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Corporate Governance and Financial Transparencies in
the Hong Kong Special Administrative Region of
The People’s Republic of China

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Introduction

The 1997 Asian financial crisis will probably go down in history as one of the most devastating economic events of this century. While the rest of the world stock markets (apart from Asia) managed an average of 4% to 5% growth for the period September 1997 to October 1998, the Asian stock markets plummeted by about an average of 40%. There were, however, some variations in the severity of the crisis for the Asian countries. For example, 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. The corresponding fall for Hong Kong was 20%. In addition, currencies across the region lost more than 50% of their value in many cases because of unexpectedly weak performance in the corporate sector.

A long list of factors have been identified as causes for the crisis which include lax supervision and weak regulation, high levels of debt, distorted incentives for project selection and monitoring, corrupt lending policies and non-market criteria for credit allocation. It is, however, clear that the crisis would not have been that severe if there was confidence in the ability of large corporations to maintain financial transparency in corporate dealings. This factor has actually been singled out as a major culprit (Far Eastern Economic Review, September 18, 1997). Hong Kong experienced less shock compared to the other Asian capital markets and this is probably because of the corporate governance mechanisms already in existence at that time which include more financial disclosures and transparencies than the other capital markets in Asia.

International investors clearly regard inadequate financial disclosure and a lack of corporate transparency as a cause of the Asian financial crisis, and are becoming more demanding in this regard. Tripathi (1998) makes 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.”

In addition, there are widespread concerns that managers may use “earnings manipulation” as a device to conceal the real financial performance of companies.

In this paper, we first outline the problems of “earnings manipulation”, followed by a review of the economic incentives for the lack of corporate transparency. We then outline the role of corporate governance in enhancing corporate transparency. The paper ends with a discussion and policy implications of some empirical research evidence of the link between corporate governance and disclosures in Hong Kong.
Accounting Earnings Manipulation

In the extant accounting literature, inadequate financial disclosure and the lack of financial transparency in corporate accounts is referred to generally as earnings manipulation or management (Schipper, 1989). The latitude available to managers in the choice of accounting methods and procedures under Generally Accepted Accounting Procedures (GAAP) actually facilitates earnings management. There are several ways managers can deliberately misrepresent the timing or amount of transactions in financial statements.

For example,

1. **Sales related**
   a. Timing of invoices (for example, moving a sale made in the next period to the current period by backdating the invoice)
   b. Phony orders (for example, reporting a sale to a nonexistent customer this period and reversing it the next period)
   c. Downgrading products (for example, classifying non-damaged goods as damaged to make sales to a customer at a lower than normal price)

2. **Expenses related**
   a. Splitting invoices (for example, having a supplier split a single purchase order into several orders with invoice dates in more than one accounting period)
   b. Recording prepayments as expenses (for example, recording advertising prepayments as expenses of the period in which the payment is made).

A discussion of earnings manipulation would be somewhat incomplete if the “big bath” phenomenon is not mentioned. Also known by other labels such as “clearing the decks” or “housekeeping”, this phenomenon occurs when management encounters a loss year, and take steps to add to the magnitude of the losses. It can do this by writing down of assets or by creating provisions for possible future losses. The net result is a big decrease in current reported income but an increase in income in future years. The overall result of all these “creative accounting” devices is that the accounts do not present a truthful picture of the underlying economic fundamentals of the company’s financial health.

A case in point regarding earnings management is the Mainland’s financial reporting system. There are two types of shares traded in the Shanghai and Shenzhen Stock Exchanges. A-shares are for domestic Chinese citizens while B-shares which are denominated in US dollars in Shanghai and Hong Kong dollars in Shenzhen are for foreigners. Note that B-share companies are required to publish summarized financial statements that are based on both Chinese GAAP and International Accounting Standards (IASs). In a recent paper, Chen, Gul and Su (1999) examined the application of Chinese GAAP and IASs for the B-shares companies listed on the Shanghai Stock Exchange. They found that there were significant differences in average profits between the application of Chinese GAAP and IASs. For each year from 1994 to 1997, the average profit per company was consistently overstated when Chinese GAAP was applied.

Four factors were identified that contributed to significant differences in earnings namely:
1. Different practices for Chinese GAAP and IAS, e.g. inventory must be valued at historical cost in Chinese GAAP whereas IAS requires the valuation at the lower of cost or market.

2. Similar practices for Chinese GAAP and IAS exist but with a lot of scope for managerial opportunistic applications under Chinese GAAP, e.g., the discretionary use of accruals by capitalizing operating leases.

3. Differences attributed to non-accounting government regulations, e.g., Financial Rules for Enterprises promulgated by the Ministry of Finance in 1993 stipulate the minimum residual value and estimated useful life for different types of fixed assets for business enterprises.

