



# **The 2008 Asian Roundtable on Corporate Governance**

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## **Session 1**

Corporate Governance in Hong Kong, China  
“Beyond Box Ticking”

### **ANALYSIS OF CORPORATE GOVERNANCE PRACTICES DISCLOSURE BY HONG KONG LISTED ISSUERS**

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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 or the World Bank

ANALYSIS OF CORPORATE GOVERNANCE  
PRACTICES DISCLOSURE IN  
2006 ANNUAL REPORTS

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## **EXECUTIVE SUMMARY**

- The Stock Exchange of Hong Kong Limited (the Exchange) has completed its second annual review (the Second Review) of listed issuers' compliance with the Code on Corporate Governance Practices (the Code).
- The Second Review involved analysis of the disclosures made by 1114 listed issuers in their 2006 annual reports. In particular, the Exchange looked at whether these issuers said they had complied with the Code's code provisions and, if not, why not. The Exchange also asked these listed issuers whether or not they chose to comply in 2006 with the Code's recommended best practices. (Issuers are encouraged but not required to disclose whether they have complied with the Code's recommended best practices.) Five hundred and fifty-eight issuers provided information regarding their compliance with the recommended best practices.
- The Second Review built on the Exchange's first annual review (the First Review), which was conducted in relation to corporate governance disclosures in the 2005 annual reports. (The results of the First Review were published in March 2007.)
- In the Second Review, the Exchange found that all of the 1114 issuers met the "comply or explain" requirements in their 2006 annual reports in respect of all of the code provisions.
- As with 2005, large listed issuers complied with more code provisions than smaller listed issuers.
- Ninety-six per cent of the 1114 issuers complied with 41 or more of the 45 code provisions, which is an improvement from the First Review. (The First Review found that 89 per cent of the 621 issuers reviewed complied with 41 or more of the 44 code provisions with which compliance was analysed.)
- Fifteen of the 32 recommended best practices were fully complied with by at least 80 per cent (446 out of 558) of relevant issuers. Twenty-five of the 32 recommended best practices were fully complied with by at least half (279 out of 558) of the relevant issuers. (In a large number of cases the reason an issuer did not comply with a recommended best practice was that the recommended best practice was not applicable to the issuer.)
- The recommended best practices relating to quarterly reporting had the lowest compliance rates.

## **BACKGROUND**

- The Code became effective in 2005. It is Appendix 14 to the Main Board Rules and Appendix 15 to the GEM Rules.
- The Code sets out the principles of good corporate governance, and two levels of recommendations: (a) code provisions; and (b) recommended best practices. Issuers are expected to comply with, but may choose to deviate from, the code provisions. The recommended best practices are for guidance only. The Code provides that issuers must state whether they have complied with the code provisions in their interim reports and annual reports. Issuers are required to explain any deviation.

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- In the First Review, the Exchange analysed disclosures made pursuant to the Code by 621 issuers (that is, all listed issuers with a financial year ended 31 December which had published a 2005 annual report). The Exchange's findings were published in a report issued on 30 March 2007. That report is available at:  
<http://www.hkexnews.hk/reports/corpgovpract/Analysis%20of%20CG%20Practices%20Disclosure.pdf>.
  - The Exchange has completed its second annual review of the disclosures made by listed issuers pursuant to the Code (that is, the Second Review). This is a summary of its work, its findings and its plans for future work.

## **SCOPE OF PROJECT AND FUTURE WORK**

- In the Second Review, the Exchange reviewed the compliance of 1114 listed issuers, which is all issuers listed as at 31 December 2006 save for those that were long suspended or delisted in 2007 and excluding one company. That company is Manulife Financial Corporation (945), which is listed on Toronto Stock Exchange (TSX) with a secondary listing on the Exchange. Pursuant to Manulife's listing agreement, it is required to comply with the TSX corporate governance rules rather than those of the Exchange.
- In addition to having a much larger target population, the Second Review also built on the scope of the First Review in the following ways:
  - the First Review was restricted to issuers' compliance with the code provisions. The Second Review covers both code provisions and recommended best practices; and
  - the First Review excluded code provision C.2.1 on internal controls because of that code provision's later commencement date. The Second Review covers all 45 code provisions.
- To facilitate its review, the Exchange sought that issuers answer a questionnaire regarding their compliance with the Code. Sections 1 and 2 of the questionnaire related to compliance with the code provisions and were mandatory. Section 3 of the questionnaire related to compliance with the recommended best practices and was voluntary. (The questionnaire is available at <http://www.hkexnews.hk/reports/corpgovpract/survey.doc>.)
- There was a 100 per cent response rate to Sections 1 and 2 of the questionnaire (that is, 1114 responses) and a 50 per cent response rate to Section 3 (that is, 558 responses).
- The findings set out in this report are based on the questionnaire responses. However, the Exchange conducted testing of a sample of the responses to Sections 1 and 2 of the questionnaire to ensure they were sufficiently reliable. (We did not test the responses to Section 3 of the questionnaire because issuers rarely disclose their compliance with the recommended best practices.)
- The Exchange plans to continue to undertake, and publish the results of, an annual review of listed issuers' compliance with the Code.
- This year the Exchange also plans to review the Code to determine whether any changes should be made. This work will be informed, in part, by the results of the First Review and the Second Review.

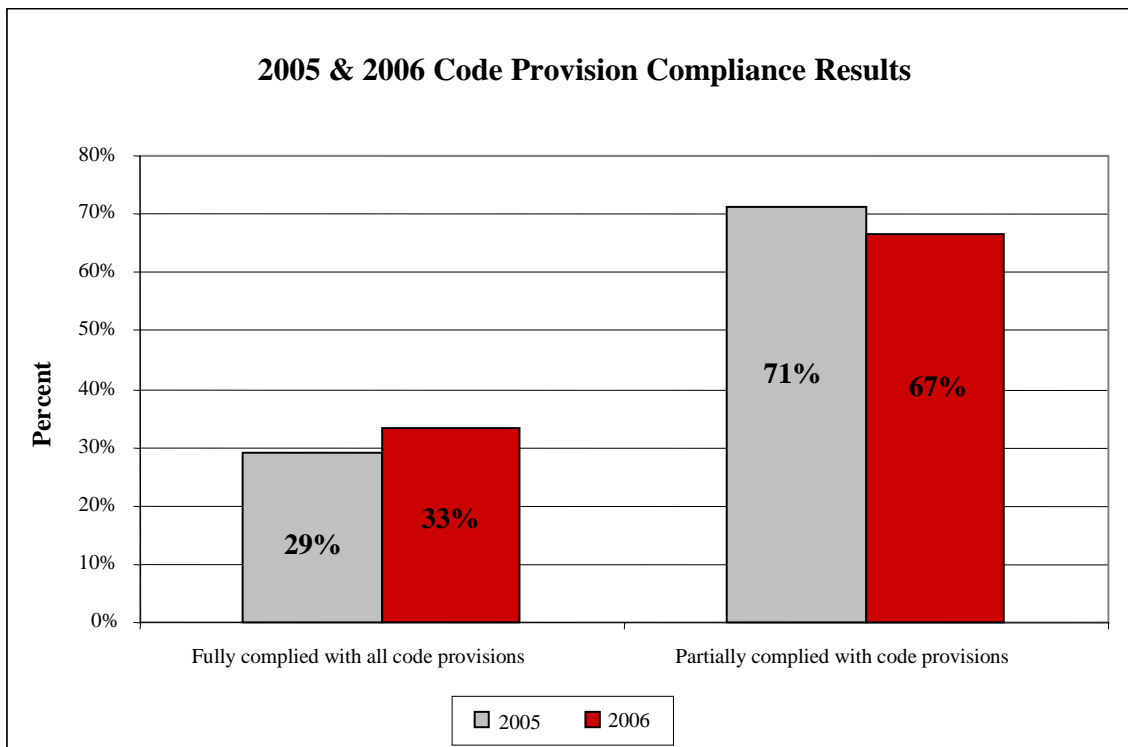
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## FINDINGS<sup>1</sup> REGARDING CODE PROVISIONS

### Overall Compliance

- Consistent with the First Review, the Exchange found that ALL of the 1114 issuers either:
  - indicated in their annual reports that they had complied with the code provisions; or
  - explained their deviation from one or more code provisions.
- Thirty-three per cent of issuers stated they had fully complied with all the code provisions for the whole accounting period. As illustrated by the graph below, that is an improvement of four per cent from the First Review.

