

**Corporate Governance Systems and
Ownership Structures:
Implications for Corporate Performance –
Evidence from Hong Kong**

By
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Abstract

Corporate governance is an important variable that can serve to enhance firm performance. This dissertation focuses on a key corporate governance variable, that of managerial ownership. While Jensen and Meckling's (1976) "convergence of interest" hypothesis suggests that increases in managerial ownership can enhance firm performance, Fama and Jensen (1983) and La Porta et al. (1999) argue that at high levels of managerial ownership there are "entrenchment effects" (that is, managers will pursue their own interests). Although there are mixed results, the UK and US literature in general suggests that the relationship between managerial ownership and firm performance is non-linear in nature and conforms to a cubic relationship corresponding to "alignment-entrenchment-alignment" (that is, alignment at low levels of managerial ownership, followed by entrenchment at intermediate levels of managerial ownership and alignment once again at high levels of managerial ownership). It is doubtful whether this relationship is the same under different corporate ownership structures. Claessens et al. (2000) document the fact that most of the firms in the East-Asian region are characterised by a concentrated form of family-controlled ownership, in contrast to the diffuse form of ownership in the UK and the US. Hong Kong is a prime example of an economy dominated by a family-controlled ownership structure.

The thesis contributes to the academic literature on corporate governance by its examination of the relationship between managerial ownership and corporate performance in Hong Kong. Based on the regression results of 1406 firm-year

observations of Hong Kong listed companies from 1995 to 1998, it is found that under the family-dominated ownership structure in Hong Kong, there is a non-linear relationship between managerial ownership and firm performance which corresponds to a pattern of “entrenchment-alignment-entrenchment”. This is in contrast to the pattern (“alignment-entrenchment-alignment”) found in the UK by Short and Keasey (1999) and in the US by Morck et al. (1988). While the finding of a non-linear relationship between managerial ownership and firm performance in this study supports both the “convergence of interest” hypothesis over certain ranges of managerial ownership and “entrenchment effects” over other ranges of managerial ownership, the discovery of a pattern which is opposite to that found in UK and US studies indicates that managerial ownership affects firm performance in a different way in Hong Kong. In Hong Kong, the convergence of interest effect only dominates the entrenchment effect in the intermediate range of managerial ownership, leading to the conclusion that a policy of providing management with larger amounts of equity within this intermediate range of managerial ownership should enhance firm performance. In contrast, increasing managerial share ownership in cases where the existing level of managerial share ownership is either low or high will have the effect of reducing firm value. The design of an optimal managerial compensation strategy for Hong Kong firms thus has to take account of the existing level of managerial share ownership.

In contrast to the finding of other studies, the results reported in this study show that board structure variables (board size, board composition and directors’ remuneration) are not significantly related to firm performance. An explanation for this may be found in the different character of the board in Hong Kong. For example, the number

of independent non-executive directors in Hong Kong is low and they are very often not truly independent, while the remuneration of directors is typically not subject to review by any board committees. If these aspects of Hong Kong board structures can be successfully reformed then corporate performance should be enhanced, in line with the results reported from other countries.

The data concerning managerial ownership and performance was partitioned in accordance with the East-Asian financial crisis, which began in late 1997. The findings from this further empirical analysis suggest that the macro-economic conditions in existence before and after the crisis affect the nature of the relationship between managerial ownership and firm performance. It is found that the convergence effect is stronger in the “prosperous years” prior to the crisis, as shown by the wider alignment range from the regression results based on the data before the East-Asian financial crisis (1995-1997). The entrenchment effect is, however, more prominent during the “difficult years” as indicated by the narrower range of alignment in the regression results based on the data for the year after the crisis (1998).

The importance of corporate governance in Hong Kong was brought into sharp prominence by the East-Asian financial crisis. Weaknesses in corporate governance regimes have been widely identified as an important factor leading to the fast downturn in economies within the whole East-Asian region. Enhancing corporate governance practices is thus important for corporate recovery and growth. Various international organizations, professional bodies, regulators and academics have spent a great deal of effort over the past six years in a wide range of activities to enhance corporate governance practices in the region, and these are reviewed in the thesis.

Due to the different cultural backgrounds and ownership structures in different countries, it can be argued that there is no single “best” corporate governance system. A secondary aim of this thesis is the evaluation of the corporate governance initiatives of various international organizations and the identification of areas for improvement and for reform in Hong Kong. Specific policy recommendations are made for the structural improvement of the corporate governance regime in Hong Kong.

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Chapter One

Introduction

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1.1 Motivation and Objectives of the Study

This thesis is concerned with corporate governance in Hong Kong. It is conducted by way of both qualitative and quantitative analyses. The qualitative analysis includes a study of the development of corporate governance regimes in different countries and a comparison among them. The contemporary efforts by international authorities and professional organisations to improve global corporate governance practices are also analysed to identify areas for improvements in Hong Kong. The quantitative analysis makes use of a set of four-year panel data of Hong Kong listed companies to study the relationship between corporate performance and managerial ownership under the predominantly family-owned corporate structure in Hong Kong. It also investigates the impact of the East-Asian financial crisis on the above relationship. Recommendations for the improvement of the corporate governance regime in Hong Kong are made by reference to the findings of both the qualitative and quantitative analyses. This section details the motivation for this thesis.

This research was initially motivated by the East-Asian financial crisis which took place in late 1997. The crisis was first triggered by the financial turmoil in Thailand in July 1997 when the Thai Government decided to float the Thai Baht on 2 July 1997. Since then, most countries in the East-Asian region experienced financial and economic turmoil (Chow, 1999) and it then became known as the East-Asian financial crisis. Hong Kong, though possessing a fairly healthy financial, banking and economic system, was caught up in the crisis in October 1997 when the Hong Kong Dollar came under speculative attack. GDP growth dropped tremendously from 5% in

1997 to -5.3% in 1998. There was much decline in the inflation rate from 5.8% in 1997 to 2.8 in 1998. From 1999 onwards, Hong Kong has experienced deflation (1999: -4%, 2000: -3.8%, 2001: -1.6%). The unemployment rate increased sharply after 1997 and reached a record high level of 7.8% in July 2002. Corporate collapses were commonplace in the years following 1997.

Before the East-Asian financial crisis, there was a well-documented bubble economy in Hong Kong (HKSAR Report, 2002). The Hang Seng index hit a then record level of 16,820 in August 1997. The property market was also flourishing; the average price went up by 48 percent during the period from January to October 1997. However, apart from the overheating economy, which was a factor contributing to the fast rate of collapse of the economy, there were other factors which also contributed to the financial turmoil in Hong Kong. Among them an important factor was the structural weaknesses in many of Asia's financial markets and, in particular, the lack of sound corporate governance systems. It has been argued by a number of governments, academics and professionals that those markets with weak corporate governance systems were subject to more volatile shocks in the financial crisis (e.g. Chow, 1999; Tsui and Gul, 2000). Hong Kong in fact experienced less shock when compared to the other Asian capital markets, which was probably due to its relatively more mature corporate governance mechanism and better-regulated capital market than other East-Asian countries (Tsui and Gul, 2000).

The East-Asian financial crisis highlighted the importance of corporate governance and brought it to the top of the agenda of various international authorities and professional organisations. The argument of a number of academics and professionals that Hong Kong has suffered to a lesser degree compared to other East-Asian countries due to its better corporate governance system prompted me to study Hong Kong's corporate governance system. The question addressed is, therefore, the extent to which Hong Kong's corporate governance system differs from that in the other East-Asian countries, and whether there are areas for further improvement. These questions prompted me to perform the qualitative part of the research, to identify the differences between the corporate governance system in Hong Kong and other countries, so as to determine whether Hong Kong's corporate governance system is better and to identify possible areas for further improvement.

Since Hong Kong was a colony of the United Kingdom (UK) for one and a half centuries, it follows the common-law system and it has adopted most of the UK's law and regulations. This raises the question of whether or not, because of this historical background, Hong Kong's corporate governance system is better than some other East-Asian countries. However, since Hong Kong people are mostly Chinese and the ownership structure of Hong Kong companies is majority family-ownership, which is very different from the diffuse form of ownership in the UK, the question arises as to whether these factors will have any impact on corporate governance. One important aspect of corporate governance research is the relationship between managerial ownership and corporate performance. However, so far most of the empirical research

has been carried out in the United States (US) and only limited study has been performed in the East-Asian region (Shleifer and Vishny, 1997). In the US, the corporate ownership structure is diffuse rather than concentrated. Thus, I have carried out an empirical study of the relationship between managerial ownership and corporate performance in Hong Kong to identify whether the relationship is different under a predominantly family ownership structure. In addition, in order to ascertain whether the East-Asian financial crisis, that is, the macro-economic condition, was also a factor responsible for the fast rate of corporate collapses, I extend the empirical study to ascertain the impact of the crisis on the above relationship.

With the above motivations in mind, the research is performed to achieve with the following principal aims and objectives:

1. to find out whether and how Hong Kong's corporate governance system is different from that in the UK, given that the rules and regulations in Hong Kong were adopted from those in the UK;
2. to compare the corporate governance systems in various jurisdictions to identify the differences between them and to analyse the strengths and weaknesses of the Hong Kong corporate governance system;
3. to study the efforts made by various international authorities and professional organisations to enhance corporate governance and to identify the initiatives and practices that can be applied in Hong Kong;
4. to ascertain the possible impact of culture and ownership structure on corporate governance, as measured by the effect of managerial ownership on firm

performance under the family-owned corporate structure in Hong Kong, and to compare the findings with the results of research performed in the Anglo-American context;

5. to ascertain the impact of the East-Asian financial crisis on the relationship between managerial ownership and firm performance in Hong Kong; and
6. to draw conclusions from the qualitative and quantitative studies in this research in order to make recommendations for further improvements of the corporate governance system and in corporate governance practices in Hong Kong.

1.2 An Overview of the Study

Motivated by the East-Asian financial crisis in late 1997 and the suggestion by a number of academics and professionals that corporate governance was an important factor in causing the fast rate of corporate collapses during and after the crisis, the thesis begins, in Chapter Two, with a comparative analysis of the historical development of corporate governance in the UK and in Hong Kong. It is necessary to study the UK's system because it is generally recognised as having a better set of corporate principles. Until 1997 Hong Kong had been a colony of the UK for one and half centuries and so most of its laws and regulations were adapted from those in the UK. However, while the UK has a well-developed code of best practice for corporate governance, Hong Kong only started to develop its corporate governance system in the mid 1990s. In addition, Hong Kong has not fully adopted the Combined Code, which is the code of best practice for corporate governance in the UK. Hence, the first part of Chapter Two studies the development and characteristics of the corporate governance systems in the UK and in Hong Kong. Comparisons are made between the two systems in order to ascertain why Hong Kong is not following the UK's practices in certain aspects and to identify areas where further improvements can be made.

The second part of Chapter Two investigates corporate governance systems and practices in a number of countries. Comparisons are made among them in order to identify common features and also different practices. The countries included in the comparative study include the two countries generally recognised to have well-developed corporate governance systems: the UK and the US; leading countries in

Europe and Asia: France, Germany and Japan; the “four little dragons” in East-Asia: Korea, Singapore, Taiwan and Hong Kong and also Hong Kong’s ‘home’ country: the People’s Republic of China (PRC). Recommendations for further improvements in the Hong Kong corporate governance system are drawn from the qualitative analyses and outlined in Chapter Seven.

The East-Asian financial crisis was a critical factor contributing to the rapid corporate collapses in the region. Hence, the qualitative analysis is extended further in Chapter Three to concentrate on the work contributed by a number of international and professional organisations, such as the Organisation for Economic Co-operation and Development (OECD), the World Bank and the Hong Kong Society of Accountants (HKSA), following the crisis. These international organisations have made continual efforts to enhance corporate governance as part of the recovery process after the crisis. Chapter Three of the thesis not only evaluates the corporate governance initiatives of these organizations, but also recognizes from the work of the organisations that there is no single corporate governance system that can be applied universally. Each country has its own historical and cultural background and hence corporate governance practices have to be adopted sensibly. The qualitative study in Chapter Three also includes an evaluation of the effectiveness of the audit committee in Hong Kong, which is an important device for improving corporate governance. Despite the fact that it has been a requirement in the UK and in some other countries that there must be an audit committee on the board of every listed company, Hong Kong only introduced this requirement with effect from 1 January 1999. Therefore, it is of

interest to find out why Hong Kong is lagging behind others countries in this respect and to assess the effectiveness of this corporate governance device. As with Chapter Two, conclusions are drawn from the qualitative analyses at the end of Chapter Three and recommendations are made in Chapter Seven for further improvements to corporate governance practices in Hong Kong.

Chapter Two finds that Hong Kong has not adopted all of the UK's corporate governance practices. In addition, the independence of the non-executive directors in Hong Kong is questionable and the quality of the board is found to be in need of improvement. One of the findings in Chapter Three is that there is no single 'best' corporate governance system that can be applied anywhere in the world. These findings might be due to the existence of differing cultures and historical backgrounds and corporate ownership structures in different countries. Culture and the nature of the corporate ownership structure are likely to play a role in affecting corporate performance. In particular, since Hong Kong is an oriental city comprised of mostly Chinese people and since Hong Kong companies are family-owned and controlled, it is interesting to explore whether this Chinese "family" culture has been influenced by Western culture, given that Hong Kong had been under the sovereignty of the UK for many years, until 1997. Before proceeding with the quantitative study, a literature review of the culture and ownership structure aspects of corporate governance is provided in Chapter Four. In particular, the "five cultural dimensions" of Hofstede are discussed, from which it may be argued that the "long-term orientation" dimension is responsible for the fast rate of growth in most of the East-Asian economies in the latter

part of the twentieth century (Hofstede, 2001, pg.351). The “long-term orientation” index value of Hong Kong is 96, which ranks second after China’s index value of 118. The index values of the US and the UK are 29 and 25 respectively, which ranks them seventeenth and the eighteenth out of the 23 countries in the “long-term orientation index value study” (Hofstede, 2001, pg.336). In computing the index, “the importance of family” is the component which accounts for the high index values (Hofstede, 2001). These index values help to explain and reinforce the conclusions of this research that the Chinese culture in Hong Kong, and its family-owned corporate structure, have an impact on corporate performance in Hong Kong.

In addition to outlining the five cultural dimensions of Hofstede, Chapter Four reviews the academic literature on corporate governance, in particular, on the relationship between managerial ownership and corporate performance. So far most empirical studies of the relationship between ownership and performance have analysed data from the US or the UK (e.g. Morck et al., 1988; Short and Keasey, 1999). Limited studies have been performed in the Asian context (e.g. Mak and Li, 2001). In Chapter Four, the literature on corporate governance is reviewed, with particular emphasis placed on the “convergence of interest” hypothesis of Jensen and Meckling (1976), the “entrenchment effect” argument of Fama and Jensen (1983), the “combined effect” argument of Morck et al. (1988) and the “endogeneity issue” of Cho (1998). The literature review in Chapter Four provides the theoretical background knowledge for the empirical part of this research.

La Porta et al. (1999) and Claessens et al. (2000) document the fact that most East-Asian corporations have a concentrated form of ownership and that most of them are family-owned and controlled. It is thus doubtful whether the findings of the prior research can be applied to the East-Asian environment, where the ownership structure is very different from that of the US and the UK. Hong Kong is, in fact, a prime example of an economy dominated by concentrated family ownership in the corporate sector. The quantitative part of the thesis investigates the impact of ownership structure on corporate performance, as measured by the relationship between managerial ownership and firm performance, using data on Hong Kong listed companies as the evidence. The aim is to identify the relationship and to ascertain whether it is different from the findings in the literature in the Anglo-American context. OLS regressions are performed on a set of panel data which consists of 1,406 firm-year observations of Hong Kong listed companies for the period from 1995 to 1998. Chapter Five describes the research methodology, including the hypotheses tested, the method of data collection and the use of OLS regression on the panel data.

In the first part of Chapter Six, OLS regression analyses are performed on the panel data of 1406 firm-year observations to determine the relationship between managerial ownership, various corporate governance variables, and firm performance during the period from 1995 to 1998. This study finds that the relationship between managerial ownership and firm performance is non-linear and cubic in nature. The particular pattern found is “entrenchment-alignment-entrenchment”, that is, at low levels of managerial ownership, managers’ interests become entrenched, resulting in a reduction

in firm performance. When managerial ownership increases further, managers then align their interests with their companies, resulting in better firm performance. The alignment range is found to be approximately between the levels of 16% and 62% of managerial ownership. When managerial ownership further increases to levels above 62%, managers' interests become entrenched once again, resulting in deteriorating firm performance. This pattern of "entrenchment-alignment-entrenchment" supports the "combined effect" argument of Morck et al. (1988). That is, the alignment range supports the "convergence-of-interest" hypothesis of Jensen and Meckling (1976) while the two entrenchment ranges support the "entrenchment" effects suggested by Fama and Jensen (1983) and La Porta et al. (1999). The wide range of alignment found in this study is consistent with the high score of the "long-term orientation" index for Hong Kong due to its Chinese culture and the importance of family (Hofstede, 2001).

However, the pattern found in this study ("entrenchment-alignment-entrenchment") is the reverse of that found in the UK by Short and Keasey (1999) and in the US by Morck et al. (1988). They both found an "alignment-entrenchment-alignment" relationship in their studies. This suggests that the concentrated ownership structure in Hong Kong affects the relationship between managerial ownership and firm performance in a different way, compared to the less concentrated ownership structures in the UK and the US. This finding is also supported by the suggestion of the recent study of Fan and Wong (2002) that studies based on UK or US data are not

necessarily applicable to East-Asian corporations due to differences in the degree of ownership concentration.

Apart from finding a reverse pattern of the relationship between managerial ownership and firm performance when compared with the studies of Morck et al. (1988) and Short and Keasey (1999), the OLS regressions in Chapter Six also find that board size, board composition and directors' remuneration do not have any significant impact on the performance of Hong Kong companies, though they are important corporate governance variables and, in some prior literature, significant results are obtained. This indicates that these variables have a different impact in the Hong Kong environment. For example, the number of non-executive directors on Hong Kong boards are low in comparison to the US and the UK, and they are very often not truly independent, while directors' remuneration packages are often not governed by remuneration committees. The results from both the qualitative and the quantitative analyses suggest that board structure and quality are areas for improvement in the corporate governance regime in Hong Kong. The detailed recommendations arising from this are discussed in Chapter Seven.

Another aim of the empirical study is to ascertain whether the East-Asian financial crisis had any effect on the relationship between managerial ownership and corporate performance. The second part of Chapter Six reports the results of OLS regressions in which the original sample was partitioned into the pre-crisis period of 1995-1997 and the post-crisis year 1998. The regression analyses are also performed on the

individual years 1995, 1996, 1997 and 1998 respectively. The results suggest that the different macro-economic environments prior to and after the crisis, and in individual years, did affect the relationship. During prosperous years (1996 and 1997) the convergence effect is more dominant. For most of the ownership ranges, managers align their interests with those of their companies. However, they become entrenched at very high levels of managerial ownership, and this behaviour is even more intense during the difficult times after the East-Asian financial crisis in 1998 and in the less prosperous year of 1995. The findings from this chapter suggest that the East-Asian financial crisis did play an important role in affecting the relationship between managerial ownership and firm performance.

The thesis concludes in Chapter Seven by summarizing the findings from the qualitative analyses and the empirical studies in all of the previous chapters. Recommendations are made by reference to the findings for improvements in corporate governance principles and practices in Hong Kong, in order to speed up the recovery process. For example, since that the results show that at high levels of managerial ownership (more than 62%), there is an entrenchment effect; if it is possible to control the management shareholding (say, to maintain it within the alignment range of between 16% and 62%), the accounting return can be maximised. Moreover, should a company's managerial ownership be highly concentrated (say, more than 62%) the company should pay even more attention to improve its corporate governance practices in order to enhance its performance. The need to improve corporate governance is even more crucial during difficult periods as it is found that the East-Asian financial

crisis did result in more entrenchment effects and deteriorating firm performance. The areas for attention include improving the effectiveness and the quality of the board and the audit committee. The proportion of independent non-executive directors on the board should also be increased and their independence should be ensured. Companies should also consider setting up a remuneration committee. These recommendations are derived from the findings from the qualitative analyses and are reinforced by the results in the empirical studies in the preceding chapters.

1.3 Contributions of the Study

This thesis contributes to the literature on corporate governance in the following ways:

1. Filling a gap in the academic literature:

Most empirical studies to date have been based on US evidence. According to Shleifer and Vishny (1997, pg.740): *“Most of the available empirical evidence [on corporate governance]...comes from the United States...Unfortunately... there has been extremely little research done on corporate governance around the world...”* However, the ownership structure in the US is quite different from that in many other countries where the structure takes a more concentrated form (La Porta et al., 1999). For example, the ownership structure in most East-Asian countries is characterized by family-ownership and control, in contrast to the more diffuse form of ownership in the UK and the US (Claessens et al., 2000).

There has been limited research performed in concentrated ownership environments. One of the few empirical studies using a concentrated ownership structure as evidence is that of Mak and Li (2001). However, it does not follow that the results based on Mak and Li’s Singapore evidence are representative of all other countries with concentrated ownership. This is because, apart from family members, the Government is another important blockholder in Singaporean corporations. The corporate ownership structure in Singapore can best be described as a mixture of family-based and Government-based ownership, rather than just family-based ownership (Mak and Li, 2001).

This research fills in a gap in the literature by examining the relationship between managerial ownership and firm performance in a concentrated family-owned form of corporate structure, using Hong Kong listed companies as evidence. The results show that the relationship is different from the findings of UK, US and also Singaporean studies.

2. Demonstrating that the family-controlled ownership structure in Hong Kong has an effect on the relationship between managerial ownership and firm performance:

Based on the regression results of 1406 firm-year observations of Hong Kong listed companies from 1995 to 1998, it is found that under the family-controlled ownership structure in Hong Kong, the pattern of the relationship between managerial ownership and firm performance is “entrenchment-alignment-entrenchment”. This is in contrast to that (“alignment-entrenchment-alignment”) found in the UK by Short and Keasey (1999) and in the US by Morck et al. (1988). While this finding supports both the “convergence of interest” hypothesis of Jensen and Meckling (1976) and the “entrenchment” effects argued by Fama and Jensen (1983), the opposite pattern from that found in UK and US studies suggests that ownership structure affects the relationship between firm performance and managerial ownership under different ownership ranges. This finding is also supported by the argument of Fan and Wong (2002) that studies based on UK or US data are not necessarily

applicable to East-Asian corporations due to differences in the degree of ownership concentration.

3. Demonstrating that culture and historical background have an impact on the pattern of the relationship between managerial ownership and firm performance:

Apart from finding a reverse form of relationship in Hong Kong (“entrenchment-alignment-entrenchment”) when compared with the UK and US studies (“alignment-entrenchment-alignment”), it is also found that the range of alignment of the relationship in Hong Kong is very wide (between the levels of approximately 16% and 62% of managerial ownership). This can be explained by the “long-term orientation” dimension of Hofstede’s studies on culture. The family-oriented Chinese culture in Hong Kong is beneficial to firm performance as evidenced by the fast rate of economic growth in most of the East-Asian countries in the latter part of the twentieth century (Hofstede, 2001). This supports the finding in this research that there is a wide range of alignment between managerial ownership and firm performance: under the family-owned corporate structure, firm performance improves when managerial ownership increases and this occurs at most of the ownership levels (from 16% to 62%). The aggregate result of individual firms’ improvement in performance is economic growth. As suggested by Hofstede, this is brought by the “long-term orientation” of the “five cultural dimensions”, though he also recognises that it is difficult to prove this link (Hofstede, 2001).

4. Demonstrating that macro-economic conditions affect the nature of the relationship between managerial ownership and firm performance:

Most previous studies on the relationship between managerial ownership and firm performance do not consider the possible impact of macro-economic conditions. This research analyses the impact of the East-Asian financial crisis on the relationship between managerial ownership and firm performance. It is found that the convergence effect is stronger in the prosperous years, as shown by the wider alignment range of the regression results for the data before the East-Asian financial crisis (1995-1997). The entrenchment effect is, however, more prominent during the difficult times as indicated by the narrower range of alignment in the regression results for the year after the crisis (1998).

5. Highlighting deficiencies in the nature of board structure and remuneration in the Hong Kong context:

Apart from managerial ownership, which is the key explanatory variable used in the regression analyses in this study, the board structure and remuneration variables are also used as independent variables to control for their possible effects on firm performance. It is found from the regression analyses that board size, board composition and directors' remuneration do not have any significant relationships with firm performance. This finding is also supported by the qualitative analyses performed in this thesis. The results suggest that these variables have a different impact in the Hong Kong context in

comparison to other countries. For example, the number of independent non-executive directors is not sufficient and very often they are not truly independent, and the remuneration of directors is not governed by any committees. These are possible reasons which could explain why the board structure and remuneration variables, which are found in some studies to have significant relationships with firm performance in some countries, do not explain firm performance in Hong Kong. These are the areas for improvement in corporate governance practices in Hong Kong, which may serve to enhance corporate performance.

On the whole, the studies performed in this thesis find that the pattern of the relationship between managerial ownership and firm performance in Hong Kong is different from that found in US and UK studies. The findings contribute to the literature on corporate governance and add weight to the view that empirical results based on US and UK evidence are not necessarily applicable to the East-Asian context due to the different form of ownership structure, and also the different cultural and historical backgrounds. Macro-economic conditions may also exhibit influences on the pattern of the relationship between managerial ownership and performance. The results from both the quantitative and the qualitative analyses in this thesis support the view that there is no single best corporate governance model that can be applied universally. It follows that each entity has to design a corporate governance system that suits its own culture, ownership structure and corporate environment in order to optimize firm performance.

Chapter Two

Historical Development and Comparison of Corporate Governance Regimes

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2.1 Chapter Objectives

Governments and companies in various nations, as well as individual and institutional investors, have become more aware of the importance of corporate governance in recent years. In Western countries, such as the United Kingdom (UK) and the United States (US), corporate governance rules are widely recognized to be better developed than in other countries, especially those from emerging nations. It is argued by international investors that the East-Asian financial crisis in late 1997 was caused by inadequate financial disclosure and lack of corporate transparency (Tsui and Gul, 2000). After the financial crisis, all the East-Asian countries have come to regard corporate governance as an important issue and have put it further up their policy agendas (Chow, 2000).

What is corporate governance? Why is it so important? In what aspects are the corporate governance systems in the UK and the US different from other countries? This chapter begins by defining corporate governance and identifying its importance. It is followed by an examination of the historical development and characteristics of the corporate governance regimes in the UK and Hong Kong, and then makes a comparison between them. In studying corporate governance, it is necessary to explore the system in the UK as a benchmark because it is recognized over the world to have a well-developed set of guidelines for corporate governance (Chow, 2000). Hong Kong, which was a colony of the UK for one and a half centuries, has adopted most of its law and regulations from the UK. However, mainly due to differences in the cultural backgrounds of the two countries, there are quite a number of differences

in the code of best practice of Hong Kong compared to that of the UK. Hence, one of the aims of this chapter is to perform a qualitative analysis by comparing the two systems in order to ascertain the areas where Hong Kong is not following the UK corporate governance practices; and thereby to identify the possible areas for further improvements in the Hong Kong corporate governance system.

The comparative analysis is also extended to the corporate governance systems in other jurisdictions. Key features of the corporate governance practices from these jurisdictions are identified. Comparisons are then made by references to the studies carried out by various consultancy firms and organisations specialising in corporate governance research. The jurisdictions covered under the comparative study include the two countries recognised to have ‘better’ corporate governance systems: the UK and the US; leading countries in Europe and Asia: France, Germany and Japan; the “four little dragons” in East-Asia: Korea, Singapore, Taiwan and Hong Kong and also Hong Kong’s home country: the People’s Republic of China (PRC).

Conclusions are drawn from the qualitative analyses in this chapter with recommendations made in Chapter Seven for further improvements in the Hong Kong corporate governance system.

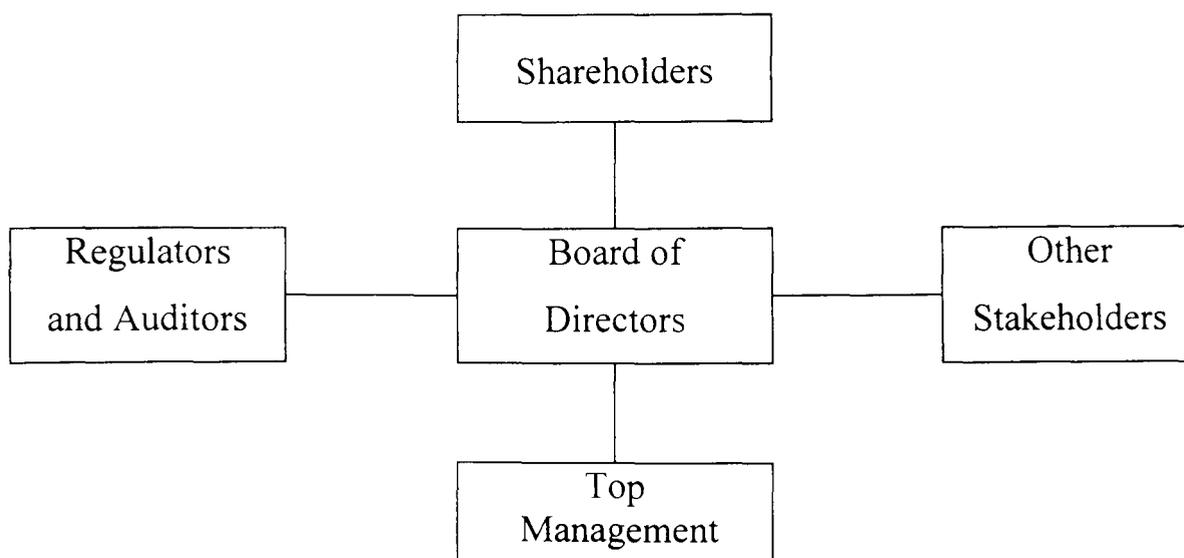
2.2 What is Corporate Governance?

2.2.1 Definition of Corporate Governance

Tricker (1995) described Corporate Governance as “the exercise of power over the corporate entity”. Corporate governance can be broadly defined as a set of interactions among key participants in a corporation, by which the broad objectives of the corporation are determined, the means of reaching those objectives are agreed and performance is evaluated. The key participants being mainly the management, the board of directors, the owners and the other stakeholders (OECD, 1998).

Corporate governance can also be defined as a system by which companies are run. At the centre of the system is the board of directors. Their actions are subject to law, regulations and the shareholders in general meetings. The shareholders in turn are responsible for appointing the directors and the auditors. The relationships among the parties can be summarized in Figure 2.1 (Tricker, 1995):

Figure 2.1 The Relationships and Boundaries of Corporate Governance



It can be observed that corporate governance involves a set of relationships among a company's management, its board of directors, its shareholders and other stakeholders (e.g. employees, customers, creditors, suppliers, communities and societies). These relationships are subject, in part, to law and regulation and, in part, to voluntary adaptation. It provides the structure through which the shareholders, directors and managers set the broad objectives of the company, the means of attaining those objectives and the monitoring of performance.

2.2.2 Importance of Corporate Governance

The board of directors is generally regarded as the central governing body which is concerned with supervising and monitoring performance and ensuring accountability of management to shareholders and other stakeholders. There has been increasing concern over what constitutes good principles and codes of best practice for corporate governance (Chow, 1996). There have also been studies indicating that a firm's corporate governance structure affects its disclosure behaviour and the quality of disclosed information (e.g. Forker, 1992).

The quality of corporate disclosure will influence the information used in making investment and loan decisions, which will affect the performance of the companies concerned. The Working Group on International Financial Crisis of the International Organization of Securities Commission (IOSCO) has stressed that adherence to improved international disclosure rules is an essential element for reforming the international financial architecture (IOSCO, 1998). Strengthening the financial

infrastructure and corporate governance system, including more corporate disclosure, are important measures for improving corporate performance.

The drive to improve international corporate governance standards has been taking place at both the national and supranational levels. For example, the OECD plays an active role in enhancing corporate governance. The OECD Principles of Corporate Governance, published in May 1999, have become the focal point of official efforts. The OECD Principles were essentially based on existing legal and regulatory arrangements and best practice among OECD member countries. The Principles are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries. They also aim to provide guidance and suggestions to stock exchanges, investors and corporations that have a role in the process of developing good corporate governance (OECD Principles, 1999). Support for this OECD project has been reaffirmed by various international organizations as part of the effort to construct a more sound international financial architecture after the East-Asian financial crisis. Other organizations, such as the International Monetary Fund and the World Bank, also use the OECD Principles as a point of reference (Thompson, 1999). The initiatives that are undertaken by the OECD and other international organizations are discussed further in Chapter Three of this thesis.