4. Special events in Chinese economic reform e.g., in 1994, the state-controlled currency exchange rate was replaced by a market based rate resulting in huge foreign exchange translation losses or gains being capitalized under Chinese regulations.

They also found that the majority of the companies reported a decrease in profits after restatement in terms of IASs. The scope for earnings manipulation by using Chinese GAAP has created some concerns for foreign investors and local citizens alike. Fortunately, steps are being taken by the Mainland Authorities to redress this problem.

In general terms, managers have a range of economic incentives for managing earnings. For example, explicit compensation contracts that link compensation to reported earnings under a bonus plan create incentives for managers to manipulate earnings. Based on this assumption, we expect that managers of firms with bonus plans are more likely to manipulate earnings upwards (e.g. choose accounting procedures that shift reported earnings form future periods to current periods). We next turn to a brief discussion of the underlying economic motivation for managers to manipulate earnings.

**Economic Incentives for Lack of Corporate Transparency**

These manipulations and motivations do not come as a surprise since a rich body of theory in economics starting with the work of Coase (1937) and more recently Holstrom and Tirole (1989) and Jensen and Meckling (1992) actually predict these events. The economic theory is based on two complementary views; the “nexus of explicit and implicit contracts” view of the firm and agency theory (Williamson, 1991). Put very simply, the firm is viewed as a “nexus of contracts” or a set of contracts between a multitude of parties and individuals and the objective of the firm according to this “theory of the firm” is to design the contracts in such a way as to minimize contracting costs including agency costs. The contracts are between the individuals and separate entities and there are myriad types of written and unwritten agreements among individuals in the firm. These contracts include formal contracts such as compensation and debt contracts and informal contracts such as informal working arrangements between managers such as organization charts and job descriptions. An important point to note here is that accounting is an integral part of the contracts that define the firm. The contracts themselves, the enforcement and the monitoring of these contracts are costly and can affect the firm’s profitability and survival. Unfortunately, it is not possible to write contracts that cover every contingency in the business environment and hence the idea of incomplete contracts. The difficulties associated with writing contracts to cover every possible situation or contingency and the monitoring of these contracts becomes significant because of the agency problem.
In the agency view, managers (risk averse agents) are expected to act opportunistically at the expense of the shareholders’ (principals’) interests (Jensen and Meckling, 1976; Fama and Jensen, 1983). The agency problem arises from the separation of ownership and control in modern corporations, or to be more precise, following Shleifer and Vishny (1997), between the firm’s financiers on one hand, including holders of both equity and debt, and the firm’s management on the other. The manager requires the financier’s funds, since she usually cannot supply the capital she requires on her own. The financier on the other hand, in the absence of a mechanism to prevent this, takes the risk that the manager can directly expropriate her capital.

This is the fundamental problem that faces modern corporations—the potential for managers to act opportunistically given that it is not possible to write contacts to cover every contingency and the difficulties of monitoring and enforcing contracts. Manifestations of these opportunistic behavior may be seen in terms of the lack of corporate disclosures and manipulation of accounting earnings. This then brings us to the problem at hand. How do we control managers to ensure that they act in ways to protect shareholders’ funds? To answer this question, we now turn to the role and nature of corporate governance.

**Corporate Governance Mechanisms in Asia**

Corporate governance mechanisms including accounting and auditing standards are designed to monitor managers and improve corporate transparency. A number of corporate governance mechanisms have been identified analytically and empirically. These may be broadly classified as internal and external mechanisms (Agrawal and Knoeber, 1996). Figure 1 below summarizes the more common mechanisms.

**Figure 1**

**Major Types of Corporate Governance Mechanisms**

![Diagram of corporate governance mechanisms.](image-url)
The main mechanisms determined by outsiders are institutional shareholdings, outside block holdings, and takeover activity. The remaining mechanisms are decided by the firm’s internal decision-makers; insider shareholding, board membership and characteristics (size of the board, number of outside independent directors, audit committees, audit quality, CEO tenure and horizon problem, remuneration committees etc), debt financing and the use of outside markets for managerial talent.

Space does not permit a discussion of all these mechanisms. Instead, we will only discuss a few of the more important internal ones. Insider ownership or management ownership of shares is a popular device to reduce agency costs since managers who own shares in the company are very likely to act in the interest of the company. Board membership and related devices are also very popular devices. The inclusion of non-executive directors on the board is expected to provide some monitoring of the board and discourage managers from making inefficient decisions. However, as discussed later, we demonstrate that it is the quality rather than the quantity of non-executive directors that is important for effective corporate governance. The CEO horizon problem is interesting and deserves some mention. CEOs in the final years in office are expected to make inefficient decisions particularly if their remuneration is based on accounting earnings. Thus, they would cut down on R&D expenditure even though it is necessary for the long-term survival in order to increase current earnings. Evidence obtained by Dechow and Sloan (1991) supports this horizon problem. Finally, recent studies suggest that debt can be used as an effective mechanism to monitor managers since the debt market provides some form of discipline (Gul and Tsui, 1998a).

