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

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1. Introduction

In this paper, I review the development of board committees and the functions of these board committees. The main board committees considered are the audit, remuneration and nominating committee. Regulatory requirements and best practice codes governing the formation of board committees in several Asian countries are then discussed. I then provide survey evidence on the actual use of board committees by Asian corporations, including the composition of these committees.

Following that, I review empirical studies that have examined the effectiveness of the major board committees. Most of these studies were conducted using Anglo-Saxon corporations, and by far, the most attention has focused on the audit committee.

I then discuss the question of whether the establishment of board committees should be driven by law, listing rules, code of best practice, or by companies themselves in response to the market. The paper concludes with a discussion of the structure and processes of effective board committees, and the difficult challenge of establishing effective board committees in Asia.

2. Development and Functions of Board Committees

2.1 Audit Committee

Requirements for public-traded corporations to form audit committees arose primarily from highly publicised cases of fraudulent financial reporting and corporate failures which raised questions about the quality of financial reporting, the effectiveness of internal control, and the independence of the external auditor.[1]

More recently, concerns over the quality of financial reporting have refocused attention on the audit committee and led to reforms in audit committee, e.g., through the recommendations of the Blue Ribbon Committee in the U.S.

The primary responsibilities of the audit committee have developed largely in line with the factors that have given rise to their existence, and they are as follows:

1. review the adequacy of the company's internal control and risk management systems;
2. oversee the financial reporting process; and
3. review and enhance the independence and effectiveness of the internal and external audit functions (e.g., by recommending the hiring, compensation and replacement of the external auditor, reviewing the provision of non-audit services, reviewing the scope and effectiveness of the internal and external audits, providing an independent channel of communication for the internal and external auditors).

In addition, the audit committee may also be charged with overseeing compliance with relevant laws and regulations and with internal codes of conduct.

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[1] For example, in the U.S., the McKesson and Robbins case which involved fraudulent financial reporting led to a proposal by the SEC for a formation of a committee of non-executive directors to assure auditor independence (Birkett, 1986). In Canada, it was a series of corporate collapses that triggered the legislative requirement for audit committees (Collier, 1996). Similar, in Singapore, the crash of the Pan-Electric group of companies in 1985 was instrumental in the introduction of a legal requirement for audit committees. The collapse was caused by high-level mismanagement and fraud.

2.2 Remuneration Committee

The pressure on companies to form remuneration committees arose in large part out of the concern over the lack of transparency of remuneration, excessive remuneration, and the perceived poor linkage between performance and remuneration. In practice, a significant part of directors' remuneration, especially those paid to executive directors, is often not subject to shareholders' approval. Therefore, directors (and executives who sit on the board or are related to directors) are essentially put in a position where they largely decide on their own remuneration. This is exacerbated by the generally poor and incomplete disclosure of remuneration policies and packages.

The primary responsibilities of the remuneration committee are generally as follows:[2]

1. to develop a framework for executive remuneration, and
2. to recommend the level and mix of remuneration packages for directors and senior executives.

Remuneration committees should not be seen solely as a tool for guarding against excessive remuneration. Rather, the remuneration committee should ensure that remuneration of executives and directors reflect their performance and contribution to the company or the Board. The remuneration committee should ensure that remuneration packages are designed such that directors and executives have incentives to enhance shareholder value, and this requires careful consideration of the mix of the remuneration packages. Also, the remuneration committee should ensure that remuneration packages are appropriate – that they are competitive but not excessive.

2.3 Nominating Committee

The impetus for the formation of nominating committees came from concerns about the process through which directors are appointed to the Board. Although directors have to be formally elected by shareholders at the AGM and under most company charters have to retire by rotation at each AGM, in practice, the CEO and controlling shareholders often have considerable influence over the appointment of directors. Common criticisms of the director appointment process are the excessive influence of the CEO, the appointment of directors who are sympathetic to management, the appointment of nominee directors by major shareholders who may not act in the interests of the company or minority shareholders, and the lack of renewal of the board of directors.

The primary responsibility of the nominating committee is to recommend appointments to the Board, whether for new directors or re-appointment of existing directors. Other responsibilities may include to review the size, structure and composition of the Board, recommend membership of board committees, recommend measures for appraising director and board performance, and to undertake director and board appraisal based on measures approved by the Board.