Specific corporate governance structures have also been recommended by various regulatory bodies, such as the United States Treadway Commission in 1987 and the

United Kingdom Cadbury Committee in 1992 (to be discussed in later sections of this chapter). However, while the system of corporate governance in the US and the UK reflects the separation of ownership and control and the diffuse nature of shareholdings in these countries, in most East-Asian countries ownership and control are more closely aligned, giving rise to different systems of corporate governance. Claessens et al. (2000) report that most East-Asian countries are characterised by concentrated corporate ownership structures that are mostly family owned and controlled. Hong Kong is an example of such an ownership structure. In Hong Kong, many listed companies are majority-controlled by a family or an individual (HKSA, 1995). The ten wealthiest families in Hong Kong owned 46.8 percent of the total market capitalization of the Hong Kong Stock Exchange in 1996 (Xiang, 1996). Also, the scope of Hong Kong's corporate disclosure requirements is much narrower than those in the US and other Anglo-Saxon countries (Gray and Vint, 1995). The nature of corporate ownership in East-Asia and the East-Asian financial crisis have raised concerns among governments, professionals and academics about the quality of corporate governance regimes and whether they can provide the platform for a sustained recovery of economies and corporations in the region. A quantitative study will be performed in this thesis to determine the relationship between managerial ownership and firm performance under the concentrated family ownership structure in Hong Kong; and the effect of the East-Asian financial crisis on the relationship.

Given the differences in culture and forms of corporate ownership and control between Western and East-Asian countries, the corporate governance systems adopted

in Western countries may not be applicable in East-Asian countries. Nevertheless, it is beyond doubt that good corporate governance regimes, whether in the West or in the East, can help to reinforce the confidence of investors, reduce the cost of capital and ultimately induce more stable capital flows. These are important ingredients to enhance corporate performance in the longer term. According to the Global Investor Opinion Survey performed by McKinsey & Company in co-operation with the Global Corporate Governance Forum on over 200 institutional investors in April and May 2002, corporate governance is of great concern for investors. A significant majority of respondents stated that they are willing to pay a premium for companies exhibiting high governance standards. The countries that have implemented governance-related reforms are welcomed by investors. Corporate governance is important and it is at the “heart” of making investment decisions (McKinsey, 2002).

2.3 Historical Development of the Corporate Governance Regime in the United Kingdom

2.3.1 Background

Concern with what is now called “corporate governance” is not unique to the 1990s or the early years of the Twenty-first Century. In the 1970s, following the oil crisis of 1973 and the demise and restructuring of industrial giants such as British Leyland, Rolls-Royce, Tele-funken and Chrysler, fundamental questions concerning the adequacy of corporate stewardship and the discharge of duties by directors and senior management were topics of debate. The de-regulation of financial markets following the “Big Bang” in 1986 made it easier for companies to raise the finance for takeover activities (Chow, 1996) but a number of companies which grew in this way collapsed during the late 1980s and early 1990s. Notable examples include the Maxwell Corporation in the UK and the Bond Corporation in Australia. The reasons for their failure included unsound business management and inadequate financial reporting.

The review of the UK’s corporate governance system started with the establishment of the Cadbury Committee in 1991. Its formation was again prompted by business scandals, such as the Guinness affair and the collapse of the Bank of Credit and Commerce International (BCCI). The intensive privatization activities in the UK in late 1980s and early 1990s and the promotion of an “equity culture” also provided further impetus for improvements to corporate governance.

Following the Cadbury Report, there were also further official reports: the Greenbury Report, the Hampel Report and the Turnbull Guidance. The reports are discussed in the following sections to assess their contribution towards the corporate governance regime in UK.

2.3.2 The Cadbury Report

Chaired by Sir Adrian Cadbury, the Cadbury Committee was formed in 1991 to review the UK's system of corporate governance from a financial reporting viewpoint. On 1 December 1992, the *Cadbury Report on the Financial Aspects of Corporate Governance* (the "Cadbury Report") was published.

A Code of Best Practice, which codified the elements of best practice already found within the then existing regime, was attached to the Report. The key elements of the Code were related to the structure and responsibilities of the board, the conduct of board meetings, the overall control of the business and the independence of external auditors. Details of the Code of Best Practice are listed in Appendix 1 at the end of the thesis.

Under the Cadbury Report, corporate governance is defined as the system by which companies are directed and controlled. Directors are responsible for the governance of their companies. The Cadbury Report stressed the responsibility and accountability of directors. The recommendations made by the Report are summarized as follows (Cadbury Report, 1992):

(a) Comply with the Code of Best Practice

All listed companies that are incorporated in UK are required to comply with the Code of Best Practice. The companies have to affirm compliance or, alternatively, state the reasons for non-compliance in their annual reports.

(b) Recommendations in relation to the directors

The intention of the Report was to increase the extent to which the directors are accountable to the shareholders. For example, there should be a separation of the chief executive and the chairman of the board. The executive directors' service contracts should not exceed three years, unless shareholders' approval is obtained. A nomination committee should be formed to assist the board in making future appointments of directors. Decisions must be made at the full board level at least on certain matters, such as investments, capital projects, financial and risk management policies.

The Report also recommended that there should be at least three independent non-executive directors appointed in each company. Ideally one of them should be the chairman. The board as a whole, through a formal selection process, should approve their nominations. These independent non-executive directors should be free from any business or financial connection with the company. They should not participate in any stock options or employee pension schemes. The independent judgement of these outside directors should be invaluable to the board, especially in cases of take-over bids, management buy-outs and the determination of directors' remuneration.

To perform their duties, the independent non-executive directors should have full access to the financial and management information of the company. They can also seek independent professional advice at the expense of the company. The majority of the audit committee and the remuneration committee should also be composed of non-executive directors.

(c) Recommendations in relation to the auditors

In order to eliminate the confusion about whether it is the responsibility of the directors or the external auditors to prepare the financial statements, directors are recommended to include a brief description of their responsibilities in preparing the accounts in the directors' reports. The audit should also be extended to include reporting on the internal control system of the company.

The Cadbury Report also intended to strengthen the independence of external auditors through the introduction of an audit committee. Auditors should have free access to the audit committee and to voice any concern about the management of the company as appropriate. Through the above means, the auditors' role in reporting to shareholders was to be reinforced.

(d) Recommendations in relation to internal control

A proper internal control system can provide reasonable assurance against material misstatement or loss. It was recommended that directors should state whether there is

a satisfactory system of internal control in the company concerned. Directors should report details such as the nature and main elements of the system, the process used in identifying major risks and the monitoring procedures.

(e) Other recommendations

It was recommended that the remuneration of the chairman and the highest paid directors should be disclosed. The basis of the remuneration should also be disclosed. In addition, it was suggested that formation of shareholder committees is desirable. These committees can serve as a direct link between the individual shareholders and the board of directors. Shareholders' opinions and concerns can be revealed to the directors through the committees.

2.3.3 The Greenbury Report

In February 1994 there was a lot of publicity concerning Mr. Cedric Brown, chief executive of British Gas, who received a 71.8 percent pay rise and a generous award of share options (Sum, 1999). In response to general concerns about the level of directors' remuneration, such as that of Mr. Brown, the Greenbury Committee was set up with the remit "to identify good practice in determining directors' remuneration and prepare a code of such practice". Chaired by Sir Richard Greenbury, the Committee published the Greenbury Report on Directors' Remuneration in July 1995. With effect from October 1995, all UK listed companies have had to comply with the "Greenbury Code" which deals with remuneration policies and remuneration

committees. The recommendations made by the Report are summarized as follows (Greenbury Report, 1995):

(a) Directors' service contracts

Directors' service contracts should be renewed every year. This annual review should be performed by a remuneration committee. Contracts should be altered if poor performance is discovered.

(b) Composition and power of remuneration committee

The remuneration committee should only consist of non-executive directors. It will determine on behalf of the board the remuneration policies. This suggestion was different from the approach taken in the Cadbury Report that the remuneration committee would make recommendations only and the actual decisions would be left with the board. The chairman of the remuneration committee should attend shareholders' meetings in order to explain the remuneration policies.

(c) Disclosure of directors' remuneration and benefits

It was suggested that complete and comprehensive information relating to the directors' pay and benefits should be made available to the shareholders. Any documents which are supplemental to the main service contracts should be made available for inspection, provided that they contain provisions such as bonus, incentive and pension schemes that will affect the cost to the company of employing the directors concerned.

(d) Restrictions on share options

Executive share options should not be issued for at least six months following a privatization or at substantial discounts to the market price. They should also be taxed as income rather than being treated as a capital gain.

2.3.4 The Hampel Report

The Hampel Committee on Corporate Governance was chaired by Sir Ronnie Hampel. The principal recommendations made by the Hampel Report in January 1998 were that directors should receive training when they are first appointed. Echoing a recommendation in the Cadbury Report, it suggested that a nomination committee should be formed and should have responsibility for the appointment of directors. In addition, at least one-third of the board should be comprised of non-executive directors. There should also be one senior independent director (other than the chairman) to whom concerns could be conveyed.

2.3.5 The Combined Code

The 'Combined Code', formally known as the *Principles of Good Governance and Code of Best Practice*, was published in June 1998. It embraces the works of the Cadbury, Greenbury and Hampel Committees. Compliance with the Combined Code was made a listing requirement by the London Stock Exchange. With effect from accounting periods ended on or after 31 December 1998, listed companies are

required to disclose in their annual reports how they have applied the principles and complied with the Code's provisions.

2.3.6 The Turnbull Guidance

Turnbull's final guidance on the implementation of the internal control requirements of the Combined Code ("the Turnbull Guidance") was published on 27 September 1999 by the Internal Control Working Party of the Institute of Chartered Accountants in England and Wales, which was chaired by Sir Nigel Turnbull. The Turnbull Guidance states that boards of listed companies should comply with the following:

- (a) assess how the company has applied the Combined Code ("the Code") principle D.2;
- (b) implement the requirements of the Code provisions D.2.1 and D.2.2; and
- (c) report on these matters to shareholders in the annual report and accounts.

Principle D.2 of the Code states that the board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets. Provision D.2.1 of the Code states that the directors should, at least annually, conduct a review of the effectiveness of the internal control system and should report to shareholders that they have done so. The review should cover all aspects of controls, including financial, operational and compliance controls, as well as risk management. Provision D.2.2 of the Code provides that companies that do not have an internal audit function should from time to time review the need for one.

The London Stock Exchange has endorsed the Turnbull Guidance and states that compliance with the Guidance will constitute compliance with Combined Code provisions D.2.1 and D.2.2 and that companies should provide appropriate narrative disclosure of how the Code principle D.2 has been applied.

The Guidance is intended to reflect sound business practice and one important effect is that it will require companies to focus on exactly what their business objectives are in order to ensure that the internal control system covers all relevant risks. The Guidance reinforces companies' continuous need to monitor and review the effectiveness of internal control and to have a risk management culture. Although the adoption of a sound internal control system does not necessarily mean that fraud can be prevented, it should assist in the detection of fraud at a stage before permanent damage has been done (Younghusband, 2000).

While this section discusses the historical development of the UK corporate governance regime, an evaluation and a comparison of it with the Hong Kong's and other countries' corporate governance systems are made in section 2.6 of this chapter; after discussing the development and features of the corporate governance systems of these countries in the two sections follow.

2.4 Historical Development of the Corporate Governance Regime in Hong Kong

2.4.1 Background

During the last two to three decades of the twentieth century, Hong Kong has developed into one of the world's major financial centres. The success of Hong Kong may be attributed to its free trade policy, its simple tax system and its user-friendly laws and regulations. In fact most of the laws and regulations in Hong Kong were adapted from the UK. However, the UK is more advanced in terms of the development of its codes of practice for corporate governance. The Hong Kong authorities only started to realise the importance of corporate governance in the mid-1990s, although the rate of progress since then has been fairly rapid (Chow, 2000).

In common with other developed financial markets, Hong Kong listed companies have also had their share of scandals. Most have involved related party transactions and misappropriations by the dominant shareholders, such as using company funds for personal purposes without disclosure in financial statements. This phenomenon is related to the so-called "family form" of ownership in Hong Kong. Analysis of the effect of the Hong Kong ownership structure on corporate governance is undertaken in later chapters of the thesis, while the sections which follow in this chapter analyse the development of the corporate governance regime in Hong Kong.

The enforcement of corporate governance in Hong Kong mainly rests with two sets of regulations. The one with legal effect is the Companies Ordinance, derived from the UK Companies Act. Other legislation includes the Securities and Futures Ordinance and the Protection of Investors Ordinance. The set of regulation without legal effect is the set of *Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong* (“the Listing Rules”). Although the Listing Rules do not have legal effect and rely on self-regulation by corporations, the most severe form of punishment can take the form of public censure (Chow, 1996).

While the Listing Rules form the basis of self-regulation for the directors and management, the accountancy professional body, namely the Hong Kong Society of Accountants (“HKSA”), has been monitoring the development of corporate governance in Hong Kong. A number of reports have produced in the past few years by the HKSA. Other professional groups have also performed studies and surveys on the topic. The findings and suggestions of these reports are discussed in this chapter.

2.4.2 The Listing Rules

The Listing Rules basically form a contract between the Stock Exchange of Hong Kong¹ and each of the listed companies in Hong Kong. Despite the fact that it has no legal effect, listed companies are expected to comply with the requirements listed in

¹ The Financial Secretary in Hong Kong announced in his 1999 Budget Speech that would be a reform of the Hong Kong exchanges in order to meet the challenges of the globalised market. Under the reform, the Stock Exchange of Hong Kong Limited, the Hong Kong Futures Exchange Limited and the Hong Kong Securities Clearing Company Limited merged under a single holding company, the Hong Kong Exchanges and Clearing Limited (HKEx). The merger was completed on 6 March 2000.

the document. In particular, companies have to comply with the Code of Best Practice attached as Appendix 14 of the Listing Rules. Otherwise, they have to state their reasons for non-compliance. The Code of Best Practice is adapted from the one in the UK. A copy of the Code of Best Practice is attached as Appendix 2 at the end of the thesis.

In addition to compliance with the Code of Best Practice, the Listing Rules require every company to appoint at least two independent non-executive directors. Details of the directors' remuneration must be disclosed in the annual reports. Prospectuses and company announcements should be in a simple and standard format and in readable language. Companies are also required to set up audit committees.

Regarding financial reporting, listed companies incorporated in Hong Kong are required to comply with Appendix 7a of the Listing Rules, while listed companies incorporated elsewhere have to comply with Appendix 7b. These are actually the Listing Agreements between the listed companies and the Stock Exchange of Hong Kong.

Apart from the above general disclosure requirements, the Listing Rules also provide that listed companies should make a number of specific disclosures. For example, there should be an improvement in corporate communication to non-registered holders of securities. Listed companies should provide better financial reporting, for example, on the details of the designated deposit arrangements with financial

institutions in the People's Republic of China ("PRC"). Related party transactions also require specific disclosure in accordance with Practice Note No.19 issued by the Stock Exchange of Hong Kong. Each of these specific disclosure requirements is discussed below:

(a) Corporate communication with non-registered holders of securities

Many securities holders do not have their securities registered in their own names, which means that they will not receive the financial statements and other notices or correspondence from their invested companies. A non-registered holder is a person or company whose listed securities are held in the Central Clearing and Settlement System ("CCASS") and who has notified the company through the Hong Kong Securities Clearing Company that he/she/it wishes to receive corporate communications. In order to better protect these investors, listed companies are required to send, at their own expenses, copies of any corporate communications to any non-registered holders whose listed securities are held in the CCASS (Appendix 7, the Listing Rules). The corporate communications include annual reports, interim reports, notices of meetings, circulars and listing documents such as prospectuses.

(b) Designated deposit arrangements with financial institutions in the PRC

If listed companies have entered into designated deposit arrangements with financial institutions in the PRC, they have to comply with a number of disclosure requirements. Designated deposit arrangements are those arrangements where funds are placed with PRC financial institutions with instructions, or on the understanding

that, the funds will be on-lent to a third party borrower. The financial institution in the PRC has no liability to repay the deposit or is only liable for a certain percentage of the amount not repaid by the borrower.

Under such arrangements, the listed companies must classify the bank deposits as accounts receivable instead of “normal” bank deposits. An explanatory note should be made to set out the detailed description of the deposit arrangements, the nature of the deposit and the liabilities of the financial institution and the borrower respectively in case of default. An explanatory note in the financial statements is also required when the repayment terms of the principal and/or interest have been rescheduled and the amounts are material. By making the above disclosures, companies will enable investors to appraise the associated risks in their investments.

(c) Related party transactions

When a company makes an advance to an entity, or provides financial assistance and guarantees to affiliated companies, which exceed 25 percent of the company’s net assets, disclosure has to be made. This is in accordance with The Stock Exchange of Hong Kong’s Practice Note No. 19, which details the disclosure requirements of related party transactions.

Apart from the above general and specific disclosures, which are currently required, the Stock Exchange of Hong Kong has also proposed a number of changes in disclosure requirements. For example, more frequent quarterly disclosures are

proposed instead of just having the announcements of interim and final results. It is also proposed that if a company plans to commit significant resources to an activity which is a non-core business, disclosure should be made. In addition, it is proposed that disclosures should be made if there are significant exposures to countries or markets that are experiencing financial upheaval. All these proposals are aimed at improving corporate transparency and enabling investors to better assess the financial position and future potential of their investments.

2.4.3 The Codes on Takeovers and Mergers and Share Repurchases

The *Codes on Takeovers and Mergers and Share Repurchases* (“the Takeovers Code” and “the Share Repurchase Code”) (collectively “the Codes”) are another major set of voluntary rules of corporate governance in Hong Kong. The Codes are issued by the Securities and Futures Commission (“the SFC”). They are applicable to public companies, whether they are listed on the Hong Kong Stock Exchange or not. The general objective of the Codes is to achieve fair treatment of all the shareholders who are affected by takeover and merger transactions and share repurchases. They also aim at ensuring the timely disclosure of adequate information to the shareholders concerned in the above transactions and events. In such a way, a fair and informed market in the shares of the companies affected by the above activities will be ensured. The Codes also provide an orderly framework within which takeovers, mergers and share repurchases are to be conducted.

In common with the Listing Rules, the Codes do not have the force of law. Although they are voluntary in nature, the Listing Rules state that non-compliance with the Codes may result in suspension of trading of the shares on the Stock Exchange of Hong Kong. Other sanctions include private reprimand, and the issuance of a public statement, involving criticism and public censure. The case may also be reported to the SFC and other regulatory bodies such as the HKSA and the Law Society. A “cold shoulder” order may also be issued which requires the dealers and financial or legal advisers to stop acting for any person who has failed to comply with the Codes for a certain stated period of time.

The Codes are administered by the Takeovers and Mergers Executive, the Takeovers and Mergers Panel and the Takeovers Appeal Committee. The roles and functions of each of them are described below:

(a) The Takeovers and Mergers Executive

This body consists of executive staff of the Corporate Finance Division of the SFC. The executive staff are available for the day-to-day administration of the Codes and for consultation. Where the relevant parties and their advisers are doubtful about the application of the Codes, the executive staff provide advice and give rulings as appropriate.

(b) The Takeovers and Mergers Panel

If any party is not satisfied with the ruling made by the Executive, the Panel will, at the request of the party concerned, review the ruling. The Panel will also consider

important or difficult cases referred to it by the Executive and hear disciplinary matters in the first instance.

(c) The Takeovers Appeal Committee

This Appeal Committee reviews disciplinary rulings of the Panel. It determines whether the sanction imposed by the Panel is unfair or excessive in the circumstances, based on the finding of the facts by the Panel.

Apart from these voluntary Codes, there are also other regulations governing the takeover, merger and share repurchases activities of public companies in Hong Kong. These include the Protection of Investors Ordinance, the Securities and Futures Ordinance and relevant sections and schedules in the Companies Ordinance. Under the Common Law system in Hong Kong, a civil claim can also be made under tort of negligence or fraud where appropriate. However, it should be reiterated that a good corporate governance system and climate depends much on voluntary rather than forced compliance.

The existence of various Ordinances, the Listing Rules and the Codes does not mean that everything is perfect and that there is no room for improvement. With the continuously changing financial and commercial environment, changes are likely to be made. The following sections describe the efforts made by accounting professionals in the development and improvement of the corporate governance framework in Hong Kong.

2.4.4 Reports by the HKSA Corporate Governance Committee

Although Hong Kong only started to realise the importance of corporate governance in the mid-1990s, there has been a speedy development of corporate governance rules since then. The corporate governance regime in Hong Kong is actually now widely regarded as a fairly good benchmark for the other Asian countries to catch up with or to follow (Chow, 2000). Many of the contributions have been made by the Hong Kong Society of Accountants (“HKSA”), which has been pro-active in promoting corporate governance good practice since 1995. Realising that the profile of shareholders and the corporate culture in Hong Kong are different from those in Western countries, the HKSA Council saw the need to approach the subject of corporate governance from a Hong Kong perspective. A Working Group on Corporate Governance was formed in March 1995, comprised of members who worked in the public sector, auditors from the Big-6 (now Big-4) accounting firms and from academia. Since then, the Working Group (which became the HKSA Corporate Governance Committee in 1998) has produced a number of reports.

The first report was produced in December 1995 and contained nineteen recommendations. In January 1997, the second report was published, providing an update to the first report and containing further recommendations. In December 1997, *A Guide for the Formation of An Audit Committee* was published and was adopted by the Stock Exchange of Hong Kong in May 1998. In November 1998, *A Guide for Directors’ Business Review in the Annual Report* was published, providing a checklist for the preparers of financial statements. In November 1999, another publication

entitled *Directors' Remuneration: Recommendations for Enhanced Transparency and Accountability* was produced, aimed principally at improving disclosure of directors' remuneration. There were also subsequent publications in 2000 to 2002. The HKSA also co-hosted a Roundtable with the OECD, the World Bank, the Securities and Futures Commission and the Stock Exchange of Hong Kong in 2000 in Hong Kong.

The first and the second reports are discussed in the sections which follow, while the other reports and initiatives are discussed in Chapter Three of the thesis.

(a) First Report of the Working Group on Corporate Governance

In December 1995, the *First Report of the Working Group on Corporate Governance* ("First Report") was published. The Working Group took the view that while rules and practices may need to be tightened in certain respects, it is equally important for the regulators to actively monitor and enforce compliance with rules and practices that have been laid down. On the other hand, it was also regarded as important that a balance should be struck between compliance and performance, so that company performance would not be stifled by over-regulation.

Since the Cadbury Report had provided an in-depth study of the financial aspects of corporate governance, the Working Group did not see the merit of 're-inventing the wheel' in considering the corporate governance requirements for Hong Kong. Therefore, the Working Group based its advice on the Cadbury Report and addressed the relevance of the recommendations of the Cadbury Report to the Hong Kong

situation. The aim was to identify areas which could and should be adopted in Hong Kong.

The Working Group had restricted the study in its First Report to three areas of the Cadbury Report. The three areas were the control of the board, financial reporting, and perception and effectiveness of the audit. After drawing up a summary of the Cadbury Report recommendations in the three areas, detailed discussions were held as to their relevance to the Hong Kong context. The Working Group found that a number of the recommendations of the Cadbury Report had, in fact, already found their way into the Listing Rules or the Code of Best Practice in Hong Kong. However, at the same time, given the corporate governance culture in Hong Kong, the application of the Cadbury concept of the independence in the board was regarded as difficult to achieve and as a long-term objective. Nevertheless, the Working Group's view was that ways of increasing board effectiveness should be investigated in Hong Kong's "dominant board" environment, which was thought likely to continue for the foreseeable future (First Report, 1995).

The First Report came up with nineteen recommendations. They are as follows:

1. Members of the same family should not make up more than half of the voting members of the board.
2. There should be mandatory appointment of a Chief Financial Officer ("CFO") at board level. The CFO should have designated responsibility for the finance

- function of the company and should be a signatory to the accounts on behalf of the board. The CFO should also have the right of access to the Audit Committee, where there is one.
3. There should be at least four board meetings per year, with six prescribed as good practice.
 4. Directors' service contracts should not exceed three years without shareholders' approval.
 5. Declaration of independence by the independent non-executive directors upon appointment and annually.
 6. Noting that some companies may have difficulties in recruiting truly independent non-executive directors, the Working Group proposed that disclosure of a past relationship, where one existed, may be acceptable, rather than to rule out such persons from recognition as an independent director. There should be a time scale (of say, one to two years) for the restriction on past relationship or transactions.
 7. The independence criteria of the independent non-executive directors should be actively monitored by the Stock Exchange of Hong Kong.
 8. The Code of Best Practice should be strengthened and refined in a number of aspects:
 - i. The board should have a formal schedule of which matters can be delegated to the executives and which are required to be put forward to the board.

- ii. There should be more direction to the director as to his right to information, and the company secretary as to his duty to provide information.
 - iii. Non-executive directors should be provided with regular information they need to ensure compliance, to enhance performance, and to set strategies and direction. This includes information on directors' duties, board procedures, recent issues of concern, the business of the company, its financial performance, etc.
 - iv. The board should be encouraged to draw up a code of ethics or statement of business practice so that all directors and employees know the standard of conduct expected of them.
 - v. Companies should be encouraged to provide internal and external training courses for directors, and induction courses to all newly appointed board members.
 - vi. The notification to the Stock Exchange of the resignation or removal of an independent non-executive director should be extended to all directors.
 - vii. The right of the independent non-executive directors to have access to separate professional advice at the expense of the company should be qualified. The board should be fully aware of such advice being sought and should be able to refuse such requests on reasonable grounds.
9. Directors should sign a statement of responsibility for preparing the accounts.

10. The annual report should contain a general statement on corporate governance.
11. The number of and attendance at board meetings should be disclosed in the annual report.
12. In addition to the audit fee, other fees paid to the auditors should be disclosed in the accounts. This can increase the transparency of the auditors' independence.
13. Auditors should be given the right to review other financial reports or information issued together with the audited financial statements. They can also report any misleading information contained therein or where it is inconsistent with the audited financial statements.
14. There can be an inclusion in the annual report of a statement of going concern by directors, reported on by auditors.
15. An inclusion can be made in the annual report of a statement on internal control by directors, reported on by auditors if material weaknesses were noted during the course of their audit.
16. There is a requirement of an Audit Committee with defined functions.
17. There is a requirement of an internal audit function.
18. The interim report should include a balance sheet and cash flow information, and be reviewed and reported on by auditors.
19. Members should be provided with ethical guidance on the interface between the board and senior management, and in particular, the role of the group finance director or the CFO in a family dominated board.

In the First Report, the Working Group considered that the Nomination Committee and Remuneration Committee were impractical or incompatible with the corporate governance environment in Hong Kong at that time. Due to the existence of dominant shareholders, it was believed that a Nomination Committee would not serve an effective purpose in Hong Kong. Regarding the Remuneration Committee, the Working Group felt that “a breathing space” of at least two years should be given before revisiting the subject, since Hong Kong was still in a catching-up phase in terms of disclosure of directors’ emoluments.

(b) Second Report of the Corporate Governance Working Group

After the release of the First Report and upon receiving the comments from various interested parties, the Working Group decided that it would be useful to conduct a statistical survey of all the 553 listed companies in Hong Kong. This would provide a factual basis for further development and implementation of the proposals suggested in the First Report.

The statistical survey mainly covered the extent to which Audit Committees existed among the listed companies in Hong Kong, the extent of information disclosed on directors and substantial shareholders and whether the annual reports disclosed a designated finance director or a chief financial officer. In addition, since there were reservations and concerns over whether it would be practicable to limit the family members to not more than 50 percent of the board as suggested in the First Report, the

survey also covered the extent of connections between directors and major shareholders in Hong Kong listed companies.

The research findings are summarised as follows:

1. *Shareholding Control:*

- i. More than half (53 percent) of all listed companies had one shareholder or one family group of shareholders owning 50 percent or more of their entire issued capital.
- ii. More than three quarters (77 percent) of all listed companies had one shareholder or one family group of shareholders owning 35 percent or more of their entire issued capital.
- iii. Almost nine out of ten (88 percent) of all listed companies had one shareholder or one family group of shareholders owning 25 percent or more of their entire issued capital.

The above observations confirmed the widespread view that the extent of control by one shareholder or one family group of shareholders was significant in Hong Kong listed companies.

2. *Control of the Board by the Major Shareholder and his Family:*

- i. Only around 9 percent of all listed companies had boards where 50 percent or more of the directors were themselves the major shareholders or related family members.

- ii. However, in almost all (96 percent) such cases, the shareholder(s) in question held 35 percent or more of the company's issued capital.

These observations indicated that despite the common existence of a dominant shareholder, the overwhelming majority of listed companies in Hong Kong had a balance between family and non-family directors on their boards. However, where members of the same family had majority representation on the board, the same family also tended to have effective control of the shareholding of the listed company.

3. *Control at the Executive Director Level:*

- i It was found that 30 percent of all listed companies had boards where 50 percent or more of the executive directors were themselves related to the family members or major shareholders.
- ii In addition, in 84 percent of such cases the shareholder(s) in question held 35 percent or more of the company's issued capital.

These findings indicated that controlling shareholders tended to appoint members of their family as executive directors to manage the companies on a full-time basis.

4. *Audit Committee:*

Approximately 2 percent of all listed companies disclosed that they had an Audit Committee.

5. Finance Director/Chief Financial Officer

It was found that nearly one-third of all listed companies had a designated Finance Director at the board level and nearly half of them were members of the HKSA.

Based on the above findings, the Working Group came to the following conclusions and made the following recommendations in their Second Report:

1. Overview

The findings confirmed the generally held view that most listed companies in Hong Kong were subject to family or individual control by majority shareholders. However, the composition of the board indicated that they were not dominated by the major shareholders. The dominance of major shareholders was more significant at the Executive Director, that is, the top management level.

The Working Group recognised that with the mandatory introduction, via the Listing Rules, of the requirement that there must be at least two independent non-executive directors, significant progress had been made in improving transparency and achieving more balance in the board. However, at the same time, the Working Group also believed that, given the predominance and continuing existence of the controlling shareholder in Hong Kong's corporate environment in the foreseeable future, there was an ongoing need for effective forms of minority protection.

2. *Recommendations*

The Working Group reconfirmed the following recommendations that were made in its First Report:

i. Maintenance of at least 50 percent Non-family Directors on the Board

The Working Group continued to recommend, as self-regulatory good practice, that listed companies should try not to have more than half of the members on the board coming from the same family.

ii. Audit Committees

The Working Group supported the establishment of Audit Committees by listed companies.

iii. Finance Director/Chief Financial Officer (“CFO”)

The Working Group suggested that where the CFO did not possess the necessary skills and experience, he should be supported by a Chief Accounting Officer (“CAO”). This person should have a right of access to the Audit Committee. It would be appropriate for either the CFO or the CAO to be a professionally qualified accountant. Such qualification should also be disclosed in the annual report of the company.

iv. Other Observations and Recommendations related to Disclosures on Directors and Substantial Shareholders

The Working Group believed that further disclosures should be made mandatory by making relevant amendments to the Listing Rules. For example, family relationship(s) between directors and substantial shareholders not being directors should be disclosed. Executive directors, non-executive directors and independent non-executive directors should be clearly identified and disclosed respectively. The Working Group also suggested that the disclosure requirements of the substantial shareholders should be simplified, as the statutory provisions in this aspect were not reader-friendly. Guidance notes, with examples of disclosures, could be prepared by the regulators for reference by the substantial shareholders.

2.4.5 Other Corporate Governance Surveys

Apart from the HKSA, there are other organisations that are interested in the nature of corporate governance in Hong Kong and in enhancing its effectiveness. Among them, back in the early 1990s, the then Price Waterhouse (currently PriceWaterhouseCoopers) conducted a survey, the results of which were published in January 1995. Although the sample was only comprised of 100 Hong Kong listed companies, it demonstrated that accounting practices in Hong Kong had come to recognise the importance of corporate governance. In addition, the findings and recommendations made in the report highlight some of the corporate governance

characteristics of Hong Kong listed companies. These also provide some insights for structural improvements of the corporate governance system in Hong Kong. Some of the major findings and recommendations made in the report are summarised below:

(a) Findings

1. Full board meetings occurred typically every two months.
2. Almost half of the sampled companies separated the roles of the chairman and the chief executive.
3. 62 percent of the companies appointed more than two non-executive directors while 13 percent failed to meet the requirement.
4. One in three companies had formal policies on corporate governance and business ethics.
5. 20 percent of companies had remuneration committees. Some of them included non-executive directors.
6. 24 percent of the companies had audit committees.
7. Over 50 percent of the companies had an internal audit department.
8. Slightly less than half of the companies had formal policies for the release of price sensitive information.
9. 30 percent of companies did not maintain procedure manuals to help control the finance function and assist in asset protection.