We have included audit quality under the board membership because the board appoints the auditors. Directors have a choice of appointing Big 5 or non-Big 5 auditors (previously Big 6). There is a body of economic theory which suggests that firms appoint Big 5 auditors because they are associated with higher quality audits (Gul and Tsui, 1998a; Gul, 1999b). Higher quality audits being defined as the higher likelihood of discovering material errors and irregularities and having discovered these errors, the higher likelihood of reporting them. Also the appointment of a Big 5 auditor signals to the market that the firm’s earnings and financial reports are more reliable.

This is by no means an exhaustive list and readers interested in pursuing this further are advised to read a paper by Danielson and Karpoff (1998). For example, they identify two more popular devices such as the poison pills and the director/officer liability indemnity. Poison pills are securities that entitle their holders to special rights if the issuing firm becomes the subject of a takeover bid and the directors’ indemnity occurs when the corporation promises to reimburse the directors for legal expenses as a result of law suits relating to the directors’ corporate actions.

Since the various mechanisms controllable by insiders are substitutable, in the absence of political or other constraints, efficiency would require that they are used optimally, i.e., each would be used until its marginal productivity (ability to generate performance) is zero. Williamson (1991) refers to this as the “discriminating match between transactions and governance structures”. In other words, we subscribe to the idea that there is an optimal mix of corporate governance mechanisms depending on the requirements and circumstances of the company in question.
Our contention is that an examination of corporate governance in Asia would reveal inefficiencies in the choice of many governance mechanisms, particularly the level of debt monitoring and board composition. It is possible that the institutional, legal and political environment in a number of Asian regimes imposes constraints that prevent an optimal solution to a firm’s corporate governance problem. As such, the notion that corporate governance mechanisms used in the west should be implanted in the Asian corporate sector needs to be viewed with caution because the economies in Asia are characterized by what Rajan and Zingales (1998) call relationship-based systems in Asia. They point out that corporate governance systems in East Asia are relationship-based as opposed to the arms-length market-based systems in the U.S. They expect this to lead to less transparency:

“Market-based systems require transparency as a guarantee of protection… By contrast, relationship-based systems are designed to preserve opacity, which has the effect of protecting the relationship from the threat of competition.”

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, 1999a). 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 systems. Suffice to say that the suggestion that western corporate governance mechanisms should be implanted wholesale in Asia needs to be viewed cautiously.

Recent Developments of Corporate Governance and Financial Disclosures in Hong Kong

The Financial Secretary in a recent Budget Speech (2000/2001) remarked that “The standard of corporate governance in Hong Kong is among the highest in the region.” He also emphasized that there is room for improvement. To maintain Hong Kong’s status as an international financial centre, it is imperative that we have to stay ahead and continue to enhance our corporate governance. To this end, the Financial Secretary has asked the Secretary for Financial Services to conduct a comprehensive study to identify and plug any gaps in our corporate governance regime and to be a benchmark in the region with the help of the Standing Committee on Company Law Reform. He recognized that the efforts of the market bodies, professional organizations and regulators will be pivotal to this endeavour.

The current framework of corporate governance in Hong Kong includes both statutory and non-statutory requirements. Statutory requirements consist of the Companies Ordinance, Securities (Disclosure of Interests) Ordinance, Securities (Insider Dealing) Ordinance and Takeover Codes. The non-statutory element refers to those required under the Listing Rules covering the number of independent non-executive directors, disclosures of connected transactions, and disclosures of the different components of directors’ remuneration.

We outline developments of corporate governance in Hong Kong in terms of the policies developed by the Hong Kong Society of Accountants, The Stock Exchange of Hong Kong, Hong Kong Monetary Authority, and Securities & Futures Commission.
Role of Hong Kong Society of Accountants (HKSA)

