

CSR-Asia

Corporate Governance in Asia 2006 Conference

Corporate Governance: An Integrated Framework and International Convergence

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Enron-Inspired Definitions of Financial Terms and Titles

EBIT

EBITDA

CEO

CFO

INED



The Case of Barings Bank (1995)

- One of England's oldest established banks was brought about by the action of one young and 'clever' trader, Nick Leeson, causing a loss of 850M pounds
- The misuse of derivatives through poor internal controls and lack of monitoring & risk management led to the downfall of Barings Bank (bought by the Dutch ING for 1 pound).
- What might be done to prevent such a collapse happening again? How could investor confidence be restored?



Why CG has Become such a Pressing Problem?

- Increased role of the private sector and capital markets in the modern economy
- Increased international interdependence and competitions for countries and companies
- The 1997 Asian financial crisis
- Media and Internet expose more corporate scandals and failures since 2002



Corporate Scandals and Failures

USA

- Enron, Worldcom, Xerox, Tyco, Sunbeam, Daiwa Bank, Global Crossing, Arizona Baptist Foundation, AOL, Rite Aid, Conseco, Cendant

Australia

- HIA, One-Tel, AWA

Europe

- Morgan Grenfell, Cable & Wireless, Guardian IT, Elan Corp.



Corporate Scandals and Failures

Singapore

- **Barings, Asia Pulp & Paper**

Japan

- **Daiwa Bank and Sumitomo Corporation**

Hong Kong

- **Peregrine Investment, Shun Shing Group, Guangnan Group, Kit Wai International**

China

- **ZhengBaiWen, Yorkpoints, Euro-Asia Agriculture, ChaoDa, Hungguan, YinGuangXia, Daqing Lianyi**



Milestones in CG Debates

1. Pre-1992: An American Debate
2. Post-1992: The Cadbury Report (UK)
3. The New CG: OECD Report (1998)
4. OECD Principles of CG (1999)
5. Post Asian Crisis and Corporate Scandals Debate (2002)
6. Internationalization of CG Practices



Consequences after 2002

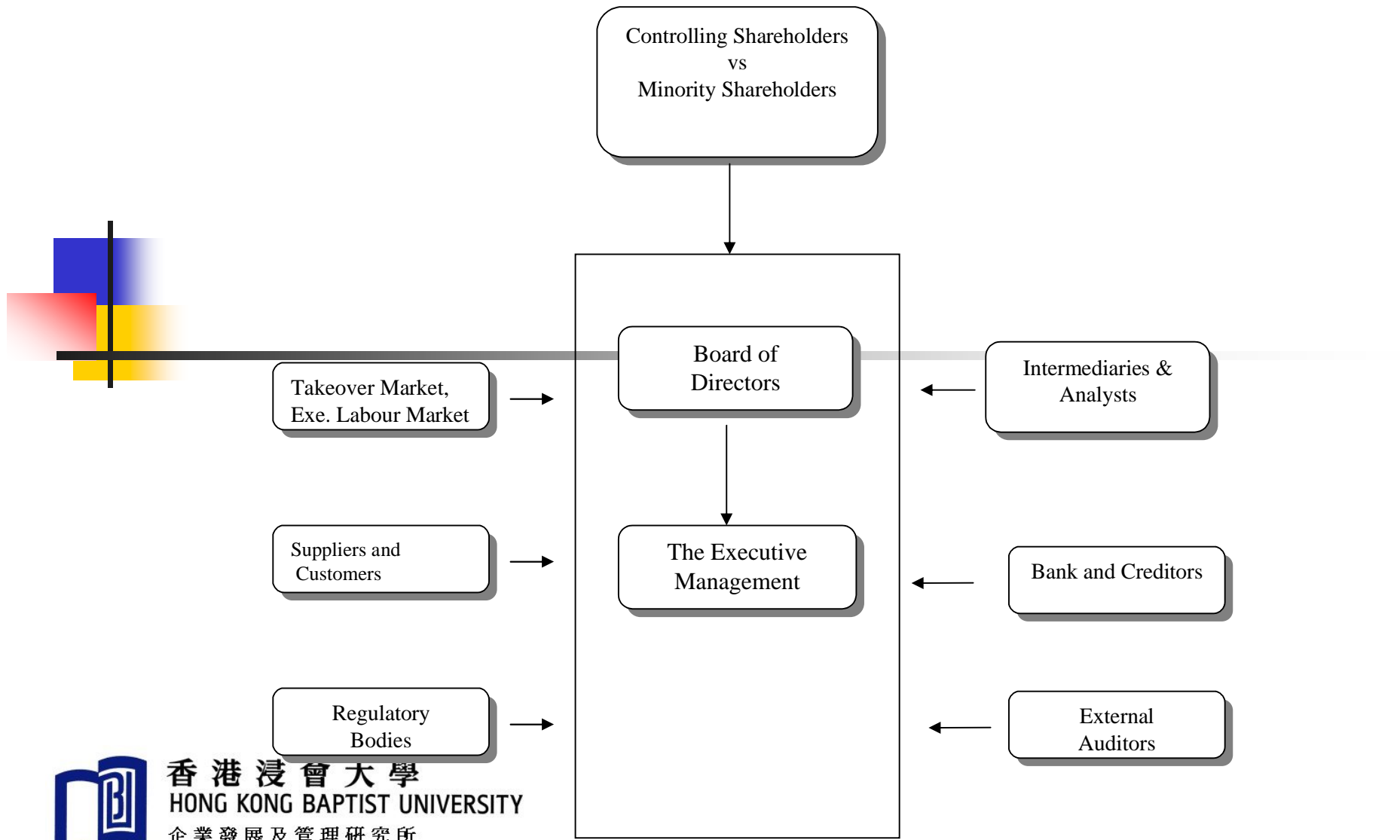
- The importance of CG became dramatically clear in 2002
- Investors' confidence collapse
- New legislations (Sarbanes-Oxley Act)
- New Listing Rules
- New Accounting & Auditing Standards



