should be made on the basis of directors' remuneration	3.56
▪ Remuneration committee members should comprise all non-executive directors	3.25
▪ Remuneration committee should be chaired by an independent non-executive director	4.03
▪ All members in the remuneration committee should be independent non-executive directors	3.06
▪ There should be a minimum of three members in the remuneration committee	4.13
▪ Disclosure in the annual report:	
• Number of remuneration committee meetings	3.38
• Attendance list of remuneration committee meetings	2.97

Appendix 7 (cont' d)

F. Nomination Committee

Factors	Average Score (5 = Agree)
▪ Establishment of nomination committee should be made compulsory	2.97
▪ If the Board or the company is too small for establishing a nomination committee,	
• external professional advisers should be hired to perform its functions	2.84
• additional disclosures should be made on the basis of directors' nomination	3.29
▪ Nomination committee should be chaired by an independent non-executive director	3.53
▪ Nomination committee members should comprise all non-executive directors	2.94
▪ All members in the nomination committee should be independent non-executive directors	2.81
▪ A representative from minority shareholders should be appointed as a member of the nomination committee of the company	2.37
▪ There should be a minimum of three members in the nomination committee	3.48
▪ Disclosure in the annual report:	
• Number of nomination committee meetings	3.03
• Attendance list of nomination committee meetings	2.71

Appendix 7 (cont' d)

Section II Alternative Arrangements for Corporate Governance

Other than the audit, remuneration and nomination committees described above, how important are the following factors in contributing to good corporate governance?

A. Quality of Independent Non-executive Directors

Factors	Average Score (5 = Agree)
▪ Independence of independent non-executive directors is most important	4.61
▪ The appointment of independent non-executive directors should be regulated by the Listing Rules of the Stock Exchange	3.97
▪ A majority of the independent non-executive directors should have an understanding of finance or accounting	3.45
▪ Reasons for the resignation/termination of independent non- executive directors should be disclosed	3.71

B. Board Structure and Practices

Factors	Average Score (5 = Agree)
▪ Chairman of the Board should not occupy the position as the CEO or Managing Director or President	3.65
▪ Restrictions on the number of family members who can sit on the Board	3.32
▪ Chairman of the Board should be an independent non-executive director	2.45
▪ Majority of the Board should be independent non-executive directors	2.61
▪ A member on the Board should represent minority interests	2.97
▪ The Board should draw up a code of ethics or statement of business practice to facilitate the standard of conduct expected of directors and employees	4.03
▪ Emphasis on the recruitment of quality directors, especially independent non-executive directors	4.35

Appendix 7 (cont' d)

C. Annual Report Disclosures

Factors	Average Score (5 = Agree)
▪ Disclosure of directors' benefits derived from exercising share options and/or warrants	4.32
▪ More disclosure on directors' dealings with related parties	4.26
▪ A separate section or general statement on corporate governance in the annual report	4.26
▪ A general statement of business risk in the annual report e.g. foreign exchange exposure	4.06
▪ Quarterly financial reporting	2.87

D. Investor Protection

Factors	Average Score (5 = Agree)
▪ Class actions against companies	3.03
▪ One-share-one-vote principle	4.06
▪ Institutional investors should have nominee directors on Boards of investee companies	2.39

E. Regulatory Enforcement

Factors	Average Score (5 = Agree)
▪ Heavier penalties and sanctions imposed on insider trading	4.48
▪ Securities and Futures Commission should have more power of enforcement	3.53

F. Others

Factors	Average Score (5 = Agree)
▪ Introduction of corporate governance rating of individual HK listed company e.g. Standard & Poor's Rating	3.61

Appendix 8

Specimen of Audit Committee and Remuneration Committee Disclosure

(Li & Fung Limited Annual Report Extract for the Year Ended 31 December 1999)

CORPORATE GOVERNANCE

The Board of Directors is committed to principles of corporate governance consistent with prudent enhancement and management of shareholder value. The accounting systems and internal controls of the Group are designed to provide reasonable assurance that assets are safeguarded against losses from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and that the financial records are reliable for preparing financial statements and maintaining accountability for assets. Qualified personnel throughout the Group maintain and monitor these internal accounting controls on an ongoing basis. The Group's Corporate Governance Division, under the supervision of the Chief Compliance Officer, systematically reviews these controls, evaluates their adequacy and compliance and reports thereon.