It can be deduced from the above findings that the sample taken by Price Waterhouse is likely to have been comprised of those companies more prone to engage in self-

regulation or to have greater resources. The reason for making this deduction is that some of the Price Waterhouse findings conflict with the findings of the Second Report of the Corporate Governance Working Group, published in 1997. For example, on the issue of the existence of Audit Committees, the report by Price Waterhouse stated that 24 percent of the 100 companies surveyed had an Audit Committee, whereas the Second Report of the Corporate Governance Working Group reported that only 2 percent of listed companies had set up audit committees out of the full population of 553 listed companies (about 10 companies).

However, whether the above findings are highly reliable is not of the utmost importance. What is important is that in general the findings showed that at least some of the sampled companies were aware of the importance of corporate governance back in the mid 1990s. For example, the roles of the chairman and the chief executive were separated in some companies. In addition, some companies had started to form remuneration committees and some had formulated formal policies on corporate governance and business ethics. However, at the same time, the findings of the report demonstrate that there were a number of areas in need of substantial improvements, such as the disclosure of price sensitive information.

(b) Recommendations

1. Independent Non-executive Directors

The report recommended that the independent non-executive directors should be present in board meetings when discussions take place on issues where

conflicts of interests by the directors might arise. For example, when matters such as directors' remuneration, loans to directors and connected transactions were discussed in the board meetings.

2. *Remuneration Committee*

The report recommended that a Remuneration Committee should be formed to fix the remuneration of the directors. The total remuneration of each director and the basis of the calculation should be disclosed.

3. *Audit Committee*

It was recommended that an Audit Committee should be formed in every listed company. The Committee should be composed of three to five non-executive directors. At least two meetings should be held annually. The main functions would include reviewing the financial statements and monitoring the finance directors and the external and internal auditors. A climate of discipline and internal control should be created to reduce the opportunity for fraud.

4. *Other recommendations*

The report also made other recommendations, including the improvement of internal control measures to minimise and avoid fraud. It also suggested that more education should be provided for directors. The effectiveness of the annual general meeting as a means of communication between the board and

the shareholders was deemed to need further improvement. More timely disclosure of information was also encouraged in the report.

Some of the above recommendations made by the HKSA and Price Waterhouse have been effected in recent years. For example, a listed company was required to have an Audit Committee with effect from 1 January 1999. Some of the issues raised have also been put forward for further discussion by the HKSA, such as the Remuneration Committee. Further evaluation of the corporate governance system and areas for improvements are discussed in sections 2.6 and 2.7 of this chapter respectively.

2.5 Other Corporate Governance Regimes

This section highlights the major features of the corporate governance systems in a number of countries. The countries include the US, Germany, France, Japan, Singapore, Taiwan, Korea and the People's Republic of China (PRC). The results of the comparisons of these systems with that in the UK and Hong Kong are presented in section 2.6.

2.5.1 The United States

The US is similar to the UK in that it is also perceived as having a well-developed corporate governance system, despite the problems highlighted by the collapse of Enron in 2001. The major characteristics of the US corporate governance system are as follows:

The directors must be elected by the shareholders, while the executive officers, including the chief executive officer, are elected by the board. Every listed company must have an audit committee and it is required by the New York Stock Exchange that the audit committee should be composed solely of independent directors. The board can delegate the business to various committees, such as the audit committee, nomination committee and compensation committee.

The auditors, though in practice selected by the board, must have their appointment approved by the audit committee or ratified by the shareholders. In addition, the audit committee is responsible for reviewing the proposed remuneration of the auditors. In

some cases, the auditors' remuneration has to be formally approved by the audit committee.

Despite the well-developed set of corporate governance practices in the US, there have been a series of corporate frauds detected since the Enron case in 2001. These have prompted the US Government, regulators, professionals and academics to address the importance of ethics and the integrity of CEOs, directors and auditors. In response to the corporate scandals, the Sarbanes-Oxley Act was promulgated in 2002 with the aim of better protecting the US investors.

2.5.2 Germany

The main characteristic of Germany's corporate governance system is the "two-tier board" structure. The two-tier board comprises of the Supervisory Board and the Management Board. The Supervisory Board's functions include supervising and guiding the management in the best long-term interests of the company. It has the legal duty to appoint and to monitor the competence of the Management Board. It also has the power to approve annual accounts and propose the level of dividend for consideration in the shareholders' meeting. Appointment of auditors is made by it on the recommendation of the Management Board.

In larger corporations, about one-third to one-half of the representatives on the Supervisory Board are appointed by employees. The balance of power on the Supervisory Board is comprised of shareholders' representatives. In smaller

corporations, all representatives on the Supervisory Board are appointed by the shareholders. Very often, shareholders' representatives are nominated by the major banks, which usually are the majority shareholders in corporations.

The Management Board is responsible for developing the strategy of the company. Although it is not bound to accept instructions from the Supervisory Board, it must report at least quarterly to the Supervisory Board on its planned activities and the profitability and progress of the company.

The standard of corporate governance in Germany is relatively high among the European countries (see section 2.6 of this chapter). In January 2000, the German Panel on Corporate Governance published the *Corporate Governance Rules for Quoted German Companies*. The rules of this Code serve as general guidelines of corporate governance for quoted companies in Germany. The essential points of the OECD Principles of Corporate Governance of May 1999 were covered in the Code. Also, recognizing that the Supervisory Board and the Management Board of German companies have the decisive functions for corporate governance, the Code defines clearly the responsibilities and duties of the two boards. It also sets out other guidelines such as information and disclosure requirements, remuneration policy and the rules governing conflicts of interest. Corporations have to communicate in their annual report their acceptance and implementation of the rules in the Code (Corporate Governance Rules. 2000).

2.5.3 France

In contrast to the German system, French companies can choose to have a unitary or a two-tier board. Most listed companies in France adopt the unitary board system. Under the unitary board system, the president possesses the widest powers to represent and manage the company. The board takes a passive role. Yet, the board has the power to hire and remove the president. The board is also responsible for carrying out specific functions like finalising annual accounts, approving major decisions and authorising guarantees.

Under the two-tier system, the situation in France is similar to that in Germany. The Management Board possesses the full executive authority while the Supervisory Board takes the monitoring role. The Management Board also needs to report quarterly to the Supervisory Board on the activities of the company.

The French standard of corporate governance is also fairly high among the European countries (see section 2.6 of this chapter). In July 1999, a document entitled *Recommendations of the Committee on Corporate Governance* was published, referred to as the “second Vienot Report”, after the committee chairman Mr. Marc Vienot. It followed on from the first Vienot Report, published in July 1995.

The second Vienot Report in 1999 clarified certain recommendations made in the 1995 report and put forward further recommendations, for example, concerning aspects of the operations of board of directors, committees and financial disclosure.

The Report Committee recommended that listed companies specify clearly in their annual reports whether they comply with the recommendations in both the 1995 and 1999 reports, and that they should explain, if applicable, their reasons of non-compliance (Vienot Report, 1999).

2.5.4 Japan

The concepts of “family”, “obligation” and “consensus” have much affected the Japanese attitude towards corporate governance. The loyalty and trust that exists in business relationships has produced a unique corporate governance culture in Japan, which is based on long-term rather than on short-term considerations.

Financial institutions and business corporations hold most of the shares in Japanese companies, over 70 percent of which are not available for trading (Sum, 2000). The Japanese management board tends to be large in size, typically comprising 30 to 40 members, most of whom are full-time employees. Non-executive directors are usually seconded from other companies in the same corporate group and are themselves employees of the company. The president makes decisions about the promotion of senior employees and the appointment of auditors and, on retirement, nominates his successor. In addition, the president usually becomes the chairman, which is a more ceremonial position.

The Japan Federation of Economic Organizations (“Keidanren”) has a committee on corporate governance. In September 1997, it published a report entitled *Urgent*

Recommendations Concerning Corporate Governance, which set out a number of recommendations, taking into account the framework of the Commercial Law in Japan at that time. The recommendations included strengthening the auditors' function, for example imposing stricter requirements on the appointment of outside auditors. It was recommended that anyone who had ever been a director, manager, or employee of a corporation, or a subsidiary thereof, could not act as an outside auditor of the corporation. In addition, it was stipulated that if any auditor resigned before the end of their term of office, the board of directors should be required to give an explanation directly to the shareholders at the meeting of shareholders. Auditors should also be permitted to attend major management or executive meetings when they requested to do so. The report also suggested that corporations should formulate their own guidelines for corporate behaviour and strive to achieve full compliance with them.

Japan's first code of practice was launched by the Corporate Governance Forum in 1998. Before issuing this code of practice, a report entitled *Corporate Governance Principles – A Japanese View (Interim Report)* was published in October 1997 by the Corporate Governance Committee of the Corporate Governance Forum. This report identified the problems to be solved in the Japanese corporate governance system. It set out the recommended principles to be adopted in the shorter term (five years' time), along with necessary legal reforms, and the principles to be achieved in the early twenty-first century. The principles were mainly related to the corporate

governance structure, and to the accountability and disclosure requirements of corporations (Interim Report, 1997).

Although the impact of the code of practice and the Interim Report was limited, some well-known companies in Japan such as Sony, Orix, Fuji and Xerox have reformed their governance structures by reducing their board sizes, appointing independent directors and forming nomination and compensation committees (Allen, 2000). The Tokyo Stock Exchange, also recognized the importance of corporate governance in publishing a policy paper entitled *The Future of the Tokyo Stock Exchange: The Way Forward* in February 1999.

2.5.5 Singapore

In addition to the above countries it is also worth examining the characteristics of the corporate governance system in Singapore. As one of the “Four Little Dragons”, Singapore is a major competitor of Hong Kong (the other three Little Dragons are Korea, Hong Kong and Taiwan). The corporate governance system in Singapore is exemplary in a number of aspects. For example, every listed company must have an audit committee. The majority of the members of the audit committee must be non-executive directors. The same auditor must be appointed for auditing all the companies within a group, allowing the auditor concerned to have a full picture of the affairs of the whole group and to be able to prevent frauds by directors and managers.

Although Singapore has the distinction of being the first East-Asian country to require audit committees (in 1989), it reviewed the effectiveness of its regulatory and financial framework following the East-Asian crisis. In July 1999, the Monetary Authority of Singapore announced that banks must form nomination and compensation committees. In December 1999, the government set up three private sector-led committees to perform a comprehensive review of issues relating to disclosure and governance. The committees will examine best practices internationally and assess the extent to which they are applicable to Singapore.

2.5.6 Taiwan

Mostly due to the government's strongly interventionist economic policies, Taiwan has not taken to modern notions of corporate governance with any alacrity. The dominant state-owned companies are usually favoured at the expense of other shareholders. Nevertheless, the Securities and Futures Commission and the Taiwan Stock Exchange, as well as certain academic and professional bodies, support a more open, market-based economic system. This suggests that there will be some degree of reform to the corporate governance practices in Taiwan. The Institute of Internal Auditors of Taipei is planning to become closely involved in corporate governance matters (Allen, 2000).

2.5.7 Korea

Korea has moved forward aggressively on corporate governance reform after the East-Asian financial crisis. In early 1998, the Korean Stock Exchange ruled that

listed companies must allocate 25 percent of their board seats to independents. Since 1999, the top 30 chaebol (i.e. conglomerates) have been required to form audit committees in their listed subsidiaries. The government also intends to strengthen the rights of institutional investors so that they can act more effectively as supervisors of the management.

In September 1999, Korea published its Code of Best Practice for Corporate Governance. It is a lengthy document and is very comprehensive. The intention was to push forward with economic reform and improve corporate governance. However, the pace of reform over the past few years has not been as fast as what was expected when the reform process first began (PERC, 1999a).

2.5.8 The People's Republic of China

The People's Republic of China ("PRC") started opening its doors to foreign investors in 1979. Since then, the Chinese economy has become more open and market-oriented. The PRC government recognizes the importance of a formal business environment, and that accountability and transparency are important factors in attracting foreign investments. In 1993, the PRC government began to establish a corporate governance system based on the American model. The PRC Company Law was promulgated in 1994, and was followed by a series of reforms. However, historical factors and cultural characteristics in the PRC have influenced much of the actual corporate practices and business ethics. As a result, the corporate governance system in the PRC is still in the developing stage.

2.6 Findings of the Comparative Study of the Corporate Governance Regimes in Different Jurisdictions

2.6.1 Comparison of the Corporate Governance Regimes in the United Kingdom and Hong Kong

The United Kingdom is recognized over the world as having a well-developed set of guidelines for corporate governance. All UK listed companies are required to comply with the Code of Best Practice, which encourages voluntary disclosure rather than regulatory enforcement. Hong Kong has been developing its corporate governance system since the mid 1990s and it is now regarded as a fairly good benchmark for the East-Asian region. However, there is still much room for further improvement.

The corporate governance rules in Hong Kong are, in fact, based on those in the UK. However, because Hong Kong is a Chinese-oriented city and its companies are mostly family-owned, different practices exist in various aspects of corporate governance in comparison to the UK. These discrepancies are inevitable given the different cultural background, political environment and level of business development in the two economies.

I have summarized in Table 2.1 the differences between the corporate governance systems in the UK and Hong Kong in a number of respects, including board structure and composition, and the audit and nomination committees. The differences in ownership structure and shareholders' rights are also highlighted.

Table 2.1 Comparison of Corporate Governance Systems in UK and Hong Kong

	The United Kingdom	Hong Kong
Shareholders		
Ownership structure: Majority shareholders	Institutional Investors	Family owned
Encourage shareholders to make use of their voting rights	The Combined Code	Not mentioned
Board Structure and Composition		
Board meetings	hold regularly	at least twice a year
Number of non-executive directors in the board of directors	at least 1/3 of the board	at least 2 independent non- executive directors
Explanation for combined post of Chairman and CEO	Yes	No
Guidelines in assessing the independence of non-executive directors	Yes	Yes
Newly appointed board members should receive appropriate training	Yes	Yes
Company Secretary		
Required to have company secretary in listed companies	Yes	Yes
Nomination Committee		
Required to set up nomination committee in listed companies	Yes	No

	The United Kingdom	Hong Kong
<i>Remuneration Committee</i>		
Required to set up remuneration committee in listed companies	Yes	No
<i>Audit Committee</i>		
Required to set up audit committee in listed companies	Yes	Yes
Commencement date to report compliance/non-compliance in annual reports	Year ended after 30 June 1993	Year commencing 1 January 1999
Number of non-executive directors in the committee	At least 3 members with the majority independent	At least 2 members with the majority independent
Audit committee should be given written terms of reference which deal with membership, authority and duties	Yes	Yes
Disclosure requirement in annual reports	Committee membership	The composition, work and number of times met
Minimum number of meetings required	Twice a year	No

It can be seen from Table 2.1 that while Hong Kong's corporate governance system is similar to that of the UK, there are differences and Hong Kong's standard does not appear to be as high as that of the UK's. For example, while board meetings are required to be held regularly in the UK, the number of board meetings required in Hong Kong is only two per year. The minimum number of independent non-

executive directors required in Hong Kong is only two, while the UK requires these directors to comprise at least one-third of the board. Part of the reason for this phenomenon is that Hong Kong only started to “catch up” with corporate governance since the mid 1990s. The other principal reason for the differences is that the ownership structure and the culture in Hong Kong is very much different from that in the UK. Further discussions of the ownership structure and culture in Hong Kong are made in Chapter Four.

In the UK, institutional shareholders are the dominant shareholders among listed companies. Section 2E of the Combined Code suggests that institutional investors should make use of their voting rights in annual general meetings and to have dialogue with the management of the company concerned. However, in Hong Kong most listed companies are controlled by family members. As a result there exists a significant convergence between ownership and management. This helps to explain why there are discrepancies between the two corporate governance systems. For example, while the UK requires the setting up of nomination and remuneration committees, Hong Kong is still considering these matters at the moment.

Although Hong Kong has required the formation of audit committees starting from 1 January 1999, it can be noted from Table 2.1 that the standard required in Hong Kong is not as high as that in UK. A more detailed evaluation of the effectiveness of audit committees in Hong Kong is undertaken in Chapter Three of the thesis.

Notwithstanding that there is scope for improvement in the corporate governance regime in Hong Kong, it has been catching up fairly rapidly. Chapter Three discusses and evaluates contemporary initiatives and efforts to develop corporate governance practices in Hong Kong, and also internationally.

2.6.2 Comparison of the Corporate Governance Regimes among Five Developed Nations

Since 1996, Davis Global Advisors, Inc. (“DGA”) has been publishing its *Leading Corporate Governance Indicators* survey. DGA is an independent, privately owned US-based consulting firm specializing in global corporate governance. The survey is designed to measure international corporate governance developments by determining the standing of five major developed nations – France, Germany, Japan, the UK and the US. DGA developed an index of 10 “Leading Corporate Governance Indicators” grouped under four categories, namely: board structure, voting rights, disclosure and takeover defenses. The indicators and the components that make up the indicators reflect concerns prevailing in the international investment community as manifested through national voluntary codes and investor guidelines. Markets are scored using a 10-point scale, with zero being the least and ten being the most favourable outcome.

In 1999, DGA updated and revised some of the components in the indicators to reflect developments and investor preferences. As such, the scores are not wholly comparable between years. Nevertheless, the survey results show that throughout the

four years, the UK maintains its first place in corporate governance standards among the world's top five developed nations. Among the non-Anglo-Saxon countries, France ranks as the market with the most corporate governance features appealing to international investors. The results of the surveys are summarized in Tables 2.2 to 2.4:

Table 2.2 Leading Corporate Governance Indicators – Market Score Comparisons 1999

Indicator	France	Germany	Japan	U.K.	U.S.
<i>Best Practice Codes</i>	8	0	2	7	9
<i>Non-executive Directors</i>	10	5	1	6	8
<i>Board Independence</i>	3	2	0	3	6
<i>Split Chairman/CEO</i>	2	10	10	9	1
<i>Board Committees</i>	8	4	3	10	10
<i>Voting Rights</i>	1	9	10	10	8
<i>Voting Issues</i>	10	9	4	9	1
<i>Accounting Standards</i>	4	6	1	9	10
<i>Executive Pay</i>	3	2	3	10	10
<i>Takeover Barriers</i>	4	4	1	10	7
<i>Overall Score</i>	5.3	5.1	3.5	8.3	7.0

Source: Davis Global Advisors, Inc.

Table 2.3 Leading Corporate Governance Indicators – Market Score Comparisons 1996-1998

Indicator	France			Germany			Japan			U.K.			U.S.		
	98	97	96	98	97	96	98	97	96	98	97	96	98	97	96
<i>Best Practice Codes</i>	10	10	10	0	0	0	5	0	0	10	10	10	10	5	5
<i>Non-executive Directors</i>	10	9	9	5	5	5	1	1	1	5	5	5	8	8	8
<i>Split Chairman/CEO</i>	1	2	1	10	10	10	10	10	10	9	9	8	1	1	1
<i>Board Committees</i>	6	6	5	1	0	0	3	3	3	10	10	8	10	10	10
<i>Voting Procedures</i>	6	6	6	6	5	5	5	5	5	9	9	9	10	10	10
<i>Voting Rights</i>	1	1	1	9	9	9	10	10	10	10	10	8	8	8	8
<i>Voting Issues</i>	10	10	10	9	8	8	4	3	3	9	9	9	1	1	1
<i>Accounting Standards</i>	4	4	4	2	1	1	1	1	1	9	9	9	10	10	10
<i>Executive Pay</i>	3	3	3	2	2	2	3	3	2	10	10	10	10	10	10
<i>Takeover Barriers</i>	4	4	4	4	3	2	1	1	1	10	10	10	7	7	7
Overall Score	5.5	5.5	5.3	4.6	4.3	4.2	4.3	3.7	3.6	9.1	9.1	8.6	7.5	7.0	7.0

Source: Davis Global Advisors, Inc.

Table 2.4 Leading Corporate Governance Indicators – Overall Ranking 1996 – 1999

Rank				Market	Score			
99	98	97	96		99	98	97	96
1	1	1	1	United Kingdom	8.3	9.1	9.1	8.7
2	2	2	2	United States	7.0	7.5	7.0	7.0
3	3	3	3	France	5.3	5.5	5.5	5.3
4	4	4	4	Germany	5.1	4.6	4.3	4.3
5	5	5	5	Japan	3.5	4.3	3.7	3.6

Source: Davis Global Advisors, Inc.

2.6.3 Comparison of the Corporate Governance Regimes among European Countries

Apart from the US-based DGA, another private entity which specialises in investigating companies' corporate governance profiles is the Belgium-based consultancy firm Déminor. In 1999 it launched a corporate governance rating service enabling institutional investors to gauge the corporate governance standards and practices of the European listed companies held in their portfolios. The service now covers 300 companies from 17 European countries and all companies in the EURO-FTSE 300 index are included. The ratings are the product of extensive analysis combining over 300 corporate governance indicators. The indicators are classified into four main categories, as follows:

1. Rights and duties of shareholders: criteria concerning voting right restrictions, voting issues, shareholder proposals and voting procedures.
2. Range of takeover defences: the presence and strength of anti-takeover devices such as core-shareholder control, board insulation, extensive cross-shareholdings, share repurchases.
3. Disclosure: the transparency of a corporation as measured by the quantity and quality of the publicly available information on its governance structure.
4. Board structure and functioning: all issues relating to the governance of a company, such as the board's election and composition, the presence of independent directors, the separation of chairman and chief executive functions, executive remuneration, the duties and workings of board committees, etc.

Each company is given a rating in each of the four categories. Each rating is measured on a scale from “5 Déminor” to “1 Déminor”, with “5 Déminor” representing the best practice and “1 Déminor” the most questionable standard. Table 2.5 shows a summary of the country ratings that Déminor compiled for the year 2000. The research was based on 1999 annual reports, information from company articles of association, annual general meetings in 2000 and other publicly available information disclosed by 15 September 2000.

Table 2.5 Country Ratings 2000

	Rights & Duties of Shareholders	Takeover Defences	Disclosure	Board Structure
UK	4	4	5	5
Germany	4	3	2	1
France	3	1	3	3
Switzerland	2	1	1	1
The Netherlands	1	1	3	2
Italy	4	1	3	2
Spain	2	1	2	2
Sweden	2	3	2	2
Belgium	3	1	3	3

Source: Déminor

It can be noted from Table 2.5 that the findings of Déminor are consistent with DGA's findings in that the UK is found to have the highest corporate governance standard when compared with other European countries. It ranks high in all of the four rating categories. France and Germany also rank fairly high in some of the categories and are of a comparable overall standard.

2.6.4 Comparison of the Corporate Governance Regimes among Asian Countries

As far as Asian countries are concerned, the Asian Corporate Governance Association (“ACGA”) published in January 2000 a report called *Building Stronger Boards and Companies in Asia: A Concise Report on Corporate Governance Policies and Practices*. The ACGA was launched in Hong Kong in August 1999 by a group of business leaders from seven Asian countries. It aims to promote sound corporate governance practices and to provide assistance and advice to Asian companies wishing to implement corporate governance practices within their firms. The report covered 11 countries in the Asian region. Extracted below are the comparisons between Hong Kong and the five Asian countries discussed in section 2.5 above – Japan, Singapore, Taiwan, Korea and China (the PRC).

The ACGA suggested that although Asian countries are not moving towards identical systems of corporate governance, there is a striking agreement among the proponents of reform in each country on the centrality of certain principles. The ACGA put

forward in its report an appendix termed as “Points of Convergence”. An extract of the appendix is shown in Table 2.6 below:

Table 2.6 Points of Convergence

	Enhancement of shareholder value	Independent directors	Higher levels of financial disclosure	Independent board committees	Codes of best practice	Importance of institutional investors
Hong Kong	Y	Y	Y	Y	Y	Y
Japan	Y	Y	Y	Y	Y	Y
Singapore	Y	Y	Y	Y	Y	Y
Taiwan	Y		Y			
Korea	Y	Y	Y	Y	Y	Y
China	Note 1	Note 1	Y	Note 1		Y

(Y = Yes, Blank = No)

Test: Does the country subscribe to the principle and apply it to domestically listed firms, or does it have plans to do so?
 “Country” refers mainly to official bodies, but also includes business or professional associations involved in corporate governance standard setting.

Note 1: These principles have been recognised as important by the China Securities Regulatory Commission.

Source: Asian Corporate Governance Association

Table 2.6 shows that the governance standards in Hong Kong, Japan, Singapore and Korea are in general higher than those in Taiwan and the PRC. However, despite the fact that there has been convergence in governance policy direction among the

countries, and that this convergence has grown over time, there are limits to this convergence. The ACGA proposed that there are also “Points of Divergence”. The following table is extracted from an appendix of the ACGA’s report:

Table 2.7 Points of Divergence

	Stakeholder focus	Single-tier board	Two-tier board	Size of best practice code			Scope of code	
				Small	Medium	Large	Limited	Comprehensive
Hong Kong		Y		Y			Y	
Japan	Y		Y		Y			Y
Singapore	Note 1	Y		Y			Y	Note 2
Taiwan			Y					
Korea	Y	Y				Y		Y
China	Y		Y					

(Y = Yes, Blank = No)

Note 1: Singapore has a stakeholder concept (i.e. corporations play a social role), but it protects workers through legislation, not through its corporate governance regime.

Note 2: Singapore’s current code focuses solely on audit committees, but it is working on a more comprehensive code.

Source: Asian Corporate Governance Association

It can be noted from Table 2.7 that while Hong Kong, Singapore and Korea have single-tier boards, the size of the best practice code in Korea is large and comprehensive. Although Singapore has a small best practice code with limited scope, it is nevertheless very comprehensive in its guidance concerning audit

committees; and a more comprehensive code is currently being developed. According to the study by the ACGA above, it appears that Hong Kong can further improve its corporate governance system by increasing the comprehensiveness of its code of best practice.

Table 2.7 also suggests that Japan cares about corporate governance. It has a medium sized code of best practice and its scope is comprehensive. Taiwan and the PRC are lacking any codes of best practice. The two countries are strongly affected by cultural factors which have hindered and delayed the development of corporate governance systems. The regulatory authority in the PRC, the China Securities Regulatory Commission, has begun to recognize the importance of corporate governance. In Taiwan, the Securities and Futures Commission and the Taiwan Stock Exchange, as well as certain academic and professional bodies, have also started to address the importance of corporate governance practices.

Another survey was conducted by the Political and Economic Risk Consultancy Limited (“PERC”) from 1997 to 1999 on transparency in the business environment of various Asian countries. PERC is a consulting firm specialising in strategic business information and analysis for companies doing business in the East and Southeast Asian countries. The survey involved asking more than 1,200 expatriates to rate, on a scale of zero to ten, the level of transparency of the business environment in the country in which they worked. A grade of zero (0) represents the best case or a very transparent environment and a grade of ten (10) represents the worst case. Although

there are some deficiencies in the survey itself, for example PERC did not define clearly the meaning of “transparency”, the results do provide some indications of the level of “transparency” in the surveyed countries. From the results, an idea of the level of corporate governance in the countries can be inferred. Extracted below are the results of the surveys for the years 1998 and 1999:

Table 2.8 Transparency of the Business Environment

	1998	1999
Hong Kong	2.82	3.58
Singapore	3.61	4.55
Taiwan	3.94	6.55
Japan	5.78	7.13
South Korea	6.58	8.50
China	6.94	8.63

Source: PERC

It can be noted from the above survey results that Hong Kong was rated the highest among the economies in terms of transparency in its business environment. Singapore was also ranked fairly high by the expatriates in the Asian region. The scores of China are not surprising given the “weak legal framework” of the country (PERC, 1999b).

PERC pointed out that in Taiwan, there is a perceived lack of credibility in government to solve problems in its finance sector and that there are close ties

between the State and many local companies which support the State's ambitions. The deterioration of the grade of Korea was especially pronounced. In 1997 when the East-Asian financial crisis first began, the Government did not know about the country's short-term foreign debt. Then, it tried to hide what it did know. Even two years after the supervision of the International Monetary Fund and a push for banking and economic reform by the new government, expatriates still perceive that the Korean government either does not know the full scale of certain problems or that it is trying to make them appear less than it is actually the case (PERC, 1999b). Although Korea has tried to push forward with economic reform and improvements in corporate governance, from the PERC survey results it appears that the pace of reform and improvement is not as fast as what was anticipated when the reform process first began (PERC, 1999a).

2.7 Summary and Conclusions

Following the downfall of a number of large corporations in the late 1980s and early 1990s, the importance of corporate governance became widely recognized by investors, corporations, professional bodies, governments and international organizations. There have been increasing demands for market transparency and accountability. The Cadbury Report can be regarded as a milestone in the development of corporate governance in the UK. The publications of the Greenbury Report, the Hampel Report, the Combined Code and the Turnbull Guidance further enhanced the recommendations of the Cadbury Committee in developing an effective corporate governance system in the UK. All of these efforts have been perceived as being successful, as evidenced by the results of various surveys and analyses conducted by specialists and research consultants in corporate governance. For example, the UK is ranked at the top of the list of countries by both the US-based DGA and Belgium-based Déminor in their studies of the five developed nations and seventeen European countries respectively.

As Hong Kong was a colony of the UK for one and a half a centuries its legal system was greatly influenced by the UK law. However, since Hong Kong is a Chinese oriented city and since most of its corporations originate from family businesses, its corporate governance system is not an exact copy of that in the UK. It has only partly adopted and followed the UK system. Hong Kong has developed its own corporate governance system in such a way as to cope with its Chinese cultural background and family ownership structure. For example, the comparison study shows that while the

UK has nomination and remuneration committees in its corporations, Hong Kong is still only considering the possibility of introducing such committees. In addition, while the UK requires that at least one-third of the board is comprised of non-executive directors, Hong Kong does not have such a requirement and it only requires at least two independent executive directors to be on the board.

In analyzing the reasons behind the East-Asian financial crisis and corporate failures, apart from the financial attacks of speculators, the other major reason can be said to be a deficiency in corporate governance systems. Given that Hong Kong has followed some of the UK corporate governance principles and practices, the corporate governance standard in Hong Kong is in general more advanced than a number of other countries in the East-Asian region. Therefore, despite the financial crisis in late 1997 has brought about many corporate collapses, in the eyes of many investors and expatriates, Hong Kong is still regarded as one of the major financial centres in the world and it is a place with reasonable transparency for business and investment, as evidenced by the survey results of PERC in 1999. This explains why Hong Kong suffered lesser after the financial crisis when compared with those countries having weaker corporate governance systems.

However, it is evident from the comparative study in this chapter that there are still a number of areas in which Hong Kong can develop further. For example, the code of best practice in Hong Kong is not comprehensive enough, according to the analysis of ACGA.

As pointed out by Mr. Magdi Iskander, Director of the Private Sector Development Department of The World Bank, there are many different corporate forms and consequently many different approaches to corporate governance reform. There is no single best model of corporate governance anywhere in the world. Each country must find a model that can best fit its own culture and history and its government's capacity to regulate (Company Secretary, 2000). It can be argued that Hong Kong has been on the right track in deriving good corporate governance principles from the UK while at the same time remaining "conservative" in certain aspects due to its cultural background. Nevertheless, there are certain areas that can be improved. For example, as revealed in the comparative study in this chapter, the areas for improvements include the setting up of nomination and remuneration committees, increasing the number of independent non-executive directors on the board and improving the comprehensiveness of its Code of Best Practice. Further recommendations for improvements are made in Chapter Seven of the thesis. If Hong Kong can further develop and improve its corporate governance system, investors' confidence can be further enhanced, which will benefit Hong Kong's economic recovery and development.

Chapter Three

Contemporary Corporate Governance Initiatives

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3.1 Chapter Objectives

The qualitative analyses in Chapter Two conclude that, despite Hong Kong's history as a colony of the UK, and most of its rules and regulations therefore being adapted from those in the UK, the corporate governance practices in Hong Kong are not exactly a copy of those in the UK. There are some weaknesses in the corporate governance regime in Hong Kong, which therefore has room for further improvement. The outbreak of the East-Asian financial crisis in late 1997 alerted various organizations, not only in Hong Kong but also in other East-Asian countries, to the importance of enhancing corporate governance as a means of hastening corporate recovery.

In fact, corporate governance has been a subject of continuous public debate for more than two decades before the East-Asian financial crisis. In particular, the October 1987 stock market crash and the collapse of BCCI triggered a great deal of academic and professional concern over the subject. It appears that every time the corporate environment is turbulent, commentators pay attention to the subject of corporate governance. The East-Asian financial crisis first broke out when the Thai Government decided to float the Thai baht on 2 July 1997. Thereafter, most countries in the East-Asian region experienced financial and economic turmoil (Chow, 1999). Again, part of the response to the East-Asian financial crisis from Governments, professionals and academics has been to suggest that better corporate governance may help to sustain the recovery of the economies in the region.