Definition of Corporate Governance

- A system that delineates the rights and responsibilities of each (primary) stakeholder of a company,
- and the design of institutions and mechanisms that direct (control or induce) board directors and management to best serve the interests of shareholders (and other stakeholders) of a company (Ho, 2001).

Stakeholders Influencing the Corporate Governance of a Company





Rights of Shareholders

Shareholders as financiers, primary stakeholders, and residual claimants

Basic rights:

- To elect and sack directors and auditors
- To be informed about corporate activities and plans
- To attend, propose agenda items, speak up, and vote at shareholders' meetings
- To exercise proxies
- To make other important decisions such as amending Articles of Association, dividends., and liquidation.



Duties of Board Directors

- Plan & direct the organization
- Select, guide, monitor & compensate the senior management
- Provide timely & accurate reports to all stakeholders to which it is accountable
- Exercise care, skills and diligence
- Avoid conflicts of interests
- Fulfill fiduciary duties by acting in good faith for the benefit of the organization as a whole



Main sources of CG Problems

- Separation of ownership and control.
- Information asymmetry and conflicts of interests.
- Incomplete principal-agent contract
- Agency costs + transaction costs
- CG mechanisms help allocate residual rights of control among primary participants of a company.
- Aligning managerial and shareholder interests by¹³
controls and incentives



Emerging global paradigm

- The board has the overall decision and oversight responsibility
- corporate boards *accountable* mainly to owners, but *responsible* for successful relations with all stakeholders



Perspectives of Corporate Governance

- Shareholder vs Stakeholder
- Stewardship vs Creating values
- Voluntary vs Regulatory
- Forms vs Substance



Management vs Leadership vs Governance

- Management: emphasizing organizing, implementation and producing results.
- Leadership: establishing direction, energizing people, and producing change.
- Governance: emphasizing delegation, control, motivation & accountability



The New Business Excellence Model

1. Corporate Governance
2. Leadership
3. Strategy & Policy
4. Resources Management
(People, Information & Knowledge, etc)
5. Process Management
6. Key Performance Results
7. (Shareholders, People, Customers, Financial, Social)