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[2] These responsibilities are set out in the U.K. Combined Code, the Malaysian Code, and the proposed Singapore Code, amongst others.

3. Requirements on board committees in Asia

3.1 Audit committees

Table 1 summarises the current requirements in selected Asian countries with respect to audit committees. It can be seen from Table 1 that many Asian countries have a legal or listing requirement that requires listed companies to have an audit committee. These include Malaysia, Singapore, Thailand and India. Audit committees are also required for Growth Enterprise Market (GEM) companies in Hong Kong, and have been recommended in the other Asian countries where they are currently not required. In general, audit committees are required to have at least 3 members, all non-executive or independent, with the Chairman being an independent director.

3.2 Other board committees

A few Asian countries have recommended remuneration and nominating committees for listed companies, including Malaysia, Singapore, Korea, and Japan. The Malaysian Code of Corporate Governance recommends a nominating committee made up exclusively of non-executive directors, the majority of whom should be independent, and a remuneration committee made up wholly or mainly of non-executive directors.[3]

The proposed Code of Corporate Governance of Singapore recommends a nominating committee of at least three directors, with a majority including the Chairman being independent, and a remuneration committee comprising a majority of independent directors and chaired by an independent director.[4]

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[3] Malaysian Code of Corporate Governance, Finance Committee on Corporate Governance, March 2000.

[4] Proposed Code of Corporate Governance, Corporate Governance Committee, 2001.

Table 1: Audit Committee Requirements in Selected Asian Countries

Country	Audit Committee Requirements
India	The Securities and Exchange Board of India (SEBI) has recently introduced the requirement that all listed companies set up a qualified and independent audit committee. The audit committee should have at least 3 members, all of whom should be non-executive, with the majority being independent. At least one director should have financial and accounting expertise, and the Chairman should be an independent director. The audit committee must meet at least 3 times a year, including once before finalisation of the annual accounts, and once every 6 months. Powers and responsibilities of the audit committee are also set out.
Malaysia	The KLSE Listing Requirements require companies to have an audit committee with at least 3 members, a majority of whom, including the Chairman, should be independent. The Listing Requirements also set out the functions and certain procedures to be followed by the audit committee. The Malaysian Code on Corporate Governance states that the board should establish an audit committee with at least three non-executive directors, a majority of whom, including the Chairman, should be independent.
Singapore	The Singapore Companies Act requires listed companies to form an audit committee of at least 3 members, a majority of whom must be independent. The Chairman must be a non-executive director. The Act also sets out basic requirements relating to the duties and responsibilities of audit committees. The Best Practices Guide of the SGX states that a majority of audit committee members, including the Chairman, should be independent.
Thailand	The Stock Exchange of Thailand requires listed companies to have an audit committee with at least 3 members, each of whom should be independent and at least one of whom should have knowledge of accounting or finance. It also sets out seven prescribed duties and responsibilities of audit committees, including the requirement to disclose in the annual report, a report on the supervisory activities undertaken by the Committee.

Table 1: Audit Committee Requirements in Selected Asian Countries (cont'd)

Hong Kong	The HKSE Code of Best Practice recommends that boards should establish an audit committee whose principal duties are to review and supervise the financial reporting process and internal controls. The audit committee should comprise a minimum of two non-executive directors, a majority of whom should be independent. The GEM Listing Rules require the establishment of an audit committee comprising at least two members. The majority of the members must be independent non-executive directors, and in the case of a committee with 2 members, both must be independent non-executive directors.
Indonesia	There is no requirement for audit committees. An earlier requirement imposed by Bank Indonesia for banks to have an audit committee was revoked, and the compliance director substituted for the audit committee. Under the Code for Good Corporate Governance produced by the National Committee on Corporate Governance, it was recommended that an audit committee comprising of representatives of the Board of Commissioners (supervisory board), outside auditors and senior members of the internal audit department be set up. The audit committee should report to the Board of Commissioners.
Japan	There is no law or listing rule requiring audit committees. Under the Commercial Code, a joint stock company must have a statutory auditor. A "large" company must have a board of auditors comprising at least three statutory auditors, at least one of whom must be an "outside" auditor. The statutory auditors are responsible primarily for oversight of management activities, and includes overseeing the external audit function, internal audit function and internal control. The Corporate Governance Forum of Japan has issued a voluntary code of Corporate Governance Principles. It is recommended that, once corporate boards contain a higher proportion of independent directors, audit committees comprising non-executive directors should be established. The audit committee's functions include reviewing the company's risk management process and compliance issues.