This chapter assesses different suggestions from various international organizations and professional bodies about how corporate governance standards may be enhanced in the aftermath of the East-Asian financial crisis. Although it is generally recognised that there is no single best model of corporate governance that can be applied universally, the principal objective of this chapter is to summarise and then draw conclusions from the various suggestions of the international and professional organizations in order to identify the areas for structural improvement in the corporate governance system in Hong Kong.

Apart from analyzing the various initiatives and suggestions of the international and professional organizations, this chapter also offers an assessment of the effectiveness of the audit committee in enhancing corporate governance standards. This is necessary because the audit committee is an important mechanism for enhancing corporate governance. However, it was not a requirement for Hong Kong listed companies to have an audit committee until 1 January 1999. Hence, an analysis is undertaken in this chapter to assess its attributes and whether it is likely to be effective in enhancing corporate governance in Hong Kong.

3.2 Efforts of International Organisations

3.2.1 OECD Principles of Corporate Governance

The Organisation for Economic Co-operation and Development (“OECD”) plays an important and pro-active role in analysing various economic issues for the benefit of member nations and making suggestions for improvements. In April 1998, the OECD ministers gave the OECD a mandate to develop a set of principles on corporate governance. The draft guidelines on corporate governance were released in December 1998. In May 1999, ministers representing the twenty-nine governments that comprise the OECD voted unanimously to endorse the *OECD Principles of Corporate Governance* (“OECD Principles”). The OECD Principles were also welcomed by the G7 leaders at the Cologne summit in June 1999.

The OECD Principles serve as reference points for efforts to evaluate and improve each OECD member country’s regulatory framework on corporate governance. They also provide guidance to stock exchanges and corporations all over the world to assist them to improve their local corporate governance standards and disclosure requirements. The OECD Principles cover five broad headings of concern, which are identified below:

(a) The rights of shareholders

This concerns the protection of shareholders’ rights and the ability of shareholders to influence the behaviour of a corporation.

(b) The equitable treatment of shareholders

This principle emphasizes that all shareholders, including minority and foreign shareholders, should be treated fairly by controlling shareholders, boards and management.

(c) The role of stakeholders in corporate governance

This principle recognises that the competitiveness and ultimate success of a company is the result of teamwork and that companies benefit from the contribution of a range of different resource providers, including employees, suppliers, creditors and the communities in which companies operate. The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders.

(d) Disclosure and transparency

This principle recommends that all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the corporation be disclosed in a timely and accurate fashion.

(e) The responsibilities of the board

The corporate governance framework should ensure the strategic guidance of the company by the board, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.

As stated in the preamble of the OECD Principles, there is no single model of good corporate governance. The Principles are non-binding. Their purpose is to serve as a reference point. They can be used by policy makers as they examine and develop legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.

The preamble of the OECD Principles further states that *“the Principles are evolutionary in nature and should be reviewed in light of significant changes in circumstances. To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices so that they can meet new demands and grasp new opportunities. Similarly, governments have an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow markets to function effectively and to respond to expectations of shareholders and other stakeholders. It is up to governments and participants to decide how to apply these Principles in developing their own frameworks for corporate governance, taking into account the costs and benefits of regulation.”*

The OECD Principles are regarded as “signposts” for activity in the area of corporate governance by the International Monetary Fund, the World Bank, the United Nations and various other international organisations (ICGN, 1999b).¹

¹ The full text of the OECD Principles can be found at the website of OECD at <http://www.oecd.org/daf/governance/principles.htm>.

3.2.2 International Corporate Governance Network (ICGN) Statement

The International Corporate Governance Network (“ICGN”) was founded in 1995 at the instigation of major institutional investors, academics and other parties interested in the development of global corporate governance practices. The ICGN’s objective is to facilitate international dialogue on issues concerned with corporate governance such that economies can best prosper and companies can compete more effectively. The charter of the ICGN empowers it to adopt guidelines when it feels that they can contribute to achieving this objective.

Following the announcement of the OECD Principles in May 1999, the ICGN applauded the OECD Principles as a declaration of minimum acceptable standards for companies and investors around the world. The ICGN welcomed the OECD Principles as “*a remarkable convergence on corporate governance issues among diverse interests, practices and cultures*” (ICGN, 1999a). However, it also stated that amplifications were required to give the OECD Principles sufficient force. Its view is that companies around the world require clearer and more concrete guidance on how the OECD Principles can best be implemented. At its annual conference in Frankfurt, the ICGN adopted its *Statement on Global Corporate Governance Principles* on 9 July 1999 (“ICGN Statement”).²

² A copy of the ICGN Statement (ICGN, 1999a) can be found at the website of ICGN at <http://www.icgn.org/documents/globalcorpgov.htm>.

The ICGN Statement advocates that companies adopt the OECD Principles as amplified in the two documents appended in the ICGN statement. The documents are entitled *ICGN Approach to the OECD Principles: A 'Working Kit' Statement of Corporate Governance Criteria* and *OECD Principles as Amplified*. The ICGN believes that it is in the best interests of companies to adhere to these recommendations even in the absence of any domestic legal requirements for implementation.

The 'Working Kit' of the ICGN Statement offers more concrete and concise guidance, while at the same time amplifying and interpreting the OECD Principles. The ICGN Statement concurs with the OECD Principles that "*along with the traditional financial criteria, the governance profile of a corporation is now an essential factor that investors take into consideration when deciding how to allocate their investing capital*" (ICGN, 1999a).

3.2.3 Global Corporate Governance Forum

The World Bank is another entity involved in the global corporate governance reform drive. In September 1999 the World Bank, together with the OECD, initiated the Global Corporate Governance Forum ("GCGF"). The GCGF aims to establish itself as a focal point for a broader dialogue on corporate governance issues and has made clear that it is not in the business of promoting any particular corporate governance model. As stated by the Head of the GCGF Secretariat, Ms. Nadereh Chamlou: "*our main objective is to broaden the debate by bringing the perspective of developing*

countries to it, and to respond to the growing need for formulating and implementing reform. Much of the debate has been generated and has been focused on developed countries..... but the concern is broadening and it is important that developing and transition economies take an active role in the debate” (Company Secretary, 2000).

Ms. Chamlou has also pointed that much of the corporate governance debate has focused on listed companies and the equity-based corporate governance systems. In Asia there are different circumstances arising from the prevalence of family-owned companies and state-owned enterprises. These are the matters that need to be addressed also.

Since the publication of the OECD Principles, there has been more attention paid to the variety of corporate forms and governance systems around the world. As stated by Mr. Magdi Iskander, another key figure in the GCGF: *“from what is being talked about in the OECD, we can enlarge the discussion to involve other countries in the process of dialogue, and to assist countries in adopting those principles and other best practices to their requirements..... it’s only in times of crisis that people really begin to focus on structural issues such as corporate governance.” (Company Secretary, 2000).*

Mr. Iskander further pointed out that, even in the Western countries, there are many different corporate forms and therefore different approaches to corporate governance reform. The goal of the GCGF is not to impose any model of corporate governance. He stressed that there is no single model of corporate governance anywhere in the

world. *“It differs from country to country, from sector to sector, and from country to country in the same sector, and even for the same company over time.”* (Company Secretary, 2000).

The role of the GCGF is to act as facilitator and to adapt basic standards and apply them in the way that can best fit a country’s culture and history, and its government’s capacity to regulate. Another GCGF figure, Mr. Pang Chung Min, has commented that corporate governance guidelines, such as the OECD Principles, are a good starting point. He also pointed out that as the preamble of the OECD Principles states that the Principles are not binding, they can always be changed or adjusted as appropriate, taking into consideration the problems facing emerging markets.

The GCGF facilitates the exchange of knowledge, the distillation from that knowledge of what the key issues are, and the determination of where resources should be deployed (Company Secretary, 2000).³ The Forum is also involved in training programmes for directors and company secretaries. It regards its mission as taking the corporate governance movement from “reports, guidelines and principles” to its next phase, namely, “implementation”.

³ In order to encourage wide participation, all interested parties are encouraged to submit their view to the GCGF Secretariat via the Internet at cqsecretariat@worldbank.org. When the Secretariat wants feedback on a specific issue, the subject matter will be posted on the Forum’s website at www.gcgf.org. Readers are then invited to submit their opinions. In this way, there will be close cooperation concerning corporate governance activities around the world.

3.2.4 Corporate Governance Roundtables in Asia

Much of the credit for placing corporate governance firmly on investors' agendas must go to the OECD and the World Bank. Recognising that its Principles may act as a benchmark rather than as a set of absolute rules, the OECD and the World Bank organise regional roundtables to provide key decision-makers from the private and public sectors with the opportunity to discuss how best to implement the Principles within their own environments (Prospective Accountant, 2000).

The OECD/World Bank roundtables are organised on a 'regional' basis: Asia, Latin America and Russia. Four roundtables have been held so far for the Asian region.⁴

The specific objectives are as follows:

- Promote better governance in the Asian region.
- Improve the understanding of corporate governance and assist in developing policy responses.
- Promote an ongoing dialogue between the private and public sectors.
- Monitor and evaluate developments in the region.
- Identify needs for technical assistance.
- Inform the international community about national and regional reform initiatives.

White Papers are issued after each Roundtable to improve the corporate governance framework in the region (OECD, 2001a).

⁴ The first Asian roundtable was held in Korea in March 1999, the second in Hong Kong in May/June 2000, the third in Singapore in April 2001 and the fourth in November 2002 in India.

(a) The First Asian Corporate Governance Roundtable

The First Asian Corporate Governance Roundtable was held in Seoul in March 1999 on the theme of “*Corporate Governance in Asia: A Comparative Perspective*”.⁵ The meeting brought together a group of high level officials, private sector decision makers and academic experts from several Asian non-member countries⁶ with their OECD counterparts in an exchange of views on the issue of corporate governance.

It was underlined by all participants of the roundtable that corporate governance was one of the main factors in the East-Asian financial crisis and an area that required major policy reform. Most of the countries declared their readiness to use the OECD Principles as a main benchmark. The main conclusions of the roundtable are summarised as follows (OECD, 1999a):

1. Corporate governance has gained increased visibility among policy makers during the last few years and there is a trend towards global convergence of corporate governance norms.
2. One of the fundamental causes of the Asian financial crisis was the lack of effective corporate governance mechanisms.
3. Corporate Asia has been plagued by over-investment, excessive conglomeration and over indebtedness. These tendencies have been, to a large extent, a result of poor corporate governance.

⁵ In addition to the OECD, this roundtable was co-hosted by the Korean Development Institute (“KDI”) and the Korean government, while the Japanese government and the World Bank provided additional sponsorship.

⁶ Chinese Taipei, Hong Kong China, India, Indonesia, Malaysia, the People’s Republic of China, the Philippines, Singapore and Thailand.

4. Protection of shareholder rights is important.
5. The disclosure regime in most Asian economies was defective. Disclosure and transparency issues need to be addressed.
6. Insolvency legislation and corporate restructuring rules need to be reformed and well set.
7. The adoption of corporate governance rules in themselves might not be enough to improve corporate performance in the region. There was perceived to be a need to improve the “infrastructure” in order to ensure effective implementation of corporate governance rules. For example, improving the capacity for the judiciary and the regulatory authorities, and providing continuing education for directors, without which reforms may never become effective.

The roundtable provided policy makers from both the public and private sectors with valuable insights into their neighbours’ problems and solutions. Further areas of corporate governance related work were also suggested by the participants, for example in the areas of market exit, smaller enterprises and the social responsibility of corporations (OECD, 1999a).

(b) *The Second Asian Corporate Governance Roundtable*

The Second Asian Corporate Governance Roundtable was held in Hong Kong in May and June 2000 on the following theme: “*The Role of Disclosure in Strengthening*

Corporate Governance and Accountability".⁷ There were some 150 high-level participants in the roundtable, from Asian securities exchange commissions, stock exchanges, government, academia, trade unions, international organisations, and business and investment institutions.

The purpose of this roundtable was to explore the role of disclosure in corporate governance, with the focus on three broad aspects of disclosure: the role of the board of directors in overseeing disclosure, accounting and audit standards and their implementation, and non-financial disclosure. There was also a session on international initiatives to improve the quality of global disclosure and to develop international benchmarks for disclosure.

The conclusions arrived at in the roundtable are summarised as follows (OECD, 2000):

1. Disclosure is a key mechanism for encouraging better corporate governance.
2. Weak disclosure regimes played an important role in the Asian crisis.
3. Much has been achieved since the Asian crisis.
4. Despite these positive developments, it was felt that the rapid recovery of Asian economies after the crisis could lead to dangerous complacency.
5. The existence of adequate rules and standards are insufficient to protect investors.

⁷ Apart from the OECD, the World Bank and the Asian Development Bank ("ADB"), the long-term partners in the Asian roundtables, this roundtable was co-hosted by the Hong Kong Securities and Futures Commission ("SFC"), the Hong Kong Stock Exchange and the Hong Kong Society of Accountants ("HKSA"). Additional sponsorship was provided by the Japanese government.

6. There was broad consensus on the need for high quality internationally comparable standards for accounting that allow for comparison of financial statements.
7. It is difficult to form a clear picture of a company in the absence of good non-financial disclosure.
8. Scepticism with respect to transparency and disclosure are deeply rooted in the business culture of the region.
9. Despite its importance, disclosure is not a panacea.
10. Corporate governance and public sector governance go hand in hand.
11. A number of significant international initiatives are underway.

In addition to reaching the above conclusions, the participants broadly endorsed the future GCGF work plan outlined by the Secretariat. However, it was generally felt by the participants that more of the roundtable's time should have been devoted to discussion of implementation issues.

(c) *The Third Asian Corporate Governance Roundtable*

The Third Asian Corporate Governance Roundtable was held in Singapore in April 2001 on "*The Role of Boards of Directors and Stakeholders in Corporate Governance*".⁸ This roundtable concentrated on the roles of boards and of stakeholders in corporate governance.

⁸ This roundtable was organised by the OECD, the World Bank and the ADB and it was co-hosted by the Monetary Authority of Singapore, the Singapore Institute of Directors and the Singapore Exchange.

Boards of directors exercise three key functions for companies, namely: monitoring management, ensuring accountability and shaping company strategies. However, very often the problem in Asia is that the board is little more than a formality. The roundtable pointed out that, by treating the boards in this way, Asian companies are foregoing the benefits of effective boards. The stated goal of the roundtable is: “*to turn Asian boards into dynamic drivers of corporate governance and guarantors of investor confidence*” (Kondo, 2001).

The role of stakeholders in corporate governance was the second topic of discussion in the roundtable. It was concluded that corporations need to view stakeholder concerns as an opportunity to enhance their companies’ long-term value. For example, active employee participation in companies’ affairs should be encouraged. It was stated that access to capital should also be improved, particularly to attract investments from key institutional capital providers such as public pension funds. These improvements can contribute to the long-term stability and value of companies.

During the meeting, participants also discussed the first draft of the Asian Corporate Governance White Paper, which contains region-specific guidance to assist policymakers, regulators, stock exchanges and other standard setting bodies in the Asian region to evaluate and improve their corporate governance frameworks (OECD, 2001b). It is envisaged that, upon completion of the Asian Roundtables series, the White Paper will be finalised and approved. Stock exchanges, institutes of directors

and individual companies are to be encouraged to use the White Paper as a tool to assess and articulate their own strategies (Kondo, 2001).

(d) The Fourth Asian Corporate Governance Roundtable

The Fourth Asian Corporate Governance Roundtable was held in India in November 2002 on “*Shareholder Rights and the Equitable Treatment of Shareholders*”.⁹ There were three main themes for discussion in this roundtable: promoting shareholder participation, preventing insider abuse and enforcing shareholders’ rights. Discussions were also made on the regional developments of corporate governance systems (OECD, 2002).

3.2.5 Reports of Various Organisations

Apart from the OECD and the World Bank, there are also a number of international organisations that have taken active roles in promoting corporate governance reform and undertaking studies of corporate governance. Examples include private entities such as the US-based Davis Global Advisors and the Belgium-based consultancy firm Déminor. The work of these two bodies is discussed in section 2.6 of Chapter Two. This section provides a summary of studies of corporate governance systems undertaken by other organisations in the Asian region after the financial crisis in 1997-98.

⁹ This roundtable was organised by the OECD in partnership with the Government of Japan and the Global Corporate Governance Forum.

(a) The Asian Development Bank

The Asian Development Bank (“ADB”) conducted a study of five countries in the East Asian region and published its findings in its report, *A Consolidated Report on Corporate Governance and Financing in East Asia*, in November 1999. The study covered the Republic of Korea, Malaysia, Thailand, Indonesia and the Philippines. These five countries were the worst hit by the financial crisis.

It was suggested by the ADB study that, in most of the above countries, the legal framework for transparency appears to have been adequate. Their respective Stock Exchanges, Securities Commissions and company laws have, in general, the necessary provisions requiring disclosure of information to protect investors. However, the problem was identified as one of enforcement and of how to strengthen regulations to facilitate enforcement. It was concluded that these countries’ governance structures are not too different from those of the UK or the US. The key difference is that East Asian countries are weak in terms of possessing the human capital and the institutional arrangements needed to enforce their corporate governance rules. The countries have the rules in place, but they do not always have the capacity to enforce them (Company Secretary, 2000).

(b) The Asian Corporate Governance Association

The Asian Corporate Governance Association (“ACGA”) was launched in Hong Kong in August 1999 by a group of business leaders from seven Asian countries. It aims to promote sound corporate governance practices and to provide assistance and

advice to Asian companies wishing to implement corporate governance practices within their firms. In January 2000 it published a report called *Building Stronger Boards and Companies in Asia: A Concise Report on Corporate Governance Policies and Practices*. The report covered 11 countries in the Asian region.

The ACGA suggested that, although Asian countries are not moving towards identical systems of corporate governance, there is a striking agreement among the proponents of reform in each country on the centrality of certain principles. The study found that the governance standards in Hong Kong, Japan, Singapore and Korea are in general higher than those in Taiwan and the PRC. However, despite the fact that there has been convergence in governance policy direction among the countries, and that this convergence has grown over time, there are limits to this convergence. A detailed analysis and discussion of the main findings of the report is included in section 2.6.4 of Chapter Two of the thesis (ACGA, 2000).

(c) The Political and Economic Risk Consultancy Limited

The Political and Economic Risk Consultancy Limited (“PERC”) is a consulting firm specialising in strategic business information and analysis for companies doing business in the East and Southeast Asian countries. From 1997 to 1999 it conducted a survey of the views of expatriates in the Asian region concerning the transparency of the business environment in various Asian countries. Hong Kong was rated the highest among Asian countries in terms of the transparency in its business environment. Singapore was also ranked fairly high, whereas a low score for China was not surprising given the “weak legal framework” of the country (PERC, 1999). A

detailed analysis of the findings of the survey is contained in section 2.6.4 of Chapter Two.

We can observe from the above sections that various international organisations have been engaged in continuing efforts to enhance international corporate governance standards. The next section discusses the efforts made by the relevant organisations and professional bodies after the East-Asian financial crisis to improve the corporate governance standards in Hong Kong.

3.3 Contemporary Corporate Governance Developments and Initiatives in Hong Kong

The Hong Kong Society of Accountants (“HKSA”) has been pro-active in promoting good corporate governance practice since 1995 and is playing an important role in monitoring the development of corporate governance in Hong Kong. Conscious of the fact that the profile of shareholders and the corporate culture in Hong Kong are different from those in the Western countries, the HKSA Council saw the need to approach the subject of corporate governance from a distinctly Hong Kong perspective. The Working Group on Corporate Governance, which became the HKSA Corporate Governance Committee in 1998, has produced a number of reports over the past few years. The findings and recommendations made in the first and second reports of the Working Group are discussed in section 2.4.4 of Chapter Two. The sections that follow provide a discussion of the work of the HKSA Corporate Governance Committee in the aftermath of the East-Asian financial crisis.

Apart from the HKSA, there are also other professional bodies and academic institutions active in enhancing corporate governance practices and standards in Hong Kong. Their work and contributions are also discussed in the sections that follow.

3.3.1 Audit Committee

The Working Group on Corporate Governance recommended and supported the establishment of audit committees by listed companies in its first and second reports. According to the findings in the second report by the Working Group, only

approximately 2 percent of all the 553 listed companies in Hong Kong in 1996 disclosed that they had an audit committee. In the US, it has been a listing requirement of the New York Stock Exchange since the late 1970s. In Canada and Australia, listed companies are required by law to have audit committees. In the UK, a great majority of listed companies have audit committees. Hong Kong was certainly lagging behind the other major international financial centres in this important aspect of corporate governance.

In December 1997, *A Guide for the Formation of An Audit Committee* was published by the HKSA Corporate Governance Committee and was adopted by the Stock Exchange of Hong Kong in May 1998. Since then, the Stock Exchange amended its Code of Best Practice to require every listed company to establish an audit committee for accounting periods commencing on or after 1 January 1999.

The Code of Best Practice provides that the audit committee should have written terms of reference which deal clearly with its authority and duties. In addition, the audit committee should have a minimum of two members. The members should be appointed from amongst the non-executive directors and a majority of the non-executive directors should be independent. The Code of Best Practice provides that, for further guidance on establishing an audit committee, listed companies may refer to the publication of the HKSA.

For companies which fail to establish an audit committee, reasons must be given in the annual report for their non-compliance with the Code of Best Practice. Hence, it

will become transparent which listed companies have not established an audit committee.

Recognising the importance of an effective audit committee, the HKSA further issued *A Guide For Effective Audit Committee* in February 2002, which focuses on how to ensure that an audit committee can operate effectively.¹⁰ It also addresses issues such as the committee's composition and procedures and practices that can help to strengthen the role and operation of an audit committee within a company's organisational structure.

However, it does not necessarily follow that, with the establishment of an audit committee, the quality and transparency of financial reporting and the internal control system of a listed company will be improved. Nevertheless, since the introduction of audit committees is an important corporate governance initiative that brings Hong Kong into line with other major international financial centers, where audit committees are already a common practice, a further discussion of the attributes and functions of an effective audit committee follows in section 3.4 of this chapter. An assessment of the benefits and effectiveness of audit committees in the Hong Kong environment will also be made in this section.

¹⁰ A full copy of the Guide can be accessed at the HKSA's website at <http://www.hksa.org.hk/publications>.

3.3.2 Directors' Business Review in the Annual Report

With the aim of improving the quality of disclosure in annual reports, the HKSA Corporate Governance Committee published its fourth report in November 1998. The report was entitled *A Guide for Directors' Business Review in the Annual Report* ("the Guide"). The Guide took into consideration Hong Kong's unique business environment and it provided directors with a summary of best practice as regards their duties for management discussion and analysis in the annual report. The Guide was developed following a review of similar guidelines and standards developed in other parts of the world. Particular reference was made to the *Guide on Operating and Financial Reviews* issued by the UK Accounting Standards Board. While the Guide was designed as a formulation and development of best practice, it is intended to have persuasive rather than mandatory force.

The HKSA recommends the use by directors of this Guide as a benchmark in preparing annual reports. Given the continuing international call for increased transparency and disclosure in annual reports, directors and their advisers should find the Guide particularly useful given the absence of guidelines in this area in the Companies Ordinance and Listing Rules in Hong Kong.

The Guide provides guidance to directors on how to prepare the Business Review section of their annual report. It states that the section should provide an objective discussion that analyses and explains the main features underlying the results and

financial position of the company concerned. The Guide provides practical guidance for drafting the Business Review section of annual reports.

According to the Guide, the Business Review can be divided into two sections: the Operating Review and the Financial Review. Regarding the Operating Review section, the following should be included:

- Operating results for the period
- Dynamics of the business
- Prospects and plans for the future
- Post balance sheet date events

Regarding the Financial Review section, the following should be included:

- Attributable return to shareholders
- Accounting policies/changes in accounting policies
- Capital structure and treasury policy
- Taxation
- Sources of funds
- Liquidity
- Going concern
- Off-balance sheet items

It is recommended that the Business Review section should discuss the nature of business activities in each of the above areas, with particular emphasis on changes in the level of activity and management policies, and should refer to the benefits

expected from such activities. However, the Guide states that the above should not be regarded as a comprehensive list of all matters that are relevant. The Business Review should also focus on other matters that are considered as significant to the business concerned.

3.3.3 Report on Directors' Remuneration

In November 1999 another report, entitled *Directors' Remuneration: Recommendations for Enhanced Transparency and Accountability* ("the Report"), was produced by the HKSA Corporate Governance Committee, with the aim of improving disclosures of directors' remuneration. The Report was prepared with reference to those parts of the OECD Corporate Governance Principles related to directors' remuneration, and was also informed by the findings of a comparative study of disclosures of directors' remuneration in major financial markets conducted by the HKSA Corporate Governance Committee. The key findings of the comparative study were as follows:

(a) Disclosure of individual directors' remuneration

In Hong Kong, the rules do not require disclosure of the remuneration of the individual highest paid directors, as required in the UK and the US. Indeed, the UK requires disclosure of each element of the remuneration package for each individual director, not just the highest paid directors. Disclosure requirements in Australia and Singapore are in common with Hong Kong in that they do not require disclosure of the remuneration of directors on an individual basis.

The current Listing Rules in Hong Kong require the disclosure of directors' emoluments in bandings: HK\$Nil to HK\$1 million and thereafter at bandings of HK\$500,000. The bandings, however, do not provide disclosure of the emoluments of individual directors by name and do not provide any analysis of the constituent elements of the remuneration. There are also no precise disclosures below the level of HK\$1 million or thereafter within the HK\$500,000 bands.

(b) All other compensation

The Hong Kong Listing Rules require the disclosure of the aggregate of directors' basic salaries, housing allowances, other allowances and benefits in kind. The US is highly prescriptive as to the constituent parts of directors' remuneration which should be disclosed. The UK also requires disclosure of "each element" of directors' remuneration.

(c) Share options

In the UK and the US, disclosure is required of the aggregate value realised by directors on the exercise of options, unexercised options at the end of the fiscal year, and the aggregate gains by the directors on the exercise of share options.

(d) General policy on directors' remuneration

In the UK, companies are required to make a statement regarding their policy on executive directors' remuneration. In the US, companies have to provide a description of their arrangements with regard to directors' remuneration.

(e) Description of contracts and terms of remuneration

In the UK and the US, there are disclosure requirements regarding employment contracts, termination of employment and change-in-control arrangements.

(f) Remuneration Committee

In the UK and the US, remuneration committees are widely used. Both the London Stock Exchange and the US Securities and Exchange Commission prescribe the functions of the remuneration committee. However, the concept has not been taken aboard in Hong Kong, where executive remuneration is generally determined by the board based on the recommendation of the executive directors.

The overall conclusion of the Report was that while the basic level of disclosure requirements on directors' remuneration in Hong Kong is comparable to other principal financial markets, transparency and accountability can be better achieved by the adoption of several further measures. The specific recommendations made in the Report are as follows:

(a) Enhanced Disclosures

1. A statement regarding the company's policy on executive directors' remuneration and share options should be given in the company's annual report.
2. The statement should also state how, and by whom, the fees and other benefits of the non-executive directors are determined.
3. A separate disclosure of directors' remuneration into "non-performance based" and "performance based" should be introduced. This can enhance the

comparability and transparency of the way directors are compensated and, in particular, the extent to which compensation is linked to firm performance.

4. In addition to standard remuneration, there should also be disclosure of all other compensation in appropriate components.
5. The disclosure of directors' share options should be expanded to include disclosure of the aggregate value realised by directors on the exercise of options, unexercised options at the end of the fiscal year, and the aggregate gains made by the directors on the exercise of their options.
6. The HKSA should develop specific recommendations on pro forma disclosure when regulators, or the Listing Rules, adopt the above recommendations.

(b) Enhanced Accountability

1. While transparency in disclosure is an important element to enable shareholders to perform their role of influencing directors' pay, disclosure cannot be an end in itself. Shareholders should have greater means of holding the board accountable. The Report proposes that remuneration committees should be appointed. The committees should be composed, either wholly or mainly, of non-executive directors, and should recommend to the board the remuneration of the executive directors.
2. The Report also reiterates a proposal made in the First Report in 1995 that, in order to strengthen shareholders' control over the level of compensation for loss of office, directors' service contract should not exceed 3 years without shareholders' approval, and directors' termination arrangements should be disclosed.

It is believed by the HKSA Corporate Governance Committee that the practice of sound corporate governance, enhanced disclosures and enhanced accountability should be self-initiated decisions of individual boards rather than matters for compliance with company or securities law, Listing Rules and the Code of Best Practice. Nevertheless, where companies fall short of public expectations, the regulators and government would have to ensure that appropriate requirements are included in the Listing Rules and company law. The HKSA recommended that its members, listed companies, public companies and the regulators adopt the recommendations made in the Report.

3.3.4 Disclosure of Corporate Governance in the Annual Report

In March 2001, the HKSA Corporate Governance Committee published another report, entitled *Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement* (“the CG Guide”). The aim of the CG Guide is to contribute towards the promotion of high standards of corporate governance disclosure in the annual reports of Hong Kong companies. This can be achieved by (CG Guide, 2001):

- Assisting those with responsibilities for preparing financial statements, such as directors and chief accounting officers, to better understand the scope and benefits of good corporate governance disclosures; and
- Making further recommendations for the enhancement of corporate governance disclosure.

In the CG Guide, a number of recommendations were made for the enhancement of corporate governance disclosure:

1. Listed companies and public corporations should be encouraged to include in their annual report a statement on corporate governance. This communicates to shareholders the strength of their corporate governance structures, policies and practices. This statement should be presented separately in the annual report with the same prominence as, for example, the directors' report. A skeleton of the statement is set out in Table 1 of the CG Guide (the content of Table 1 of the CG Guide is produced as Appendix 3 at the end of the thesis).
2. The CG Guide also repeats the HKSA's recommendations that boards should appoint remuneration committees composed of wholly or mainly non-executive directors to make recommendations to the board regarding the remuneration of executive directors.
3. To enhance comparability and transparency of the way directors are compensated, and the extent to which directors' remuneration is linked to the company's performance, the remuneration should be analysed between "performance based" and "non-performance based" compensation.
4. Disclosure should also be made of the remuneration of individual directors by name. This can allow more transparency and informed judgements to be made on the fairness and reasonableness of the remuneration in the light of the performance of the company concerned. Nevertheless, approval of the board and consent of the individual directors should be obtained before publishing the details of the remuneration of individual directors.

5. Provision should be made for analysis of directors' standard remuneration among basic salaries, benefits in kind, housing and other allowances.
6. Regarding directors' share options, disclosures should be extended to include disclosure by individual directors of the aggregate value realised on the exercise of options during the year.
7. Directors should set out in a separate statement their responsibilities in connection with the preparation of the financial statements.
8. Disclosure should also be made of non-audit fees paid to auditors in order to increase transparency regarding the auditors' independence.

Apart from making the above recommendations for the enhancement of corporate governance disclosure in Hong Kong, the CG Guide also set out an overview of the corporate governance disclosure in annual reports in Hong Kong. The CG Guide also contains four appendices, which provide the following statements and checklists:

1. Illustrative statement on corporate governance
2. Illustrative disclosure in respect of directors' remuneration, directors' share options and directors' shareholdings
3. Illustrative statement of directors' responsibilities for the financial statements
4. Detailed corporate governance disclosure checklists, concerning:
 - A. Capital structure
 - B. Board structure and functioning
 - C. Management discussion and analysis
 - D. Remuneration
 - E. Audit committee

- F. Related party transactions
- G. Other mandatory disclosures
- H. Other voluntary disclosures

The above eight checklists provide very detailed description of the existing disclosure requirement in Hong Kong together with the recommendations of the HKSA for enhanced corporate governance disclosure.

3.3.5 Best Corporate Governance Disclosure Awards

Apart from producing the above reports, the HKSA also engages actively in other work to promote and enhance corporate governance best practice. For example, it co-hosted a Roundtable with the OECD, the World Bank, the Securities and Futures Commission and the Stock Exchange of Hong Kong in May/June 2000 in Hong Kong (discussed in section 3.2.4 of this chapter). It also organises regular professional seminars on topics related to corporate governance. In addition, it initiated the “Best Corporate Governance Disclosure Awards” competition in 2000 with the aim of providing a benchmark of existing best practice, thereby assisting and encouraging more companies to emulate the achievement of the best of their own corporate governance practices, policies and disclosures. In order to qualify for the Awards, the winners must demonstrate a high standard of corporate governance practices and disclosures.