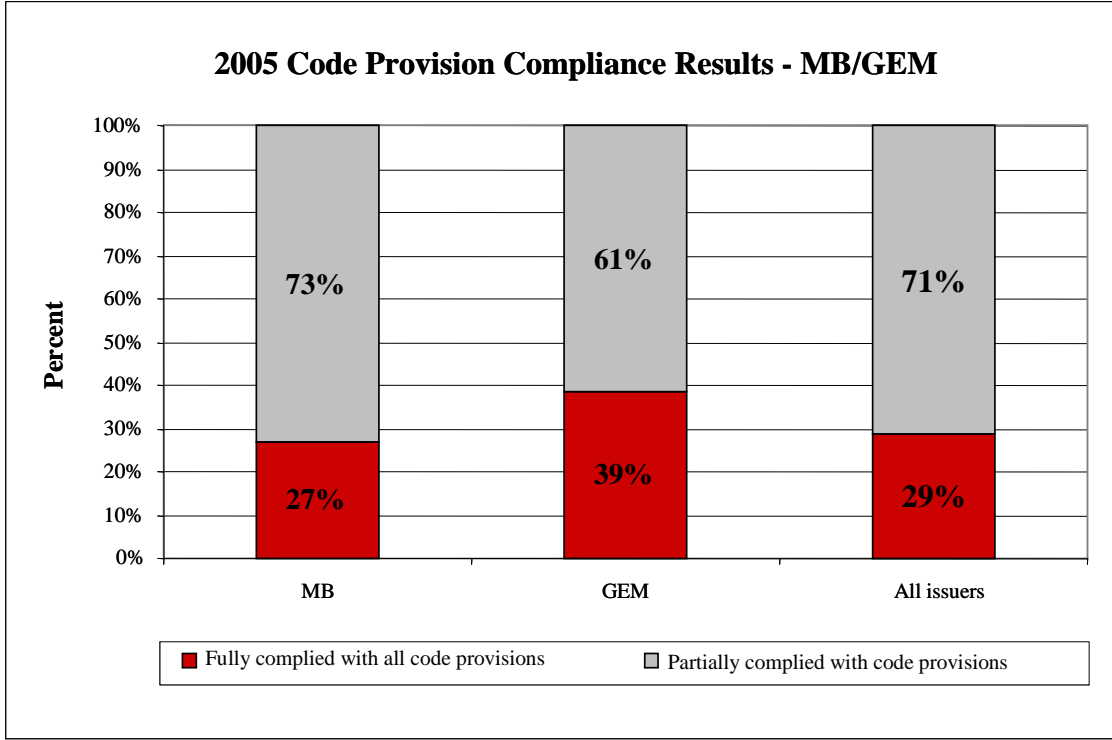
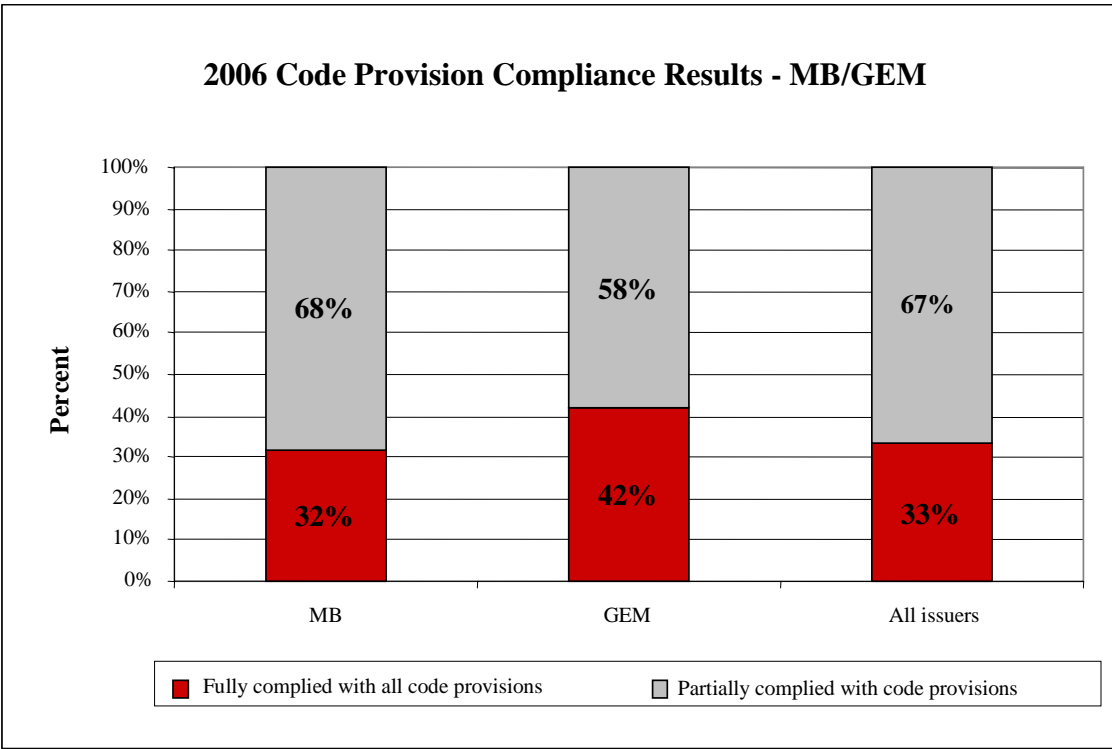
Remarks: Issuers having “partially complied with the code provisions” means that the issuer disclosed that they had complied with only some of the code provisions (whilst deviating from others) and/or they had complied with all of the code provisions but not for the whole year.