Table 1: Audit Committee Requirements in Selected Asian Countries (cont'd)

South Korea	The Korean Commercial Law allows companies to choose either an auditor or an audit committee. The audit committee must consist of at least 3 directors, a majority of whom should not be executive directors. The Code of Best Practice for Corporate Governance produced by the Committee on Corporate Governance recommended the formation of audit committees with at least two-thirds independent directors. Under regulations introduced by the Ministry of Finance and Economy, companies with a market capitalisation of over 2 trillion won must establish an audit committee with two-thirds independent outside directors.
Taiwan	There is no audit committee requirement in Taiwan. There is a board of directors and a board of supervisors. The board of supervisors is supposed to perform the functions of audit committee although it has more general mandate to monitor the management performance. Although the system of audit committee has been proposed, it has not been written into law yet.

In Korea, nomination and remuneration committees with at least one-half independent directors are recommended. [5] In Japan, remuneration committees comprising solely of independent directors, and nominating and corporate governance committees comprising a majority of independent directors have been recommended. [6] In India,[7] companies are expected to form a remuneration committee with a minimum of three non-executive directors including an independent Chairman. In Indonesia, it has been recommended that companies should form a Remuneration and Nomination Committee for the purpose of appointing members of the Board of Commissioners and Board of Managing Directors, determining the remuneration of these members, and evaluation of their performance.[8]

In addition, a few Asian countries have mandated committees other than audit committees for specific types of companies. In Korea, nominating committees are now required for companies with a market capitalisation of over 2 trillion won, under regulations introduced by the Ministry of Finance and Economy.

In Singapore, the Monetary Authority of Singapore (MAS) has introduced a requirement for local banks to form a Nomination Committee and a Compensation Committee.[9] The Nominating Committee must comprise of five board members to be approved by the MAS. This Committee is responsible for identifying individuals and reviewing nominations by the board or

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[5] Code of Best Practice for Corporate Governance, Committee on Corporate Governance, 1999.

[6] Corporate Governance Principles, Corporate Governance Forum of Japan, 1998.

[7] Draft Report of the Kumar Mangalam Committee on Corporate Governance, 1999.

[8] Code for Good Corporate Governance, The National Committee on Corporate Governance, March 2000.

[9] MAS Notice No. 622 specifies the requirement for locally-incorporated banks to have a Nomination Committee and a Compensation Committee. It also specifies the size, composition, functions and duties of the Nomination Committee, and the size and composition of the Compensation Committee.

shareholders for the following positions: Board membership, the Executive Committee of the Board, the Compensation Committee, the Audit Committee, the Chief Executive Officer / Deputy Chief Executive Officer / President / Deputy President, and Chief Financial Officer. The Compensation Committee must have at least 3 members of the Board, a majority of whom are not employees of the bank. In addition, under the SGX Practice Note No. 9h, companies having a share option scheme have to form a board-level committee to administer the scheme, and to disclose the members of this committee in the annual report. In India, a committee to address shareholders' complaints chaired by a non-executive director is required for listed companies.

4. Board Committee Practices in Asia

There is clearly an increasing recognition among Asian countries of the importance of having effective board committees to promote good corporate governance. The preceding discussion indicates many proposals to reform board committees where they are already currently required, or to require them where they are not currently required. This is especially so in the case of the audit committee. Therefore, one can anticipate more Asian companies forming these board committees in the near future.

What is the current practice regarding these board committees in Asia? In this section, I provide survey evidence on the use and composition of these board committees from Singapore, Malaysia, and Thailand. Most of this evidence is based on annual report data that I have collected.

4.1 Singapore

Table 2 shows the reported use and composition of audit, remuneration and nominating committees for a sample of 271 SGX-listed companies, based on the 1999/2000 annual reports. Most companies have the minimum of 3 members on the audit committee as required by the Companies Act and SGX Rules. It can be seen many companies have an executive director serving on the audit committee – in fact, around two-thirds of all companies in the sample.