Objectives of Corporate Governance

1. Detect and deter misconducts & bad decisions, focus on control & compliance to minimize downsides
2. Create strategic values and enhance competitiveness/performance
3. Corporate social responsibilities



Major Attributes of Firm-level Corporate Governance

- **Managerial Discipline**
- **Ownership Structure**
- **Protection of Shareholders' Rights**
- **Controlling Shareholders' Behaviour**
- **Checks & Balances**
- **Board Independence**
- **Board Leadership**



Major Attributes of Firm-level Corporate Governance

- **Integrity**
- **Fairness**
- **Transparency**
- **Responsibility**
- **Accountability**
- **Monitored & Respect by Different Stakeholders**
- **Social Awareness & Participation**



4 Levels of Forces Shaping CG

- **Individual ethics and corporate culture**
 - **Internal control and incentive mechanisms**
 - **External monitoring & bonding mechanisms**
 - **Regulations and their enforcement and other institutional arrangements**
- + **Market and Environmental Forces**



CG Involves Contracts of Trust

- Partly self-enforced
- Partly enforced by law & regulators
- Partly enforced by competitive market forces

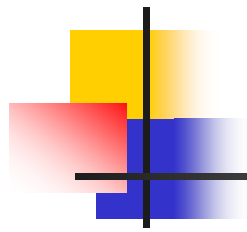
=> Raising CG quality is a challenge involving all the market participants: issuers, directors, regulators, policy makers, auditors, advisors, educators & investors



OECD CG Principles

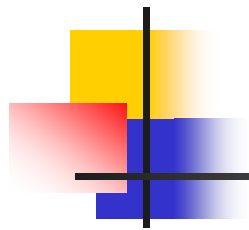
- Rights of Shareholders
- Equitable Treatment of Shareholders
- Role of Stakeholders
- Disclosure & Transparency
- Responsibility of the Board

=> Focus on the Company rather than one group of people.



Ho's CG Framework

1. CG Commitments and Policy
2. Ownership Structure and Influence
3. Shareholders' Rights & Participation
4. Controlling Shareholders' Behavior and Connected Party Transactions



Ho's CG Framework

5. Board of Directors (and Supervisors)
6. Top management & Pays
7. Internal Control, Risk Management
and Audits
8. Disclosure & Transparency



The Conceptual Framework of Corporate Governance

Institutions

(Economic, political, legal, social, cultural)