In the first year of its launch in Year 2000 there were, altogether, 54 entries in the competition. The entrants were judged by the quality of presentation and disclosure

of corporate governance information in their latest annual reports in respect of the financial year up to 31 March 2000.

The judging criteria were as follows (Judges' Report, 2000):

1. Overall presentation
2. Promptness of reporting
3. Quality of disclosure of the following information:
 - Capital structure
 - Board structure and functioning
 - Management discussion and analysis on operating and financial affairs as well as on non-financial performance information
 - Remuneration policy and packages analysis of directors and key executives
 - Audit committee's composition, role and function
 - Related party transactions and relationship
 - Other voluntary disclosures such as social responsibility, community services, etc.
4. Compliance with corporate governance disclosure requirements of the Companies Ordinance and the Stock Exchange Listing Rules.

The overall comments of the judges were that compliance with the mandatory corporate governance disclosure requirements of the Listing Rules and the Companies Ordinance is generally high. However, companies should be encouraged to make

more voluntary disclosures, rather than just merely meeting the minimum statutory or regulatory requirements.

Among the seven winners of various awards, the “Grand Award” winner was HSBC Holdings plc. The overall comment to this Grand Award winner was that it set a high standard of corporate governance that Hong Kong listed companies should aspire to in terms of compliance, disclosure, layout and presentation of the annual report. HSBC has established more extensive corporate governance practices than those called for in local standards.¹¹ These include a larger number of independent directors, reports from board committees, a detailed “Report of The Directors” which also includes the compensation paid to individual directors and senior executives (Judges’ Report, 2000).

The HKSA once again organised this Awards competition in 2001. The number of entrants increased from 54 to 62. The Grand Award winner was still HSBC Holdings plc. The judges commented that, while the overall standard had improved, there were also areas where improvements could be made. Apart from providing commentaries on the annual reports of the individual winners and the overall standard of entries, the judges’ report also set out recommendations for improvements (Judges’ Report, 2001).

¹¹ It must be recognised, of course, that as it is also listed on the London, New York and Paris stock exchanges, HSBC is subject to stricter disclosure requirements than other Hong Kong companies.

While the first two years' competitions focused more on establishing benchmarks, the third competition in 2002 placed more emphasis on encouraging improvements. This shift of emphasis was reflected by the introduction of a new "Significant Improvement Award" in the competition. This was introduced to encourage and recognise local businesses which, without necessarily being subject to the demands of more stringent overseas regulatory requirements, nevertheless show a desire to raise their own standards (Judges' Report, 2002).

The general finding of the third competition was that improvements had been observed. More companies and organisations were including statements of policy and practice in relation to corporate governance. For example, more information was given in relation to the number of board and committee meetings held and there was a greater number of independent non-executive directors involved on boards and committees (Judges' Report, 2002).

There was no Grand Award made in 2002, although HSBC Holdings plc attained the "Diamond Award", the highest rank in the Heng Seng Index Category of the competition. The awards made to HSBC over the years reflect the fact that, as a UK-domiciled company, it complies with the UK's Combined Code on corporate governance. The fact that no purely Hong Kong-based company has won the top award suggests that Hong Kong companies that do not have a foreign listing still have room to improve the quality of their corporate governance.

3.3.6 Other Corporate Governance Reports and Conferences

Apart from the HKSA, there are other professional bodies and academic institutions active in promoting and enhancing corporate governance in Hong Kong. The contributions by these organisations are summarised as follows:

(a) Reports published by the Hong Kong Institute of Company Secretaries

The Hong Kong Institute of Company Secretaries (“HKICS”) is an independent professional body. It is an association of the Hong Kong members of the Institute of Chartered Secretaries and Administrators of London. The principal aim of the HKICS is to promote and advance the efficient administration of commerce, industry and public affairs.

The HKICS also works closely with various authorities and contributes towards corporate governance issues. In April 2001, it published a research report entitled *Division of Duties and Responsibilities between the Company Secretary and Directors in Hong Kong*. The research report was based upon the findings of questionnaire returns from company secretaries and directors of Hong Kong listed companies. Twenty company secretaries and twenty directors, chairmen and chief executive officers were also interviewed in the research process.

The focus of the report was on the division of duties and responsibilities between the company secretary and the directors in the context of recent corporate governance developments in Hong Kong. The principal findings and recommendations of the report were as follows:

1. While the current professional training of company secretaries tends to involve a reasonably appropriate balance of legal and financial knowledge, consideration needs to be given to introduce other aspects of corporate governance, administration and management. The scope must also include both the listed and private company dimensions.¹²
2. The role of the company secretary's support for the efficiency and effectiveness of the board needs to be more fully explored and emphasised. The HKICS can do more to enhance the training and effectiveness of company secretaries.
3. The report found that it remains questionable as to whether the independent non-executive directors are truly independent and whether they understand their roles. Training and education of directors has not been extensive enough. It is suggested that the Hong Kong Institute of Directors can do more in this regard.
4. There is no one corporate governance structure that is ideal for all companies and circumstances. Prescriptive legislation ought to be avoided.
5. While the board of directors remains responsible for the governance of corporations, the supportive role of company secretaries is an important aspect which must not be underestimated. It needs to be built upon and encouraged.

¹² In addition, to provide a wider degree of training and recognition, the HKICS may explore the development of a masters degree programme, for example an MA or MBA in Corporate Governance.

(b) Conferences organised by the Hong Kong Institute of Company Secretaries

Apart from conducting regular continuing professional seminars on topics relating to corporate governance, the HKICS has also hosted three conferences on corporate governance in Hong Kong in the last few years.¹³ The first conference was held in November 1998 on the theme of “Corporate Governance and the Challenges Ahead”. Trends in corporate governance and issues related to responsibility, transparency and information technology were discussed, as well as governance issues in emerging markets.

The second conference, “Corporate Governance 2000 – A Practical View”, was held in November 2000 and focused on corporate governance issues related to the banking and insurance industries, corporate ratings and audit committees. The third conference, “Corporate Governance 2002 – A Practitioner’s Perspective”, was held in October 2002. Following the Enron collapse, the conference focused on the quality of directors and on issues concerning ethics and integrity.

(c) Conferences and Symposia organised by other institutions

In addition to the HKSA and HKICS, various universities in Hong Kong are also active in holding conferences and symposia to exchange ideas and research on corporate governance issues.

¹³ Participants at the conferences included academics, professionals, government officials and representatives from regulatory authorities. The conferences provide a forum for participants to exchange ideas on improving the corporate governance systems not only for Hong Kong companies, but also for various organisations in the East-Asian region and emerging markets more generally.

For example, The Chinese University of Hong Kong held its first “Symposium on Corporate Governance and Disclosures” in March 1999. Discussions in the symposium mainly concerned management control and financial disclosures. In February 2001, it held a “Symposium on Corporate Governance and Disclosure: Enhancing the Competitiveness of Hong Kong”, during which corporate governance issues such as disclosure and transparency were discussed. In February 2002, it organised its third symposium entitled “Symposium on Corporate Governance and Disclosure: The Impact on Globalisation”. The symposia were well attended by academics, professionals and government officials.

The City University of Hong Kong has been organising its “Asia-Pacific Journal of Accounting and Economics Symposium” annually since the Year 2000. Corporate governance issues, especially those related to the Asia-Pacific region, have been discussed during these symposia.

In addition to academic institutions, the Hong Kong Securities and Futures Commission (“SFC”) held a conference entitled “Corporate Governance in the Pan Chinese Market” in Hong Kong in October 2001. Various corporate governance issues, such as, the role of shareholders and auditors, the benefits of transparency, and the responsibility and training of directors, were discussed during the conference. During the conference various representatives from the Stock Exchange and the SFC emphasised that they were working together on an overall review of the Listing Rules and the Codes on Takeovers and Mergers and Repurchases in order to further improve the corporate governance regime in Hong Kong.

3.3.7 Corporate Governance Review

In his Budget Speech of 2000/01, the then Financial Secretary Mr. Donald Tsang announced that a comprehensive review of corporate governance should be undertaken in order to identify and plug any gaps in Hong Kong's corporate governance regime. The Standing Committee on Company Law Reform ("SCCLR") is responsible for conducting this Corporate Governance Review ("CGR") in Hong Kong.

The primary objectives of having laws and rules are to ensure that minimum standards of behaviour are reflected in the law and that they are complied with. However, with a view to maximising returns to shareholders, there is a broader objective of raising the standards of corporate behaviour, which also involves raising the general ethical standards of managers and controlling shareholders. The SCCLR considers that too many prescriptive rules and regulations will not achieve the objective of maximising returns to shareholders. As each type of company may have different governance needs depending on, for instance, its size and objectives, the corporate governance "wisdom" is that it is not practicable to prescribe detailed rules for every type of company. To achieve a correct balance, it believes that it is crucial that there must also be the right "culture". This involves self-discipline, by the board, the management and controlling shareholders as well as market discipline, to help monitor the performance of companies (SCCLR, 2001).

In order to address gaps in the regulatory regime, the SCCLR considers that the standard of the regulatory regime in Hong Kong must be at least commensurate with

that of international jurisdictions, with variations if necessary to take into account the Hong Kong corporate environment.

For example, one of the considerations of the SCCLR is that in many Hong Kong listed companies a single dominant shareholder or single group of persons controls the company. This may be the significant shareholder or a person connected with the “controlling” shareholder. Typically the “controlling” shareholder would appoint persons connected with him onto the board of a listed company, or its subsidiaries.

One of the first tasks of the CGR has been to commission two major surveys. The first is a survey of the attitudes of international institutional investors towards corporate governance standards in Hong Kong. The second is a comparative survey of the development of corporate governance standards in both the competitor jurisdictions in South-East Asia and jurisdictions elsewhere in the world. The jurisdictions in the survey include Australia, Singapore, Taiwan, the UK and the US.

In order to conduct the CGR, three sub-committees were established, which are:

1. The Directors Sub-Committee;
2. The Shareholders Sub-Committee; and
3. The Corporate Reporting Sub-Committee.

The terms of reference of the three sub-committees can be found in Appendices 4 to 6 at the end of this thesis.

Essentially, the CGR is proceeding on two major fronts, as follows:

1. The universities have been or will be commissioned, after a tendering exercise, to undertake various surveys and research projects which have been identified by the three sub-committees.
2. Since mid-2000, the sub-committees have been considering papers on specific subjects, having regard to their terms of reference, which can be considered in advance of the results of the consultancy projects. It is possible that some of these subjects may have to be reconsidered in the light of the findings of the consultancy projects while a number of issues cannot be considered until the results of the consultancy projects are known.

In July 2001, the SCCLR published a Consultation Paper seeking public opinions on the proposals made in the first phase of the CGR.¹⁴ The second phase of the CGR is still on-going. It is the plan of the SCCLR to deal with the CGR in phases. This will enable some proposals to be implemented at an earlier stage than others, rather than including all proposals in a major report, whose preparation would take a longer time and delay the implementation of certain reforms.

¹⁴ A full copy of the Consultation Paper can be found at the web-site of the Hong Kong Companies Registry at <http://www.info.gov.hk/cr>.

3.4 A Study of the Audit Committee in Hong Kong

As discussed in section 3.3.1 above, the Stock Exchange of Hong Kong in May 1998 adopted the recommendation made by the HKSA regarding the formation of audit committees. Every listed company was required to establish an audit committee for accounting periods commencing on or after 1 January 1999. Any company failing to comply with this requirement must report the reasons for non-compliance in their annual report.

However, the mere existence of an audit committee in a company does not necessarily mean that the quality and transparency of financial reporting will improve and that the company will be better monitored and governed. This section explores the effectiveness of audit committees in enhancing corporate governance standards in Hong Kong. The attributes and functions of an effective audit committee are also discussed.

3.4.1 Attributes of an Effective Audit Committee

While the precise authority and structure of an audit committee will vary depending on the circumstances of the company concerned, the attributes that are essential for an effective audit committee include the following (Sun, 1996):

1. The committee is vested with proper authority, status and responsibility.
2. The members of the audit committee are remunerated at a level to reflect the significant responsibility and time commitment involved in serving on the committee.

3. The committee is made up of independent non-executives with suitable experience and expertise who are prepared to commit sufficient time and effort to the task.
4. The committee meetings are properly planned with a formal agenda and supporting materials prepared in sufficient detail to allow consideration of issues and an understanding of their implications.
5. The committee reports formally to the board and the shareholders in the annual report.

George (1999a) also pointed out some essential attributes of an effective audit committee:

1. It should have clear, written terms of reference.
2. Audit committee meetings should be held regularly, typically three or four times each year. Management and auditors can also be invited to attend the meetings. The meetings should have an agenda and minutes should be properly prepared by the audit committee secretary.
3. The audit committee members should possess the industry sector knowledge and the necessary skills and experience in sufficient breadth and depth.
4. The chairman of the audit committee should be appointed directly by the board. He/she should have a strong and independent character and have a financial background and knowledge of the requirements of the Stock Exchange.
5. The chairman should also have clear communication with the finance director of the company and be kept informed of the views of the finance director.

3.4.2 Functions and Responsibilities

An effective audit committee can perform the following functions (Sun, 1996):

1. it can serve as a vehicle of communication among the shareholders, directors, auditors and regulators;
2. it can create a climate of discipline and sound financial control;
3. it can contribute to ensuring balanced and understandable financial reporting;
4. it can be a counterbalance to the chairman, chief executive or finance director.

While the precise responsibilities of audit committees will vary depending upon the circumstances of a particular company, in principle, the basic responsibilities are assisting the board to fulfil its duties concerning internal control and financial and management reporting (HKSA, 1997):

(a) Financial and other reporting

This mainly concerns with the review of the completeness, accuracy and fairness of the interim and annual financial statements of the company concerned. The review should challenge the quality of earnings and the completeness and fairness of disclosures together with the appropriateness of statements given by the directors in the Directors' Report.

(b) Internal control

Business risk is a major concern for the management of a company. Audit committee members should obtain assurances that management systematically identifies key areas of risk and that an appropriate control environment is enforced and maintained.

In reviewing the adequacy of the control environment, the audit committee has to review reports by the internal auditors and any management letters submitted by the external auditors. The process may also involve site visits and a review of documentation of the company's systems. The audit committee members should also meet with the internal auditors, external auditors and management to discuss the findings and resolutions.

(c) Audit

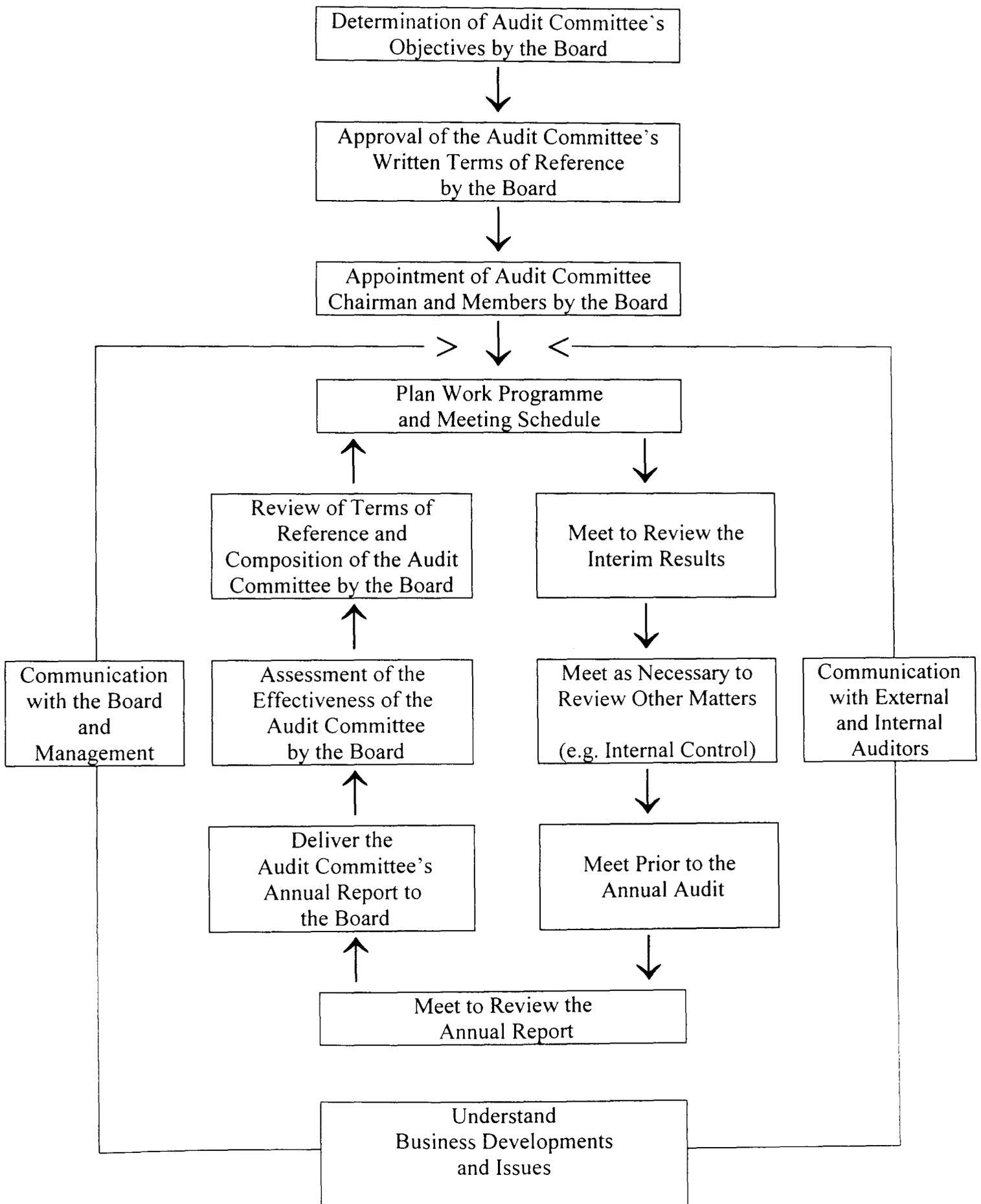
The audit committee should monitor internal and external audit coverage to ensure all key risk areas are considered. This involves reviewing and discussing with the auditors the current year's audit plan and the resolution of issues from prior years.

(d) Responding to management needs

Apart from the above specific areas of financial reporting, internal control and audit, the audit committee also considers a wide range of issues. The issues can be specifically delegated by the board, be referred to in the terms of reference, or may arise as a natural extension of the review of the company's affairs. The audit committee may also review compliance with statutory regulations and other regulatory, industry or legal requirements and social obligations.

The detailed responsibilities of the audit committee should be clearly documented in the terms of reference (HKSA, 1997). A typical work cycle of an audit committee can be found in the figure on the following page:

Figure 3.1 Illustrative Work Cycle of an Audit Committee



Source: George (1999a), *Audit Committees: A Major Corporate Governance Initiative*

3.4.3 Benefits from an Effective Audit Committee

An effective audit committee serves as a means to increase board effectiveness, accountability, transparency and objectivity. If an audit committee possesses the correct attributes and functions properly, it can bring the following benefits to the companies and the investors concerned (HKSA, 1997):

1. improve the quality of financial reporting, by reviewing the financial statements on behalf of the board;
2. create a climate of discipline and control which will reduce the opportunity for fraud;
3. enable the non-executive directors to contribute an independent judgement and play a positive role;
4. help the finance director, by providing a forum in which he can raise issues of concern;
5. strengthen the position of the external auditor, by providing a channel of communication and forum for issues of concern;
6. provide a framework within which the external auditor can assert his independence in the event of a dispute with management;
7. strengthen the position of the internal audit function, by providing a greater degree of independence from management;
8. increase public confidence in the credibility and objectivity of financial statements and of the board.

Sun (1996) also suggested that an effective audit committee can produce the following benefits:

1. improve the quality of financial reporting;
2. reinforce management's control-consciousness and the company's overall control environment, thereby reducing the risk of illegal and improper acts or management fraud;
3. in the case of disagreement, mediate between the finance director and the auditors.

However, experiences from both Hong Kong and other parts of the world have revealed that there are a number of factors rendering the audit committee ineffective. An assessment of the effectiveness of the audit committees of listed companies in Hong Kong follows in the next section.

3.4.4 Assessment of Effectiveness

As discussed above, an audit committee can only be effective if it possesses a number of attributes and is functioning properly. For example, it must have clear written terms of reference, with adequate authority and resources, consist of capable members and a strong chairman, meet regularly with support from the board and be able to establish clear lines of communication with the board, finance director and the auditors (George, 1999a).

However, in practice, audit committees are very often not as effective as they are supposed to be. This is because there are a number of factors and limitations which may render an audit committee ineffective. For example (Sun, 1996):

1. when an audit committee is set up for the sake of appearance rather than out of a real commitment to good corporate governance,
2. sometimes an audit committee is set up merely to act as a rubber stamp for decisions made by the executive directors,
3. there is a lack of clarity as to the relationship between the audit committee and the board to which it is accountable due to unclear terms of reference,
4. there is a lack of commitment by the board to allow and encourage the audit committee to operate with appropriate authority, independence and objectivity,
5. there is a lack of appropriate expertise among the audit committee members,
6. there is a lack of commitment by and incentives to members to devote sufficient time and effort to the audit committee.

While it is generally agreed that the most important characteristics of effective audit committee members are independence, business experience and financial expertise (Mackintosh, 1999) it is also noted that some common problems with audit committees are that many members are not “independent” and do not possess the appropriate financial skills (Ng, 2000). Listed companies often find it difficult to attract high calibre individuals with broad and relevant business and financial experience to act as non-executive directors. Since audit committee members are appointed from amongst the non-executive directors of the board, audit committees face the same problems in attracting effective members (George, 1999b).

Ng (2000) also points out that smaller companies may not consider forming an audit committee, believing that they have alternative means of handling corporate governance matters (such as through the full board of directors) and may not consider it necessary or beneficial to form a specific sub-committee. In addition, smaller companies may not be in the financial position to be able to afford the potentially high costs of forming an audit committee. The possible benefits of audit committees may be outweighed by the costs for smaller companies.

In a recent project on the relationship between audit committees and internal control in Hong Kong, conducted by a group of students studying at the Hong Kong Polytechnic University, there was a similar finding relating to the size of companies. Large companies (measured by number of employees exceeding 5,000) were found to prefer setting up an internal audit department, whereas small companies were less willing to spend extra resources on internal auditing. They preferred to rely on external auditors rather than setting up an internal audit department. Also, small companies did not agree that audit committees could perform the functions of reviewing accounting and management information systems and internal control systems. The other major findings and recommendations of the project were as follows:

1. Most directors agreed that audit committees have the responsibilities to review and approve the proposed annual internal audit program, thereby improving the internal control systems and the effectiveness of internal audit.

2. While the HKSA recommended that audit committees be solely comprised of non-executive directors, the aim was that it would lead to more independence. Consistent with this assumption, the project group found that audit committees with more non-executive directors have more frequent meetings with the chief internal auditors.
3. However, it appears that the audit committees are not very effective as such and there is still much room for improvement in the following areas:
 - Audit committees should be involved in making decisions about the dismissal of the chief internal auditors.
 - Audit committees should have more meetings each year with the internal auditors.
 - Audit committees should be delegated with more authority and they should play a more active role in the review and approval of the annual internal audit programs.

As noted from the above project, and the comments made by George, Sun and Ng, there are limitations and deficiencies in the current structure and attributes of the audit committees in Hong Kong companies.¹⁵ Given that most Hong Kong companies are family-owned, very often the executive directors are either substantial shareholders or related persons. As a consequence, there is a tendency for executive directors to retain power in their hands rather than giving authority to the audit committees. Because of Hong Kong's family-owned corporate structure and its deeply-rooted

¹⁵ George, Sun and Ng are professionals and academics with extensive experience of corporate governance in Hong Kong.

Chinese culture, the setting up of audit committees in listed companies is only a fairly recent initiative. It is inevitable that it will take time for companies to improve the composition of audit committees and to vest them with proper authority. This is an important move as an effective audit committee will not only facilitate communication among the company, the auditors and the regulators, it can also serve as an agent to improve the corporate governance standard of the company concerned, thereby contributing to the improvement of overall corporate governance standards in Hong Kong.

3.5 Summary and Conclusions

In this chapter, the work of various international organisations, local professional bodies and academic institutions in enhancing corporate governance after the East-Asian financial crisis are discussed and analysed. While many organisations have contributed proposals and ideas to create a better corporate governance framework, it is unanimously agreed that there is no single “best” model of corporate governance anywhere in the world. As pointed out by Mr. Iskander, Director of the Private Sector Development Department of The World Bank, there are many different corporate forms and consequently many possible approaches to corporate governance reform. Each country must find a model that can best fit its own culture and history and its government’s capacity to regulate (Company Secretary, 2000).

Despite the fact that there is no single “best” model, there are some common features of effective corporate governance. It is worth noting that all the studies, forums, roundtables and conferences have discussed issues relating to the following:

1. Improving the effectiveness of the board. For example, increasing the number of “quality” independent non-executive directors, providing more training to directors and requiring the directors to be accountable for their responsibilities and duties.
2. Enhancing the transparency of disclosures in financial statements. For example, more voluntary disclosures are encouraged, and a corporate governance statement should also be included in annual reports.

3. Encouraging more timely disclosures of various financial and non-financial transactions, especially if they are material in nature, connected with directors and if they are related-party transactions.
4. Recognising the benefits that can be brought about by an effective audit committee, audit committees should be empowered with more authority. The terms of reference of audit committee should be clearly defined. The attributes and commitments of the audit committee members, the number of meetings held and the communications of the audit committee members with the management and auditors are also important factors in making the audit committee effective.
5. Establishing remuneration committees can benefit companies in a number of aspects. For example, they can recommend to the boards the remuneration of executive directors and give advice on various remuneration matters. An effective remuneration committee should be composed of wholly or mainly non-executive directors.

As noted by the Asian Development Bank in its study of the corporate governance systems in various Asian countries, most countries' governance structures are not far from those of the UK or the US. However, the problem is one of enforcement and of how to strengthen corporate governance regulations to facilitate enforcement. Many countries have rules in place but they do not always have the capacity to enforce them. They often lack the human capital and institutional arrangements needed to make the rules work (Company Secretary, 2000).

From the qualitative analyses in Chapters Two and Three, it is generally found that Hong Kong's corporate governance structure is one of the better ones among various East-Asian countries. However, there is still much room for improvement, especially in respect of audit committees, remuneration committees and the level of transparency of disclosures. Further recommendations for improving the corporate governance regime in Hong Kong are made in Chapter Seven. In fact, most of the areas that require improvements are associated with the family-ownership corporate structure in Hong Kong and its traditional Chinese culture. The directors or management who are also substantial shareholders are reluctant to delegate authority to independent officers and executives. They also tend to keep their decisions and business information as secret as possible and they do not like the idea of "transparency". These characteristics are not only common in most Hong Kong companies, but also in various East-Asian countries. Hence, adoption of corporate governance rules in themselves might not be enough to improve corporate performance in Hong Kong and in the East-Asian region. There is a greater need, perhaps, to improve the infrastructure in order to ensure effective implementation of the rules. For example, improving the capacity of the judiciary and the regulatory authorities, as well as providing training and continuing education to directors, without which corporate governance reforms may never become effective.

The Hong Kong Government has begun take steps to improve the corporate governance regime. Meanwhile, the views of the public have been sought on the first phase of proposals contained in the Consultation Paper of the Corporate Governance Review ("CGR") in Hong Kong. The second phase of the CGR is on-going. Hong

Kong Exchanges and Clearing Limited is also proposing to amend the Listing Rules to enhance corporate governance.¹⁶ It issued a Consultation Paper in January 2002 seeking public opinions on its proposed changes to the Listing Rules. It is envisaged that with the effort and input of the Government and the regulatory bodies, corporate governance standards in Hong Kong companies can be further improved. However, to be successful, this will require continual efforts by the Government, professional organisations, regulatory authorities, as well company management as a whole.

As discussed above, given the unique historical background, culture and family-ownership structure in Hong Kong companies, the models that are applicable in international jurisdictions may not necessarily be suitable and effective in Hong Kong. It is reasonable to argue that Hong Kong has been on the right track in deriving sound corporate governance principles from the UK while remaining “conservative” in certain aspects due to its cultural background. It is not an easy task to develop and arrive at an optimal corporate governance framework for Hong Kong companies, especially regarding improvements in those corporate governance practices which are considered as being “too conservative” and require improvement. In order to help to design a better model of corporate governance for Hong Kong corporations, the above qualitative analyses are not sufficient in themselves. In the remaining parts of the thesis, empirical analyses are conducted to ascertain the possible impact of the family-owned corporate structure in Hong Kong on firm

¹⁶ Hong Kong Exchanges and Clearing Limited (HKEx) is the holding company of the Stock Exchange of Hong Kong Limited, the Hong Kong Futures Exchange Limited and the Hong Kong Securities Clearing Company Limited. HKEx went public in June 2000 following the integration of the securities and futures market in March 2000.

performance. The possible impact of the East-Asian financial crisis on firm performance is also analysed empirically. The results from both the qualitative and the empirical studies are then reviewed and integrated so as to derive a set of recommendations for improving corporate governance standards in Hong Kong.

Chapter Four

Literature Review

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4.1 Chapter Objectives

In the previous two chapters, a critical analysis of corporate governance regimes in selected countries is carried out. The corporate governance initiatives proposed and adopted by international organisations, local professional bodies and governments in the aftermath of the East-Asian financial crisis are also discussed. However, since historical background and culture differ across countries, the corporate governance models that are applicable in particular international jurisdictions may not be suitable and effective in all East-Asian countries. Therefore, it is not an easy task to develop and arrive at an optimal corporate governance framework for companies in each jurisdiction. Also, it is suggested by various organisations, for example, the Asian Development Bank, that actually the governance structures in most of the East-Asian countries are not far from those of the UK or the US. The countries have corporate governance rules in place, but they are often weak in terms of the human capital and institutional arrangements needed to enforce these rules (Company Secretary, 2000).

Another reason that may account for the weaker corporate governance structures in the East-Asian countries is that the form of corporate ownership differs from that found in the UK and the US. There have been numerous academic studies which have examined the relationship between ownership and performance, but most of them are based on US evidence, where the largely dispersed ownership structure is very different from the concentrated form of ownership which characterises the East-Asian region. It is therefore doubtful whether the findings of these studies are applicable to other parts of the world. The recent study of Fan and Wong (2002) also suggests that

prior research focusing on US corporations is not applicable to East-Asian corporations due to the differences in ownership concentration and the different types of agency problems that they give rise to.

In this thesis, an empirical study is performed to determine the relationship between managerial ownership and corporate performance using Hong Kong evidence. The principal aim is to ascertain the impact of managerial ownership on corporate performance in a family-owned corporate structure and to uncover any differences from the findings in the UK and US contexts.

Before carrying out the empirical study, this chapter contains a review of the academic literature on corporate governance, with particular reference to studies of the relationship between managerial ownership and corporate performance. A discussion of corporate ownership structures in the UK, the US and Hong Kong will also be included in this chapter, by reference to the relevant literature. The possible impact of cultural differences will also be discussed, with emphasis placed on the leading work in this area by Hofstede. The chapter ends by discussing the possible impact of the endogeneity issue for the study of the relationship between managerial ownership and firm performance in the Hong Kong context.

4.2 Previous Research on Corporate Governance

The literature on agency theory provided the major contribution towards corporate governance thinking in the late 1970s and 1980s. Key contributions were made by Jensen and Meckling (1976), Fama and Jensen (1983) and Jensen (1986). Inherent in this theoretical perspective is a particular view of the nature of man: essentially, that he is self-interested rather than altruistic. As an individual utility maximiser, he cannot be trusted always to act in the best interests of others (Tricker, 1995). Jensen and Meckling (1976) define an agency relationship as:

“A contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximisers there is good reason to believe that the agent will not always act in the best interests of the principal...”

Jensen and Meckling (1976, pg.308)

As a result of this behaviour, Jensen and Meckling (1976) further argued that the transaction costs such as further disclosure, independent outside directors and audit committees, should be incurred to the point at which the reduction of the loss from non-compliance of the above measures equals the increase in enforcement costs.

Following the 1987 stock market crash and a number of well-publicized corporate collapses such as the Bank of Credit and Commerce International (BCCI), there has

been a great deal of academic and professional debate over the matter of corporate governance. Governance problems often arise as a result of the separation of ownership and control within a business organization (Fama and Jensen, 1983; Shleifer and Vishny, 1997). Corporate governance mechanisms are introduced to control the agency problem to ensure that managers act in the interests of the shareholders and other stakeholders. Several corporate governance mechanisms have been identified in the literature. For example, Agrawal and Knoeber (1996) identify seven mechanisms. Of these, three mechanisms are determined by outsiders, namely: institutional shareholdings, outside block holdings and takeover activity. The other four mechanisms are decided by insiders, namely: board membership and characteristics, inside shareholding, debt financing and the use of outside markets for managerial talent. The adoption of more governance mechanisms will strengthen internal control and provide an “intensive monitoring package” for a firm to reduce opportunistic behaviours and information asymmetry (Leftwich et al., 1981; Welker 1995).