Around 39% reported the use of a share option scheme committee. As noted earlier, the SGX requires companies that have implemented a share option scheme to have a board-level committee administering the scheme. On average, around 1 in 4 directors sitting on the share option committee is an executive director. Around 15% of companies reported the use of a remuneration/compensation committee, with on average 19% of members of this committee being executive directors. Only eleven companies (4%) reported the use of a nominating committee – with 5 being the banks, for which a nominating committee is mandatory.

Table 2: Use and Composition of Board Committees for Singapore Listed Companies (n=271)

Board Committee	Number (Percentage) Reporting Use	Mean (Median) Size	Mean (Median) Percentage Executives	Mean (Median) Percentage Non-Executives
Audit	271 (100%)	3.19 (3)	21% (33%)	79% (67%)
Share Options	107 (39%)	2.97 (3)	26% (25%)	74% (75%)
Remuneration	40 (15%)	3.13 (3)	19% (0%)	81% (100%)
Nominating	11 (4%)	5.20 (5)	30% (30%)	71% (70%)

Other committees that companies reported using are the Executive or Management Committee, Finance Committee, Investment Committee, Policy Committee, Strategy Committee, Risk Management Committee, Credit Committee, and Management Development Committee, but these were relatively uncommon.

Table 3 reports the use of board committees and the composition of these committees obtained from a survey of board practices of 102 SGX-listed companies conducted by the Singapore Institute of Directors.[10] The survey findings are largely consistent with those based on the annual report analysis.

Table 3: SID (2000) Survey Board Committees and their Composition (n=102)

Committee	Number (%) of Companies with Committee	Average Size of Committee	Average Number of Executive and Non-Executive Directors	
			Executive	Non-Executive
Audit	102 (100%)	3.2	0.8	2.5
Share Options	34 (33%)	3.3	1.5	1.8
Remuneration	29 (28%)	3.1	1.0	2.2
Strategy	12 (12%)	4.3	2.3	1.6
Executive	11 (11%)	3.9	2.3	1.6
Nomination	7 (7%)	4.0	1.9	2.1
IT	5 (5%)	4.6	2.0	2.6
Investment	5 (5%)	3.6	1.6	0.9
Technology	3 (3%)	3.0	3.0	0
Others	3 (3%)	3.0	1.0	2.0

The Survey also revealed that for the majority of companies (69%), the Chairman was involved in the identification of the most recent appointment to the Board, with other board members (46%), CEO (25%), and major shareholders (24%) also involved in many cases. In only 4% of cases was the Nomination Committee involved. However, 26% of companies indicated that they intend to use a Nomination Committee for the appointment of the next director.

In the PWC (1997) and PWC (2000) surveys, the introduction of remuneration (compensation) and nominating committees were both identified as areas requiring improvement in Singapore.

4.2 Malaysia

Table 4 shows the use and composition of various board committees by Malaysian listed companies, as reported in their 1999 annual reports.

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[10] Singapore Board of Directors Survey 2000, Singapore Institute of Directors and Egon Zehnder International.

Table 4: Use and Composition of Board Committees for Malaysian Listed Companies (n=290)

Board Committee	Number (Percentage) Reporting Use	Mean (Median) Size	Mean (Median) Percentage Executives	Mean (Median) Percentage Non-Executives
Audit	290 (100%)	3.22 (3)	22% (33%)	78% (67%)
Remuneration	2 (0%)	3.50 (3.50)	0% (0%)	100% (100%)
Nominating	2 (0%)	3.00 (3)	0% (0%)	100% (100%)

As can be seen, few companies report the use of a remuneration or nominating committee. Clearly, with the implementation of the Malaysian Code of Corporate Governance, the use of remuneration and nominating committees can be expected to rise significantly.

4.3 Thailand

All firms seeking a listing on the Exchange from January 19, 1998 onwards must establish an audit committee before getting approval, while all currently listed companies must form one by December 31, 1999. Table 5 shows the use and composition of board committees by Thailand listed companies, as reported in their 1999 annual reports. Not surprisingly, all Thai companies reported the use an audit committee, with all reporting that members are all independent non-executive directors, as required by the SET.[11] There was no reported establishment of remuneration and nominating committees.