To date, the Corporate Governance Committee of the Hong Kong Society of Accountants (HKSA) has responded to the debate in corporate governance in Hong Kong with five publications namely, First Report of the Working Group on Corporate Governance (1995), Second Report of the Corporate Governance Working Group (1997a), A Guide for the Formation of An Audit Committee (1997b), A Guide for Directors’ Business Review in the Annual Report (1998) and Directors’ Remuneration-Recommendations for Enhanced Transparency and Accountability (1999). After reviewing international best practice and taking into account the unique characteristics of Hong Kong, the First Report (HKSA, 1995) contains 19 recommendations covering broadly the role and responsibilities of board of directors, financial reporting and audit, and observations relating to disclosures and corporate governance. The Second Report (HKSA, 1997a) provides further recommendations covering board membership, finance directors, chief financial officers and consists of a survey covering the extent of the establishment of audit committees and the levels of disclosures on directors and substantial shareholders. The Second Report (HKSA, 1997a) specifically states that there is a gap on disclosures of family relationships between directors and whether the director is employed by or is a director of a substantial shareholder (see Paragraph 9(2)(a) of Appendix 7a, b and i of the Listing Rules). Additional disclosures on executive, non-executive directors and independent non-executive directors (INDs) and fees paid to INDs in whatever capacity are recommended as amendment to the Listing Rules. Family relationships between directors and substantial shareholders who are not directors should also be disclosed. In an attempt to enhance corporate governance of listed companies, the Hong Kong Institute of Directors is also planning to issue a guideline for non-executive directors to clarify their roles and duties (SCMP, 3 April, 2000).

The third HKSA publication, A Guide for the Formation of an Audit Committee (1997b) was formally endorsed by the Stock Exchange of Hong Kong (SEHK) as recommended guidance to comply with the establishment of an audit committee in its Code of Best Practice in 1998. The Amendments to the Code of Best Practice of the SEHK Listing Rules only require listed issuers to “establish an audit committee with written terms of reference which deal clearly with its authority and duties” (SEHK, 1998a). It does not specify any other matters relating to the establishment of the audit committee. The HKSA’s A Guide for the Formation of an Audit Committee (1997b), on the other hand, provides more details. The key recommendation from the Guide is for the board to set up an audit committee. It also recommends that written terms of references covering the four aspects of responsibilities namely, financial and other reporting, internal control, internal and external audit and any other needs of management be stated explicitly as the authority and duties for the audit committee. The major responsibility of the audit committee should include the review and supervision of the company’s financial reporting process and internal controls. In reviewing and supervising the company’s financial reporting process, special attention should be directed to the disclosure of related party transactions and any unusual items. Members of the audit committee should ensure that an adequate internal control environment is established and maintained, for example, the role and function of internal audit and its relationship to the external audit process. This will help members assess the key areas of risk and its associated uncertainties. The recommended size of the audit committee should consist of a minimum of three non-executive directors with the majority being independent. This is a deliberate attempt by the HKSA to emphasize the importance of independence and quality of the members of the audit committee. “The committee will only be as good as the people in them” (HKSA, 1997b, p. 4). The Guide
(HKSA, 1997b) spells out that the committee should consist of members who have some broad business background as well as the necessary skills and experience to carry out their duties and responsibilities. It also recommends that the chairman of the audit committee be appointed by the board with the company secretary acting as secretary of the committee. Disclosures on the composition, work and frequency of meetings of the audit committee should also be made in the annual report. It also suggests that the committee should report to the board regularly on matters within its terms of reference. The communication should include recommendations on the appointment of the external auditor, conclusions on discussions with the external auditor pertaining to the audit process, conclusions on the internal audit function and the efficacy of the company’s internal control system.

To further enhance transparency and quality of financial disclosures in annual reports, the fourth report entitled *A Guide for Directors’ Business Review in the Annual Report* (HKSA, 1998) was issued after surveying local and international best practice. It contains a comprehensive framework for directors to discuss and analyze business performance in an attempt to allow investors and users to better understand past performance with a view to assess the future potential of the business. It includes two main elements: operating review and financial review. Operating review covers significant features of operating performance, material transactions and the dynamics of the business with prospects and future plans as well as post balance sheet events. Financial review includes a discussion of the capital structure, liquidity, going concern and off balance sheet items. This is also a deliberate attempt to provide some guidance for management to disclose and discuss the potential uncertainties and risks that the business will encounter.

To further enhance disclosures and accountability in directors’ remuneration, HKSA in its recent report on *Directors’ Remuneration - Recommendations for Enhanced Transparency and Accountability* (1999) documented a comparative study on the disclosure requirements of directors’ remuneration covering Hong Kong, and other principal financial markets including USA, UK, Singapore and Australia. The basic assumption underlying this study is that there should be sufficient disclosures of directors’ remuneration in order that their performance can be assessed. To be more accountable to shareholders, boards should establish a remuneration committee, with the majority of members being independent non-executive directors, to recommend the remuneration for executive directors and this requirement should be stipulated in the Code of Best Practice. It also recommends that disclosures on directors’ remuneration be increased to include a statement on the company’s policy on executive directors’ remuneration and share options. Additional disclosures on benefits for non-executive directors should be given as well. To better allow shareholders to assess the performance of directors in relation to the company’s performance, two separate categories of remuneration should be disclosed namely, performance based and non-performance based components. Given the prevalence of share option as a key element of directors’ remuneration, more details should be provided namely, the disclosure of aggregate value realized by directors on the exercise of options, the aggregate value of in-the-money, unexercised options at the end of the fiscal year and the aggregate gains made by the directors on the exercise of options.

