



**The Fourth Asian Roundtable on Corporate  
Governance**

***Shareholder Rights and the Equitable  
Treatment of Shareholders***

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***Corporate Governance in Emerging Markets:  
An Asian Perspective***

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*The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its Member countries, the ADB or the World Bank*

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## **I. Background**

The 1997 Asian financial crisis was probably the single most devastating economic event of this century. Currencies across the region lost more than 50% of their value in many cases because of unexpectedly weak performance in the corporate sector. The stock markets plummeted by about an average of 40%. The crash in Indonesia and Malaysia was more catastrophic than in Hong Kong and Taiwan – the main stock price index fell 52% in Malaysia and 37% in Indonesia between 1996 and 1997. Though a long list of factors such as high levels of debt, corrupt lending policies, non-market criteria for credit allocation, distorted incentives for project selection and monitoring have been identified as causes for the crisis, it is clear that the crisis would not have been that severe if there were confidence in corporate governance and financial transparency in these corporations. Poor corporate governance has been singled out as a major culprit for the Asian financial crisis (Far Eastern Economic Review, September 18, 1997). Johnson et al. (2000) also presented evidence that the weakness of legal institutions for corporate governance had an important effect on the extent of depreciations and stock market declines in the Asian financial crisis. Hong Kong experienced less shock i.e. only a 20% drop in stock price index as compared to the other Asian capital markets and this is probably because of the corporate governance mechanisms already in existence at that time which included more financial disclosures and transparencies than the other capital markets in Asia.

International institutional investors clearly regarded weak corporate governance, inadequate financial disclosure and a lack of corporate transparency as a cause of the Asian financial crisis. In particular, Tripathi (1998) made the following point:

“Pressure from multilateral agencies on the global market for more disclosure of financial data is rising. Asian companies that want to tap international capital markets will have to meet more stringent reporting requirements.”

Given the above backdrop, corporate governance is the most topical issue that concerns Governments including relevant policy makers, regulators, professional bodies and institutes such as the accounting profession, securities and directors institutes. The Governments and its related Policy Making units have made a great deal of efforts since 1997 to enhance its requirements or disclosures to improve its corporate governance

standards. Hong Kong's Financial Secretary in its 2000 Budget Speech has put corporate governance as the forefront driver of his priorities for Hong Kong's future economic development and initiated a Corporate Governance Review to be implemented by the Standing Committee on Company Law Reform. Malaysia has recently implemented its Code on Corporate Governance in 2000.

Having considered the key economic driver of corporate governance in the Region, the next section outlines the theoretical underpinning for unique agency problems in the Emerging Markets in Asia.

## **II. Economic Incentives for Lack of Corporate Governance and Transparency**

In the agency view, managers are expected to act opportunistically at the expense of the shareholders' interests (Jensen and Meckling, 1976; Fama and Jensen, 1983). The agency problem arises from the separation of ownership and control in modern corporations. This is the fundamental problem that faces modern corporations-the potential for managers to act opportunistically given that it is not possible to write contracts to cover every contingency and the difficulties of monitoring and enforcing contracts (Tsui and Gul, 2000). Manifestations of these opportunistic behaviors may be seen in terms of the lack of corporate disclosures and manipulation of accounting earnings. Managers have a range of economic incentives for managing earnings (Tsui and Gul, 2000). For example, explicit compensation contracts that link compensation to reported earnings under a bonus plan create incentives for managers to manipulate earnings (Coase, 1937; Holstrom and Tirole, 1989; Jensen and Meckling, 1992). However, it is impossible to write contracts that cover every contingency in the business environment. The difficulties associated with writing contracts to cover every possible situation and monitoring as well as enforcing these contracts becomes significant because of the agency problem. The implementation of effective corporate governance mechanisms seems to offer a solution to monitor and reduce these opportunistic behaviors.