Table 5: Use and Composition of Board Committees for Thai Listed Companies (n=200)

Board Committee	Number (Percentage) Reporting Use	Mean (Median) Size	Mean (Median) Percentage Executives	Mean (Median) Percentage Non-Executives
Audit	200 (100%)	3.02 (3)	0% (0%)	100% (100%)
Remuneration	0 (0%)	-	-	-
Nomination	0 (0%)	-	-	-

4.4 Other countries

In Hong Kong, audit committees are recommended for mainboard companies, and required for GEM companies. In 1998, only 26 of the Hang Seng 100 component stocks have audit committees.[12] Similarly, it is uncommon for Indonesian companies to have audit, remuneration and nominating committees.[13] In a recent survey by the Tokyo Stock Exchange of corporate governance of 1,310 listed companies, 55.8% indicated that they have already implemented measures to strengthen the function of auditors and board of auditors.[14] 69.4% have increased the number of external auditors, and 80.9% have appointed auditors who have no financial interest in

[11] I did not find any Thai listed companies reporting the use of a remuneration or nominating committee.

[12] I would like to thank Professor Judy Tsui for this information.

[13] See Kurniawan, D.M. and N. Indriantoro, "Corporate Governance in Indonesia," The Second Asian Roundtable on Corporate Governance, Hong Kong, 2000.

[14] Survey on Listed Companies' Corporate Governance, Tokyo Stock Exchange, November 2000.

the company. For the companies that have implemented measures to strengthen the function of the board of auditors, more than 90% have external auditors comprising a majority of the board of auditors. However, only 3.9% have a board of auditors that comprise exclusively of external auditors. For the companies that have not introduced measures to strengthen the board of auditors, 10.4% plan to do so in the future, mainly through increasing the number of external auditors.

Twenty-two percent of companies indicated that they have formed an organisation which decides directors' remuneration (such as a remuneration committee). However, only 8.9% of companies indicated that they have introduced, are introducing or are considering introducing a remuneration committee. The percentages of companies planning to introduce other board committees, such as a management personnel appointment committee (similar to nominating committee), are similarly low.

5. Do Board Committees Enhance Corporate Governance?

Why use board committees? Delegating specific board responsibilities to smaller board committees can be an effective way of managing the myriad responsibilities of the board. Board committees can improve decision-making by the Board. Some board committees are formed largely with this consideration in mind – for example, executive, strategy and IT committees, to name a few. Having board committees may be especially useful if the board is large, given the difficulties of large-group decision-making.

However, the primary reason for having board committees is to enhance the monitoring function of the board and its accountability to shareholders and other stakeholders. Board committees can allow non-executive and independent directors to deliberate and make recommendations in areas where there may be conflict of interests between management and shareholders. This is especially so in matters dealing with financial reporting, internal control, remuneration, and the appointment or removal of directors. It is therefore unsurprising that the three most commonly advocated board committees for improving corporate governance are the audit committee, nominating committee, and the remuneration committee. Further, in most cases, these committees are expected to have at least a majority of independent directors.

5.1 Studies of Audit Committee Effectiveness

Given that two of the major roles of the audit committee are to oversee the financial reporting and internal control systems of companies, several studies have examined whether the existence and composition of audit committees are related to the incidence of financial statement fraud. Dechow *et al*.[15] and McMullen[16] found that, compared to non-fraud companies, fraud companies were less likely to have an audit committee in place prior to the fraud. Beasley found that fraud companies had lower percentages of outside directors on their audit committees.[17] However, this relationship did not exist once the proportion of outside directors was controlled for.

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[15] Dechow, P.M., R.G. Sloan, and A.P. Sweeney, Causes and Consequences of Earnings Manipulations: An Analysis of Firms Subject to Enforcement Actions by the SEC, Contemporary Accounting Research, Spring 1996, pp. 1-36.

[16] McMullen, D.A., Audit Committee Performance: An Investigation of the Consequences Associated with Audit Committees, Auditing: A Journal of Practice and Theory, Spring 1996, pp. 87-103.