**Role of The Stock Exchange of Hong Kong (SEHK)**

The OECD in its recent set of Principles of Corporate Governance (1999, p.2) emphasizes the key responsibilities of directors, one of which is directors’ remuneration. In Hong Kong as in...
many Asian countries, “the board generally determines its own remuneration”. In an attempt to improve accountability and transparency in directors’ remuneration, the Stock Exchange of Hong Kong recommended requirements to disclose the banding of directors’ remuneration and the compulsory appointment of at least two independent non-executive directors as early as 1994. This issue of accountability and transparency is more pronounced when HKSA documented in its First (1995) and Second (1997a) Corporate Governance Reports that many boards of listed companies in Hong Kong and in other Asian countries are controlled by a dominant shareholder. It is found that 53% of all listed companies have one shareholder or one family group holding more than 50% or more of issued capital. Though one of the key recommendations in the First Report is to have no more than half of the voting members of the board from the same family, the findings from the Second Report reveal that only 9% of the listed companies display such family dominance in the boards. Against the above unique institutional environment in Hong Kong, this lack of transparency and accountability of directors’ remuneration is more serious when the chairman of the board is also the chief executive i.e. the problem of CEO dominance. The monitoring role of the chairman of the board over the CEO disappears when there is CEO dominance. In this case, the chairman approves the directors’ remuneration recommended by the CEO who is not only responsible for allocating his/her own remuneration package but that of other executive directors as well.

To enhance transparency and market efficiency, the Stock Exchange of Hong Kong issued a Market Consultation Policy Paper (SEHK, 1998b) on financial disclosure aiming to enhance the quality of periodic financial reporting by its listed issuers. Specifically, it advocates increased relevance, timeliness and credibility concerning interim financial reports. It stipulates a complete set of annual financial statements; reduces the time allowed for publishing these interim reports and suggests an independent party to review them. It also recommends that financial disclosure by financial conglomerates be brought in line with those disclosures required for listed banking companies with analyses of profit and loss account, operating profit by division and by product, balance sheet and off-balance sheet exposures. In addition, the SEHK expects to require detailed provisions for the management discussion and analysis which aims to increase the disclosure on the liquidity and financial risk of companies.

The GEM Listing Rules (July 1999) documented a chapter on “Directors, Secretary and Corporate Governance Matters”. It covers detail requirements on directors’ responsibilities, the duties of the audit committee and the appointment of a qualified accountant and compliance officer. These are considered to be significantly more demanding requirements than those listed in the main market. As an example, the Code of Best Practice in the main market Listing Rules only requires the establishment of an audit committee with a majority of members being independent non-executive directors and a written term of reference. The GEM Listing Rules require the audit committee to be chaired by an independent non-executive director with specified duties to cover review of the company's annual report and accounts, half-year report and quarterly reports as well as reviewing and supervising the company’s financial reporting and internal control procedures. Specifically, the company is required to keep full minutes of all meetings of the audit committee and specifies the rights of executive directors to the full and unlimited access to all books and accounts of the company. It is probably because of the overall increased risks of these growing enterprises that the requirements of corporate governance need to be more detailed and specific than those companies listed on the main market.
Role of Hong Kong Monetary Authority (HKMA)

The Hong Kong Monetary Authority (HKMA), with a commitment to strengthen corporate governance in banks and authorized institutions, recently reviewed its “Best Practice Guide” by specifying more detail guidelines on corporate governance. More specifically, the HKMA’s Guideline on Corporate Governance of Locally Incorporated Authorized Institutions (2000) specifies that the board of directors should ensure that policies, procedures and controls be established to manage the different types of risks including credit, interest rate, market, liquidity, operational, reputation, legal and strategic and others with which the institution is faced with. A suggestion is made to establish specialized board committees such as audit committee or risk management committee with a terms of reference covering the review of the adequacy of risk management policies and systems and including regular communication to the board. The Guideline also stipulates that a policy on connected lending should be established in accordance with Section 83 of the Banking Ordinance. This provision is particularly important given the significant negative impact it brought to banks in the Asian financial crisis. With respect to the important role that independent non-executive directors (IND) can play in corporate governance, the HKMA extends the requirement of the SEHK by requiring at least three INDs for boards of local banks by the end of June 2001. In addition, it recommends that chairman and chief executive of an institution should be separate. In the event of chief executive and chairman being the same person, a stronger independent element in the board is recommended with at least one third of the board being INDs. The requirement of an audit committee with written terms of reference is similar to that of the Code of Best Practice of the SEHK. The Guideline goes further to deal with the effectiveness of boards by recommending monthly board meetings or quarterly meetings at a minimum and attendance of directors being at least two thirds of board meetings held in each financial year.