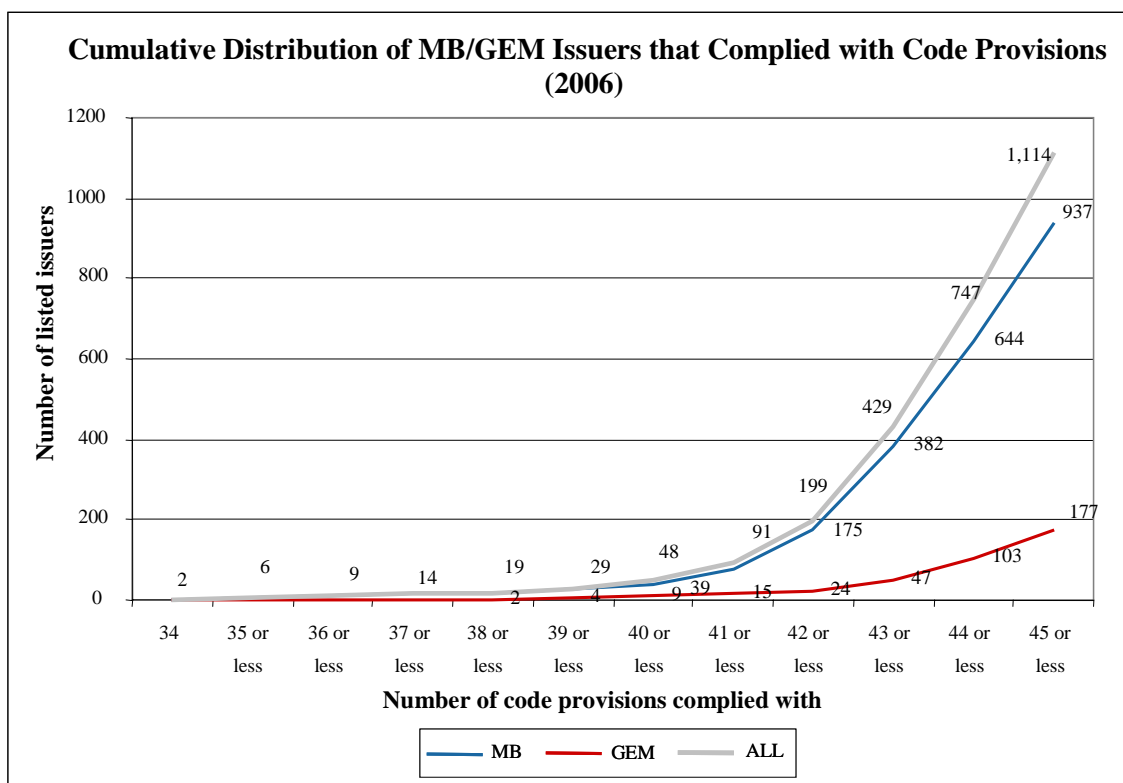
- Compliance of GEM issuers was higher than MB issuers (42 per cent for GEM vs 32 per cent for MB), which is generally consistent with the First Review findings (39 per cent for GEM vs 27 per cent for MB).

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<sup>1</sup> References to \$ are to Hong Kong dollars. Percentages are approximate; they are generally rounded to the nearest full percentage.



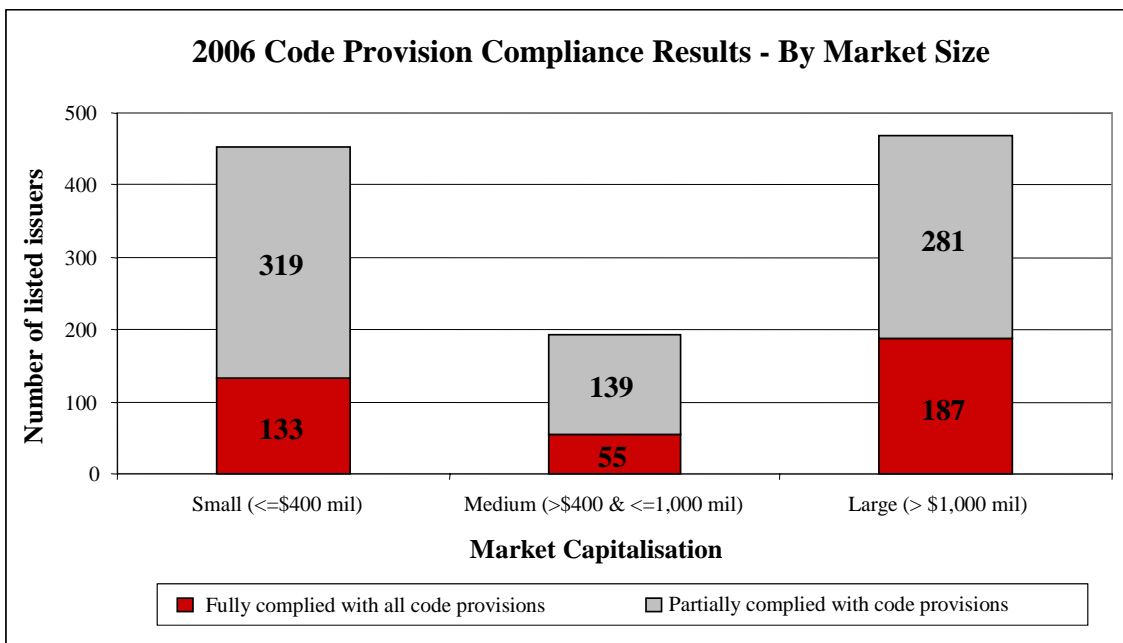
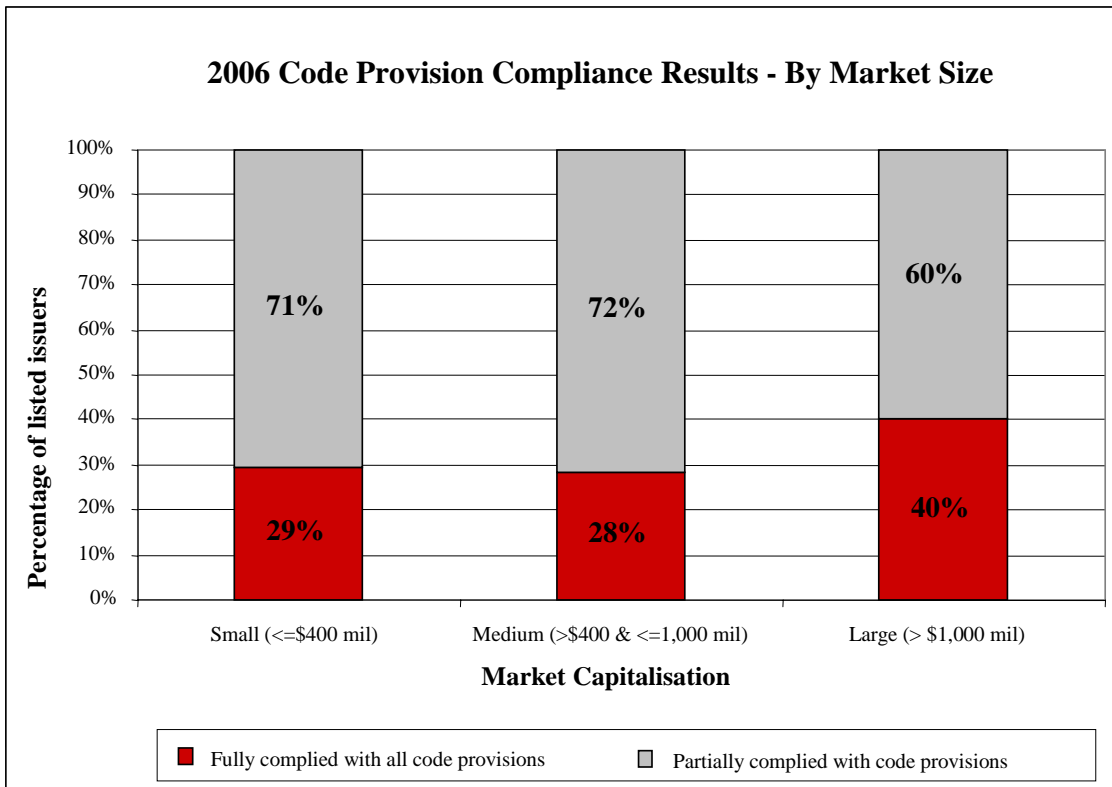
- About 96 per cent of listed issuers (1066 out of 1114) stated that they had fully complied with 41 or more of the 45 code provisions. That compares favourably with the findings of the First Review, which were that about 89 per cent of listed issuers (550 out of 621) stated that they had fully complied with 41 or more of the 44 code provisions that were considered.
- The line graph below illustrates issuers' compliance levels in more detail. The same information, in addition to a more detailed comparison with the findings of the First Review, is provided in the following table.