17 Beasley, M.S., An Empirical Investigation of the Relation Between Board of Director Composition and Financial Statement Fraud, The Accounting Review, October 1996, pp. 443-465.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the U.S. published a study of 200 U.S. companies that had SEC enforcement actions against them for financial statement fraud over the period January 1987 and December 1997.[18,19] Based on data from the study, Beasley *et al.* found that fraud companies were less likely to have an audit committee and were less likely to have audit committees comprised entirely of outside directors. In addition, audit committees in fraud companies met less frequently than in non-fraud companies, this difference being especially pronounced for companies in the technology and health care industries.[20] Klein found that audit committee independence is related to the informativeness of accounting data in valuation, and to earnings management. However, the difference is earnings management is only found between audit committees with and those without a majority of independent directors. There was no difference in earnings management for audit committees with all independent directors compared to those with a majority only of independent directors.[21]

Carcello and Neal examined the impact of the composition of audit committees on auditor reporting for financially distressed firms.[22] They found that the greater the percentage of affiliated directors on the audit committee, the less likely is the auditor to issue a going-concern report. Wild found that the market's reaction to earnings report is more than 20 percent greater after the formation of the audit committee than before, suggesting that the audit committee improves the quality of financial reporting and auditing.[23]

Several U.K. studies have examined the impact of audit committees on corporate governance. Peasnell et al. studied whether the incidence of earnings management depends on board monitoring, including the presence of an audit committee.[24] They focus n situations where performance is either poor (and therefore there is an incentive to manage earnings upwards) or exceptionally good (and therefore there is an incentive to manage earnings downwards). They found that companies that have a larger proportion of outsiders on their boards are less likely to manage earnings upwards in the event of poor performance. However, this is true only for companies where managerial ownership is low and therefore there is little alignment of shareholders' and managers' interests. They found no evidence of a direct relationship between audit committee existence and earnings management. However, they found that the relationship

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18 Beasley, M.S., J.V. Carcello and D.R. Hermanson, Fraudulent Financial Reporting: 1987 – 1997, An Analysis of U.S. Public Companies, New York, NY: COSO.

19 Financial statement fraud cases involve improper revenue recognition, overstatement of assets, understatement of expenses/liabilities, misappropriation of assets, inappropriate disclosure, and other techniques.

20 Beasley, M.S., J.V. Carcello, D.R. Hermanson and P.D. Lapides, Fraudulent Financial Reporting: Consideration of Industry Traits and Corporate Governance Mechanisms, Accounting Horizons, December 2000, pp. 441-454.

21 Klein, A., Causes and Consequences of Variations in Audit Committee Composition, Working Paper, New York University, April 2000; Klein, A., Audit Committee, Board of Director Characteristics, and Earnings Management, October 2000.

22 Carcello, J.V. and T.L. Neal, Audit Committee Composition and Auditor Reporting, The Accounting Review, October 2000, pp. 453-467.

23 Wild, J.J. The Audit Committee and Earnings Quality, Journal of Accounting, Auditing and Finance,1996, pp. 247-276.

24 Peasnell, K.V., P.F. Pope and S. Young, Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?, Working Paper, Lancaster University, October 2000.

between board composition and earnings management is most pronounced where an audit committee is present. This is consistent with audit committees enhancing the monitoring role of outside directors.

Song and Windram studied 27 post-Cadbury cases dealt with by the Financial Reporting Review Panel (FRRP) in the U.K.[25] These cases involves accounts that did not appear to have been prepared in according with the requirements of the U.K. Companies Act 1985, the accounting standards issued by the ASB and financial reporting standards. Using a sample of control firms matched by industry sector that did not have financial reporting irregularities, they found that companies with financial reporting irregularities had a lower proportion of outside directors on the board. They also found that companies that had audit committees with more members with financial management experience and with formal qualifications in accounting or auditing are less likely to experience financial reporting irregularities. In addition, higher audit committee meeting frequency is associated with lower incidence of financial reporting irregularities.

In summary, the empirical evidence support the role of audit committees in corporate governance, especially in relation to financial reporting and external auditing. Further, the composition of these committees is also important.