In Asia, one unique institutional feature that is different from the other developed economies such as USA and UK and distinguishes itself from the above agency problem is the concentration of ownership. Though there are many different variations on concentrated ownership in Asia, there is a predominance of family or state-owned businesses in these emerging markets. Claessens et al (1999) found that there is evidence of expropriation of minority shareholders' wealth by majority or controlling shareholders in East Asian countries. While recognizing this unique feature that may have resulted in corporate successes in the East Asian economies in the past, the challenge is to implement effective corporate governance mechanisms to balance the interests between majority and minority shareholders (Jordan, 1999). The recent McKinsey Report (2001) urged that the distinct ownership structure such as the importance of family owned businesses in emerging markets should be recognized more explicitly. Otherwise, this unique ownership structure could continue to act as an impediment to corporate governance reform.

Apart from the ownership structure that would set the scene for the unique agency problems in the emerging markets, it is important to understand the underlying legal

framework that defines the rights of shareholders, in particular, those of the minority shareholders. La Porta et al. (1998) examined the legal protection of investors and found that common law countries offer considerably more protection to investors than civil law countries. Their results also showed that countries with more concentrated ownership of shares are associated with less investor protection. Amongst the several emerging markets examined, in this study, common law countries such as Hong Kong, India, Malaysia, Singapore, and Thailand offer more investor protection than civil law countries such as Indonesia, Philippines, Korea and Taiwan.

The above theoretical analysis on ownership structure and legal systems forms the basis of our understanding on corporate governance regimes in the emerging markets. The next section presents the analytical framework to understand different corporate governance regimes in this Region.

### **III. Corporate Governance Regimes**

Rajan and Zingales (1998) pointed out that corporate governance systems in East Asia are relationship-based as opposed to the arms-length market-based systems in the developed economies such as the USA. Market-based systems are characterized by diverse shareholding. They posited that market-based systems by definition require more transparency as a guarantee of protection to investors which are more diverse. By contrast, relationship-based systems which have more owner/managers are designed to disclose less information and thus resulting in a preservation of opacity. This has the effect of protecting the relationship and the companies from the threat of competition. On the other hand, it is expected that this would lead to less transparency and disclosures.

These relationship-based systems are evident in many Asian countries. For example, in Korea, the existence of chaebols controlled by family members and linked to influential politicians and bankers has contributed to the lack of financial transparency (Gul and Kealey, 1999). Similar problems also exist with the huge Japanese conglomerates or keiretsus with their close banking ties (Gul, 1999). In Hong Kong, listed companies may also be characterized as family owned. The unique institutional arrangements which engender these relationship-based systems must be recognized in implementing corporate governance mechanisms.

The above distinct corporate governance system in Asia with its unique ownership structure and legal system shed light on the notion that the market based corporate governance system in the developed economies may not be effective in the emerging economies. The following section gives a detailed comparison on the different types of corporate governance regimes in the emerging markets.

#### **(i). Different Types of Corporate Governance Regimes in Emerging Markets**

In order to understand the different types of corporate governance regimes in the emerging markets, it is necessary to appreciate the institutional, legal and political environments that would impose constraints on the implementation of an optimal solution to

an effective corporate governance regime. The following categorizes and describes the different types of corporate regimes in the emerging markets.

#### 1. Market based corporate governance regime

The market based regime is the one that characterizes efficient equity markets and dispersed ownership (McKinsey, 2001). Examples of the countries classified as market based regimes are developed economies such as U.S.A., U.K., Canada, and Australia. These countries have well-developed capital markets and diffusely owned corporations. As mentioned above, these systems by definition require transparency as a guarantee of investor protection (Rajan and Zingales, 1998).

Though Claessens et al. (2000) identified Japan as having the largest share of widely held firms, followed by Korea and Taiwan, it is nonetheless classified as non-market based in terms of the corporate governance regimes in Asia.

#### 2. Family based corporate governance regime

Emerging markets in general have high concentrated ownership, particularly family ownership. It should be noted that the agency problems that stem from the conflicts of interest between owners/managers and minority shareholders are different in the emerging markets. (Shleifer and Vishny, 1997). Using a sample of 67 Hong Kong listed companies, Gul et al. (1998) documented that family control is associated with lower audit fees. This is consistent with the view that family firms are subject to fewer typical agency problems or separation between managers and shareholders than non-family firms. However, such concentrated ownership of a large proportion of the corporate sector could lead to the suppression of minority rights and could adversely affect the economic development of these markets characterized by weak enforceability of these legal and regulatory institutions (Claessens et al., 2000). Johnson et al. (2000) presented evidence to show that the weakness of these legal institutions for corporate governance had accentuated the extent of depreciations and stock market declines in the Asian financial crisis.