There are a number of major areas of research on corporate governance issues. For example, on the role and composition of the board of directors, on directors’ remuneration, on management turnover, on voluntary disclosures, on audit and remuneration committees, on institutional shareholders and on managerial ownership, etc. The leading literature on these studies are discussed in this section.

(a) Studies on the role and composition of the board of directors

One major strand of research examines the role and composition of the board of directors in reducing agency costs; and whether the existence of non-executive directors on the boards are valuable (e.g. Rosenstein and Wyatt, 1990; Forker, 1992; Wallace and Naser, 1995; Kren and Kerr, 1997). Directors play an important role in the corporate governance process (Fama and Jensen, 1983). A major role of the board is its control functions (Pound, 1995). Directors monitor and assess managerial performance, decide compensation levels of senior managers, provide advice, and provide links to other organisations. They resolve the agency conflicts between shareholders and managers. Outside directors who are unaffiliated with the firm have the most independence to credibly arbitrate these conflicts (Hanson and Song, 2000). Outside or independent non-executive directors are perceived as a tool for monitoring management behaviour (Rosenstein and Wyatt, 1990). Leftwich et al. (1981) and Fama and Jensen (1983) argue that the larger the proportion of independent non-executive directors on the board, the more effective it will be in monitoring managerial opportunism. Forker (1992) finds that a higher percentage of independent non-executive directors on the board enhances the monitoring of the financial disclosure quality and reduces the benefits of withholding information. Chen and Jaggi (1998) also find that the proportion of independent non-executive directors on the board is positively related to the quality and extent of financial disclosure.

Rosenstein and Wyatt (1990) provide evidence of a positive abnormal stock return when outside directors are added to the boards. They suggest that the market expects better performance from firms with more outside directors. Byrd and Hickman

(1992), Lee et al. (1992) and Brickley et al. (1994) suggest that board composition matters and that outside directors provide effective monitoring. Yermack (1996), on the contrary, finds that there is no association between the percentage of outside directors and firm performance, though he finds that firm value and performance is a decreasing function of board size. Baysinger and Butler (1985), Hermalin and Weisbach (1991), and Bhagat and Black (1997) all find no meaningful relations between board composition and firm performance. Therefore, the results reported in the literature in this aspect are mixed, but in general, they suggest that board composition may be associated with corporate policies and performance.

(b) Studies relating to directors' remuneration

A further line of research studies how corporate performance is related to corporate governance factors such as directors' remuneration. The linkage between performance-based compensation and firm performance has been studied extensively. While some empirical findings establish a strong statistical link between compensation and performance, the results are not conclusive (Milkovich and Newman, 1993). It can be seen from the findings in the literature that there is still lacking of consensus on the precise relationship between directors' remuneration and corporate performance. For instance, while Hirschey and Pappas (1981) find a negative association between accounting income and directors' cash compensation, Kumar et al. (1993) find that there exists a positive relationship between earnings and directors' remuneration. Agrawal et al. (1991) analyze pooled time-series cross-sectional regressions and find that cash compensation is positively related to both shareholders return and sales growth. Ciscel (1977) finds a weak correlation between cash

compensation and both sales and profits, while Baker et al. (1988) find that there is a statistically significant positive association between the logarithm of sales and CEO compensation. Core et al. (1999) find that board structure variables are somewhat more important than ownership structure variables in predicting future performance, and that board and ownership structure are associated with the level of chief executives' compensation.

Smyth, Boyles and Peseau (1975) and Hirschey and Pappas (1981) argue that in a rate-of-return regulated environment such as public utilities, the role of compensation is to provide incentives for sales maximization rather than profit maximization. Duru and Iyengar (1999) carried out an investigation of firms through a number of years' observations and found that there is a positive association between changes in compensation and changes in firm performance in the electric utility industry.

According to Persons (1999), the Research & Development (R&D) expenditure had a significantly positive association with executive remuneration. He finds that firms in high-technology industries use R&D expenditure, in addition to earnings, in compensation contracts to motivate directors to undertake risky R&D projects which benefit the firms' long-term well-being. Several studies have documented the relevance of R&D, which is a major constituent for some industries (for example high technology industry and pharmaceutical industry), in determination of a firm's market value. Chan et al. (1990) find a significantly positive market reaction to announcements of increased R&D expenditure. Lev and Sougiannia (1996) report that

adjusting earnings and book values by R&D capitalization measure yields value-relevant information to investors.

Both Mayers and Smith (1992) and Traichal et al. (1999) report positive relation between growth opportunities and pay-for-performance sensitivity. Traichal et al. (1999) also find evidence in support of Jensen and Meckling's (1976) alignment of director incentive through stock ownership, and that stock ownership lowers pay-for-performance sensitivity.

So far most of the research in this topic was carried out under the American or European contexts. Studies of the Asian countries are limited. The only piece of recent literature that used Hong Kong companies data appeared to be Firth et al. (1999), which include a spectrum of listed companies in Hong Kong, in 1994 and 1995, excluding banking corporations. Firth et al. (1999) find that the major explainer of directors' pay levels is company size. Accounting profitability is also an explainer while stock return has little or no statistically significant relationship with directors' remuneration.

(c) Studies relating to top management turnover

Another line of research is on the relationship between firm performance and top management turnover. The existence of a negative relationship between firm performance and the probability of a top management change is found by Shleifer and Vishny (1997). This finding is supported by the US studies of Schwartz and Menon (1985), Warner et al. (1988), Fredrickson et al. (1988), Lubatkin et al. (1989), Canella

et al. (1991), Datta and Guthrie (1994) and Denis and Denis (1995) and the Japanese studies by Anderson et al. (1992), Kaplan (1994) and Kang and Shivdasani (1995). Weisbach (1988) finds that the association between CEO replacement and poor performance is greater as the proportion of independent outside directors on the board increases. However, Denis and Denis (1995), Davidson et al. (1990) and Kang and Shivdasani (1995) record performance improvements which followed top management dismissals. Dalton and Kesner (1983), Friedman and Singh (1989) and Puffer and Weintrop (1991) all fail to document any statistically significant relationship between firm performance and top management changes.

(d) Studies on voluntary disclosures in financial statements

Voluntary disclosure and its determinants is another line of research in corporate governance. Again, most studies were done in the US or other developed countries (e.g. Malone et al., 1993; Raffournier, 1995; Lang and Lundholm, 1996). The corporate governance attributes that may influence voluntary disclosure practice examined in these studies include ownership structure (e.g. Craswell and Taylor, 1992; Mckinnon and Dalimunthe, 1993; Hossain et al., 1994; Raffournier, 1995), the proportion or existence of independent directors (e.g. Forker, 1992; Malone et al., 1993), the appointment of a non-executive director as chairman and the existence of an audit committee (e.g. Forker, 1992).

(e) Studies on audit and remuneration committees

There are also studies on other corporate governance variables. For example, on the functions and effectiveness of audit committees and remuneration or compensation

committees. The functions of an audit committee include ensuring the quality of financial accounting and control system (Collier, 1993). The existence of an audit committee may improve internal control system and thus it is regarded as an effective monitoring device for improving disclosure quality (Forker, 1992). McMullen (1996) also provides support for the association between the presence of an audit committee and more reliable financial reporting. The importance of the compensation committee is also supported empirically. The compensation committee plays an important role in overseeing a firm's compensation programmes and the composition of the committee influences executive compensation practices (Newman, 2000). Belliveau et al. (1996) find that the social status of the chairman of the compensation committee has a strong influence on CEO compensation. O'Reilly et al. (1988) find a strong association between CEO compensation and the compensation levels of outside directors on the compensation committee. Newman and Mozes (1999) find that CEO compensation practices differ depending on whether insiders are present on the compensation committee.

(f) Studies on the impacts of institutional or block shareholders

Another study in corporate governance is on the impacts of institutional or blockholder ownership. Regarding the studies on the relationship between institutional ownership and firm value, Brickley et al. (1988), Mikkelsen and Ruback (1985) and Denis and Denis (1995) all find a positive relationship between the two variables. However, Pound (1988), Barclay and Holderness (1991) and Lorderer and Martin (1993) suggest that the strength of the relationship depends upon the behaviour of the major shareholders. Pound (1988) suggests that the major shareholders have an impact on

firm value only when they become actively involved in the corporate governance of the firm concerned. Shleifer and Vishny (1986) contend that blockholders may monitor the actions of management effectively because they represent a credible takeover threat if firm performance declines. Shivdasani (1993) finds that ownership by blockholders who are unaffiliated with the management raise the likelihood of a hostile takeover attempt. Denis et al. (1997) suggest that the probability of a CEO being terminated is positively related to the presence of an outside blockholder. These findings suggest that the larger the shareholding of an outside blockholder, the greater the monitoring of management actions.

(g) Studies on the effect of managerial ownership on firm performance

The last by not the least, an important study in corporate governance is on the relationship between managerial ownership and firm performance. One of the principal findings was contributed by Morck et al. (1988), who find that the relationship is non-linear and cubic in nature. McConnell and Servaes (1990) find a curvilinear relationship between the two variables. Mehran (1995) find that both the performance measures of Tobin's Q and return on assets increase significantly with CEO ownership. On the contrary, Denis and Denis (1994) find that there is no difference in performance between majority-controlled firms and other firms. Demsetz and Villalonga (2001) also find no systematic relationship between ownership structure and firm performance. The literature concerning the relationship between managerial ownership and corporate performance has thus produced mixed and contradictory findings. Agrawal and Knoeber (1996) and Rediker and Seth (1995) suggest that prior studies on the linkages between ownership concentration and firm

performance have been mixed because these studies only focused on a single corporate governance variable. They suggest that the role of corporate governance mechanisms should be studied as a “bundle” of variables since corporate governance variables may be used as substitute devices.

Given that the main theme of this thesis is to study the relationship between managerial ownership and firm performance, the academic literature in this area of study is reviewed in further detail in the next section. In addition, this study also incorporates other corporate governance variables apart from managerial ownership in order to derive a better measurement of the relationship between ownership and performance. The variables include the main corporate governance variables, namely, board size, board composition, directors’ remuneration, with control variables for the effects of size, debt levels, growth, industries and macro-economic conditions. Further details of the variables used in this study are provided in Chapter Five.

4.3 Relationships between Managerial Ownership and Corporate Performance

There have been numerous academic studies addressing different aspects of corporate governance. Section 4.2 has discussed the major findings of the studies about various corporate governance attributes, for example, the roles of the board and board composition (e.g. Rosenstein and Wyatt, 1990; Forker, 1992) and executive compensation (e.g. Core et al., 1999), etc. in enhancing corporate governance and firm performance. Another important line of research in corporate governance concerns the effects of managerial ownership on corporate performance (e.g. Morck et al., 1988; McConnell and Servaes, 1990; Short and Keasey, 1999). So far, most of the studies have been conducted on US companies. Limited research has been performed on Asian or Hong Kong companies. This thesis concentrates on the issue of how managerial ownership and other corporate governance variables affect corporate performance in the Hong Kong context. This section examines the literature in this aspect of corporate governance study.

Corporate governance problems very often originate as a result of the separation of ownership and control within business organization (Fama and Jensen, 1983). In fact, this question was raised as early as 1776 by Adam Smith. He argued that the separation of ownership and control in large publicly listed corporations created poor incentives for professional managers to operate their firms efficiently. *“The directors of such [joint-stock] companies, however, being the managers rather of other people’s money than of their own, it cannot well be expected, that they should watch over it*

with the same anxious vigilance with which the partners in a private copartnery frequently watch over with their own." (Jensen and Meckling (1976), quoting Adam Smith, *The Wealth of Nations* (1776)). Berle and Means (1932) also suggest that there is an inverse correlation between the diffuseness of shareholdings and firm performance. While both the arguments of Smith and Berle and Means implied that performance can be improved by increasing managerial ownership, a view supported by a number of subsequent studies, such as the classical "convergence of interest" hypothesis of Jensen and Meckling (1976), there are other research findings providing contradictory results, the arguments of which are mainly based on the "entrenchment of interest" of company management (Fama and Jensen, 1983). Hence, there has been on-going research and unresolved debates as to the exact nature of the relationship between ownership and performance.

Jensen and Meckling (1976) propose that managerial ownership can help to control agency problems since share ownership provides managers with incentives to reduce private perquisite consumption. Following Jensen and Meckling (1976), the notion that shareholdings by managers help to align the interests of shareholders and managers is well documented in the agency literature. This "convergence of interest" hypothesis contends that as managerial ownership in a firm increases, the firm's performance increases uniformly, as managers are less inclined to divert resources away from value maximization.

Demsetz (1983) and Fama and Jensen (1983), on the contrary, contend that while market discipline forces managers to adhere to value maximization at very low levels

of ownership, at higher levels of managerial ownership managers find it worthwhile to consume perquisites as they have sufficient control to follow their own objectives without fear of discipline from other ownership interests. Under this “entrenchment of interest” argument, the managers would believe that additional consumption of perquisites, such as an attractive salary, may outweigh the loss that they will suffer from a reduced value of the firm. The resultant effect of this “entrenchment of interest” is a reduction in firm performance at high levels of managerial ownership.

The “entrenchment” hypothesis is also supported in Hart (1983) and Jensen and Ruback (1983), who contend that low levels of managerial shareholdings may be associated with low job security, thereby motivating management to strive for value maximization. When shareholdings are sufficiently high to entrench its positions, management may start to behave against the interests of the shareholders.

Apart from the above, there are other empirical studies about the relationship between managerial ownership and firm performance which give different and conflicting results. Some studies find that there is no relationship between managerial ownership and performance. For example, Demsetz and Lehn (1985) perform a linear regression of an accounting measure of the profit rate on ownership concentration and find no evidence of a relationship between the two variables. Some studies find a positive relationship between the two variables. For example, Mehran (1995) find that both the performance measures of Tobin’s Q and return on assets increase significantly with CEO ownership. Other studies suggest that there are non-linear relationships between the two variables, exhibiting various patterns, though most of the studies are mainly

based on the “convergence of interest” hypothesis of Jensen and Meckling (1976) and the “entrenchment of interest” argument of Fama and Jensen (1983). For example, while Morck et al. (1988) find a cubic non-linear relationship (“alignment-entrenchment-alignment”) between the two variables, McConnell and Servaes (1990) find a curvilinear relationship (“alignment-entrenchment”). Thus, the actual relationship between managerial ownership and corporate performance may arise as a result of some “combined effect” of the “convergence of interest” hypothesis and the “entrenchment” argument.

The empirical study in this thesis is mainly based on the “combined effect” argument, which was first verified empirically by Morck et al. (1988). Apart from Morck et al. (1988), McConnell and Servaes (1990) and Short and Keasey (1999), etc. also find that there are non-linear relationships between managerial ownership and firm performance.

(a) The findings of Morck et al. (1988)

Morck et al. (1988) make use of piecewise linear regression techniques to estimate the relationship between firm performance and managerial ownership of 371 Fortune 500 firms in 1980. They use Tobin’s Q (the ratio of a firm’s market value to the replacement cost of its physical assets) as a measure of performance and the percentage of shares owned by the board of directors as a measure of managerial ownership. Their results reveal a non-linear, cubic relationship between Tobin’s Q and managerial ownership, with a pattern which takes the form of “alignment-entrenchment-alignment” as managerial ownership is increased. The relationship is

fairly robust to the inclusion of several control variables including R&D and advertising ratios, leverage, size and industry dummies and the split in the board ownership measure between managers and outside directors. However, the result is not robust when profit rate is used as alternative performance measure.

With regards to the finding of the “alignment-entrenchment-alignment” pattern of relationship, the two alignment ranges indicate that there is a positive relationship between Tobin’s Q and managerial ownership in the range from 0% to 5% and beyond the 25% ownership levels respectively, though the magnitude of the response of performance to given changes in managerial ownership is substantially less beyond the 25% level. The two alignment ranges suggest that when managerial ownership increases, firm performance also improves. That is, “convergence of interest” is dominant within the 0% to 5% managerial ownership range and above the 25% level. However, within the 5% to 25% range of ownership, firm performance deteriorates when managerial ownership increases. This negative relationship between the two variables denotes the “entrenchment” effect.

Thus, Morck et al. (1988) empirically verify that the relationship between managerial ownership and firm performance is a “combined effect” of “alignment” and “entrenchment” of interests. When managerial ownership increases from 0% to 5%, there is alignment of interests. Also, as suggested by Hart (1983) and Jensen and Ruback (1983), low levels of managerial shareholdings may be associated with low job security, thereby motivating management to strive for value maximization.

However, when managerial ownership further increases, firm performance deteriorates and this takes place between the levels of 5% and 25% of managerial ownership. This finding shows that at higher levels of managerial ownership, managers find that they have sufficient control to follow their own objectives without fear of discipline from other ownership interests. External shareholders find it difficult to control the actions of the managers. The managers find that they can benefit more by consuming perquisites, resulting in a reduction of firm value within this range of ownership. This finding supports the “entrenchment” argument, that is, when shareholdings are sufficiently high to entrench its positions, management may start to behave against the interests of the shareholders (Fama and Ruback, 1983; Fama and Jensen 1983). This results in a reduction of the value of the firms which is positioned in the “entrenchment range” of the non-linear relationship in Morck et al. (1988).

When managerial ownership further increases beyond 25%, firm performance improves again (Morck et al., 1988). This can be explained by the “convergence of interest” hypothesis of Jensen and Meckling (1976). Managerial ownership can help to control agency problems since share ownership provides managers with incentives to reduce private perquisite consumption. When managerial ownership in a firm increases, the firm’s performance increases uniformly, as managers are less inclined to divert resources away from value maximization (Jensen and Meckling, 1976). When managerial ownership is above 25%, the “entrenchment” effect is overridden by the “alignment” effect, resulting in a net improvement in firm performance (Morck et al, 1988.)

(b) The Findings of McConnell and Servaes (1990)

Following Morck et al. (1988), McConnell and Servaes (1990) also examine the relationship between Tobin's Q and insider and blockholder ownership in two different cross-sectional samples, one for 1976 and the other one for 1986, using slightly more than 1,000 Compustat firms. Tobin's Q is regressed on different variations and combinations of measures of insider and blockholder in the ownership structure of the firms. For blockholder ownership, they find a positive but insignificant relationship. For insider ownership, they find a curvilinear relationship between the two variables. This result is obtained by regressing Tobin's Q against "managerial ownership" and "managerial ownership squared".

McConnell and Servaes (1990) find that the coefficient on managerial ownership is statistically significant and positive. The coefficient on managerial ownership squared is found to be statistically significant and negative. This curvilinear relationship between firm performance and managerial ownership shows that the value of the firm firstly increases and then decreases, as ownership becomes more concentrated in the hands of managers. The point of inflection is around 40% to 50% of managerial ownership. That is, alignment (positive relationship between managerial ownership and firm performance) exists between the 0% and approximately 40–50% ownership range, beyond which entrenchment (negative relationship between managerial ownership and firm performance) starts to take place. The results of McConnell and Servaes (1990) are robust when some control variables used in Morck et al. (1988) are included in the regression and also when the accounting rate is used as an alternative

performance measure. After McConnell and Servaes adjust their sample to make it more comparable to the sample used by Morck et al. (1988), they attempt to replicate Morck et al.'s piecewise linear regression, but they cannot.

(c) Comparison of the findings of Morck et al. (1988) and McConnell and Servaes (1990)

Although McConnell and Servaes (1990) also find a combination of the alignment and entrenchment effects in their study, the pattern of the relationship is different from that of Morck et al. (1988). In Morck et al. (1988), the pattern is “alignment-entrenchment-alignment” and entrenchment occurs in the 5% to 25% ownership range. McConnell and Servaes (1990), however, find that the pattern is curvilinear in the form of “alignment-entrenchment”, with the point of inflection at about the 40–50% level of managerial ownership.

Kole (1995) suggests that the different findings of the above two studies are attributable to differences in the sizes of the firms analyzed. Morck et al. (1988) analyze only large firms (371 firms from the Fortune 500). McConnell and Servaes (1990) analyse a larger sample of firms: 1173 firms in 1976 and 1093 firms in 1986, and this work is further extended by adding 1943 firms for 1988. Kole (1995) argues that “on average, the positive relationship between Tobin's Q and managerial ownership is sustained at higher levels of ownership for small firms than it is for larger firms” (pg.426).

(d) The findings of Short and Keasey (1999)

Short and Keasey (1999) perform a test on the relationship between firm performance and managerial ownership on 225 firms listed on the London Stock Exchange for the period from 1988 to 1992. They test for a cubic form of the relationship between firm performance and managerial ownership. The model is a general extension of the Morck et al. (1988) piecewise model, but Short and Keasey (1999) allow the coefficients on the managerial ownership variables to determine their own turning points. Their results support the general findings of the US study of Morck et al. (1988) of a non-linear cubic relationship between firm performance and managerial ownership. The pattern of the relationship is also the same as that found in the study of Morck et al. (1988), that is, it takes the form of “alignment–entrenchment–alignment”.

When Short and Keasey (1999) use the return on shareholders’ equity (RSE) as the firm performance measure, they find that entrenchment occurs within the ownership range of 15.58% to 41.84%. When they use the valuation ratio (VAL) as the performance indicator (VAL = market value of firm at its accounting year end divided by the book value of equity at the accounting year end), entrenchment occurs within the range of 12.99% to 41.99% of ownership (Short and Keasey, 1999). The similarity of the turning points under the two performance measures employed in Short and Keasey’s (1999) study indicates the robustness of the general relationship for UK corporations.

(e) Comparison of the findings of Morck et al. (1988) and Short and Keasey (1999)

Although Short and Keasey (1999) also find a non-linear relationship between managerial ownership and firm performance and the pattern (“alignment-entrenchment-alignment”) is the same as that found in Morck et al. (1988), there are a number of differences between the findings of Short and Keasey (1999) and Morck et al. (1988), which are as follows:

1. A comparison of the entrenchment range found in the Short and Keasey (1999) study (approximately 13-16% to 42%) with that found in the Morck et al. (1988) study (5% to 25%) suggests that UK managers become entrenched at higher levels of equity ownership than US managers.
2. Another difference between the findings of Short and Keasey (1999) and Morck et al. (1988) is that a cubic relationship between firm performance and managerial ownership exists for both the accounting measure (RSE) and the market measure (VAL) of performance in Short and Keasey’s (1999) study. The results for the three ranges (alignment–entrenchment–alignment) are all statistically significant. However, in the study of Morck et al. (1988), significant results only occur when Tobin’s Q (that is, the market measure) is used as the dependent variable. When Morck et al. use the accounting measure of performance (profit rate) a statistically significant relationship only exists for the positive slope in the 0% to 5% ownership range, while the coefficient on the variable denoting ownership of 25% or more is negative and

insignificant. This suggests that accounting performance does not increase as managerial ownership rises above the 25% ownership level in US corporations.

Thus, although both the studies of Short and Keasey (1999) and Morck et al. (1988) indicate that the relationship between managerial ownership and firm performance is non-linear with a pattern of “alignment-entrenchment-alignment”, there are some differences in the details of the findings.

As noted from the above two US studies of Morck et al. (1988) and McConnell and Servaes (1990) and the UK study of Short and Keasey (1999), despite the fact that the precise form of the relationship between firm performance and managerial ownership is still open to debate, the results indicate that the relationship involves a combination of the alignment and entrenchment effects, resulting in a non-linear relationship. The movement is, in general, from alignment to entrenchment and then, possibly, to alignment again as managerial ownership increases.

(f) Other Empirical Evidence

Apart from the literature discussed above, there are other studies of the relationship between managerial ownership and firm performance, which give results supporting the “combined effect” argument (a combination of the convergence and entrenchment of interests) of Morck et al. (1988).

For example, Chen, Hexter and Hu (1993), using data from the Fortune 500 companies, find that there is a curvilinear relationship (“alignment-entrenchment”)

between Tobin's Q and managerial ownership for the year 1976. Tobin's Q increases in the managerial ownership range of 0% to 7% and thereafter it falls in the 7% to 100% range of managerial ownership. However, they find that when data for the two years of 1980 and 1984 are used, the relationship takes a non-linear, cubic form with a pattern of "alignment-entrenchment-alignment". Tobin's Q increases in the managerial ownership range of 0% to 7%, and thereafter it falls, in accordance with the results from the 1976 data. However, when the ownership percentage reaches 12%, Tobin's Q increases all the way up to the 100% level of managerial ownership.

There are also other studies which support the "combined effect" argument. Examples include Hermalin and Weisback (1991), Hubbard and Palia (1995), Faccio and Lasfer (1999) and Davies et al. (2002).¹ The studies that take the endogeneity issue into consideration are further discussed in section 4.6 of this chapter.

While a number of studies support the "combined effect" argument of Morck et al. (1988) with various patterns of the non-linear relationships, some studies only support either the "convergence of interest" hypothesis or the "entrenchment" hypothesis. Still some others find that there is no systematic relationship between ownership and performance at all. For example, the study of Mehran (1995) based on 195 US industrial companies finds that both the performance measures of Tobin's Q and return

¹ Using data for 752 firms listed on London Stock Exchange during 1995, Davies et al (2002) find support for a quintic specification of the relationship between managerial ownership and firm value, suggesting that the correct form of the relationship is a double humped curve. This is in contrast to studies, including the present study, that assume a cubic specification and by construction only one hump.

on assets increase significantly with managerial (CEO) ownership. This finding supports the “convergence of interest” hypothesis of Jensen and Meckling (1976). Holderness et al. (1999), as in Morck et al. (1988) find a significant positive relationship between firm performance and managerial ownership within the 0%-5% level of managerial shareholdings but, they do not find any statistically significant relationship beyond the 5% managerial shareholdings.

Demsetz and Lehn (1985) perform a linear regression of an accounting measure of the profit rate on ownership concentration and find no evidence of a relationship between the two variables. Denis and Denis (1994) find that there is no difference in performance between majority controlled US firms (represented by managerial ownership exceeding 50%) and other US firms. Holderness and Sheehan (1988) also find no significant difference in performance between majority held and diffusely held US firms. Murali and Welch (1989) obtain similar findings in that there is no significant difference in performance between closely held and widely held US firms. Demsetz and Villalonga (2001) also find no systematic relationship between ownership structure and firm performance.

As noted from the above literature review, it can be observed that so far most of the empirical research have been conducted in a non-Asian context (e.g. Forker, 1992; Malone et al., 1993; Morck et al., 1988; McConnell and Servaes, 1990). Limited research has been performed on Asian markets. According to Shleifer and Vishny (1997, pg.740): “*Most of the available empirical evidence [on corporate*

governance]...comes from the United States...Unfortunately... there has been extremely little research done on corporate governance around the world..."

However, the ownership structure in the US is quite different from that in many other countries where the structure takes more of a concentrated form (La Porta et al., 1999). For example, the ownership structure in most East-Asian countries is characterized by family-ownership and controlled, which is in contrast to the more diffuse form of ownership in the UK and the US (Claessens et al., 2000).

Shlerifer and Vishny (1997) and La Porta et al. (1999) focus on the central agency problem associated with high ownership concentration. La Porta et al. (1999) suggest that controlling shareholders' interest is very unlikely to be the same as that of the minority shareholders. The central agency problem in corporations with high ownership concentration stems from the tendency of the controlling shareholders to expropriate the minority shareholders.

Given that the ownership structures in the UK and the US are very different from that in many other countries, in particular the concentrated form of ownership in most East-Asian countries, it is doubtful whether the same sort of relationship between managerial ownership and firm performance exists under a concentrated ownership environment. In addition, even if there is a relationship, the pattern of the relationship may not be the same as that found in the UK and US studies given the differences in cultural backgrounds and ownership structures. Fan and Wong (2002) suggest that the results of prior research focusing on UK and US corporations are not applicable to East-Asian corporations due to the differences in ownership concentration. So far,

limited studies have been performed in the East-Asian context. In addition, no empirical study has examined the relationship between managerial ownership and corporate performance using data on family-controlled companies. The present study fills this gap in the literature and aims to ascertain the relationship between managerial ownership and firm performance, and the pattern of the relationship, using Hong Kong listed companies as evidence.

Since ownership structure and cultural background may have impacts on the relationship between managerial ownership and firm performance, the following two sections describe the corporate ownership structure in the UK, the US and Hong Kong, with a review of the relevant literature (section 4.4) and the possible impact of culture on firm performance, by making particular reference to the “long-term orientation” dimension of Hofstede’s study of the “five cultural dimensions” (section 4.5).

4.4 Ownership Structure in the United Kingdom, the United States and Hong Kong

The corporate ownership pattern in Hong Kong is very different from that in the UK and the US. In fact, the pattern in the UK is also quite different from that in the US. Kester (1992) reports that 60% of the shares in UK listed companies in 1990-91 were held by institutional investors (such as pension funds, insurance companies and other investment companies). In the US, these types of investors held around 40% of the shares in listed companies, that is, two-thirds the level of that in the UK. In the US, the majority of shares were held by individual households (54%) while households in the UK held around 21% (Kester, 1992).

In Hong Kong, institutional ownership is minimal with the majority of listed shares held by family members or related parties. Due to its historical background and Chinese culture, companies are generally owned, controlled and managed by family shareholders. Family members typically constitute the basis for developing business from the inception of a company. Most Hong Kong companies usually start off as small private companies, and even when they grow bigger and bigger and become public and listed companies, family members still retain their shareholdings and control of the company. Family control is achieved not only through owning shares personally, but also by the use of investment companies or holding companies to hold shares in the company concerned. In many cases, vehicles such as nominee shareholders and cross-shareholdings of affiliated companies are used to strengthen family control. These features and characteristics make the exact nature of family

shareholdings in a listed company difficult to ascertain, though it is well recognised that the corporate structure in Hong Kong is predominantly family-owned.

According to a study by the Hong Kong Society of Accountants (HKSA) on all listed companies in Hong Kong in 1996, 53% of them had one shareholder or one family group owning 50% or more of the entire issued capital. In addition, almost nine out of ten (88%) of all listed companies had one shareholder or one family group of shareholders owning 25% or more of the entire issued capital (HKSA, 1997). La Porta et al. (1999) also find that firms in Hong Kong are family-controlled and there are hardly any widely held firms in Hong Kong. Since most companies are family-owned and they are also controlled by the same group of family members, a separation of ownership and control does not take place for most of the companies in Hong Kong.

These differences in ownership structures have implications on corporate governance mechanisms. For example, Demsetz (1983) suggests that large blockholder is a mechanism to curb management entrenchments; Shivdasani (1993) finds that large unaffiliated shareholders and hostile takeovers are complementary mechanisms for corporate control. Shleifer and Vishny (1986) also argues that blockholders may monitor management actions effectively because they represent a credible takeover threat if company performance declines. Thus, takeover threat is an effective corporate governance mechanism in the UK, where the blockholders in most corporations are institutional shareholders and they are not the managers of the corporations. However, in Hong Kong where the blockholders are very often the family shareholders who are also the management, there is seldom separation of

ownership and control. Corporate raiders or interested parties will not be able to takeover ill-performed companies through open-market purchase given that the companies are controlled by family shareholders. Thus, takeover is not an effective mechanism for corporate performance monitoring in a family controlled corporate environment (Ko et al., 1999). La Porta et al. (1999) also suggest that in corporations with high ownership concentration, controlling shareholders' interest is very unlikely to be the same as that of the minority shareholders. Thus, the tendency of the controlling shareholders to expropriate the minority shareholders results in the central agency problem associated with high ownership concentration.

Despite the family-controlled business has a number of drawbacks as described above, it also has its advantages such as strong leadership and a cohesive management team. It may be conjectured that the rapid development of the Hong Kong economy, from a fishing village in the early twentieth century to a prosperous industrial economy in the 1960s and 1970s and thereafter to a major international financial centre is related to the “convergence of interest” hypothesis of Jensen and Meckling (1976) due to the convergence of interests of the family controllers who are also the majority shareholders. However, as mentioned above there is a risk that the family controllers, who are also the majority shareholders, will expropriate the minority shareholders so as to maximise their own interest according to the central agency problem, as argued by La Porta et al. (1999). As a consequence, the exact nature of the relationship between ownership and performance in a family owned corporate environment is uncertain unless and until it is found out empirically.