5.2 Studies of Remuneration Committee Effectiveness

Compared to audit committees, very few studies have examined whether remuneration (compensation) committees affect corporate governance. Using firms from the 1992 Fortune 250, Newman and Mozes found that when insiders are on the compensation committee, CEO compensation practices are more favourable for the CEO.[26] They did not find a significant difference in compensation levels between firms whose compensation committees consist of at least one insider and those whose compensation committees consisted solely of outside directors. However, they found that the relationship between CEO compensation and firm performance was more favourable towards the CEOs of firms with insider-influenced compensation committees compared to CEOs of firms with compensation committees consisting solely of outside directors. In particular, less weight is placed on unfavourable performance when insiders serve on the compensation committee. This result is consistent with the study by Conyon and Peck for a sample of U.K. firms, which found that the proportion of non-executive directors on the board and the presence of a remuneration committee affected the relationship between performance and top management remuneration, but not the level of top management remuneration.[27] In summary, previous studies suggest that the major benefit of remuneration committees is not controlling the level of remuneration, but helping ensure that remuneration is linked to performance.

6. What Should Drive Board Committee Establishment?

There is some divergence in the approaches by different Asian countries to the establishment of board committees. In the case of audit committees, they are required by law in Singapore, and by

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[25] Jong, J. and B. Windram, Benchmarking Audit Committee Effectiveness in the UK, Working Paper, Napier University, November 2000.

[26] Newman, H.A. and H.A. Mozes, Does the Composition of the Compensation Committee Influence CEO Compensation Practices?, Financial Management, Autumn 1999, pp. 41-53.

[27] Conyon, M.J. and S.I. Peck, Board Control, Remuneration Committees, and Top Management Remuneration,1998, pp. 146-157.

listing requirements in Thailand, Malaysia and India. In the Hong Kong, they are recommended best practice only (except for GEM firms in Hong Kong). In the case of the other committees, they are generally recommended best practice only, with exceptions such as the remuneration committee for Indian listed companies, and certain requirements imposed on specific types of companies (such as large companies in Korea and banks in Singapore).

Mandating committees through law may be justified to quickly restore or instill confidence. In Singapore, for example, audit committees were introduced in response to a major corporate collapse which caused a crisis in the stock market, resulting in the Singapore and Kuala Lumpur stock markets to be closed for three days in December 1985.[28] In the case of the compensation and nomination committee requirements for banks, they were introduced after the financial crisis in 1997, and reflect the importance of ensuring a robust banking sector. The use of law will quickly result in the institutionalisation of these committees. However, clearly, such an approach assumes that a one-size-fits-all approach to corporate governance is appropriate, which can be questioned. The legal approach will also often result in companies complying with the letter, rather than with the spirit, of the legal requirements. In addition, the law is usually slow in adapting to changes in the business environment. Therefore, in my view, the legal approach to forming board committees should be used with care, and these legal rules and the continuing need for them should be reviewed from time to time.

At the other end of the spectrum, one could leave the establishment of board committees completely to the market, without any rules or guidance from regulators. The U.S. and Australia best typify this approach in the sense that while companies are expected to inform investors as to how they practice corporate governance, including the use of board committees, the formation of these committees is left to the companies. This of course is the disclosure-based philosophy to regulation in its purest form. However, even in the U.S., the audit committee is mandated by the NYSE and NASDAQ. I believe that such an approach only works where capital markets and external corporate governance mechanisms (such as market for corporate control and active institutional investors) are very well developed, and Asia does not fit this description. Certainly, the survey evidence presented earlier indicate that board committees are only established when they are required by law or listing rules.

Between these two extremes are the use of listing rules or a voluntary code to drive the establishment of board committees. For example, under the Malaysian code and the proposed Singapore code, remuneration and nomination committees are recommended but not required. However, companies have to disclose and explain if they do not have these committees. I believe that using a listing rule to mandate an audit committee, which is generally recognised as being the most important board committee, coupled with a voluntary code to encourage the establishment of other board committees, is a sensible and pragmatic approach to encouraging the establishment of these board committees for most Asian countries.

7. Pre-requisites for Effective Board Committees

Although board committees can enhance corporate governance, they are not a panacea. For example, audit committees have not prevented a series of spectacular business failures in Canada. Nevertheless, there are certain common features of board committees that can enhance their effectiveness. These include:

1. Qualified and independent committee members

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[28] Woon, W., Company Law (2nd edition), Sweet and Maxwell, Asia, 1997.