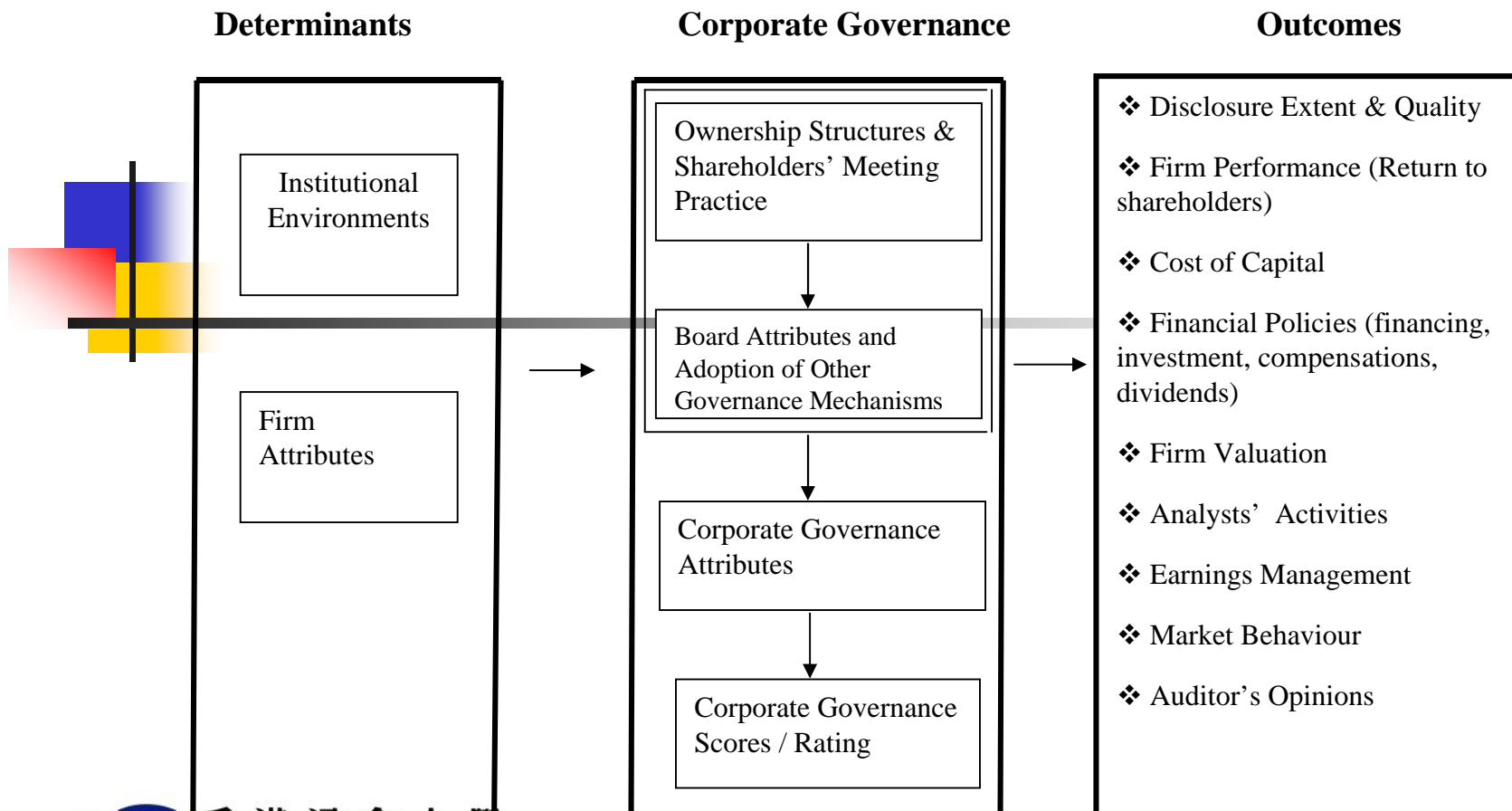
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Government -- Market --- Firms

∨

Corporate Governance Practice

A Research Model for Corporate Governance



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Empirical Evidence of Good CG on Firm Performance

- There have been western studies showing that the better CG, the higher the firm's profits, company valuations, stock prices and price to book ratio,
- also the lower in cost of capital and capital expenditures



CG is another Management Fad?

QCC

TQM

BPR

ISO

BSC

BEX

.

.

CG



CG Vs TQM

- It' been widely adopted not because firms expect to see real improvements but because it is a fad.
- Some companies adopt a typical-form of TQM because they get favorable ratings by regulators or they have to demonstrate to stakeholders that they are keeping up, regardless whether or not such actually works or is well-adapted to their particular needs.



Effects of New CG Measures

- Not every CG measure is suitable to every organization (e.g. separation of chairman and CEO, board independence from top managers).
- Some CG measures may be complimentary to each other, others may substitute each other
- Some of these CG reforms may have unexpected side effects (political tactics of CEOs) or a negative effect on performance



Form vs Substance

- Don't take CG claims by companies at face value
- CG causing no impacts may be due to not adopting CG in substance



SOX 2002 New Rules

- Listed companies must have a majority of outside independent directors
- Listed companies are required to have a minimum three-person audit committee composed entirely of outside independent directors
- Each Member of the audit committee must be financially literate and at least one member must be a financial expert
- Audit committee members may be compensated only with directors' fees



SOX 2002 New Rules

- The audit committee must directly appoint, retain, compensate, evaluate, and terminate the company's independent auditors.
- Listed companies must have a compensation committee composed entirely of outside independent directors.
- Listing companies must have a nominating committee composed entirely of outside independent directors.
- Shareholders must be given the opportunity to vote on all equity compensation plans

The logo consists of a vertical black line intersected by a horizontal black line. To the left of the vertical line, there are three overlapping squares: a yellow one at the top, a red one in the middle, and a blue one at the bottom. The text 'Enron Corporation, 1999 Annual Report' is positioned to the right of the logo.