However, there has been limited research performed in concentrated ownership environments. So far most empirical studies are based on UK and US evidence where the ownership structure takes a more diffuse form when compared with the concentrated form of ownership in most East-Asian countries. One of the few empirical studies using a concentrated ownership structure as evidence is that of Mak and Li (2001). Their study is based on evidence from Singapore, which has, according to the authors, more concentrated stock ownership and a weaker market for corporate control than the US. Mak and Li (2001) find that corporate ownership and board structure are related in Singapore, but none of their ownership and board structure variables are significantly associated with firm value. However, it does not follow that the results based on Mak and Li's Singapore evidence are representative of all other countries with concentrated ownership. In addition to family members, the government is another important blockholder in Singapore corporations. The corporate ownership structure in Singapore can best be described as a mixture of family-based and government-based ownership, rather than just family-based ownership (Mak and Li, 2001). This can be contrasted with the ownership structures in Japan and Germany, which are bank-based, and the ownership structure in Hong Kong, which is family-based.

Claessens et al. (2000) find that there is extensive family control in more than half of the East-Asian corporations. In addition, the separation of management from ownership control is rare. The top management of about 60% of firms that are not widely held is related to the family of the controlling shareholder (Claessens et al., 2000). Hong Kong is given as an example of a place which has a family-controlled

ownership structure. The findings of Claessens et al. (2000) have important implications for the ability and incentives of controlling shareholders to expropriate from minority shareholders, which is also suggested by La Porta et al. (1999). Despite the fact that the family ownership is a predominant form of ownership in most East-Asian countries, no empirical study has yet been performed to determine the impact of a family-based ownership structure on firm performance, hence the focus of the present study is on this topic.

The way in which family control may affect corporate performance can be viewed from two perspectives: convergence and entrenchment of interests. The exact pattern of the relationship between ownership and performance depends on the interactions between the two perspectives: whether one perspective dominates the other (that is, whether “convergence” will override “entrenchment” or vice versa). Also, the interactions might not be the same under different ownership ranges (that is, there might be a non-linear relationship). Given the fact that managers who are also family shareholders tend to align their interest more to the companies than those managers who are unconnected with the companies concerned, ownership structure might affect the relationship between firm performance and managerial ownership. Studying the relationship is important because the family-owned corporate structure is not unique to Hong Kong. A number of other countries, especially those in the East-Asian region, also have a family-owned corporate environment (La Porta et al., 1999). Hence, studying the relationship is not only important for the Hong Kong context, but also can contribute to the structural development of corporate governance systems in other family-owned corporate regimes.

4.5 Culture and Hofstede’s “Five Cultural Dimensions”

(a) Definitions of culture and problems in applying Hofstede’s findings

Apart from ownership structure, the historical and cultural backgrounds of corporations may also have impacts on the relationship between managerial ownership and firm performance. This section discusses the possible impacts of culture on firm performance, with particular reference to Hofstede’s study.

There are many definitions of culture, but almost all of them refer to culture as a set of shared values, beliefs and practices. For example, Kuper defines culture as “*a matter of ideas and values, a collective cast of mind*” (Kuper, 1999). Another well-known ‘anthropological consensus’ definition of culture is that “*culture consists in patterned ways of thinking, feeling and reacting, acquired and transmitted mainly by symbols, constituting the distinctive achievements of human groups, including their embodiments in artifacts; the essential core of culture consists of traditional (i.e. historically derived and selected) ideas and especially their attached values*” (Kluckhohn, 1951, pg. 86). The milestone research in culture is contributed by Hofstede. According to Hofstede, culture is the aggregate of values, beliefs, and customs that define common characteristics of a human group much like personality explains an individual’s identity (Hofstede, 1980). He also defines culture as “*the collective programming of the mind which distinguishes the members of one group from another*” (Hofstede, 1991). Collective programming takes place at the national and at the organizational level. While national cultures distinguish members of one nation from another, organization cultures distinguish the employees of one

organization from another. There is a clear distinction between national cultures and organization cultures. National cultures refer to the profound beliefs, values and practices that are shared by the vast majority of people of a certain nation. They are reflected in the ways people behave at school, in the family, on the job, etc. and they are reinforced by national laws and governmental policies. Organization or corporate culture refers to the values, beliefs and practices that are shared by most members of an organization. These values, beliefs and practices may stem from regional or occupational groups or from common organizational experiences and, consequently, may not be applicable outside that organization. Therefore, cultures as found within organizations will differ to some extent within one nation, but they are supposed to differ even more from nation to nation (Van Oudenhoven, 2001).

Baskerville (2003) identifies the problems of using Hofstede's cultural indices in accounting research. The problems include the assumption of equating nation with culture and the difficulties of, and limitations on, a quantification of culture represented by cultural dimensions and matrices. Baskerville (2003) suggests that a problem in the assumption of Hofstede is that he equates nation states with culture. Cultures do not equate with nations; for example, from the *Encyclopedia of World Cultures* (O'Leary and Levinson, 1991), it can be identified that in the Middle East there are 35 different cultures in 14 nations. There are 98 different cultures identified in 48 countries in Africa and 81 cultures in 32 countries of Western Europe. In North America, there are 147 American native cultures and 9 American folk cultures (Baskerville, 2003). For any study of cross-cultural comparisons, one has to address two important problems, which are about classification and definitions; and the

problem of sampling and the units of comparison (Goodenough, 1964). Despite the fact that there have been critiques periodically of Hofstede's work, the attractiveness of using his indices in research is compelling. Some recent accounting studies involving cross-cultural comparisons have incorporated some or all of Hofstede's dimensions, for example, Yamamura et al. (1996), Tsui (1996), Chow et al. (1999) and Goodwin and Goodwin (1999).

Arguments against using Hofstede's indices of cultural dimensions in accounting research mainly stem from the assumption of Hofstede that nations are equated with culture. However, as noted from the argument of Van Oudenhoven (2001) discussed above, it is inevitable that cultures as found within organizations will differ to some extent within one nation, but they are supposed to differ even more from nation to nation. Hence, though it might not be totally correct to assume that nations are equal to culture, it is reasonable to use Hofstede's study of cultural dimensions to identify the cultural characteristics of a nation and to compare it with the other nations. In particular, since the empirical study in this thesis is about the relationship between managerial ownership and firm performance in Hong Kong, which does not involve a cross-country or cross-cultural empirical analysis, the problems as suggested by Baskerville (2003) on the quantification of culture represented by cultural dimensions and matrices are not concerns in the current study. What is relevant in the current study is to identify the cultural characteristics in Hong Kong, by making references to Hofstede's milestone study in culture's consequences, in order to assist in identifying the possible impact of culture on the relationship between managerial ownership and firm performance in a family-controlled, concentrated ownership environment like

Hong Kong. In fact, Hofstede (2001) also recognizes the increasing popularity of studying “organizational” or “corporate” culture in the management literature (e.g. Deal and Kennedy, 1982; Peters and Waterman, 1982, etc.). Hofstede (2001) also points out that *“if national cultures describe the collective mental programming of otherwise similar persons from different nations, organizational cultures should describe the collective mental programming of otherwise similar persons from different organizations. ‘Otherwise similar’ also means from within the same nation(s).”* Hofstede’s study is reviewed in the following section.

(b) Hofstede’s Cultural Dimensions

Back in 1967, employees in International Business Machines Corporation (IBM) were asked to complete an attitude survey in order to provide a management tool for organization development. The survey was repeated until 1973, which resulted in more than 116,000 responses from 88,000 employees in 72 countries. Hofstede was the head of the international team conducting the survey. Out of the 72 countries, 40 countries were initially used for further analysis for reasons of stability of data. In a later stage, data from 10 more countries and three multicountry regions were added to the analysis (i.e. 53 nations in total). From the analysis and theoretical reasoning, Hofstede postulated four cultural dimensions on which the nations differ from one another. Each of the 53 nations was given a score based on the four dimensions, which were factored from attributes such as achievement, creativity, autonomy, and self-determination, among others, to provide a relative measure of group characteristics that, taken together, represent value orientations. The publication *“Culture’s Consequences”* was published in 1980. Since Hofstede has offered an

empirically based classification of cultures and his coverage of nations is impressive. his study has made a major contribution to contemporary cross-cultural psychology.

The four cultural dimensions in Hofstede's 1980 study are as follows:

1. Power distance

The term power distance is taken from the work of Mulder. Mulder (1977, pg. 90) defines power as "*the potential to determine or direct the behaviour of another person or other persons more so than the other way round,*" and power distance as "*the degree of inequality in power between a less powerful Individual (I) and a more powerful Other (O), in which I and O belong to the same social system.*" Power distance can thus be used as a measure of the interpersonal power or influence between a boss and a subordinate as perceived by the less powerful of the two, that is, the subordinate. This dimension resembles Fiske's (1992) *Authority Ranking* which refers to cultural patterns which vary according to the degree of rank and hierarchy. It also corresponds to Schwartz's (1994) *Hierarchy* value.

2. Uncertainty avoidance

Uncertainty about the future is a basic fact of human life. In a country, employment stability and rule orientation are two ways of avoiding uncertainty. In an organization this can be coped with by the use of technology or rules (Hofstede, 2001). It relates to the strictness of rules used to deal with uncertain and ambiguous situations. This concept is the opposite of Schwartz's *Intellectual Autonomy* (Schwartz, 1994).

3. Individualism-Collectivism

It relates to the degree to which people have freedom to adopt their own approach to their job. Triandis (1994) defines individualism as follows: “*People in individualistic cultures often give priority to their personal goals, even when they conflict with the goals of important in-groups, such as the work group conversely, people in collectivist cultures give priority to in-group goals*” (Triandis, 1994). Employed individuals in an individualist culture are expected to act rationally according to their own interests, and work should be organized in such a way that this self-interest and the employer’s interest coincide. In a collectivist culture, an employer never hires just an individual, but a person who belongs to an in-group and the employee will act according to the interests of this in-group (Hofstede, 2001).

4. Masculinity-Femininity

This dimension relates to the extent to which highly assertive values predominate, such as acquiring money and goods at the expense of the others, versus showing sensitivity and concern for the welfare of others. Masculine culture countries strive for a tough, performance society while feminine countries strive for a tender, welfare society (Hofstede, 2001). This dimension corresponds a great deal with Schwartz’s *Mastery versus Harmony* value (Schwartz, 1994).

Although Hofstede's work encompassed 116,000 respondents in 72 countries, the measurements were distinctly "Western". A further work carried out around 1985 by Hofstede and Bond included a fifth dimension. This fifth dimension was found from the answers of a "Chinese Value Survey" (CVS), which was carried out in 23 countries and developed by Michael Harris Bond in Hong Kong from values suggested by Chinese scholars. This dimension was not found in the IBM survey because the IBM questionnaire was designed by Westerners. This "Eastern" dimension, comprised of eight individual values, was initially named by the authors as "Confucian dynamism", and was later termed as "long-term orientation". It was initially termed "Confucian dynamism" because it is based on items reminiscent of the teachings of Confucius, on both of its poles. It opposes long-term to short-term aspects of Confucian thinking: persistence and thrift to personal stability and respect for tradition. A culture which is deemed to demonstrate a high degree of Confucian dynamism will rank four particular values as being of high importance, and concurrently rank four values as being relatively unimportant. Those values considered relatively important are: (1) persistence or perseverance, (2) ordering relationships by status and observing this order, (3) thrift, and (4) having a sense of shame. Those considered relatively unimportant are: (1) personal steadiness or stability, (2) protecting one's "face", (3) respect for tradition, and (4) reciprocation of greetings, favours, or gifts. Hofstede and Bond explain these values specifically in terms of East-Asian entrepreneurship and the unusual success of private enterprise development in non-communist Asian economies. While Confucian dynamism is not proprietary to China or to other Asian cultures, and Hofstede and Bond also find parallel values

among a number of South American, African, and subcontinental Asian populations. The composite concepts are conspicuously missing in Western values systems.

(c) Hong Kong's "position" in the four cultural dimensions study of Hofstede

Table 4.1 below shows a summary of the index scores and ranks of the UK, the US and Hong Kong in the IBM survey conducted by Hofstede, before adding the fifth dimension of "long-term orientation":

Table 4.1 Index Score and Rank of the UK, the US and Hong Kong in Hofstede's IBM Survey

Country	Power Distance		Uncertainty Avoidance		Individualism/Collectivism		Masculinity/Femininity	
	Index	Rank	Index	Rank	Index	Rank	Index	Rank
The UK	35	42-44	35	47-48	89	3	66	9-10
The US	40	38	46	43	91	1	62	15
Hong Kong	68	15-16	29	49-50	25	37	57	18-19

Source: Hofstede (2001 pg. 500)

As shown in Table 4.1, Hong Kong has a relatively high index score in power distance when compared with the UK and the US. This implies that in Hong Kong organizations have more centralized decision structures and more concentration of authority. The ideal boss is an enlightened autocrat and managers rely more on formal rules. Subordinates are expected to be told rather than to be consulted. The leadership style is authoritative rather than consultative (Hofstede, 2001).

Regarding uncertainty avoidance, the index score of Hong Kong is a little bit lower than that in the UK and the US, but they are comparable in terms of the rank. That is, there is not much difference in this dimension among the three countries. All three are relatively weak in terms of uncertainty avoidance.

However, there is a great difference between the scores of Hong Kong and those of the UK and the US in terms of individualism and collectivism. The UK and the US rank high in the individualism dimension by having very high index scores, in contrast to the low index score of Hong Kong. Hong Kong exhibits more characteristics in the 'collectivism' dimension while the UK and the US are 'individualistic'. Thus, in work organizations employees in the UK and the US are supposed to act as economic men. The hiring and promotion decisions are based on skills and rules only. Employees perform best as individuals and there is more belief in individual decisions. On the contrary, employees in Hong Kong act in the interest of their 'in-groups'. The hiring and promotion decisions take the employees' in-group into account. Family relationships are seen as an advantage in hiring. Employees perform best in 'in-groups' and there is more belief in collective decisions.

Lastly regarding masculinity and femininity, the index score of Hong Kong is comparable to that in the UK and the US, though it is a little bit lower. That is, there is not much difference in this dimension among the three places. All the three places are relatively more masculine than feminine.

In summary, Hong Kong is “positioned” as having a large power distance and weak uncertainty avoidance, and it is also more collectivistic and masculine. While it is similar to the UK and the US in the two dimensions of uncertainty avoidance and masculinity, it is quite different from the UK and the US in possessing small power distance and individualistic characteristics. These findings are reflected in the ownership structure and management style in Hong Kong: the large power distance is characterized by centralized decision structures and concentration of authority is a result of the majority family owners centralizing their power and controlling their companies. At the same time, because the companies are owned and controlled by majority family shareholders, in Hong Kong the ethos is collectivist rather than individualist. As argued by Hofstede, in a collectivist country, family relationships are seen as an advantage in hiring. Employees act in the interest of their ‘in-groups’ and the hiring and promotion decisions take the employees’ ‘in-group’ into account. Employees perform best in ‘in-groups’ and there is more belief in collective decisions. However, at the same time, since Hong Kong was under the sovereignty of the UK, it had an established set of rules and regulations and was a fairly stable city, and so it is therefore weak in the aspect of uncertainty avoidance. In addition, given that Hong Kong is a capitalist city, it was influenced by the Western culture to be more masculine than feminine.

(d) *Hong Kong’s “position” in the fifth cultural dimension study of Hofstede and Bond*

Table 4.2 below shows the long-term orientation (LTO) index values of the 23 countries under the Chinese Value Survey of Hofstede and Bond.

Table 4.2 Long-term Orientation Index Values for 23 Countries

Score Rank	Country or Region	Long-term Orientation Index
1	China	118
2	Hong Kong	96
3	Taiwan	87
4	Japan	80
5	South Korea	75
6	Brazil	65
7	India	61
8	Thailand	56
9	Singapore	48
10	Netherlands	44
11	Bangladesh	40
12	Sweden	33
13	Poland	32
14	Germany (F.R.)	31
15	Australia	31
16	New Zealand	30
17	United States	29
18	Great Britain	25
19	Zimbabwe	25
20	Canada	23
21	Philippines	19
22	Nigeria	16
23	Pakistan	00

Source: Hofstede (2001 pg. 356)

As shown in Table 4.2, the top five positions are occupied by East-Asian countries, namely, China, Hong Kong, Taiwan, Japan and South Korea. Hong Kong has a high index of “long-term orientation” (96) which ranks second after China (118).² It can be seen that, apart from China, the other four places have demonstrated fast development in the last few decades of the twentieth century, though China has been catching up rapidly in recent years. Among the four places, Japan is well-known as a developed nation. The other three places are actually three of the “Four Little Dragons” in East Asia. Singapore, being one of the “Four Little Dragons”, also ranks fairly high in the index scores. Its position is the ninth among the 23 countries in Bond’s study.

The economic miracle of Japan and the Four Little Dragons has taken economists by surprise. The existence of a relationship between Confucius’s teachings and economic growth in the latter part of the twentieth century has been suggested before, but it has never been proven. One of the defendants was the American futurologist Herman Khan who formulated a “neo-Confucian hypothesis” in 1979. It was suggested by Khan that the economic success of the countries in East Asia could be attributed to their common cultural roots going back far into history, and that this cultural inheritance under the world market conditions of the post-World War II period became a competitive advantage for successful business activity.

² Bond initially published factors scores for 22 countries which varied from -1.00 for Pakistan to 0.91 for Hong Kong in 1987. These factor scores were brought into a 0-100 range by a linear transformation. The data for China came in after the scale had been fixed. As a result, the index for China was put outside the range, at 118. The figures represent the relative positions of the countries which are not absolutes (Hofstede, 2001, pg.355).

The data collected in the Chinese Value Survey (CVS) lend support to Khan's views. The LTO scores of the CVS are strongly correlated with national economic growth in the period of 1965-1985 preceding the CVS study, and even more in the period of 1985-1995 following it. LTO is identified as a major explanation of the explosive growth of the East-Asian economies in the latter part of the twentieth century. The East-Asian instrument of the CVS provides strong evidence for the role of culture in the development of the East-Asian countries and lends support to the "neo-Confucian hypothesis", so far considered speculative (Hofstede, 2001. pp.371 and 378).

However, it should be noted that culture in the form of certain dominant values is a necessary but not a self-sufficient condition for economic growth. The two other conditions necessary are the existence of a market and the existence of a political context that allows development. The need for a market explains why the growth of the East-Asian economies started only after 1955, as this was the first time in history that the conditions for a truly global market were fulfilled. The need for a supportive political context was met in Japan and the Four Little Dragons, though in different ways, with the role of the Government varying from active support to laissez-faire. Economic growth of China, however, was hampered by the violence of the 1966-76 Cultural Revolution. This period is a traumatic memory for almost all Chinese, and was, among other things, an attempt by the then ruler in China, Mao Zedong, to escape the Confucian tradition. Mao preached the positive value of contradiction and conflict, as opposed to the Confucian value of harmony. Eventually, the thinking of Confucius 'won' again. In spite of the hampering effect brought about by the Cultural

Revolution, China's average economic growth rate for 1965-85 (4.8%) was comparable to that in Japan (4.7%) (World Bank, 1987). Of course, it should be noted that China started at a very low national income level. It is obviously more difficult to turn around a nation of more than a billion people than one of 3 million, like Singapore. Politics has also played a major role in economic development and will continue to do so (Hofstede, 2001, pg.368).

From the findings of Hofstede's study of five cultural dimensions, it may be concluded that Hong Kong's position is fairly unique. Its Chinese culture and customs enable it to score very high in the LTO index. These LTO scores are found to be strongly correlated with national economic growth. The fact that Hong Kong has operated under a laissez-faire political policy has been an important ingredient in generating fast economic growth, given its high LTO index.

4.6 The Endogeneity Issue

Before describing the conduct of the empirical study, it is necessary to consider the endogeneity issue. The studies performed by Morck et al. (1988), McConnell and Servaes (1990) and Short and Keasey (1999) do not consider the endogeneity issue. Demsetz (1983) argues that ownership structure is endogenously determined. Demsetz and Lehn (1985) provide evidence of the endogeneity of a firm's ownership structure, argued for by Demsetz (1983). Demsetz and Lehn (1985) treat ownership structure as an endogenous variable and run a linear regression of an accounting measure of the profit rate with ownership concentration. They find no evidence of a relationship between the profit rate and ownership concentration. Kole (1996) also provides evidence of a reversal of causality in the ownership-corporate value relationship. She suggests that corporate value could be a determinant of the ownership structure rather than being determined by it.

Cho (1998) replicates the study of Morck et al. (1988) by running OLS regressions based on a cross-section of Fortune 500 manufacturing firms in 1991. He reports a similar non-monotonic relationship between managerial ownership and firm performance as that found by Morck et al. (1988). The OLS regression results show that ownership structure affects corporate value with a pattern of "alignment-entrenchment-alignment". However, when Cho (1998) treats the ownership structure as endogenously determined, he finds that it is actually corporate value that affects ownership structure but not vice versa. The findings of Cho (1998) call into question the results of those studies that treat ownership structure as exogenous.

The results of other studies of the relationship between ownership and performance which take into consideration the endogeneity issue are mixed. For example, Holderness et al. (1999) confirm the endogeneity of managerial shareholdings in their study. Lorderer and Martin (1997) find that insider ownership fails to predict performance (Tobin's Q), but that Tobin's Q is a negative predictor of insider ownership. Hermalin and Weisbach (1988) find a significant non-monotonic relationship between managerial ownership and performance (alignment-entrenchment-alignment). Himmelberg et al. (1999) find no meaningful correlations between managerial ownership and performance. Demsetz and Villalonga (2001) also find that there are no systematic relationships between ownership structure and firm performance.

Most companies in Hong Kong are founded by families who are also major shareholders and are involved in the management of their companies. As a result, the nature of share ownership is not influenced by firm performance to the same extent as it would be in the US or the UK, where family ownership is less prevalent. There is thus reason to believe that the ownership structure of Hong Kong companies is exogenously rather than endogenously determined. That is, managerial ownership is more likely to have an impact on corporate performance than vice versa. The endogeneity issue is thus likely to be less relevant in the Hong Kong context.

4.7 Summary

In the qualitative analyses in Chapters Two and Three it is noted that Hong Kong has not adopted all of the UK's corporate governance practices. In addition, there are a number of particular weaknesses in Hong Kong's corporate governance regime, for example, the lack of remuneration committees, inadequate disclosure and a question mark over the 'independence' of independent non-executive directors. These weaknesses mainly stem from the Chinese culture, reflected in the family-owned corporate structure in Hong Kong, which differs from the more diffuse form of ownership in the UK and the US.

To better investigate what corporate governance initiatives and changes should be implemented in Hong Kong, it is necessary to study the effects of various corporate governance variables on firm performance and the impact that culture is likely to play in affecting firm performance. Before carrying out the empirical study to ascertain the effect of the concentrated family-owned corporate structure on firm performance in Hong Kong, this chapter has reviewed the academic literature on various aspects of corporate governance. The detailed review of the relationship between managerial ownership and firm performance shows that the relationship can take different forms when different data are used in different years in different countries. For example, some studies find a linear relationship (e.g. Mehran, 1995) while some find a curvilinear relationship (e.g. McConnell and Servaes, 1990) and others find a cubic relationship (e.g. Morck et al., 1988 and Short and Keasey, 1999). The various forms of the relationship found in the above studies all support the "convergence of interest"

hypothesis of Jensen and Meckling (1976) and/or the “entrenchment of interest” argument of Fama and Jensen (1983).

However, the existing studies have mostly been carried out in the UK or the US contexts. There has been limited research performed using data from East-Asian corporations. The ownership structure in most East-Asian countries is characterized by family-owned and controlled firms, in contrast to the more diffuse form of ownership structure prevalent in the UK and the US (Claessens et al., 2000). As a consequence, the empirical results based on UK and US data may not be applicable to the East-Asian context. The empirical study in this thesis fills a gap in the academic literature by determining the nature of the relationship between managerial ownership and firm performance under the concentrated family-owned corporate structure in Hong Kong.

The review of the academic literature in this chapter concerning the characteristics of the ownership structure in Hong Kong suggest that the family ownership structure might beneficially affect firm performance as there is a convergence of interests between the family shareholders who are also typically in control. However, there is also a risk that the family controllers will expropriate the minority shareholders so as to maximize their own interest, according to the central agency problem associated with high ownership concentration, as argued by La Porta et al. (1999). Hence, the form and the pattern of the relationship between ownership and performance in Hong Kong corporations will not be known until the empirical study is carried out.

Apart from ownership structure, the chapter also reviews and discusses the possible impact of culture on firm performance. The leading work on culture by Hofstede is reviewed, with particular reference to the “long-term orientation” (LTO) dimension of his “Five Cultural Dimensions” study. Given the fact that Hong Kong has a very high score on the LTO dimension, its Chinese oriented culture might be beneficial to performance, as suggested by Hofstede in his LTO study. His study suggests that the fast economic growth of the East-Asian countries in the latter half of the twentieth century could be partly explained by the Chinese culture in these countries. LTO scores are found to be highly correlated with economic growth. The fact that Hong Kong had been a colony of the UK and operated under a laissez-faire political policy is also a factor has served to enhance its LTO index and thus its economic growth.

Thus, despite the fact that a number of other East-Asian countries also have the family-owned form of corporate structure, Hong Kong’s historical background and its Chinese culture made it different in certain aspects from the other East-Asian jurisdictions. Hence, the effect of the concentrated form of family-ownership on corporate performance in Hong Kong can only be uncovered after performing the empirical study, the results of which are reported in the remaining chapters of the thesis.

Chapter Five

Empirical Framework and Methodology

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5.1 Chapter Objectives

As noted from the literature review in Chapter Four, there has been continuous research performed on various corporate governance variables, though limited research has been performed in the East-Asian context. Chapter Four also shows that the ownership structure in Hong Kong is very much different from that in the UK and the US. In Hong Kong, companies are mainly family-owned and controlled. The directors are very often a group of individuals from the same family or are related to the substantial shareholders who come from the same family. This different form of corporate structure, however, is not unique to Hong Kong. Claessens et al. (2000) find that large family shareholders reign over more than half of the East-Asian corporations. It is therefore of interest to find out whether this form of corporate structure will have a similar or a totally different effect on the relationship between managerial ownership and firm performance when compared with the studies in the UK and the US, where the ownership structure is more diffuse in form.

The empirical part of this thesis is thus to find out the relationship between managerial ownership and corporate performance using Hong Kong evidence. The principal aim is to ascertain the impact of managerial ownership on corporate performance in a family-owned corporate structure and to uncover any differences from the findings in the UK and US contexts. Further analysis will also be performed to ascertain whether the East-Asian financial crisis has any impact on the relationship.

While the results of the empirical study will be discussed in Chapter Six, this chapter presents the empirical framework and the research methodology. To test the relationship between managerial ownership and corporate performance in Hong Kong, the OLS regression method is adopted. The regression is performed on a set of panel data which consists of 1406 firm-year observations for the period from 1995 to 1998 on companies listed on the Hong Kong Stock Exchange. The sample and variables used in the study are described in detail in this chapter.

5.2 Empirical Framework

The convergence of interest hypothesis suggests that managerial ownership can help to control agency problems since share ownership provides managers with incentives to reduce private perquisite consumption. As managerial ownership increases, firm performance increases (Jensen and Meckling, 1976). However, this alignment of interests is offset and replaced by the entrenchment effect when ownership further increases as managers have sufficient control over firms and find it worthwhile to consume perquisites, which reduces the value of the firms. This entrenchment behaviour stems from the separation of ownership and control in business organizations (Fama and Jensen, 1983).

The “convergence” and “entrenchment” of interests arguments are supported by a number of subsequent studies. In particular, Morck et al. (1988) is the first paper verifying the “combined effect” of the “convergence of interests” hypothesis and the “entrenchment” argument. This “combined effect” results in a non-linear relationship between managerial ownership and firm performance as found in a number of studies, for example, Morck et al. (1988), McConnell and Servaes (1990) and Short and Keasey (1999). Under this “combined effect” argument, the exact pattern of the relationship depends on the interactions between the two perspectives: whether one perspective dominates the other (that is, whether “convergence” will override “entrenchment” or vice versa). Also, the interactions might not be the same under different ownership ranges (that is, there might be different patterns of the non-linear relationship). It can be noted from the studies in the UK (Short and Keasey, 1999)

and the US (Morck et al., 1988; McConnell and Servaes, 1990) that the pattern of the non-linear relationship runs from alignment to entrenchment and then possibly alignment again, though there are differences in terms of the statistical significance of the results and the turning points of alignment and entrenchment. It is of interest to know whether a similar pattern of relationship will exist in Hong Kong where the ownership structure is very different from that in the UK and the US.

The main issues are therefore: is there any relationship between firm performance and managerial ownership in Hong Kong? If there is such a relationship, is it a linear one, or is it non-linear in nature? If it is non-linear in nature, does it take the form of a curvilinear relationship, as in the study of McConnell and Servaes (1990)? Or, is it of a cubic form, similar to that reported in the studies of Morck et al. (1988) and Short and Keasey (1999)? Even if it is non-linear in nature, is the pattern of the relationship the same or different from the findings in the above UK and US studies? An empirical study based on a sample of companies listed on the Stock Exchange of Hong Kong is conducted for the present study to answer the above questions.

As stated above and explained in the literature review sections in Chapter Four, the relationship between managerial ownership and corporate performance is non-linear and cubic in nature with the pattern of “alignment-entrenchment-alignment” in Morck et al. (1988) and Short and Keasey (1999), though the range of entrenchment in the latter (approximately 13-16% to 42%) is different from the former (5% to 25%). This shows that UK managers become entrenched at higher levels of equity ownership than US managers. Short and Keasey (1999) suggest that greater institutional monitoring

and a lower ability to mount takeover defences in the UK lead to management becoming entrenched at higher levels of ownership when compared with the situation in the US. Nevertheless, the above two studies in general provide strong evidence of a positive relationship between firm performance and managerial ownership at high levels of ownership, which is consistent with the Jensen and Meckling (1976) model. High levels of managerial ownership help to align the interests of shareholders and managers (Jensen and Meckling, 1976) where there is separation of ownership and control.

In Hong Kong, however, the situation differs from that in the UK and the US. Most companies in Hong Kong are family-owned and controlled. Almost nine out of ten listed companies in Hong Kong have one family group holding 25% or more of the issued capital (HKSA, 1997). Hence, the separation of ownership and control does not take place for many companies in Hong Kong. Given the likelihood that managers who are also family shareholders have more incentive to align their interests with the interests of their company than those managers who are unconnected with the company for which they work, we might expect family ownership to affect the relationship between firm performance and managerial ownership. Because of the concentrated family ownership structure in Hong Kong, which contradicts the normal assumption that ownership and control are separated, I have reason to hypothesize that the nature of the relationship between managerial ownership and firm performance in Hong Kong will be different from that in the UK and the US.

Given that no study of the relationship between managerial ownership and firm performance has been conducted under a concentrated family-owned corporate structure before, the exact pattern of the relationship will not be known unless and until it is verified empirically. Hence, I adopt an exploratory approach by constructing three hypotheses which might explain the nature of the relationship. Nevertheless, no matter which hypothesis is supported in the OLS regression analyses, I believe that it is reasonable to expect there to be a wide range of alignment between managerial ownership and firm performance in Hong Kong, possibly with some entrenchment effects. This expectation is based on the fact that there is seldom separation of ownership and control in Hong Kong corporations. Family owners who are also managers should align their interests more to their companies' interests in comparison to UK or US managers with no family connections. In addition, as shown in the findings of Hofstede and Bond's cultural study of the "long-term orientation" dimension, Hong Kong's inherent Chinese culture and family relationships are positively related to economic performance. The "convergence of interests" effect should, therefore, be prevalent in Hong Kong companies.

However, as suggested by La Porta et al. (1999), there are central agency problems associated with high ownership concentration. There may be a tendency for the controlling shareholders to expropriate the minority shareholders when there is high ownership concentration. When this expropriation happens, the entrenchment effect might override the alignment effect. The resultant effect of "entrenchment of interests" will lead to a decrease in firm performance. Hence, the exact pattern of the relationship will depend on the interactions between the two effects under different

levels of managerial ownership, which might also be affected by macro-economic conditions or the presence of other variables. All of these possible implications are taken into account in this study and are explained in the relevant sections of the thesis. The section which immediately follows explains the three hypotheses concerning the relationship between managerial ownership and firm performance in Hong Kong companies that are tested.

5.3 Hypotheses

Given that this is the first empirical study of the relationship between managerial ownership and firm performance in a family-owned and controlled context, an exploratory approach is taken by constructing three hypotheses to test the relationship, using Hong Kong companies as evidence. It is envisaged that the hypotheses can test whether there is any relationship between firm performance and managerial ownership, and, if the answer is “yes”, that the form and pattern of the relationship can be determined.