Role of Securities & Futures Commission (SFC)

Very recently, the Securities & Futures Commission unveiled a consultation paper on the “Composite Securities and Futures Bill” on 2nd April 2000. This bill consolidates all the ten securities and futures related ordinances into a single law. Key recommendations include: wider investigative power for SFC, power for investors to sue over misleading information, SFC power to decide to take civil or criminal action against market malpractice such as insider trading. This Bill aims to establish a regulatory framework to meet with international best practice to enhance market efficiency and transparency. To further consider the level of financial disclosures, we need to turn our attention to the recent development of accounting and auditing standards.

Development of Accounting Standards

As at March 2000, there are 24 accounting standards and six interpretation statements covering many accounting issues. All standards and interpretations are first issued as exposure drafts for comments and (re-exposed if necessary) before they are issued as statements. In addition, Statement 2.01 provides a framework for the preparation and presentation of financial statements and thus gives guidance to accountants in circumstances where there is no specific accounting standard. Most of the standards issued are closely in line with International Accounting Standards (IAS) in terms of measurement, recognition and disclosure.
Thirteen (13) new/revised standards were issued in the last two years and two proposed statements are still at the exposure draft stage as at 31 March 2000. The only new element introduced is the issuance of Interpretation Statements. The practice of issuing Interpretation Statements commenced in October 1998 and six statements were issued (one withdrawn because of consolidation into standards) and three exposure drafts are still outstanding as at 31 March 2000. The purpose of these statements is to cover specific issues that need further clarification. These interpretation statements have the same status as the background material and implementation guidance contained in accounting standards.

The standards issued/revised during the period cover many areas and aim to improve the quality of financial reporting. These new standards provide guidance in standardizing accounting treatments and improve the information to be disclosed. Improving the financial transparency and enhancing the quality of financial reports of companies will help lower the probability of recurrence of the crisis in 1997.

The two main revisions to the existing standards are: *Presentation of Financial Statements* (2.101) and *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies* (2.102). The new version of SSAP 2.101 prescribes the basis for presentation of financial reports, in order to enhance the comparability of financial reports between entities. It also requires the presentation of a new statement, the statement of recognized gains and losses. In general, this new statement provides additional information about the changes of equity other than those resulting from transaction with shareholders.

The three important new standards are: *Accounting for Investments in Securities* (2.124), *Interim Financial Reporting* (2.125) and *Segment Reporting* (2.126). The new statement 2.124 provides guidance on the accounting issues related to investments in securities other than those investments in subsidiaries, associate and joint ventures. The standard distinguishes between held-to-maturity securities and other investments and provides two alternative methods of classification of investments other than held-to-maturity securities: a benchmark method and an alternative method. The benchmark method is different from that in the IAS while companies can follow the alternative method that is consistent with IAS. The two methods differ in the way that investments are classified and changes in fair value of investments are accounted for. Under the benchmark method, securities held for an identified long-term purpose are carried at cost less diminution in value which is other than temporary. Other investments are carried at fair value, with changes in fair value recognized in the profit and loss account. Under the alternative method, all investments other than held-to-maturity securities are carried at fair value, with changes in fair value recognized in the profit and loss account.

The new standard 2.125 improves the quality of the interim financial reports (mainly half-yearly report) by establishing the minimum requirements on the form and content. The new standard 2.126 requires more extensive disclosures as compared to those recommended under the replaced accounting guideline. Companies are required to follow this new standard while the previous guideline provides recommendations for accounting practice. The information required to be disclosed includes the classification of major financial information according to (1) business segments and (2) geographical segments. The segmental information enables users to understand the risk and profitability of different segments.

As part of the future agenda, the HKSA is developing the following SSAPs which are closely modelled on the equivalent IAS namely:
1. Provisions, contingent assets and contingent liabilities
2. Intangible assets
3. Impairment of assets
4. Business combinations
5. Consolidated financial statements and accounting for investments in subsidiaries

There is also a preliminary plan to develop guidance on accounting for derivatives in Hong Kong.

In summary, the development of accounting standards has been in a reasonable pace. The new and revised standards aim to improve the quality of financial information and the level of disclosures by stipulating the acceptable alternative treatment and increasing the level of disclosures.

Development of Auditing Standards

Currently, there are 22 standards (SAS) and 24 practice notes and auditing guidelines covering most of the key issues in auditing. These auditing standards follow the International Standards of Auditing (ISA). No new auditing standard was issued in the last two years. Six new practice notes were issued, mainly covering matters related to special audit engagements, such as insurance clients, retirements schemes, solicitors’ accounts and flag day charitable fund-raising accounts. The auditing standards contain basic principles and essential procedures with which auditors are required to comply in an audit engagement. They also include explanatory and other material which, rather than prescriptive, is designed to assist auditors in interpreting and applying those basic principles and essential procedures. Auditing guidelines and industry auditing guidelines will be phased out and subsequently replaced by practice notes. The practice notes are issued to assist auditors in applying auditing standards of general application to particular circumstances and industries, such as insurance clients and retirement schemes.