Enron Corporation, 1999 Annual Report

OUR VALUES

- RESPECT: We treat others as we would like to be treated.
- INTEGRITY: We work with customers and prospects openly, honestly and sincerely.
- COMMUNICATION: We have an obligation to communicate.
- EXCELLENCE: We are satisfied with nothing less than the very best in everything we do.



WorldCom Governance: Board

- Large: 11 members
- Insiders: 6/11
- Outsiders appointed by CEO Ebbers: 4/5
- CEO power:
 - * Ebbers a Director since 1985
 - * By-laws provide for CEO/President, not Chairman, to run board meetings
- Frequency: meet 4 times in 2001

Source: Abbie Smith



WorldCom Governance: Audit

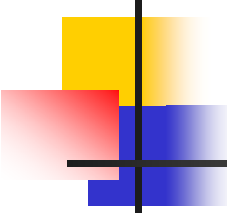
Audit Committee

- Frequency: 5 times
- Independence: 4/4 appointed by CEO
- Qualifications: none with accounting or audit expertise

External Auditor

- Auditor: Arthur Andersen
- Long tenure: since incorporation
- Fees: 2001 audit fees \$4.4m; non-audit fees \$12.4m

Source: Abbie Smith



Principal CG Models Worldwide (by legal system)

1. Common Law (US, UK, Canada, Australia)
2. Code Law (Continental Europe, Latin America, Japan)
3. Asia-Pacific (HK, Taiwan, Singapore, Korea, Malaysia, Thailand, Indonesia)
4. PRC (or included in Asia-Pacific)



These Models Differ in the Roles of:

- Market
- Ownership structure
- Directors/managers
- Stakeholders (investors, employees, creditors, customers, regulators)
- Groups of related companies
- Governments and public governance



Common-Law Shareholder Value CG Model

- Rules of CG, market and accounting are mainly a market responsibility
- Shareholdings are diversified
- Shareholders alone are represented in independently monitoring managers → 'shareholder value' model
- CEO is usually a powerful decision-maker
- Information asymmetry is reduced by timely public disclosure, across the market
- Market participants assumed outsiders, "at arm's-length"



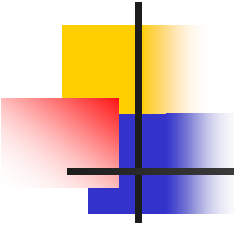
Code-Law Stakeholder CG Model

- Rules of CG, market and accounting are mainly a government responsibility
- Politically powerful stakeholder groups are represented in both codifying and implementing CG
- CEO only follows the board's decisions
- Information asymmetry is reduced by direct (insider) access by representatives "across the table". No arm's-length presumption



East-Asia Insider-Control CG Model

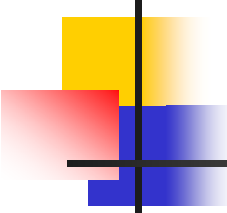
- Insiders represent some type of corporate group structure & employees have little influence
- Except HK & Singapore, capital is more likely to be group-supplied
- Cross-shareholdings are extensive
- Governance relies more on mutual monitoring
- Politics and business are close
- Organized labor, individual shareholders have relatively little influence, litigation is rare
- Except HK & Singapore, financial reporting quality is low (i.e. non-timely loss recognition)



All Models have Variants Differences in East Asia

4 main variants across the region:

- Japan (*Keiretsu*), Korea (*Chaebol*)
- Hong Kong and Singapore
- Taiwan, Malaysia, Thailand, Phillipines, Indonesia
- PRC

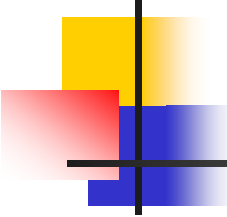


All Models have Variants

Hong Kong as a Special Case

- HK has a strong British common law basis
- HK has a mature stock market
- HK's family-controlled companies are common
- Group structures reflect the role of kinship-based relationships in Chinese culture