Overall, the nine East Asian countries all have high family ownership, approximately on average about 50% except Japan (Claessens et al, 2000). For example, Indonesia has the highest concentrated family ownership of about 72%, Malaysia and Thailand both score about 67% and 62% respectively. Hong Kong, Singapore and Taiwan are also classified as family based corporate governance regimes. Hong Kong documenting that 53% of all listed companies in Hong Kong have one shareholder or one family group holding more than 50% of issued capital (HKSA, 1995; 1997). Singapore has very high concentrated ownerships both in family and state scoring 55% and 24% respectively (Claessens et al. 2000). Taiwan's 90% of total companies consists mainly of small- and medium-sized enterprises (SMEs) and family-control remains a dominant characteristic even in large corporations (Taiwan Securities and Future Institute, 2001).

This unique family ownership has led to a relationship based corporate governance regime whereby less transparency on corporate governance practices such as disclosure of financial information is expected in market based regime.

### 3. Bank lending corporate governance regime

Banks in emerging markets are characterized by the government which intervened extensively in lending decisions. This has led to little interest in deriving good disclosure from the companies. Examples are Korea, Indonesia and Malaysia, where the government would act as a de facto guarantor for loans extended to companies in targeted industries.

Gul and Kealey's (1999) study highlighted the lack of financial transparency in Korean chaebols which are controlled by family members and linked to influential politicians and bankers<sup>1</sup>. Similar problems also existed with the huge Japanese conglomerates or keiretsus with their close banking ties (Gul, 1999). These lending decisions of these banks were made primarily on the basis of relationship rather than on an objective assessment of the prospects of the company. These banking lending relationships generally characterize the lack of effective corporate governance mechanisms and lack of transparency in these bank lending corporate governance regimes.

### 4. Government affiliated corporate governance regime

Another significant relationship based corporate governance system is the government affiliated regime. China has very high state ownership with 64% and 65% of total shares issued on Shanghai and Shenzhen market respectively (Shanghai Securities Exchange Year Book (1998). Lin (2000) also stated that the non-freely tradable state and legal person shares together account for the majority of these listed companies in China.

Singapore came second to China in terms of the proportion of state ownership i.e., 23.5% in East Asia (Claessens et al, 2000). The Singapore government directly or indirectly controls up to 80% of the listed companies in Singapore (Mak and Chng, 2000). This government ownership has been reduced in the 1990s through a privatization program. Malaysia's state ownership is also relatively high i.e. about 13% (Claessens et al., 2000). The above government affiliated listed companies no doubt have affected the corporate governance regime in China, Singapore and Malaysia in the past decade or so. With the emergence of the World Trade Organization in China and the need for East Asian countries to attract foreign capital such as institutional investors, the Governments of these countries have made extra strides to develop codes of corporate governance to overcome the inherent difficulties arising from government ownership.

In conclusion, the distinct relationship-based corporate governance regimes in terms of family ownership, bank lending relationships and government ownership in emerging

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<sup>1</sup> Korea's 30 largest chaebols had very high average debt-equity ratios (348% in 1995, 519% in 1997). Some chaebols' debt-equity ratios even exceeded 1000%. Korean banks continued their lending to high debt-equity firms with some even with negative equity suggesting that the financial institutions were not making their lending decisions based on the chaebols' financial performance (Joh, 2001)

markets could result in less financial transparency leading to possibility of earning manipulations by corporate managers to expropriate wealth from the minority shareholders. The next section describes the recent developments of corporate governance and financial disclosures in the emerging markets.

## **(ii). Recent Developments of Corporate Governance and Financial Disclosures in Emerging Markets**

Given the inadequate financial disclosures and lack of effective corporate governance mechanisms in the relationship based corporate governance regimes, reliable and quality financial reporting and disclosures are of paramount importance to enhancing corporate governance standard and practices. This is consistent with the OECD Principles of Corporate Governance (1999) which state that:

“The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.”