Seven new SAS’s are still under the exposure draft stage. One covers revision to the existing standard (SAS 600) and six are new standards (SAS 110, SAS 130, SAS 150, SAS 160, SAS 450 and SAS 700). The revised SAS 600 follows the IAS. The new standards deal with other contentious issues, such as that relating to the auditor’s responsibilities in relation to subsequent events (SAS 150).

What remains is for us to turn our attention to some academic research studies in Hong Kong which can shed light on the relationship between corporate governance and financial disclosures.

Research Studies on Corporate Governance and Financial Disclosures in Hong Kong

It is fair to say that a considerable amount of work by academics in Hong Kong have already shed some light on some of the issues in corporate governance. We now briefly review these research findings and readers are encouraged to refer to the papers for more information.

This study examines whether the proportion of independent non-executives directors (INDs) on corporate boards is associated with more corporate disclosures. Recall that since 1994, The Stock Exchange of Hong Kong required listed companies to appoint at least two independent non-executive directors on the board in an attempt to improve corporate governance. The inclusion of more independent outsider directors is expected to provide more board monitoring which in turn should increase financial transparency and corporate disclosures. So a basic hypothesis tested in the study is that firms with a higher proportion of outside directors would be associated with higher corporate disclosures. However, they recognize that in Hong Kong, family ownership is a unique institutional arrangement which could affect the role of corporate governance mechanisms (i.e. relationship-based system). More specifically, they expect that independent non-executive directors would have little or no impact on improving corporate disclosures for family owned companies since these family owned companies, because of their power and control of management, are likely to appoint “friends” and associates who are “supporters” of management as independent non-executive directors.

They collected data for two years in 1993 and 1994. Corporate disclosures are measured in terms of an instrument developed by Wallace and Naser (1995) with 30 disclosure items relating to all aspects of financial statements such as the balance sheet, notes to the financial statements and so on. Family ownership is measured by classifying firms into two categories, those with less than or greater than 10% owned by family members. Research findings show that the higher the proportion of independent non-executive directors (INDs), the more comprehensive are the financial disclosures. This suggests that the inclusion of INDs on corporate boards could increase firms’ voluntary disclosures. However, this monitoring by INDs is likely to be less effective if the firms are family controlled. This suggests that the effectiveness of INDs on family owned or controlled firms is reduced by their close association to the family.

“CEO Dominance and Voluntary Corporate Disclosure Strategies in Hong Kong Annual Reports”, Working Paper, City University of Hong Kong by Ferdinand A. Gul and Sidney Leung (2000).

The objective of this study is to examine the link between CEO dominance, non-executive director quality and voluntary corporate disclosures of Hong Kong companies. Anectodal evidence suggests that vesting the power of the CEO and chairman of the board in one person (CEO dominance) creates a strong individual power base which could erode the board’s ability to exercise effective control. This phenomenon can constrain board independence and reduce its ability to execute its oversight and governance roles (Millstein, 1992). Therefore, the Cadbury Committee (1992) recommended that large companies should separate the roles of CEO and chairman. There is as yet no such listing requirement in Hong Kong. Based on the above reasoning, the study expected that firms with CEO dominance are more likely to be associated with lower levels of voluntary disclosures since the board is less likely to be effective in monitoring management and ensuring a higher level of transparency.

Based on Jensen and Meckling’s (1976) argument that other monitoring mechanisms can mitigate the abuse of managerial discretion as a result of CEO dominance, the study also examines the role of the quality of non-executive directors as the control mechanism to mitigate the problem resulting from CEO dominance. This control mechanism is particularly pertinent for Hong Kong’s corporate governance framework because the SEHK only
mandates in 1994 that all listed companies must appoint at least two independent non-executive directors. The SEHK is silent on the issue of quality of these INDs. Gul and Leung in their study measure non-executive director quality in terms of whether the directors also concurrently hold directorships in other listed companies. This reflects the INDs’ standing, wider experience and expertise in monitoring management. By being directors in other companies, there are also more incentives for these directors to be effective monitors of management in order to preserve reputation capital or improve their position on the external labor market. On the basis of the above argument, it is expected that the negative relationship between CEO dominance and voluntary disclosures is mitigated by non-executive director quality.

Using observations from 396 Hong Kong listed companies for 1996, the researchers find that CEO dominance is significantly associated with lower voluntary corporate disclosures and that it is the quality rather than the number of non-executive directors that mitigates the negative association between CEO dominance and voluntary disclosures. The results of this study suggest that the regulatory authorities should consider the issue of whether the CEO should not be the chairman of the board in order to achieve effective monitoring over the firm’s management. To further improve corporate governance, regulators should not focus only on the quantity of independent non-executive directors but also the quality as well.