AUDIT COMMITTEE

An Audit Committee has been established since 1998 to act in an advisory capacity and make recommendations to the Board. Its members currently include:

Dr Victor FUNG Kwok King – *Chairman*
Mr Paul Edward SELWAY-SWIFT
Mr Allan WONG Chi Yun
Professor Franklin Warren McFARLAN
Mr Leslie BOYD
Mr James SIU Kai Lau (Chief Compliance Officer) – *Secretary*

The Audit Committee met four times during the past 12 months to review with management the accounting principles and practices adopted by the Group and to discuss auditing, internal control and financial reporting matters in conjunction with the Company's auditors.

COMPENSATION COMMITTEE

A Compensation Committee has been formed since 1993 to approve senior executive remuneration including annual allocation of Share Options to employees under the Company's Employee Share Option Scheme. Its current members include Mr Allan WONG Chi Yun, an independent non-executive Director, Dr Victor FUNG Kwok King, the Group's non-executive Chairman and Mr William FUNG Kwok Lun, the Group's Managing Director.

Appendix 9a

Regression Results on the Association between ROE and Existence of Audit Committees (N = 408)

$$ROE = a + b_1AC + b_2CR + b_3MBRATIO + b_4DE + b_5LAT + b_6FC + b_7INDUSTRY + e$$

Variables	Coeff	T- value
INTERCEPT	-1.63	-7.13***
AC	0.10	2.18**
CR	0.01	1.05
MBRATIO	-0.06	-10.10***
DE	-1.01	-4.90***
LAT	0.12	7.51***
FC	0.10	1.24
PROPERTY	-0.15	-2.09**
TRANSPORT	-0.09	-0.80
ELECTRONIC	-0.11	-1.45*
CONSTRUCTION	-0.01	-0.11
DISTRIBUTORS	0.11	1.18
ENGINEERING	0.05	0.39
HOUSEHOLD	-0.03	-0.35
FINANCE	-0.09	-1.08
F-value	14.28***	
Adj R^2	0.314	

*** $p<0.01$ ** $p<0.05$ * $p<0.1$

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Appendix 9b

Regression Results on the Association between ROA and Existence of Audit Committees (N = 408)

$$ROA = a + b_1AC + b_2CR + b_3MBRATIO + b_4DE + b_5LAT + b_6FC + b_7INDUSTRY + e$$

Variables	Coeff	T- value
INTERCEPT	-0.67	-8.09***
AC	0.02	1.36*
CR	-0.00	-0.00
MBRATIO	-0.01	-6.32***
DE	-0.42	-5.72***
LAT	0.05	8.62***
FC	0.04	1.29*
PROPERTY	-0.05	-1.87**
TRANSPORT	-0.02	-0.50
ELECTRONIC	-0.02	-0.88
CONSTRUCTION	0.01	0.16
DISTRIBUTORS	0.03	0.73
ENGINEERING	0.05	1.15
HOUSEHOLD	0.00	0.12
FINANCE	-0.05	-1.55*
F-value	10.88***	
Adj R^2	0.254	

*** $p<0.01$ ** $p<0.05$ * $p<0.1$

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Appendix 9c

Regression Results on the Association between Tobin' s Q and Existence of Audit Committees (N = 408)

$$\text{Tobin's } Q = a + b_1AC + b_2CR + b_3MBRATIO + b_4DE + b_5LAT + b_6FC + b_7INDUSTRY + e$$

Variables	Coeff	T- value
INTERCEPT	0.45	1.43*
AC	0.04	0.68
CR	0.01	1.35*
MBRATIO	0.21	24.43***
DE	0.02	0.08
LAT	0.03	1.24
FC	-0.04	-0.33
PROPERTY	-0.33	-3.40***
TRANSPORT	-0.38	-2.31***
ELECTRONIC	-0.17	-1.58*
CONSTRUCTION	-0.13	-0.84
DISTRIBUTORS	-0.25	-1.87**
ENGINEERING	-0.13	-0.80
HOUSEHOLD	-0.12	-1.11
FINANCE	-0.20	-1.63**
F-value	46.75***	
Adj R^2	0.611	