Timely and accurate financial disclosures are emphasized because of the possible earnings manipulations by corporate managers (Tsui and Gul, 2000). Managers can conceal financial information by a range of methods because accounting standards provide managers with considerable latitude and discretion in financial reporting. Johnson et al. (2000) also showed that managerial agency problems can make countries with weak legal systems vulnerable to the effect of a sudden loss of investor confidence. The lack of transparency and the low quality of available information precipitated a crisis of confidence which led to rapid and massive outflows of capital out of many Asian countries during the financial crisis.

It should be recognized that while better disclosures may not have prevented the Asian financial crisis, it would probably have provided earlier warnings to policy makers, businesses and investors and may even have allowed them to develop better responses and strategies. Therefore, one of the fundamental corporate governance mechanisms in relationship-based systems in the emerging markets is the reliability and timeliness of financial information and disclosures. This notion is also supported by McKinsey & Company’s 2001 Emerging Market Investor Opinion Survey<sup>2</sup>. Three major areas where reform in emerging markets were identified as priorities:

“Accountancy Standards. The accuracy of accounts is the first priority of investors, the timeliness and coverage of accounts taking second priority”.

Other priorities identified for the emerging markets are the enforceability of legal rights and the maintenance of an effective regulatory system.

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<sup>2</sup> The McKinsey Emerging Market Investor Opinion Survey 2001 was undertaken by the corporate governance team in McKinsey & Company. Forty-six private equity investors were surveyed during International Finance Corporation’s Global Equity Conference. They had approximately US\$5 billion assets under management, 90% of which was invested in emerging markets (McKinsey, 2001).

Recent reforms in many jurisdictions in emerging markets had already begun to strengthen the disclosure regimes for listed companies to adequately protect investors and to ensure greater accountability by a company's board and management. Some countries have commenced converging their accounting and auditing standards with international accounting standards. The following section discusses the recent developments in accounting and auditing standards in the emerging markets.

### **(iii). Development of Accounting Standards**

Changes in accounting standards in emerging markets are being implemented to better protect shareholders. Nestor (2002) pointed out that one of six trends in OECD member countries that have profound impact on the global corporate governance landscape is the harmonization of financial reporting standards. The continuing convergence of International Accounting Standards (IAS) and U.S. GAAP had also encouraged an increasing number of countries in the emerging markets to either harmonize, converge or directly adopt IAS as their domestic accounting standards or as alternative to their domestic accounting standards. Table 1 gives evidence of the different ways in which the emerging markets have adopted IAS. Based on the above analysis, the following section discusses the unique factors that contribute to the effectiveness of corporate governance regime in the emerging economies.

## **IV. Unique factors on Effectiveness of Corporate Governance Regime in Emerging Markets**

The above analysis clearly indicates that effective corporate governance regimes in the emerging markets need to take into consideration the legal and regulatory framework and the respective roles that they play. In some of these jurisdictions, disclosure and listing regulations were insufficient to ensure the availability of complete, accurate and timely financial and non-financial information (OECD 2001). For example, some countries had weak disclosure rules on cross-shareholdings, cross guarantees, and related-party transactions. In other jurisdictions such as Japan, the requirements for consolidated financial statements for corporate groups were inadequate.

Stock Exchanges and Regulatory Authorities such as the Securities and Futures Commission and Monetary Authority in emerging markets are also playing their role to enhance better accountability and transparency of their listed companies and amend their listing rules aimed at improving corporate governance practices. Since the Asian financial crisis, developing economies have taken great efforts to improve their disclosure requirements as well.

The Stock Exchange of Hong Kong, for example, has proposed 30 amendments to the Listing Rules in its recent consultation paper currently soliciting views from all the stakeholders and the public. Some of the major proposed changes are (CLSA, 2002):

- Quarterly reporting to be required and be released within 45 days of quarter end, and to contain a balance sheet.
- One-third of board members must be independent non-executive directors (INEDs) with a minimum of two INEDs on the board.
- Disclosure on the following is required in the annual reports:
  - A report on corporate governance practices prepared by the companies' board of directors.
  - Any deviation from the minimum standards of the Code of Best Practice on Corporate Governance will have to be disclosed.
  - Disclosure on the number of audit committee meetings held during the year with a record of attendance
  - Disclosure on individual director's remuneration.
- Any director's contract exceeding three years will require the approval of minority shareholders.