Number of code provisions complied with	2006			2005		
	MB	GEM	Total	MB	GEM	Total
34	2	0	2	0	0	0
35	4	0	4	0	0	0
36	3	0	3	1	0	1
37	5	0	5	3	0	3
38	3	2	5	6	1	7
39	8	2	10	9	0	9
40	14	5	19	47	4	51
41	37	6	43	78	10	88
42	99	9	108	115	20	135
43	207	23	230	117	30	147
44	262	56	318	139	41	180
45	293	74	367	---	---	---
<b>Total</b>	<b>937</b>	<b>177</b>	<b>1114</b>	<b>515</b>	<b>106</b>	<b>621</b>

### Overview of Compliance by Market Size

- In the Second Review – consistent with the First Review’s conclusions and the experience in other jurisdictions – the Exchange found that the size of listed issuers is a significant driver of corporate governance practice.
- As illustrated by the graphs below, again in 2006, large listed issuers complied with more code provisions than small and medium-sized listed issuers.

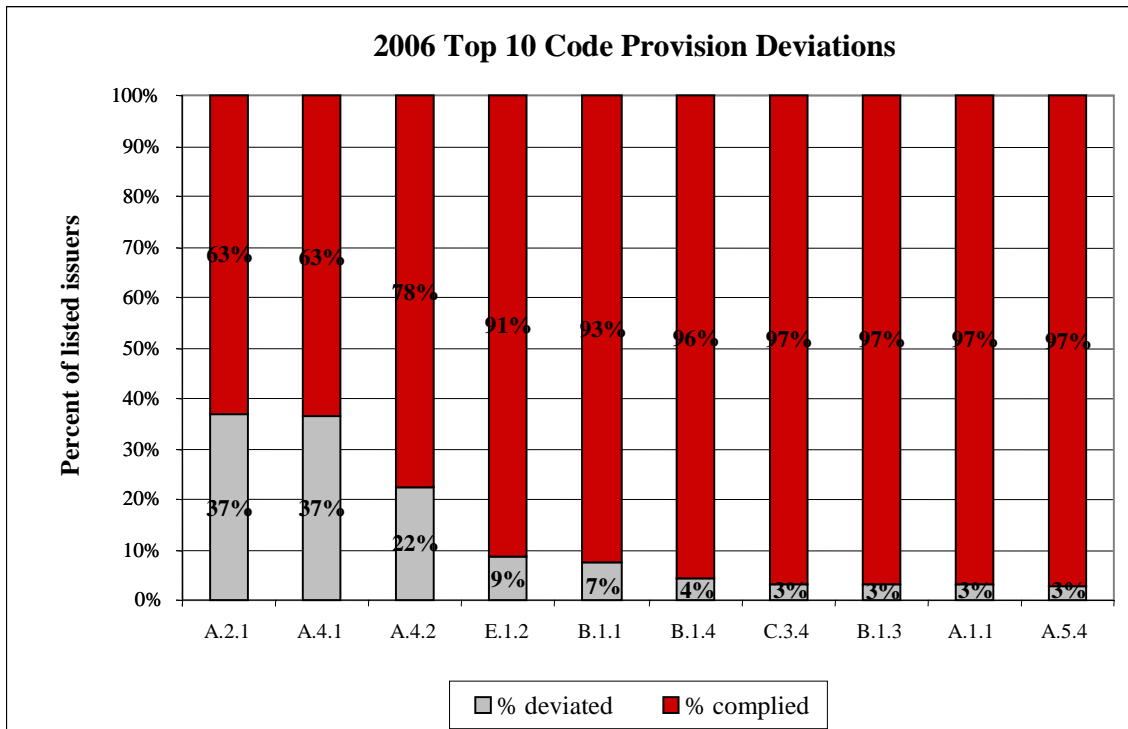


### Overview of Compliance by Code Provision

- The following table illustrates that the code provisions most commonly deviated from have not changed significantly since 2005. (The top ten most common deviations are highlighted. There is only one difference between the findings of the First Review and those of the Second Review. In 2006, code provision C.3.3, dealing with the terms of reference of the audit committee, was replaced by code provision A.5.4, dealing with compliance with the Model Code, in the top ten most common deviations.)

Code provision	2006	2005
	% of compliance (by the 1114 listed issuers)	% of compliance (by the 621 listed issuers)
A.1.2	100%	100%
A.1.5	100%	100%
A.5.2	100%	100%
A.6.2	100%	100%
A.6.3	100%	100%
C.1.1	100%	100%
C.1.2	100%	100%
C.1.3	100%	100%
C.3.2	100%	100%
C.3.5	100%	100%
C.3.6	100%	100%
E.2.2	100%	99.8%
E.2.3	100%	99.8%
A.1.4	99.9%	100%
A.1.8	99.9%	100%
A.2.2	99.9%	99.8%
A.2.3	99.9%	100%
A.5.3	99.9%	100%
A.6.1	99.9%	99.4%
C.3.1	99.9%	99.7%
A.1.6	99.8%	100%
A.5.1	99.8%	100%
E.1.1	99.8%	99.7%
A.3.1	99.7%	100%
D.1.1	99.7%	99.7%
D.2.2	99.7%	100%
E.2.1	99.6%	98.6%
D.2.1	99.6%	99.8%
A.1.7	99.1%	99.8%
C.2.1	98.9%	NA
B.1.2	98.7%	99.7%
B.1.5	98.7%	100%
A.1.3	98.5%	98.4%
C.3.3	98.5%	96.6%
D.1.2	98.2%	98.7%
A.5.4	97.3%	97.7%
A.1.1	97.0%	96.1%
B.1.3	96.9%	97.3%
C.3.4	96.7%	97.3%
B.1.4	95.6%	97.6%
B.1.1	92.7%	76.7%
E.1.2	91.4%	92.3%
A.4.2	77.5%	62.6%
A.4.1	63.4%	62.0%
A.2.1	63.0%	69.7%