This study examines the relationship between CEO duality and firm performance. The authors hypothesize that CEO duality (CEO and chairman being the same person) would lead to lower firm performance because of the problem of CEO dominance. This relationship is also tested using both family owned and non-family owned companies. Based on a sample of listed companies in Hong Kong from 1994 to 1996, the preliminary research results show that there is some marginal support for the negative association between CEO duality and firm performance only for non-family owned firms.

Other work is underway in Hong Kong to better understand the role of corporate governance mechanisms. For example, recently the Hong Kong Government’s Research Grants Council awarded a Competitive Earmarked Research Grant to Ferdinand A. Gul and Judy Tsui (1998b) to study “Hong Kong Directors’ Remuneration and Corporate Performance: An Analysis of the Role of Family Ownership, Non-executive Directors, Audit Committees and Investment Opportunities”. The authors have already commenced to collect data covering the extent of CEO dominance, family ownership, and the number of non-executive directors for all listed companies in Hong Kong from 1993-96. Their preliminary findings reveal that bonus schemes are related to firm performance and growth opportunities only for non-family owned companies. The role of traditional corporate governance mechanisms in family owned companies require further scrutiny since the economic incentives for managers and owners of family owned companies are expected to be different.

**Some Recent Preliminary Findings – Hang Seng 100 Companies**

A recent preliminary analysis of Hang Seng 100 (HS100) annual reports with fiscal year end date in 1998 reveals some important developments in Hong Kong corporate governance. It is
found that 38% of the HS100 companies have CEO dominance (chief executive officer being the same person as the chairman of the board of directors) with 15% showing CEO dominance by family relationship. Out of 100 companies, 39% have two or more family members within the board of directors, with 28% ranging between 2-3 family members on the board. In addition, 26% of these 100 companies have disclosed the existence of audit committees as compared to 2% in 1995 (survey conducted by HKSA). Nineteen percent (19%) of these companies have also disclosed information that they have held at least one audit committee meeting in 1998. The results also show that none of the companies disclosed any information relating to the constitution and quality of membership of the audit committee (such as the total number of members, the number, qualification and experience of independent non-executive directors), and written terms of reference. Though the SEHK Listing Rules stipulate at least two independent non-executive directors, 33% of these 100 companies have more than two independent non-executive directors. These results suggest that the HS100 companies are progressive in adopting corporate governance mechanisms.

Policy Implications

Needless to say, the results of these studies have policy implications. For example, the results suggest that the Stock Exchange of Hong Kong needs to consider ways and means to ensure the objectivity of the independent non-executive directors. A good way is to require additional disclosure on the clear identification of the number of executive directors, non-executive directors and independent non-executive directors (INDs). An annual statement to declare the independence status of INDs is also suggested. Disclosures requiring amounts of fees and any other payments to INDs in whatever capacity may overcome the problem suggested in the above studies. In addition, special attention should be paid to the quality of INDs rather than the quantity of INDs.

Concluding Comments

One of the reasons identified for the recent financial crisis is the lack of corporate transparency and possible earnings manipulations by corporate managers. Managers can conceal financial information by various methods largely because current financial standards provide managers with considerable latitude and discretion in financial reporting. We discuss this under the section on accounting earnings manipulation. We also later provide an overview of agency theory which explains the economic motivations for managers to conceal and manage financial information. Basically, the agency problem stems from the separation of ownership and control and the conflict of interests between managers and shareholders. Managers act to maximize their own welfare at the expense of shareholders and other stakeholders. These activities include managing earnings to increase accounting-based compensation schemes and investments in non-value maximizing projects. The question then is how do we control managers? To do this, we turn to corporate governance mechanisms. These may be classified as internal and external mechanisms. The paper provides an explanation for some of the more popular internal devices such as management ownership of equity and board composition. From these general ideas, the paper then moves on to examine the situation in Hong Kong. The major corporate governance developments in Hong Kong are identified including the recent development of accounting and auditing standards. Finally, the paper provides some empirical evidence of research studies that have found evidence for some linkage between various corporate governance devices, corporate disclosures and performance. These results are important since they establish two important features unique
to Hong Kong. First, “traditional” corporate governance devices such as non-executive directors seem to be ineffective in family owned companies (these are characterized as relationship-based systems). Second, it seems that the quality of non-executive directors is more important in ensuring higher corporate disclosures than the number of non-executive directors. Finally, it is worth pointing out that there are a number of on-going research projects undertaken by academics in the Department of Accountancy in City University and other tertiary institutions in Hong Kong on corporate governance issues covering not only Hong Kong but also the Mainland and other Asian countries.

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