Other emerging markets are also changing its legal and regulatory requirements. Korea passed a new law in 2001 that specified at least one-third of independent directors must be on the board and required the establishment of audit committees. Companies in China are now required to file quarterly reports starting from 2003 and Singapore is set to tighten quarterly reporting deadlines from within 60 days in 2003 to within 45 days by 2004.

Many East Asian countries have issued codes or guidelines on corporate governance. Malaysia and India, for example, require companies to devote a section of their annual reports to the implementation of corporate governance principles, along with detailed compliance report. Recently, jurisdictions such as Hong Kong, Malaysia, and Singapore, have also established "secondary" markets to cater to young and high-growth companies. Given the higher risks associated with these small, start-up companies, these markets require more disclosures to protect investors.

The Securities and Futures Commission usually is the front line regulator of listing related matters and oversees the performance of the stock exchange. It has the responsibility to enhance market efficiency and improve transparency. After the Asian financial crisis, many countries have revamped their listing requirements. Codes of best practices of corporate governance have been formulated with more requirements for independent directors etc. Apart from the front line regulator, Monetary Authorities usually require more financial disclosures as well as more stringent corporate governance requirements.

Private sector bodies such as Societies of Accountants in emerging economies have also responded to the demand for better financial transparency and good corporate governance. The Hong Kong Society of Accountants (HKSA), for example, recommended changes in regulations such as the role and responsibilities of board of directors, improving financial reporting and audit. The HKSA also advocated recommendations covering board membership including the inclusion of finance directors on boards, the establishment of board sub-committees such as audit committee and remuneration committee.

Based on the above analysis, a strong disclosure system must be underpinned by an effective legal and regulatory framework. With a few exceptions, the regulatory framework in the region lacked the institutional capacity and effective and credible sanctions to ensure that companies complied with the relevant regulations and that accounting and auditing self-regulatory organizations were diligent in ensuring their members applied the relevant disclosure standards.

Apart from the effective legal and regulatory framework that needs to be improved for good corporate governance, it is of paramount importance that the quality of independent non-executive directors in the board and the three board sub-committees must be assured. Against a background of relationship based corporate governance system whereby the INEDs are usually connected to the companies, the quality of the independent non-executive directors is even more important.

## **V. Concluding Comments**

Emerging market corporate governance reform has not progressed very substantially despite the willingness of policy makers and investors to press for change. First, corporate governance reform needs to devote more emphasis to driving change through institutional reform of capital markets and underlying structure of property rights to complement practical improvements to governance at the corporate level. Second, the importance of concentrated ownership such as family owned businesses, government affiliated corporations in emerging markets should be recognized more explicitly. Without the proper incentives, relationship based system could continue to act as a major obstacle to corporate governance reform. One should recognize that developing economies have distinct legal and regulatory framework and unique ownership structure that are markedly different from those which prevails in the developed capital markets such as U.S. and U.K. Any adoption of corporate governance mechanisms from market based system to relationship based system must be done with extreme caution.

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**Table 1**  
**International Accounting Standards in Emerging Markets**

<b>Panel A</b> <b>Adopted IAS or Allow Domestic and Foreign Companies</b> <b>Following IAS to be Listed on Their Exchanges</b>		<b>Panel B</b> <b>Allow Foreign Companies Following IAS to be Listed on Their</b> <b>Exchanges</b>	
<b>Country</b>	<b>Exchange</b>	<b>Country</b>	<b>Exchange</b>
China	Shanghai Stock Exchange	Hong Kong	Stock Exchange of Hong Kong
		Japan	Tokyo Stock Exchange
		Malaysia <sup>†</sup>	Kuala Lumpur Stock Exchange
		Singapore	Stock Exchange of Singapore
		Taiwan <sup>†</sup>	Taiwan Stock Exchange
		Thailand	The Stock Exchange of Thailand

<sup>†</sup> Reconciliation to local GAAP is required  
Source: IASC website, [www.iasc.org.uk](http://www.iasc.org.uk)