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- Listed issuers stated that they had fully complied with 13 (around 29 per cent) of the 45 code provisions. In the First Review, the Exchange found that the relevant issuers (that is, the 621 listed issuers that made up the First Review's target population) had fully complied with 20 (around 45 per cent) of the 44 code provisions within the scope of the First Review.
  - Whilst this would appear to be a decline in issuers' full compliance with the code provisions (that is, full compliance with 45 per cent of the code provisions in 2005 vs full compliance with 29 per cent of the code provisions in 2006), it should be noted that the Second Review's target population was much larger than the target population of the First Review (that is, 1114 listed issuers in the Second Review compared with 621 listed issuers in the First Review). Also, each of the code provisions that were fully complied with in 2005 but not in 2006 (that is, code provisions A.1.4, A.1.6, A.1.8, A.2.3, A.3.1, A.5.1, A.5.3, B.1.5 and D.2.2) had a compliance rate in 2006 of at least 98.7%. All but one was complied with by 99.7% or more of issuers.
  - The five code provisions most commonly deviated from were the same in 2005 and 2006. They were:
    - code provision A.2.1 (dealing with separation of the roles of chairman and chief executive officer, or CEO);
    - code provision A.4.1 (dealing with non-executive directors, or NEDs, being appointed for a specific term, subject to re-election);
    - code provision A.4.2 (dealing with directors appointed to fill a casual vacancy being subject to election by shareholders at the first general meeting after their appointment and every director being subject to retirement by rotation at least once every three years);
    - code provision E.1.2 (dealing with attendance and questioning of the chairman of the board and chairman of various committees at the annual general meeting, or AGM); and
    - code provision B.1.1 (dealing with establishing a remuneration committee with a majority of independent non-executive directors, or INEDs).
  - As illustrated by the graph below, by far the most common deviations were in respect of code provisions A.2.1 and A.4.1, followed by A.4.2. Thirty-seven per cent of listed issuers deviated from each of code provisions A.2.1 and A.4.1 and about twenty-two per cent of listed issuers deviated from code provision A.4.2.
  - These most common deviations are considered further below.



### Detailed Analysis of Top Five Deviations

#### Code Provision A.2.1

- Code provision A.2.1 provides that “The roles of chairman and chief executive officer should be separate and should not be performed by the same individual. The division of responsibilities between the chairman and chief executive officer should be clearly established and set out in writing”.

Status of compliance	2006		2005	
	Number of non-compliant listed issuers	% of non-compliant listed issuers	Number of non-compliant listed issuers	% of non-compliant listed issuers
Decided not to follow the code provision	324	78.6%	146	77.7%
Rectified the deviation during the year	28	6.8%	27	14.4%
Proposed to rectify the deviation	60	14.6%	15	7.9%
<b>Total</b>	<b>412</b>	<b>100%</b>	<b>188</b>	<b>100%</b>

- Twenty-two per cent of the listed issuers that disclosed they had deviated from code provision A.2.1 said that they had rectified, or proposed to rectify, the deviation during the year. However, similar to 2005, the vast majority of listed issuers that deviated from code provision A.2.1 disclosed they had made a positive decision not to follow this code provision.
- As shown by the table below, there were a number of reasons given for issuers’ decisions not to comply with code provision A.2.1 but the most common in both 2005 and 2006 was that the issuer considered that having the same person in the roles of chairman and CEO provided the issuer with strong and consistent leadership, allowing for more effective operation of the business.

Reasons given by issuers for their decision not to follow code provision A.2.1	2006		2005	
	Number of non-compliant listed issuers	% of non-compliant listed issuers	Number of non-compliant listed issuers	% of non-compliant listed issuers
Same person provides the Group with strong and consistent leadership, and allows for more effective business planning and implementation of long-term business strategies	100	30.8%	58	39.7%
All directors make a contribution, bringing different experience and expertise	58	17.9%	26	17.8%
The Board has confidence in the person who acts as CEO and chairman for reasons including that the person is knowledgeable, well known and/or has a good understanding of the operations of the issuer	34	10.5%	20	13.7%
It is necessary due to the size of the Group, the scope and/or nature of its business and/or some other practical reason relating to the corporate operating structure	41	12.7%	20	13.7%
The issuer considers that its arrangements are sufficiently consistent with the Code and the deviation has no materially adverse impact on its corporate governance structure	7	2.2%	1	0.7%
The responsibilities of the chairman and CEO are clear and distinct and therefore need not be set out in writing	3	0.9%	3	2.1%
Other reasons	3	0.9%	0	0%
More than one of the above	78	24.1%	18	12.3%
<b>Total</b>	<b>324</b>	<b>100%</b>	<b>146</b>	<b>100%</b>

#### Code Provision A.4.1

- Code provision A.4.1 provides that “Non-executive directors should be appointed for a specific term, subject to re-election”.

Status of compliance	2006		2005	
	Number of non-compliant listed issuers	% of non-compliant listed issuers	Number of non-compliant listed issuers	% of non-compliant listed issuers
Decided not to follow the code provision	309	75.9%	146	62.1%
Rectified the deviation during the year	41	10.1%	45	19.1%
Proposed to rectify the deviation	57	14.0%	44	18.8%
<b>Total</b>	<b>407</b>	<b>100%</b>	<b>235</b>	<b>100%</b>

- Like with code provision A.2.1 and consistent with the finding in the First Review, the majority of listed issuers that deviated from code provision A.4.1 disclosed they had decided not to follow this code provision.
- Almost all of those issuers (98 per cent or 302 out of 309) did so because, rather than appointing non-executive directors (or NEDs) for a specific term, the issuers' NEDs are subject to retirement by rotation each annual general meeting – often pursuant to the companies' bye-laws or Articles of Association.

#### Code Provision A.4.2

- Code provision A.4.2 provides that “All directors appointed to fill a casual vacancy should be subject to election by shareholders at the first general meeting after their appointment. Every director, including those appointed for a specific term, should be subject to retirement by rotation at least once every three years”.

Status of compliance	2006		2005	
	Number of non-compliant listed issuers	% of non-compliant listed issuers	Number of non-compliant listed issuers	% of non-compliant listed issuers
Decided not to follow the code provision	93	37.0%	58	25.0%
Rectified the deviation during the year	90	35.9%	48	20.7%
Proposed to rectify the deviation	62	24.7%	126	54.3%
Proposed to rectify one limb but decided not to follow the other limb	6	2.4%	---	---
<b>Total</b>	<b>251</b>	<b>100%</b>	<b>232</b>	<b>100%</b>

- Code provision A.4.2 has two limbs:
  - all directors appointed to fill a casual vacancy should be subject to election by shareholders at the first general meeting after their appointment (the First Limb); and
  - every director should be subject to retirement by rotation at least once every three years (the Second Limb).
- As was the case in 2005, it appears that some issuers deviated from only one limb whilst others deviated from both limbs. Specifically:
  - about 10 per cent (9 out of 93) of relevant issuers disclosed that they had deviated from the First Limb;
  - about 78 per cent (73 out of 93) of relevant issuers disclosed that they had deviated from the Second Limb; and
  - about 12 per cent (11 out of 93) of relevant issuers disclosed that they had deviated from both the First Limb and the Second Limb.
- A significant proportion of those issuers that deviated from this code provision disclosed that they had or intended to rectify the deviation.

- The most common reason for deviation from the Second Limb was that the chairman and managing director are not subject to retirement by rotation (the First Reason). The other key reason given was that, rather than requiring retirement by rotation at least once every three years, the issuers' constitutional documents provide for one-third of the directors – or if their number is not three or a multiple of three, then the number nearest to one-third – to retire from office each year (the Second Reason).
- The First Reason and/or the Second Reason were cited by 79 issuers. About seventy-seven per cent (61 out of 79) cited the First Reason, about ten per cent (8 out of 79) cited the Second Reason, and the balance (10 out of 79) said their deviation was due to both the First Reason and the Second Reason.