Strictly, Hong Kong has its own unique
CG model



Agency Problems in Different Parts of the World

- In US/UK with diffused ownership, conflicts of interests exist mainly between the board/management and outside shareholders
- In East Asia (excluding Japan & China) with controlling families, conflicts exist mainly between the controlling shareholders/directors and outside minority shareholders
- In China with the controlling state, conflicts exist among the state, its agents as directors/managers, and outside minority shareholders

A Comparison of the UK/US Model and the East Asian Model

	The UK/US Model	The East Asian Model
Shareholder Environment	◆ Dispersed ownership	◆ Concentrated ownership
	◆ The separation of owners and managers	◆ Owners as directors and managers
	◆ Highly developed institutional investment	◆ Reliance on family and/or state finance
Capital Market	◆ Active & liquid stock market (incl. IPOs)	◆ Less developed and less liquid stock market
	◆ Active market for corporate control	◆ Limited markets for corporate control
	◆ Tight regulation	◆ Loose regulation
Independence and Performance	◆ Non-executive majority board	◆ 'Insider' board
	◆ Arm-length activities	◆ Relationship-based activities
	◆ Aligned incentive	◆ Incentives aligned with major shareholders
Transparency and Accountability	◆ High disclosure & transparency	◆ Low disclosures & transparency
	◆ Clear line of accountability	◆ Unclear line of accountability
	◆ High minority protection	◆ Inadequate minority protection



Is there Global Convergence?

- Globalization is causing some convergence toward the US/UK model
- Partly due to the political process
- There are also powerful market forces at work:
 - Good CG leads to competitive advantages
 - Global market competition forces companies to adopt global best practice
 - Cross-border transactions
 - The insider-access model is inefficient for cross-border transacting



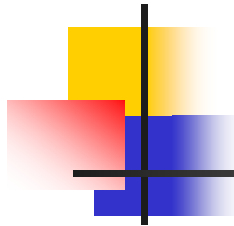
Is there Global Convergence?

- There are important limits to convergence
- The relative efficiencies of the CG models are likely to differ in periods of change and stability
- Don't take CG claims at face value
- No one size fits for all



Is there a Best CG Model?

- Optimal or best CG model depends on some institutional factors:
 - Stock market sophistication/depth
 - investor protection & litigation means
 - Ownership structures
 - Directors/managers' acceptance of fiduciary duties
 - Role of Government
 - Quality of Public Governance
- Relative performance of different CG models would differ in different period of development and different regions
- Cost-effectiveness concerns



Real Convergence?

- There is less convergence than real
- Do We Need a Set of International CG rules?



Convergence : Rules vs Quality

- It costs little for a country to claim adopting the highest quality rules and say one has high standards → 'cheap talk' or 'lip service'
- Very few countries will say "we have low standards"
- It is another matter to implement and actually obtain high standards → need strong incentives
- Mandatory rules could cause superficial change



East Vs West

Therefore we could not assume most commonly-adopted CG measures in the West or other economies are directly applicable to China or Hong Kong.

- Differences in legal development, ownership structures, cultural values, board experience.
- One size does not fit all!



CG Attributes Seen as 'Bad' in US/UK but not necessarily in Asia

- Concentrated ownership
- Less than half of board directors are outside independent
- The controlling shareholder serves as both Board Chairman & CEO
- Directors own little or no stock
- Directors compensated only with cash
- Directors are more independent of (work closely with) top managers



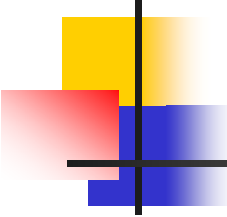
Inter'l CG Rating Agencies

- CLSA
- Political and Economic Risk Consultancy
- Standard and Poors
- Governance Metrics International (mostly non-Asian)
- International Financial Corporation/OECD
- Moody's Investors Services
- Others (Core Ratings, Deminor, Innovest, FTSE/ISS, Investor Responsibility Research Center, Pensions Investment Research Consultants, Vigeo, McKinsey, Corporate Library, TCL, etc.)