*** $p<0.01$ ** $p<0.05$ * $p<0.1$

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Appendix 10a

Regression Results on the Association between ROE and Size of Audit Committees and Membership for Companies with Audit Committees (N=220)

$$ROE = a + b_1 INED\_DUM + b_2 LNACNMEM + b_3 CR + b_4 MBRATIO + b_5 DE + b_6 LAT + b_7 FC + b_8 INDUSTRY + e$$

Variables	Coeff	T- value
INTERCEPT	-1.77	-7.66***
INED_DUM	0.09	1.37*
LNACNMEM	0.28	3.23***
CR	0.02	2.39***
MBRATIO	-0.04	-6.74***
DE	-0.97	-5.24***
LAT	0.10	6.92***
FC	0.08	0.96
PROPERTY	-0.10	-1.52*
TRANSPORT	-0.10	-0.93
ELECTRONIC	0.07	0.96
CONSTRUCTION	-0.02	-0.19
DISTRIBUTORS	-0.01	-0.06
ENGINEERING	0.12	1.01
HOUSEHOLD	0.09	1.17
FINANCE	-0.10	-1.37*
F-value	10.80***	
Adj R^2	0.402	

*** $p<0.01$ ** $p<0.05$ * $p<0.1$

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Appendix 10b

Regression Results on the Association between ROA and Size of Audit Committees and Membership for Companies with Audit Committees (N=220)

$$ROA = a + b_1 INED\_DUM + b_2 LNACNMEM + b_3 CR + b_4 MBRATIO + b_5 DE + b_6 LAT + b_7 FC + b_8 INDUSTRY + e$$

Variables	Coeff	T- value
INTERCEPT	-0.68	-7.36***
INED_DUM	0.04	1.39*
LNACNMEM	0.11	3.17***
CR	0.01	2.23**
MBRATIO	-0.01	-4.44***
DE	-0.44	-5.85***
LAT	0.04	6.53***
FC	0.05	1.41*
PROPERTY	-0.03	-0.92
TRANSPORT	-0.00	-0.05
ELECTRONIC	0.04	1.28
CONSTRUCTION	-0.01	-0.12
DISTRIBUTORS	0.00	0.11
ENGINEERING	0.06	1.22
HOUSEHOLD	0.05	1.77**
FINANCE	-0.05	-1.62*
F-value	8.54***	
Adj R^2	0.341	

*** p<0.01 ** p<0.05 * p<0.1

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Appendix 10c

Regression Results on the Association between Tobin's Q and Size of Audit Committees and Membership for Companies with Audit Committees (N=220)

$$\text{Tobin's Q} = a + b_1\text{INED\_DUM} + b_2\text{LNACNMEM} + b_3\text{CR} + b_4\text{MBRATIO} + b_5\text{DE} + b_6\text{LAT} + b_7\text{FC} + b_8\text{INDUSTRY} + e$$

Variables	Coeff	T- value
INTERCEPT	0.35	0.74
INED_DUM	0.07	0.54
LNACNMEM	0.38	2.11**
CR	0.03	1.56*
MBRATIO	0.22	19.84***
DE	0.27	0.71
LAT	0.01	0.32
FC	-0.13	-0.80
PROPERTY	-0.37	-2.68***
TRANSPORT	-0.51	-2.34***
ELECTRONIC	-0.14	-0.89
CONSTRUCTION	-0.23	-1.08
DISTRIBUTORS	-0.56	-3.06***
ENGINEERING	-0.14	-0.57
HOUSEHOLD	-0.05	-0.33
FINANCE	-0.36	-2.33***
F-value	30.34***	
Adj R^2	0.668	

*** $p<0.01$ ** $p<0.05$ * $p<0.1$

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Appendix 11a

Regression Results on the Association between Audit Fees and Existence of Audit Committees (N = 355)

$$\text{Audit Fees} = a + b_1\text{LAT} + b_2\text{SUB} + b_3\text{CR} + b_4\text{DE} + b_5\text{ROA} + b_6\text{FOREIGN} + b_7\text{OPIN} + b_8\text{YE} + b_9\text{BIG5} + b_{10}\text{AC} + b_{11}\text{BOD\_SIZE} + b_{12}\text{CEOCHAIR} + b_{13}\text{P\_INED} + e$$