### Code Provision E.1.2

- Code provision E.1.2 provides “The chairman of the board should attend the annual general meeting and arrange for the chairman of the audit, remuneration and nomination committees (as appropriate) or in the absence of the chairman of such committees, another member of the committee or failing this his duly appointed delegate, to be available to answer questions at the annual general meeting. The chairman of the independent board committee (if any) should also be available to answer questions at any general meeting to approve a connected transaction or any other transaction that is subject to independent shareholders' approval”.

Status of compliance	2006		2005	
	Number of non-compliant listed issuers	% of non-compliant listed issuers	Number of non-compliant listed issuers	% of non-compliant listed issuers
Decided not to follow the code provision	39	40.6%	48	100.0%
Rectified the deviation during the year	8	8.3%	0	0%
Proposed to rectify the deviation	49	51.1%	0	0%
<b>Total</b>	<b>96</b>	<b>100%</b>	<b>48</b>	<b>100%</b>

- Given the nature of code provision E.1.2, it is probably the case that issuers' behaviour needs to be assessed year-to-year; it seems unlikely that issuers would have a positive policy in place that would contravene the code provision, for example, to provide that the chairman of the board need not attend the annual general meeting. For that reason there also seems little point in distinguishing between issuers that said they had decided not to follow the code provision and those that did not comply but proposed to rectify their deviation.
- The Exchange notes with some concern that, in 2006, almost nine per cent (96 out of 1114) of issuers failed to comply with this code provision. (Likewise, in 2005 almost eight per cent failed to comply.)
- Reasons given for deviation in 2006 included, most commonly, business engagement or other commitment. This was also the most common reason for deviation in 2005.

### Code Provision B.1.1

- Code provision B.1.1 provides “Issuers should establish a remuneration committee with specific written terms of reference which deal clearly with its authority and duties. A majority of the members of the remuneration committee should be independent non-executive directors.”

Status of compliance	2006		2005	
	Number of non-compliant listed issuers	% of non-compliant listed issuers	Number of non-compliant listed issuers	% of non-compliant listed issuers
Decided not to follow the code provision	16	19.8%	12	8.3%
Rectified the deviation during the year	44	54.3%	125	86.2%
Proposed to rectify the deviation	21	25.9%	8	5.5%
<b>Total</b>	<b>81</b>	<b>100%</b>	<b>145</b>	<b>100%</b>

- Whilst code provision B.1.1 still has one of the highest levels of deviation, 2006 saw a very significant improvement in compliance.
- In the First Review the Exchange found a compliance rate of only 76.7 per cent. In the Second Review the compliance rate was 92.7 per cent.
- Moreover, the large majority of issuers that did not comply with this code provision in 2006 said that they had or planned to rectify their deviation.
- Of the 16 issuers that decided not to follow code provision B.1.1, 14 issuers deviated from the code provision by not having a remuneration committee. They cited reasons including:
  - the small size of the issuer; and
  - the board's preference to maintain responsibility for setting remuneration policies and packages.
- The other two issuers that decided not to follow code provision B.1.1 deviated in that they had established a remuneration committee but it did not have an INED majority.

#### **FINDINGS REGARDING CODE PROVISION C.2.1**

- Code provision C.2.1 provides that “(t)he directors should at least annually conduct a review of the effectiveness of the system of internal control of the issuer and its subsidiaries and report to shareholders that they have done so in their Corporate Governance Report. The review should cover all material controls, including financial, operational and compliance controls and risk management functions”.
- This code provision was excluded from the First Review because of its later commencement date. (Code provision C.2.1 became effective for accounting periods commencing on or after 1 July 2005. The other code provisions became effective for accounting periods commencing on or after 1 January 2005.) For that reason and because the Exchange is aware that some issuers have considered the implementation of code provision C.2.1 challenging, the Exchange paid particular attention to code provision C.2.1 in the Second Review.
- Of the 1114 issuers the subject of the Second Review, 27 issuers advised that code provision C.2.1 did not yet apply to them in 2006 because their 2006 financial year commenced before 1 July 2005. Therefore, the target population for this aspect of the Second Review is 1087 issuers.

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## Frequency of Review

- Code provision C.2.1 provides that an issuer's directors should conduct the internal control review at least annually.
- Almost all issuers told the Exchange that they had done so – less than one per cent (8 out of 1087) of issuers disclosed that they had not conducted any review but they intended to rectify that in the future.<sup>2</sup>
- Some issuers advised that they had conducted the required review more often than once during the year:
  - 20 per cent (219 out of 1087) of issuers said they conducted the review half-yearly (or twice in 2006); and
  - 10 per cent (109 out of 1087) of issuers said they conducted the review three or more times per annum.
- Whilst the Exchange is pleased that issuers are conducting regular internal control reviews, we are surprised that some issuers are able to undertake complete reviews as often as three or more times per annum. The Exchange urges issuers to ensure that such reviews are thorough. (See below regarding the Exchange's findings in respect of the methodology of issuers' reviews.)

## Method of Review

- The Exchange asked issuers for information regarding how they undertook the reviews. A large number of respondents (more than 35 per cent or about 400 out of 1079) advised that the review was conducted by their internal audit function. Some respondents (more than 10 per cent or 122 out of 1079) referred to an external auditor or consultant having been retained to conduct the review.
- Issuers also told the Exchange the following:
  - seven per cent (75 out of 1079) of issuers that complied with code provision C.2.1 said that they had established written internal control policies and practices such as a checklist or guidance manual;
  - almost four per cent (40 out of 1079) of issuers said that the review was conducted using a risk-based approach;
  - quite a number of issuers (about 30 out of 1079) disclosed that their review was conducted with reference to the internal control framework enunciated by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which includes risk-based factors. Some issuers also mentioned guidance prepared

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<sup>2</sup> One issuer advised that it did not know how often the review was conducted because there had been a change in control of the company and the new management were unable to obtain the information from the previous management.

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by the HKICPA<sup>3</sup>, the Sarbanes-Oxley Act of 2002 and the Turnbull Guidance regarding compliance with the Combined Code's principle C.2 on internal controls<sup>4</sup>;

- two per cent (23 out of 1079) of issuers said that they had either issued an internal control questionnaire or conducted interviews with relevant management and staff members for the purpose of evaluating their internal control environment and risk; and
- three issuers advised that they had established a whistleblower policy to facilitate the reporting of any improper activities relating to fraud, questionable accounting or internal control matters.

## **Review Challenges**

- The Exchange asked issuers to tell us what, if any, significant challenges they faced in complying with code provision C.2.1. Almost 52 per cent (559 out of 1079) of issuers either made no comment or said that they had encountered no significant challenges.
- Other responses included:
  - almost 15 per cent (159 out of 1079) referred to the additional workload and compliance cost resulting from code provision C.2.1;
  - more than seven per cent (78 out of 1079) said that they had had difficulties determining or defining the scope and nature of the review that was required – some said this was because there was no formal guidance or procedures to follow;
  - about four per cent (44 out of 1079) said that it was difficult conducting the review effectively because of changes in the business environment such as internal reconstruction, changes in regulatory regime and/or business expansion;
  - about three per cent (35 out of 1079) said that it was difficult getting internal clients (that is, relevant members of their organisation) to co-operate in order that the review could be undertaken effectively; and
  - others mentioned challenges including: geographical, political, legal, regulatory and cultural differences between the local company and its overseas/PRC subsidiaries; difficulties retaining competent professionals to undertake the review; difficulties standardising the method of internal control review due to the company being engaged in various business sectors; and lack of experience in undertaking such reviews.
- The Exchange also asked issuers to tell us what, if any, further guidance they would like from the Exchange in respect of code provision C.2.1. The majority of respondents (81 per cent, or 876 out of 1079) made no comment or said that no further guidance was necessary.