2. Clearly defined charter
3. Regular, carefully planned meetings
4. Adequately resourced (including access to independent professional advice)
5. Adequate training/orientation for members
6. Balance between continuity and renewal

In other words, it is insufficient to have board committees, if the appropriate structure and processes are not in place for these committees. Unfortunately, it appears that board committees are often formed to meet the "letter" of the legal, listing or best practice guidelines, without sufficient consideration of these structure and process features.

8. Ideal Composition and Expertise of Board Committees

Independence is clearly an essential feature of the audit, remuneration and nomination committees. Without independence, much of the value of forming these committees will be diminished. However, equally important is that committee members have the necessary expertise. The necessary expertise clearly depends on the responsibilities of the committee.

In the case of an audit committee, it is important to be separate from management in order for the audit committee to effectively discharge its responsibilities. The audit committee's responsibilities revolve around oversight of controls over management actions – overseeing the internal control system, overseeing financial reporting, and overseeing the external audit process. For this oversight to be effective, it is strongly recommended that the audit committee should not include executive directors. In the case of audit committees, some accounting or financial management expertise would also be important, given the oversight responsibilities over financial reporting and internal control. Unfortunately, existing requirements tend to focus on the independence of these committees, and not sufficiently on the expertise or qualification of audit committee members. This has now been recognised through requirements and best practice guides specifying accounting and financial expertise qualifications for audit committee members, for example, in Thailand, Malaysia and now Singapore (following the lead of the Blue Ribbon Committee in the U.S.).

Since the typical responsibilities of the remuneration committee are to recommend the remuneration framework and packages for directors and senior executives, it is also important for this committee to be somewhat removed from management. Whether the remuneration committee needs to consist of all non-executive or independent directors can be debated. There are two arguments in favour of having executive directors (especially the CEO) on this committee. First, if the remuneration committee also sets remuneration packages for senior executives, the CEO should have a say in how senior executives are rewarded. Second, requiring all committees to consist of all non-executive or independent directors would either overburden these directors, or create a board that is long on independence and short on expertise.

Just as expertise is important for an audit committee, it is also important for a remuneration committee. In this case, knowledge of compensation practices and the design of compensation packages would be useful. With the increasing use of stock-based compensation (especially options), knowledge of how to structure such stock-based compensation and the valuation of these options may also be useful. Of course, such expertise can be obtained by the committee through the use of external consultants, so a Board may not need to appoint a board member solely with the view to having this expertise available.

The required expertise of a nominating committee depends on whether the nominating committee's responsibilities include recommending performance measures and undertaking board and director appraisal.[29] If so, then the committee would require expertise in undertaking performance appraisal, either through a board member or through the use of external consultants.

One possibility that can be considered is allowing the board to co-opt outside experts into these committees. This is because the specialised expertise required for certain board committees may not be available among the board members, especially given that board appointments require consideration of not only specialised skills, but also business or management experience, industry knowledge, strategic planning experience and customer-based experience or knowledge.

9. How Should Committees Be Appointed?

Given that the nomination committee is responsible for assessing candidates for appointment to the Board and would therefore have good knowledge of the background and qualifications of candidates, this committee can also play an important role in recommending appointments to board committees. Indeed, this is recommended by the Malaysian Code and some companies have indicated that this is indeed one of the roles of the nomination committee.

10. Relationship Among the Board, Board Committees, Management and Shareholders

In order for the board committees to effectively discharge their responsibilities, they should have complete access to management and employees. They should be able to invite any executive or employee to attend board committee meetings.

Board committees should report to the Board in the first instance. In addition, some codes, such as the Singapore Code, recommends that the Chairs of the audit, remuneration and nomination committees should be available at the AGM to answer questions from shareholders. This would further enhance the accountability to, and communications with, shareholders.

11. Concluding Comments

Board committees can play an important role in corporate governance, in terms of improving decision-making by the Board, but especially in enhancing the monitoring of management and accountability to shareholders. There is a considerable push towards the establishment of these board committees and improving the functioning of these committees, especially the audit committee.

However, board committees are not a panacea, and it is counter-productive to push for the establishment of these committees (especially through mandatory rules) if there is a lack of qualified independent directors to serve on these committees. Unfortunately, in most of Asia, the lack of qualified independent directors is a real issue and represents a significant challenge to the establishment of effective board committees, and indeed effective boards of directors.

[29] As recommended by the proposed Singapore Code.