Variables	Coeff	T- value
INTERCEPT	3.19	8.34***
LAT	0.21	7.21***
SUB	0.12	5.73***
CR	-0.02	-1.92**
DE	0.19	0.51
ROA	0.01	0.04
FOREIGN	0.31	1.80**
OPIN	0.06	0.22
YE	0.03	0.31
BIG5	0.25	1.29*
AC	-0.13	-1.47*
BOD_SIZE	0.02	1.32*
CEOCHAIR	-0.03	-0.36
P_INED	0.22	0.74
F-value	16.56***	
Adj R^2	0.364	

*** p<0.01 ** p<0.05 * p<0.1

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Appendix 11b

Regression Results on the Association between Audit Fees and Size of Audit Committees and Membership for Companies with Audit Committees (N = 188)

Audit Fees = a + b_1LAT + b_2SUB + b_3CR + b_4DE + b_5ROA + b_6FOREIGN + b_7OPIN + b_8YE + B_9BIG5 + b_{10}LNACNMEM + b_{11}INED_DUM + b_{12}CEOCHAIR + b_{13}BOD_SIZE + + b_{14}P_INED+ e

Variables	Coeff	T- value
INTERCEPT	3.03	5.35***
LAT	0.20	5.08***
SUB	0.15	5.25***
CR	-0.04	-1.58*
DE	0.08	0.15
ROA	-0.24	-0.54
FOREIGN	0.32	1.48*
OPIN	0.03	0.09
YE	-0.08	-0.67
BIG5	-0.07	-0.27
LNACNMEM	0.46	1.96**
INED_DUM	0.08	0.47
CEOCHAIR	-0.03	-0.24
BOD_SIZE	0.02	0.66
P_INED	0.03	0.07
F-value	10.87***	
Adj R^2	0.425	

*** $p<0.01$ ** $p<0.05$ * $p<0.1$

The above asterisks indicate significance levels in a one-tailed or two-tailed t test (as appropriate)

Variable Definitions:

AC	Dummy variable, 1 = existence of audit committees, 0 otherwise
INED_DUM	Dummy variable, proportion of number of INEDs to number of AC members, 1 = 50% or above, 0 otherwise
LNACNMEM	Size of audit committees, defined as the natural logarithms of number of members in AC (only for companies with AC)
ROE	Return on equity, defined as the ratio of net profits to average shareholders' fund
ROA	Return on assets, defined as the ratio of net profits to average total assets
Tobin's Q	Summation of market value of equity on the ending balance sheet date, closing stock value of long-term debt, short-term debt and preference shares, then divided by the reported closing book value of total assets (Tsui and Lynn, 2001)
CR	Current ratio, defined as current assets divided by current liabilities
DE	Debt-to-total asset ratio
FC	Family ownership, defined as the proportion of outstanding shares directly owned by the dominant family
LAT	A proxy for size, defined as the natural logarithm of total assets
MBRATIO	Total market value of shares outstanding divided by total book value of common equity
AUDFEE	Natural logarithm of total audit fees
SUB	Square root of the number of subsidiaries
FOREIGN	Proportion of subsidiaries that represents foreign operations
OPIN	Dummy variable, 1 = qualified audit report, 0 otherwise
YE	Dummy variable, 1 = non-March 31st year-end, 0 otherwise
BIG 5	Dummy variable, 1 = Big 5 auditors, 0 otherwise
BOD_SIZE	Total number of directors in the board of directors
CEOCHAIR	Dummy variable, 1 = CEO and chairman of the board of directors being the same person, 0 otherwise

P_INED	Proportion of independent non-executive directors to total number of directors in the board
PROPERTY	Industry dummy, 1 = property, 0 otherwise
FINANCE	Industry dummy, 1 = finance firms, 0 otherwise
TRANSPORT	Industry dummy, 1 = transport, 0 otherwise
ELECTRONIC	Industry dummy, 1 = electronic, 0 otherwise
CONSTRUCTION	Industry dummy, 1 = construction, 0 otherwise
DISTRIBUTORS	Industry dummy, 1 = distributors, 0 otherwise
ENGINEERING	Industry dummy, 1 = engineering, 0 otherwise
HOUSEHOLD	Industry dummy, 1 = household goods, 0 otherwise