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<sup>3</sup> Internal Control and Risk Management – A Basic Framework

<sup>4</sup> Financial Reporting Council's "Internal Control: Guidance For Directors on the Combined Code" (also known as the Turnbull Guidance sets out guidance regarding compliance with code provision C.2.1 of the UK's Combined Code, which is in very similar terms to code provision C.2.1 of the Code.

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- Others made suggestions including the following:
    - almost 10 per cent (104 out of 1079) of issuers said that the Exchange should clarify the scope of the required review by defining the role of the internal audit function in the review and/or what is the measurement of "effectiveness";
    - more than three per cent (40 out of 1079) of issuers asked for further guidance but did not specify exactly what guidance would assist; and
    - other issuers suggested: there should be guidelines tailored for different industries or circumstances such as dual listing; the Exchange should provide case studies / illustrative examples / sample checklists; and the Exchange should conduct training or provide a forum for issuers and relevant professionals to share their experiences.
  - The Exchange has commenced a review of the Code with a view to identifying whether any amendment should be made or further guidance given. As part of this work we will consider the suggestions made by issuers in response to the Second Review questionnaire including those set out above.

## **FINDINGS REGARDING RECOMMENDED BEST PRACTICES**

### **Overall Compliance**

- As noted above, recommended best practices are for guidance only, that is, issuers are encouraged but not required to state whether or not they have complied with each recommended best practice. As it is not mandatory, few issuers make such disclosures.
- In the Second Review, the Exchange asked issuers about the extent to which they meet the recommended best practices. Issuers were not required to provide this information but the Exchange is grateful to the significant number of issuers that did respond. About 50 per cent (462 MB issuers and 96 GEM issuers out of a total of 1114) of issuers (the Relevant Respondents) chose to respond to the section of the questionnaire relating to the recommended best practices.
- About four per cent of the Relevant Respondents (22 out of 558) said that in 2006 they complied with all thirty-two recommended best practices.
- None of the recommended best practices were fully complied with by all Relevant Issuers. However, fifteen of the recommended best practices were fully complied with by at least 80 per cent (446 out of 558) of the Relevant Issuers. (More detail regarding the compliance rates for each of Main Board issuers and GEM issuers is set out below.)
- Those recommended best practices were the following:
  - recommended best practice A.1.10 (which provides that board committees should adopt, so far as practicable, the principles, procedures and arrangements in code provisions A.1.1 to A.1.8 dealing with the role and procedures of the board);
  - recommended best practices A.2.4, A.2.5, A.2.6, A.2.8 and A.2.9 (which relate to the role and responsibilities of the chairman);

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- recommended best practice A.3.2 (which provides that an issuer should appoint independent non-executive directors representing at least one-third of the board);
  - recommended best practices A.5.6, A.5.7 and A.5.8 (dealing with the responsibilities of directors including, for example, disclosure of directors' significant commitments, attendance at and participation in meetings of the board and its committees as well as general meetings, and making positive contributions to the development of issuers' strategies and policies through independent, constructive and informed comments);
  - recommended best practice B.1.6 (which provides that a significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance);
  - recommended best practices C.2.2 and C.2.4 (dealing with the board's annual review of the effectiveness of the system of internal controls of the issuer and its subsidiaries, and disclosure relating to that review);
  - recommended best practice C.3.7 (dealing with the terms of reference of the audit committee); and
  - recommended best practice D.1.3 (dealing with disclosure of the division of responsibility between the board and management).
- Recommended best practices A.2.4, A.2.5, A.2.6, A.2.8, A.2.9 and A.5.8 were each complied with by more than 97 per cent (541 out of 558) of Relevant Issuers.
  - By market – fourteen recommended best practices were fully complied with by at least 80 per cent of the Relevant Issuers listed on the Main Board and sixteen recommended best practices were fully complied with by at least 80 per cent of the Relevant Issuers listed on GEM. Recommended best practice C.3.7 was complied with by about 79 per cent of the Relevant Issuers listed on the Main Board. Recommended best practice D.1.4, which provides that issuers should have formal letters of appointment for directors setting out the key terms and conditions relative to their appointment, was complied with by about 86 per cent of the Relevant Issuers listed on GEM.
  - The following table sets out a more detailed overview of issuers' responses in relation to compliance with the Code's recommended best practices. Amongst other things, the table illustrates that some of the recommended best practices were not applicable to a number of issuers. That is because some of the recommended best practices work together such that if one is deviated from, one or more others will not apply. For example, if an issuer does not adopt quarterly reporting in accordance with recommended best practice C.1.4, then recommended best practice C.1.5, which also relates to quarterly reporting, will become inapplicable. Likewise, if an issuer does not establish a nomination committee in accordance with recommended best practice A.4.4, then recommended best practices A.4.5 to A.4.7 will not apply.

Recommended best practice	Topic of recommended best practice	Comply		Not comply		Partially comply		NA	
		Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers
A.1.9	Insurance cover for directors	365	65.4%	191	34.2%	2	0.4%	0	0.0%
A.1.10	Application of board principles, procedures and arrangements to board committees	511	91.6%	24	4.3%	23	4.1%	0	0.0%
A.2.4	Role of chairman	549	98.4%	6	1.1%	0	0.0%	3	0.5%
A.2.5	Chairman's responsibility for establishment of good corporate governance practices and procedures	547	98.0%	8	1.4%	0	0.0%	3	0.6%
A.2.6	Chairman's encouragement regarding directors' contribution to the board	551	98.7%	4	0.7%	0	0.0%	3	0.6%
A.2.7	Annual meetings between chairman and NEDs	332	59.5%	220	39.4%	0	0.0%	6	1.1%
A.2.8	Chairman's role in communication with shareholders	543	97.3%	12	2.2%	0	0.0%	3	0.5%
A.2.9	Chairman's role in relation to contribution of NEDs	548	98.2%	7	1.3%	0	0.0%	3	0.5%
A.3.2	Boards with at least one-third INEDs	471	84.4%	87	15.6%	0	0.0%	0	0.0%
A.3.3	Issuer website to include list of, and information about, directors	430	77.1%	124	22.2%	4	0.7%	0	0.0%
A.4.3	More than nine years' service affecting NED independence	386	69.2%	71	12.7%	0	0.0%	101	18.1%
A.4.4	Establishment and composition of a nomination committee	228	40.9%	330	59.1%	0	0.0%	0	0.0%
A.4.5	Terms of reference of the nomination committee	229	41.0%	4	0.8%	0	0.0%	325	58.2%
A.4.6	Availability of the terms of reference of the nomination committee	223	40.0%	10	1.8%	0	0.0%	325	58.2%
A.4.7	Resources for the nomination committee	232	41.6%	1	0.2%	0	0.0%	325	58.2%