Limitations of Ratings by Inter'l Commercial Agencies

- Do not take care of local environment and uniqueness
- Unfair to directly compare with different countries with the same dimensions/items
- As commercial agencies, there may be potential conflicts of interests
- Lack of academic rigors & independence
- Different results due to different assumptions, criteria, weightings, sample size, data sources, and scoring methods
- Same firm receiving different scores/ratings could confuse the market



S & P Corporate-level CG Index/Score

4 criteria used by Standard & Poors:

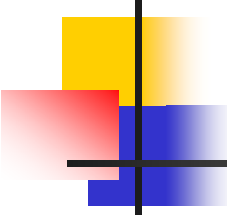
- Ownership structure and concentration
 - Financial stakeholder rights and relations
 - Transparency and disclosure
 - Board structure and process
- ➔ a total of 98 items



CLSA Corporate-level CG Index/Score

- 7 aspects used by CLSA:
 - Discipline (15%)
 - Independence (15%)
 - Fairness (15%)
 - Transparency (15%)
 - Responsibility (15%)
 - Accountability (15%)
 - Social Awareness/responsibility (10%)

A total of 57 items to measure (30 subjective, 70% objective).



GMI Corporate-level CG Index 2005

- 6 aspects
- Sample: 23 countries
- International avg. 6.5 (2,588 firms)
- Out of 26 firms with a score of 10, 20 are from US
- Canada ranked 1, UK 2nd, US 2nd, Australia 4th, HK 18th, Singapore 14th, Japan 22nd
- China not covered



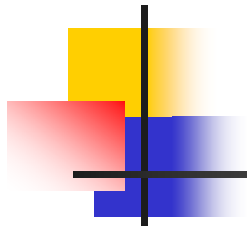
GMI Corporate-level CG Index

	HK	Singapore
Board Accountability	4.23	6.02
Fin. Disclosures	4.95	5.40
Shareholder Rights	5.31	5.34
Pay Disclosures	4.40	5.15
Disp.of Ownership	6.14	5.64
Firm Behavior	6.06	5.88
Average	4.63	5.32



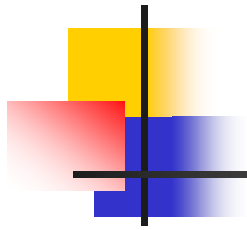
Interpreting the CG Scores

- What score is good or bad?
- => relative, there is no standard stating what score is good or bad
- The company has to try to reach the highest score as possible
- To be cautious in using the CG scores.
- Not easy to directly compare scores across companies (especially not in the same industry)



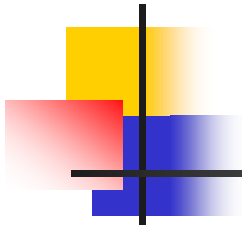
Interpreting the CG Scores

- Not every CG measure is suitable to every organization.
- Each company has its own CG strengths and weaknesses
- A company may have some strong points which are not recorded well through the questionnaire



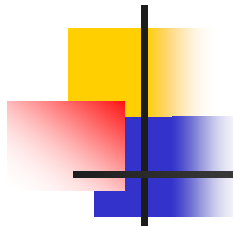
Interpreting the CG Scores

- CG is actually not something absolute which can be measured exactly or with certainty by using a special tool.
- CG has many dimensions or aspects and there is no tool yet able to measure it perfectly.
- Each assessment tool has its strong points (simple) and weak points (objectivity & independence).



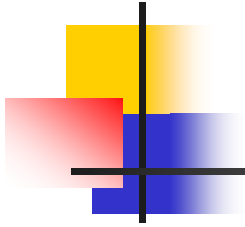
Implications

- Good CG cannot rely on stringent legislation and enforcement
- Raising the awareness & ethical standards of market participants
- Securing top management's commitment to good CG
- Cultivating a healthy corporate culture & core values by the management



Conclusions

- CG is not just a matter of rules & regulations, it is also a matter of people, culture & ethics.
- Companies need to embrace the principles and ideas behind CG and move away from an attitude of box-ticking compliance.
- One size does not fit all- be flexible and cost-effective



Questions are welcome 歡迎提問