Recommended best practice	Topic of recommended best practice	Comply		Not comply		Partially comply		NA	
		Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers
A.4.8	Information to be disclosed in respect of proposed resolution to elect an INED	396	71.0%	106	19.0%	0	0.0%	56	10.0%
A.5.5	Continuous professional development for directors	348	62.4%	199	35.6%	11	2.0%	0	0.0%
A.5.6	Directors' disclosure of their other commitments	511	91.6%	30	5.4%	15	2.7%	2	0.3%
A.5.7	NEDs' attendance and participation in the board and its committees as well as general meetings of the issuer	508	91.0%	27	4.9%	17	3.0%	6	1.1%
A.5.8	NEDs to contribute through independent, constructive and informed comments	543	97.3%	9	1.6%	0	0.0%	6	1.1%
B.1.6	Ensuring ED remuneration links reward and performance	504	90.3%	51	9.1%	3	0.6%	0	0.0%
B.1.7	Disclosure of senior management remuneration on an individual and named basis	273	48.9%	249	44.6%	28	5.0%	8	1.5%
B.1.8	Disclosure of reasons if the board approves remuneration or compensation arrangements previously refused by the remuneration committee	403	72.2%	24	4.3%	0	0.0%	131	23.5%
C.1.4 (MB only <sup>5</sup> )	Content, publication and timeliness of quarterly financial results	72	15.6%	390	84.4%	0	0.0%	0	0%

<sup>5</sup> Recommended best practice C.1.4 applies to Main Board issuers only; it does not apply to GEM issuers. Therefore the total pool of Relevant Issuers is reduced to 462 i.e. the number of Relevant Issuers that are Main Board-listed.

Recommended best practice	Topic of recommended best practice	Comply		Not comply		Partially comply		NA	
		Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers	Number of listed issuers	% of listed issuers
C.1.5 (MB only <sup>6</sup> )	Giving reasons for ceasing to publish quarterly financial results once commenced	75	16.2%	2	0.5%	0	0.0%	385	83.3%
C.2.2	Scope of the board's annual review of the effectiveness of the system of internal controls of an issuer and its subsidiaries	477	85.5%	57	10.2%	14	2.5%	10	1.8%
C.2.3	Scope of issuers' disclosure in their Corporate Governance Report regarding the issuer's compliance with the code provisions on internal controls	380	68.1%	135	24.2%	29	5.2%	14	2.5%
C.2.4	Disclosures to provide meaningful information and not give a misleading impression	517	92.7%	0	0.0%	0	0.0%	41	7.3%
C.2.5	Annual review and disclosure of same regarding need for an internal audit function	355	63.6%	101	18.1%	2	0.4%	100	17.9%
C.3.7	Terms of reference of the audit committee	449	80.5%	104	18.6%	5	0.9%	0	0.0%
D.1.3	Disclosure of the division of responsibility between the board and management	467	83.7%	85	15.2%	1	0.2%	5	0.9%
D.1.4	Directors to understand delegation arrangements including by issuers having formal letters of appointment for directors	443	79.4%	94	16.9%	18	3.2%	3	0.5%

<sup>6</sup> Recommended best practice C.1.5 applies to Main Board issuers only; it does not apply to GEM issuers. Therefore the total pool of Relevant Issuers is reduced to 462 i.e. the number of Relevant Issuers that are Main Board-listed.

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- The most common deviations are considered in more detail below.

### **Detailed Analysis of Most Common Deviations**

- The recommended best practices that Relevant Issuers most often failed to fully comply with were C.1.4, A.4.4 and B.1.7.
- In addition to recommended best practices C.1.4, A.4.4 and B.1.7, recommended best practices C.1.5 and A.4.5 to A.4.7 were also fully complied with by less than 50 per cent of Relevant Issuers. However, the low level of full compliance with recommended best practice C.1.5 was due to Relevant Issuers' deviation from recommended best practice C.1.4. Similarly, the low level of full compliance with recommended best practices A.4.5 to A.4.7 was due to Relevant Issuers' deviation from recommended best practice A.4.4.

### **Recommended Best Practice C.1.4**

- This recommended best practice provides that issuers should announce and publish quarterly results within 45 days after the end of the relevant quarter. It applies only to Main Board issuers. (There is an equivalent mandatory rule in the GEM Listing Rules.)
- Recommended best practice C.1.4 had the lowest level of full compliance.
- Almost 16 per cent (72 out of 464) of Relevant Issuers listed on the Main Board advised that they complied with recommended best practice C.1.4. A couple of issuers said that they proposed to comply in the near future. However, the large majority indicated that they had decided not to follow this recommended best practice (including those that said it was not applicable).
- Where reasons for non-compliance were given, the most common was that quarterly reporting is too significant a burden and therefore not cost / time / resource effective. Other reasons included the following:
  - 18 issuers said that it would not be in shareholders' best interests because it would shift the issuer's focus to short-term financial performance;
  - 11 issuers said that they do not consider it necessary as their business is stable and there are no significant operational changes from quarter to quarter;
  - 11 issuers said that the existing disclosure regime including, for example, making ad hoc disclosures of price sensitive information and publishing operational data every month, is sufficient;
  - 10 issuers said that quarterly financial reports do not reflect the actual performance of the company due to seasonality of business operation; and
  - five issuers said that it would be difficult for overseas' subsidiaries / associates of the issuer to report quarterly.
- In a consultation paper published by the Exchange on 31 August 2007, the Exchange proposed that quarterly reporting should become mandatory. Should that consultation proposal be adopted, then eventually (and upon quarterly reporting becoming mandatory),

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recommended best practices C.1.4 and C.1.5 will cease to apply. (The consultation paper is available at <http://www.hkex.com.hk/consul/paper/2007831e.pdf>.)

#### Recommended Best Practice A.4.4

- This recommended best practice provides that issuers should establish a nomination committee with a majority of INEDs.
- Fifty-nine per cent (330 out of 558) of Relevant Issuers said that they did not comply with recommended best practice A.4.4.
- Of those that did not comply:
  - almost five per cent (15 out of 330) said that they would rectify their practices so that they would comply soon;
  - almost nine per cent (29 out of 330) said that they intended to reconsider their position in relation to this recommended best practice as soon as practicable;
  - the balance (286 out of 330) said that they had made a positive decision not to adopt this recommended best practice.
- Where issuers gave reasons, the reasons included the following:
  - the most common reason was that the Board is responsible for the nomination process, which the issuer considers allows for more informed / balanced decisions as to nomination;
  - nomination duties are discharged by the executive committee, remuneration committee, human resources personnel or shareholders;
  - the issuer has a written nomination procedure or appointments are made pursuant to the company's constitutional documents; and
  - the issuer's size, structure or resources do not warrant or allow for a nomination committee with a majority of INEDs.

#### Recommended Best Practice B.1.7

- Recommended best practice B.1.7 provides that issuers should disclose details of any remuneration payable to members of senior management, on an individual and named basis, in their annual reports and accounts.
- Fifty-one per cent (285 out of 558) of Relevant Issuers said that they did not comply with recommended best practice B.1.7.
- Of those that did not comply:
  - one issuer said that it would rectify its practices so that it would comply soon;

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- 11 per cent (31 out of 285) said that they intended to reconsider their position in relation to this recommended best practice as soon as practicable;
  - 76 per cent (217 out of 285) said that they had made a positive decision not to adopt this recommended best practice; and
  - the balance partially complied or said that the recommended best practice was not applicable to them.
- Where issuers gave reasons, by far the most common reason was that the information is too sensitive to disclose publicly. Other reasons included:
    - the issuer's organisational structure / size of payroll is too small to warrant disclosure;
    - disclosure would facilitate staff being headhunted by other organisations;
    - disclosure would cause conflict amongst employees; and
    - there is no value to shareholders in this information being disclosed.