The arguments of the three hypotheses are as follows:

Hypothesis (1)

Because of the different ownership structure in Hong Kong, I hypothesize that the effect of managerial ownership on firm performance is very different from that in the UK and the US. In the UK and the US, when managerial ownership gradually increases, firm performance improves due to the convergence of interests (Jensen and Meckling, 1976). However, when managerial ownership increases up to a certain point, the issue of the separation of ownership and control jumps in. Firm performance deteriorates due to the entrenchment of interests (Fama and Jensen, 1983). However, when managerial ownership further increases, the alignment effect comes in again and offsets the entrenchment effect. Firm performance increases again due to convergence of interest at high levels of managerial ownership (Jensen and Meckling, 1976). The two turning points according to Morck et al's (1988) study

are 5% and 25%. For Short and Keasey's (1999) study, the turning points are approximately 13-16% and 42% respectively.

Since Hong Kong's situation is that most companies are owned and controlled by the same group of family members, I anticipate that the entrenchment effect may not take place (or it may be relatively insignificant) when managerial ownership increases. Instead, the alignment effect should be further reinforced since the managers, who are also the family shareholders, are more concerned about firm performance as their levels of ownership in the firm are higher. So, I expect that the relationship between firm performance and managerial ownership will be a linear and positive one. That is, firm performance increases as managerial ownership increases due to the convergence of interest.

Hypothesis (2)

However, as argued by La Porta et al. (1999), there are central agency problems associated with high ownership concentration. There is a tendency for the controlling shareholders to expropriate the minority shareholders when there is high ownership concentration. Hence, there is a possibility that at high levels of managerial ownership the managers are exploiting their powers to the detriment of the minority shareholders. This will harm the value of the firms. This is especially the case if some of the managers are employed personnel and not family members. So, I believe that firm performance will deteriorate at high levels of ownership due to the entrenchment effect. If this is true, the relationship between firm performance and managerial ownership will be curvilinear (alignment followed by entrenchment).

which would be similar to the findings of McConnell and Servaes (1990). However, since most Hong Kong companies are family-owned, I expect that the range of alignment for Hong Kong companies will be wider than that in the US, that is, entrenchment will occur at a managerial ownership level higher than the findings (40-50%) of McConnell and Servaes (1990).

Hypothesis (3)

There is a third possibility for the relationship. While I expect that alignment of interests takes place for a wide range of managerial ownership due to the family-owned corporate structure, and that at high levels of managerial ownership there may be some entrenchment effect, it is doubtful that there will be a relationship between firm performance and managerial ownership at the low levels of managerial ownership. Given that almost nine out of ten of all listed companies have one family group holding 25% or more of the issued capital (HKSA, 1997), very few companies in Hong Kong are not family-owned. In those companies which are not family-owned, the managers are very often employed personnel. If these managers own shares in the companies, their percentage holdings are usually not very high. While there is a possibility that they will align their interests with the companies (alignment of interest), there is also a likelihood that they will look out for their own interests (entrenchment effect). Hence, at low levels of managerial ownership, the relationship between firm performance and managerial ownership may be positive (alignment) or negative (entrenchment). If it is positive, then the overall effect is a curvilinear relationship (alignment at both the low and mid levels of managerial ownership and followed by entrenchment at high levels of managerial ownership), which is similar to

the findings of McConnell and Servaes (1990). However, if the relationship between firm performance and managerial ownership is negative at the low level of managerial ownership, the overall picture will be entrenchment followed by alignment and then by entrenchment again. Under this scenario, though there are also two turning points, the pattern of the relationship is “entrenchment–alignment–entrenchment” which is the opposite of the findings of “alignment–entrenchment–alignment” in the studies by Morck et al. (1988) and Short and Keasey (1999).

The three hypotheses are tested by performing OLS regressions on the following:

$$\text{Performance} = \alpha + \beta_1 \text{Managerial Ownership} + \gamma \text{Control variables} \quad (1)$$

$$\text{Performance} = \alpha + \beta_1 \text{Managerial Ownership} + \beta_2 \text{Managerial Ownership}^2 + \gamma \text{Control variables} \quad (2)$$

$$\text{Performance} = \alpha + \beta_1 \text{Managerial Ownership} + \beta_2 \text{Managerial Ownership}^2 + \beta_3 \text{Managerial Ownership}^3 + \gamma \text{Control variables} \quad (3)$$

Hypothesis (1)

As explained above, the aim of Hypothesis (1) is to test whether there is a linear relationship between firm performance and managerial ownership. Managerial ownership is defined as the percentage of ordinary shares held by the directors in the company. Two measures of performance are employed in the study, namely, accounting and market measures. Following Short and Keasey’s study, the ratio of the return on shareholders’ equity (RSE) is used as the accounting measure. Regarding the market measure, the valuation ratio (ProxyQ) is employed. This is defined as the sum of the market value of ordinary shares issued and the book value of

total debt divided by the book value of total assets. It can be seen as an approximation to Tobin's Q as used in the US studies of Morck et al. (1988) and McConnell and Servaes (1990). Hypothesis (1) can be further elaborated as follows:

$$RSE = \alpha + \beta_1 \text{ Managerial Ownership} + \gamma \text{ Control variables} \quad (1)(a)$$

$$\text{ProxyQ} = \alpha + \beta_1 \text{ Managerial Ownership} + \gamma \text{ Control variables} \quad (1)(b)$$

Hypothesis (2)

The aim of Hypothesis (2) is to test whether there is a curvilinear relationship between firm performance and managerial ownership, in line with the findings of McConnell and Servaes (1990). The turning point (whether it is “from alignment to entrenchment” or “from entrenchment to alignment”) will be determined should a curvilinear relationship be found. Hypothesis (2) can be further elaborated as follows:

$$RSE = \alpha + \beta_1 \text{ Managerial Ownership} + \beta_2 \text{ Managerial Ownership}^2 + \gamma \text{ Control variables} \quad (2)(a)$$

$$\text{ProxyQ} = \alpha + \beta_1 \text{ Managerial Ownership} + \beta_2 \text{ Managerial Ownership}^2 + \gamma \text{ Control variables} \quad (2)(b)$$

Hypothesis (3)

The aim of Hypothesis (3) is to test whether there is a cubic form of the relationship between firm performance and managerial ownership, as per the findings of Morck et al. (1988) and Short and Keasey (1999). If the cubic relationship is found (whether it is ‘alignment-entrenchment-alignment’ or “entrenchment-alignment-entrenchment”), the turning points will be computed as appropriate. Hypothesis (3) can be further elaborated as follows:

$$\text{RSE} = \alpha + \beta_1 \text{ Managerial Ownership} + \beta_2 \text{ Managerial Ownership}^2 + \beta_3 \text{ Managerial Ownership}^3 + \gamma \text{ Control variables} \quad (3)(a)$$

$$\text{ProxyQ} = \alpha + \beta_1 \text{ Managerial Ownership} + \beta_2 \text{ Managerial Ownership}^2 + \beta_3 \text{ Managerial Ownership}^3 + \gamma \text{ Control variables} \quad (3)(b)$$

The reasons why the OLS regression method is adopted are discussed in section 5.4. Regarding the sample chosen for the study and the variables used in the regressions, they are described in section 5.5.

5.4 The OLS Regression Model

To examine the relationship between managerial ownership and firm performance, multiple regression analyses are performed on 1406 firm-year observations of Hong Kong listed companies. This allows “firm performance” to be set as the dependent variable and “managerial ownership” and other corporate governance variables to be set as the independent variables so that the impact of the individual independent variables on firm performance can be measured quantitatively. This methodology is adopted because it is most suitable under the circumstances. The financial data for the regression analysis were collected from databases while the ownership data were obtained manually from company annual reports. Despite the time consumed in collecting the ownership data, the data sources are reliable and the final sample size is sufficient for performing empirical tests. For this type of research, alternative methodologies such as using questionnaires and conducting interviews are likely to have been less successful. This is because response rates to these types of surveys in Hong Kong are usually fairly low as people are reluctant to disclose information. In addition, as the aim of this research is to study the relationship between firm performance and managerial ownership, an empirical test using the regression method is the most appropriate method to ascertain the nature of the relationship.

In this study, the ordinary least squares (OLS) multiple regression method is employed. This method is adopted because of the following reasons:

1. Despite the name of OLS, there is nothing ‘ordinary’ about this method. In fact, it has some ‘extraordinary’ properties and it is used most frequently to

estimate the population regression function (PRF) on the basis of the sample regression function (SRF) (Gujarati, 1999).

2. This study not only aims to test the relationship between managerial ownership and firm performance, but also aims to explore whether there are any relationships between other corporate governance variables (board size, board composition and directors' remuneration) and firm performance. Hence, the OLS regression is not just performed on two variables, but rather on a number of variables. A regression model with more than one explanatory variable is known as a multiple regression model. The OLS regression method allows multiple regression analyses to be performed on the equations as detailed in section 5.3 to test the hypotheses and the possible relationships between firm performance and various corporate governance variables. Other control variables can also be added to the OLS regression model. In this study, the control variables used are firm size, sales growth and the debt ratio.
3. The sample of this study consists of a set of panel data: 1406 firm-year observations from 1995 to 1998 on companies listed on the Hong Kong Stock Exchange. The OLS multiple regression method is an appropriate method to test this “pooled time-series cross-sectional regression model”. For example, Fan and Wong (2002) and Qi et al. (2000) also use this regression method on their panel data sets which pool observations both cross-sectionally and intertemporally. One way to apply the method to panel data is to set dummy variables to control for the fixed effects. In this study, these correspond to the calendar years and the industry groups. By defining the years and the industries as dummy variables, the pooled OLS multiple regressions can

control for the changes in macro-economic conditions over time and the possible effects of industry types on the relationship between firm performance and the explanatory variables.

4. As explained in section 5.3, given that this is the first empirical study of the relationship between managerial ownership and firm performance in the family-owned and controlled context of Hong Kong, an exploratory approach is taken to test the relationship. The OLS regression method allows separate regressions to be performed on each of the three equations, as detailed in section 5.3, in order to test whether the relationship is linear or non-linear (curvilinear or cubic) in nature. Should a non-linear relationship be found, the turning points can then be computed by the mathematical method of differentiation as in Short and Keasey (1999).
5. Most importantly, given that the dependent variables in this study are RSE and ProxyQ, which are “continuous quantitative” variables rather variables which are “discrete”, “dummy” or “qualitative” in nature, the OLS regression method is appropriate, rather than other regression methods like logit, probit or ANOVA. The logit and the probit methods are used when the dependent variable is a dummy, or dichotomous, or binary variable and the explanatory variables can be dummy, or quantitative, or a combination of both. The ANOVA method is used when the regression model contains only dummy explanatory variables (Gujarati, 1999). In this study, the dependent variable is quantitative in nature and the explanatory and control variables are a combination of quantitative and dummy variables; hence, the OLS multiple regression model is the BLUE (the best linear unbiased estimator) with these

types of variables. The coefficient values of each quantitative independent variable found from the regression results will indicate the respective magnitude of their impact on the dependent variable in the regression, while at the same time controlling for the effect of the year and industry dummy variables.

5.5 Description of the Data

5.5.1 Sample

The sample consists of 1406 observations from companies listed on the Stock Exchange of Hong Kong for the period from 1995 to 1998. The basis of selection is random and the sample consists of property companies, industrial and utility companies and consolidated enterprises. Consolidated enterprises include companies such as hotels and retail companies. Finance companies are specifically excluded from the sample because they have different income measuring rules from companies in other sectors.¹ The breakdown of the sample is shown in Table 5.1:

Table 5.1 Breakdown of Sample (by Sectors and Years)

Sector	1995	1996	1997	1998	Total
Consolidated Enterprises	140	140	138	136	554
Properties	77	75	75	75	302
Industrial	135	129	125	125	514
Utilities	9	9	9	9	36
Total	361	353	347	345	1406

¹ There were 553 companies listed on the Hong Kong Stock Exchange as at 31 December 1995 and the number increased gradually to 693 by the end of 1998. The number of finance companies was 61 during the four years 1995-1998. That is, the financial sector comprised of 11% and 9% of the total number of listed companies in Hong Kong during the years ending 31 December 1995 and 1998 respectively.

5.5.2 Variables

The variables used in this study include measures of firm performance, managerial ownership and other control variables. Ownership data mainly come from the Wardley cards published by Wardley Data Services Ltd. and individual companies' annual reports. Financial data are collected from the Pacap (Pacific-Basin Capital Markets Research Center) database, Datastream and also individual companies' annual reports. Table 5.2 gives a summary of the variables used in the study:

Table 5.2 Description of Variables

Variables	Description
Dependent Variables RSE ProxyQ	Return on Shareholders' Equity Tobin's Q (approximation)
Ownership Variable Managerial Ownership (DIRSH)	Percentage of ordinary shares held by directors
Control Variables:- Board Structure Variables Remuneration (lnRem) Board Size (BoardSize) Board Composition (PropNexe)	Natural logarithm of Directors' remuneration (<i>fee + emoluments + bonus</i>) Total number of directors on the board Percentage of non-executive directors on the board
Other Control Variables Size (lnSales) Debt Ratio (TD/TA) Growth (Salesgrowth)	Natural logarithm of sales Total debt divided by book value of total assets Annual growth rate of sales

(a) Firm Performance Variables

The accounting based measure of performance used in this study is the return on shareholders' equity (RSE). It is calculated as the profits attributable to shareholders, divided by the value of shareholders' equity as at the financial year end of the individual firms in each of the four years 1995 to 1998.

Regarding the market based measure of performance (ProxyQ), it is calculated based on the sum of the market value of shares and the book value of total debt divided by the book value of total assets as at the financial year end of the individual firms in each of the four years 1995 to 1998². It is an approximation to Tobin's Q used in the US studies by McConnell and Servaes (1990) and Morck et al. (1988).

(b) Managerial Ownership Variable

Managerial ownership (DIRSH) is measured by the percentage of ordinary shares owned by directors as at the financial year end in each of the companies concerned. That is, all the four years' managerial ownership data are collected. This should give a better and more accurate estimate than most previous studies where only cross-section data are used or where only one year of ownership information is collected in a set of panel data. Table 5.3 shows the data relating to managerial ownership of equity for the sampled years:

² See section 5.6 for the limitations of data relating to ProxyQ.

Table 5.3 Managerial Ownership Data

<i>Managerial Ownership (DIRSH) %</i>	1995	1996	1997	1998
Mean	42.67	41.53	40.16	39.11
Median	48.75	47.69	46.94	46.18
Standard deviation	24.64	24.38	25.09	25.19
Minimum	0.00	0.00	0.00	0.00
Maximum	83.24	78.15	86.82	80.76

(c) Control Variables

A number of control variables are used in the regression model to control for potential influences on the performance of firms in addition to managerial ownership. The variables used include directors' remuneration, board size, board composition, firm size, firm growth and the debt ratio.

Directors' remuneration is included as a control variable to account for its possible effect on firm performance. The variable is measured by taking the natural logarithm of the aggregate value of directors' fees, emoluments and bonuses received during the financial year concerned ($\ln\text{Rem}$)³.

³ See section 5.6 for the limitations of data relating to directors' remuneration.

A number of studies have examined how board size and board composition affect firm performance. For example, Rosenstein and Wyatt (1990) document the monitoring function of outside directors. They find that companies will benefit in terms of corporate performance and stock returns by increasing the number of outside directors. The number of directors (BoardSize) and the proportion of non-executive directors on the board (PropNexe)⁴ are used in the study not only as control variables, but also as an attempt to determine whether they have any impact on corporate performance. In common with the other variables in the study, the above three board structure variables (LnRem, BoardSize and PropNexe) are also collected at the financial year end for each firm in the sample for each of the four years 1995 to 1998.

Firm size is measured by taking the natural logarithm of the sales value (lnSales) as at the financial year end of each firm in each of the four years. The size of a firm affects performance because larger firms may find it easier to generate funds internally and to access funds from external sources. Bigger firms also allow economies of scale which can bring a number of beneficial effects on firm performance. The variable of annual growth rate in sales (Salesgrowth) is used to control for the impact of growth on the firm's performance.

The debt ratio is measured by the book value of total debt divided by the book value of total assets (TD/TA) as at the financial year end of each firm in each of the four years. Stiglitz (1985) argues that control over management actions is effectively

⁴ See section 5.6 for the limitations of data relating to board composition.

exercised not by shareholders, but by lenders and, in particular, the banks. Jensen and Meckling (1976) and Grossman and Hart (1982) also suggest that debt may be used to resolve conflicts between managers and shareholders as it reduces management discretion to consume excessive perquisites, which should increase the value of the firm's equity. Alternatively, firms with higher debt ratio have heavier interest burdens and their profits are eroded by the higher interest expenses. In addition, according to the pecking order theory, each firm's observed debt ratio reflects its cumulative requirements for external finance. In this case, the debt ratio is negatively correlated with the profitability of the firm (Myers, 1984)⁵. The debt ratio is used as a control variable in this study to determine its possible relationship with firm performance.

Tables 5.4 and 5.5 show the summary statistics and the Pearson correlation matrix for the variables used in the study. The correlation coefficients among the explanatory variables are found to be low, and all are well below the arbitrary cut-off point of 0.80 used in most research (Studenmund, 2001). This suggests that there are no multicollinearity problems.

⁵ Myers (1984, pg. 582) states that "recent work based on asymmetric information gives predictions roughly in line with the pecking order theory." He goes on to argue that "in the modified pecking order story, observed debt ratios will reflect the cumulative requirement for external financing...For example...a profitable firm will end up with an unusually low debt ratio compared with its industry average, and it won't do much of anything about it. It won't go out of its way to issue debt and retire equity to achieve a more normal debt ratio. An unprofitable firm in the same industry will end up with a relatively high debt ratio (Myers 1984, pg. 589)."

Table 5.4 Summary Statistics for Variables (Data from 1995 to 1998)

<i>Variables</i>	Mean	Standard Deviation	Maximum	Median	Minimum
<i>Performance Variables</i>					
Return on Shareholders' Equity (RSE)	-0.04	0.7929	2.51	0.05	-21.94
Tobin's Q approximation (ProxyQ)	1.03	1.0930	30.37	0.85	0.14
<i>Ownership Variable</i>					
Managerial Ownership (%) (DIRSH)	40.89	24.83	86.82	47.31	0.00
<i>Control Variables: Board Structure Variables</i>					
Directors' Remuneration (lnRem)	15.68	1.3106	19.64	15.81	9.21
Board Size (BoardSize)	8.64	2.8461	22.00	8.00	3.00
Board Composition (PropNexe)	0.41	0.1565	1.00	0.38	0.00
<i>Other Control Variables</i>					
Size (lnSales)	20.47	1.4911	24.71	20.60	14.29
Debt Ratio (TD/TA)	0.40	0.1934	1.70	0.39	0.01
Growth (Salesgrowth)	0.20	1.0072	20.25	0.06	-0.97

Table 5.5 Pearson Correlation Matrix (Data from 1995 to 1998)

<i>Variables</i>	RSE	ProxyQ	DIRSH	lnRem	Board Size	Prop Nexe	lnSales	TD/TA	Sales growth
RSE	1.000	-0.070** <i>(0.008)</i>	0.052 <i>(0.052)</i>	0.054* <i>(0.044)</i>	0.041 <i>(0.122)</i>	0.034 <i>(0.207)</i>	0.105** <i>(0.000)</i>	-0.240** <i>(0.000)</i>	0.058* <i>(0.028)</i>
ProxyQ		1.000	-0.021 <i>(0.435)</i>	0.030 <i>(0.266)</i>	0.023 <i>(0.396)</i>	0.004 <i>(0.882)</i>	-0.015 <i>(0.586)</i>	0.067* <i>(0.012)</i>	-0.003 <i>(0.899)</i>
DIRSH			1.000	0.008 <i>(0.763)</i>	-0.133** <i>(0.000)</i>	-0.070** <i>(0.010)</i>	-0.100** <i>(0.000)</i>	0.063* <i>(0.019)</i>	-0.018 <i>(0.489)</i>
lnRem				1.000	0.297** <i>(0.000)</i>	-0.055* <i>(0.045)</i>	0.493** <i>(0.000)</i>	0.137** <i>(0.000)</i>	0.053* <i>(0.049)</i>
BoardSize					1.000	-0.015 <i>(0.580)</i>	0.416** <i>(0.000)</i>	0.008 <i>(0.752)</i>	-0.002 <i>(0.939)</i>
PropNexe						1.000	0.075** <i>(0.006)</i>	-0.111** <i>(0.000)</i>	-0.023 <i>(0.395)</i>
lnSales							1.000	0.257** <i>(0.000)</i>	0.090** <i>(0.001)</i>
TD/TA								1.000	0.026 <i>(0.328)</i>
Sales growth									1.000

Note:

Significance levels of the Pearson correlation between the variables are shown underneath the relevant correlation coefficient in bracket and in italic form.

- * Correlation coefficient is significant at the 0.01 level (2-tailed)
- ** Correlation coefficient is significant at the 0.05 level (2-tailed)

5.6 Limitations of the Data

There are a number of limitations relating to the sample and the variables adopted in this study:

(a) Sampled Years from 1995 to 1998

At the time of data collection, the financial data available from the Pacap database was up to the year 1998. In addition, audit committees were only made a requirement from 1 January 1999 onwards. Given the above facts, it was decided to define the sample period from 1995 to 1998 for the following reasons: first, the sample period consisting of four years of panel data covering 1406 observations, which should be sufficient to estimate the relationship between managerial ownership and firm performance. Second, the sample period of 1995 to 1998 allows a study of the impact of the East-Asian financial crisis on the relationship. This is performed by running separate regressions for the pre-crisis (1995-97) and the post-crisis period (1998). Third, of course, it would have been preferable to include observations for a greater number of years and, in particular, to include more years in the post-crisis period after 1998. However, given that the collection of managerial ownership data was conducted manually, observation by observation, the data collection process was very time-consuming. Thus, including more years after 1998 would not only have involved much more time in the collection of the ownership data, but would also have involved much more time in getting the financial data from sources other than the then available Pacap database. Matching the data from other sources with the data obtained from the Pacap database would have represented a significant problem. Fourth, given that audit committees were only made a requirement with effect from 1

January 1999, it might be more appropriate to repeat the study again in later years by including several more years' observations (for example, the years 1999 to 2001), so that the presence of an audit committee can be included as an additional variable to measure its possible impact on firm performance. Having considered the above costs and benefits relating to data availability, it was decided that the sample period for this study would be the four years from 1995 to 1998.

(b) Exclusion of Finance Companies from the Sample

The sample consists of 1406 observations from companies listed on the Stock Exchange of Hong Kong for the period from 1995 to 1998. The basis of selection is random and the sample consists of companies from all the industries except the finance industry. Finance companies are specifically excluded from the sample because they have different income measuring rules from companies in other sectors. Although finance companies are excluded, the sample is a representative one given that the financial sector only comprised of 11% and 9% of the total number of listed companies in Hong Kong during the years ending 31 December 1995 and 1998 respectively.

(c) Measurement of Ownership

This study is mainly concerned with the impact of the concentrated family ownership structure in Hong Kong on firm performance. Hence, originally it was my intention to measure the effect of family ownership, rather than managerial ownership, on firm performance. However, during the manual data collection process, I noted that it is impracticable to collect data on family ownership. This is because, although the

annual reports of Hong Kong companies disclose directors' shareholdings, there are no disclosures of shares held by family shareholders. To determine precisely the number of shares held by family shareholders is not possible because very often shares are held by nominees or by holding or related companies. Hence, I can only adopt an alternative measurement: to measure managerial ownership (DIRSH). I have decided to use DIRSH as the explanatory variable, not only due to the fact that other researchers have used it as their independent variable, but also because it is impractical to measure family shareholdings accurately in Hong Kong.

However, I nevertheless attempt to ascertain the relationship between family shareholdings and DIRSH in Hong Kong. Some "large scale" funded researchers, for example, Claessens et al. (2000, pg.106) have investigated this issue; they found that 66% of all firms in Hong Kong in 1996 were held by family members. Also, the HKSA (1997) found that 53% of all firms in Hong Kong in 1996 had one family group holding 50% or more of the entire issued capital. Although this study measures DIRSH and not family shareholdings, it can be seen from the studies of Claessens et al. (2000) and the HKSA (1997) that the major form of ownership in Hong Kong is "family" ownership.

It was possible to test the correlation between DIRSH and family shareholdings in Hong Kong using the percentage of shares held by family members for 53 companies from the sample in this study (for these 53 companies, the percentage of family shareholdings could be determined). It was found that the correlation between family shareholdings and DIRSH is 0.978 (p-value<0.0001). In Demsetz and Villalonga

(2001, pg.214) where the sample of companies is the same sample used in the original Demsetz and Lehn (1985) study, they find that the correlation between the fraction of shares owned by important shareholding families and the fraction owned by management is 0.67. Given that the correlation is not a low figure in the US, where the corporate structure is not as “family-concentrated” as it is in Hong Kong, it is not surprising that a correlation of 0.978 is found from the sub-sample in this study.

While the 53 companies for which family ownership data are available may not be representative of the full sample in this study, we would expect the correlation between family ownership and DIRSH in Hong Kong to be higher than that found for companies in the US (i.e. at some point between 0.67 and 0.978). Hence, DIRSH can be regarded as a surrogate (or at least a close approximation) for family ownership in Hong Kong.

(d) Measurement of Market Performance

In US studies (e.g. Morck et al. 1988), Tobin’s Q is used as a common measure of the market performance of a firm. In Hong Kong, given that the replacement values of assets are not available in annual reports, I have adopted an alternative way to calculate a market measure which is based on the sum of the market value of shares and the book value of total debt divided by the book value of total assets as at the financial year end of the individual firms in each of the four years 1995 to 1998. The measure is termed ProxyQ in this study which denotes the fact that it is a close approximation to the measure of Tobin’s Q used in the US studies.

(e) Measurement of Directors' Remuneration

In this study, directors' remuneration is included as a control variable and it is measured by taking the natural logarithm of the aggregate value of directors' fees, emoluments and bonuses received during the financial year concerned. There are some deficiencies in this measure because certain benefits received by the directors, such as stock option benefits, are not included in the measure. This is due to the fact that the disclosures of options and other benefits received by the directors are not standardised and are not adequately reported in Hong Kong company annual reports.

(f) Measurement of Board Composition

Board composition is another control variable in this study. Originally it was intended to collect data on both the number of independent non-executive directors and the number of non-executive directors (i.e. to examine them as two separate variables). However, during the process of data collection, it was found that the reporting of the information was not adequate for this purpose and was not standardised in most of the company annual reports.

Some companies report only non-executive directors without defining whether they are independent or not. Some companies report independent non-executive directors without any additional information on the non-executive directors. Some companies make no disclosures of non-executive and independent non-executive directors. Some further annual reports disclose both types of directors.

Hence, the only solution is to aggregate the disclosed numbers of independent non-executive directors and non-executive directors of each firm, and then divide this aggregate number by the board size of the firm. This generates the variable PropNexe, which represents the proportion of non-executive directors on the board.

Chapter Six

Empirical Results and Analyses

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6.1 Chapter Objectives

In this chapter, OLS regression analyses are performed on panel data comprising 1406 firm-year observations to determine the relationship between managerial ownership, various corporate governance variables, and firm performance during the period from 1995 to 1998. The results suggest that the relationship between managerial ownership and firm performance is non-linear and cubic in nature. The particular pattern found is “entrenchment-alignment-entrenchment” which supports Hypothesis (3) as detailed in Chapter Five.

Although this pattern of “entrenchment-alignment-entrenchment” supports the “combined effect” argument of Morck et al. (1988), it is the reverse of the pattern found by Short and Keasey (1999) and Morck et al. (1988). Both of these studies found an “alignment-entrenchment-alignment” relationship in their UK and US studies respectively. This suggests that the concentrated ownership structure in Hong Kong may affect the relationship between managerial ownership and firm performance in a different way, compared to the less concentrated ownership structures in the UK and the US. This finding is also supported by the suggestion of the recent study of Fan and Wong (2002) that studies based on UK or US data are not necessarily applicable to East-Asian corporations due to differences in the degree of ownership concentration.

Another aim of the empirical study is to ascertain whether the East-Asian financial crisis had any effect on the relationship between managerial ownership and corporate performance. The second part of this chapter reports the results of the OLS

regressions in which the original sample was partitioned into the pre-crisis period of 1995-1997 and the post-crisis year of 1998. The regression analyses are also performed on the individual years 1995, 1996, 1997 and 1998 respectively. The results suggest that the different macro-economic environments prior to and after the crisis, and in individual years, did affect the relationship. During prosperous years (1996 and 1997) the convergence effect is more dominant. However, managers become entrenched at very high levels of ownership, and this behaviour is even more intense during the difficult times after the East-Asian financial crisis in 1998 and in the less prosperous year of 1995. The findings suggest that the East-Asian financial crisis did play an important role in affecting the relationship between managerial ownership and firm performance.

The empirical research conducted for this thesis has produced results that are statistically significant. The findings contribute to the academic literature in that ownership structure and macro-economic conditions do appear to have an influence upon corporate performance. The details of the findings are presented in the remaining sections of this chapter.

6.2 Findings and Analyses

6.2.1 Accounting Measure of Performance

Table 6.1 presents the results of the relationship between firm performance as measured by the return on shareholders' equity (RSE) and managerial ownership (DIRSH) using the data from 1995 to 1998. The explanatory power of the regression model is fairly good, given the significant F-statistics shown in the table. It can also be seen from the table that both Hypothesis (1) and Hypothesis (3) are supported.

Under Hypothesis (1), there is a positive linear relationship between RSE and managerial ownership because the coefficient on the variable DIRSH is positive and it is statistically significant. Firm performance improves as managerial ownership increases in companies.

Hypothesis (3) is also supported. The coefficients of the variables DIRSH, DIRSH² and DIRSH³ are all statistically significant. The relationship is found to be of the cubic form. Since the signs of the coefficients of the variables DIRSH, DIRSH² and DIRSH³ are negative, positive and negative respectively, the relationship between RSE and managerial ownership is “entrenchment-alignment-entrenchment”. This is in accordance with the argument that I set out in Chapter Five. The two turning points are 16.10% and 62.73% respectively.¹

¹ The turning points of the cubic function are calculated by denoting RSE as y and DIRSH as x in the equation: $y = -1.875x + 7.318x^2 - 6.189x^3$. The values of the turning points (x) are found by differentiating y with respect to x . That is, letting $\hat{y}/\hat{x} = 0$ and solving for the values of x . To determine whether the turning point is a maxima or a minima, the value of $\partial^2 y/\partial x^2$ is computed. If $\partial^2 y/\partial x^2 > 0$, it is a maxima. If $\partial^2 y/\partial x^2 < 0$, it is a minima.

Table 6.1 Relationship between RSE and Managerial Ownership

Regression Results using the Data from 1995 to 1998 (n=1406)

Dependent variable (RSE)	<u>Hypothesis 1</u>	<u>Hypothesis 2</u>	<u>Hypothesis 3</u>
Independent variables	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic
DIRSH	0.294 3.345 ****	0.111 0.364	-1.875 -2.287 **
DIRSH ²	N/A	0.262 0.624	7.318 2.674 ***
DIRSH ³	N/A	N/A	-6.189 -2.609 ***
lnRem	-0.0005 -0.026	0.0016 0.082	0.0029 0.149
BoardSize	-0.0085 -1.000	-0.0087 -1.032	-0.0069 -0.808
PropNexe	-0.0284 -0.205	-0.0219 -0.158	0.0038 0.028
lnSales	0.111 5.875 *****	0.111 5.822 *****	0.106 5.553 *****
TD/TA	-1.250 -10.784 *****	-1.247 -10.747 *****	-1.229 -10.591 *****
Salesgrowth	0.0401 1.893 *	0.0398 1.882 *	0.0396 1.876 *
Intercept	-1.855 -5.408 *****	-1.860 -5.420 *****	-1.776 -5.165 *****
Adjusted R ²	0.095	0.094	0.098
F-statistic	20.808 *****	18.248 *****	17.048 *****
Inflection points	N/A	N/A	16.10% 62.73%
Hypothesis 1 and Hypothesis 3 are supported Assuming all other variables are constant: Hypothesis 1: RSE = 0.294 DIRSH Hypothesis 3: RSE = - 1.875DIRSH + 7.318DIRSH² - 6.189DIRSH³			
* Significant at 0.1 confidence level using two-tailed test ** Significant at 0.05 confidence level using two-tailed test *** Significant at 0.01 confidence level using two-tailed test **** Significant at 0.001 confidence level using two-tailed test ***** Significant at 0.0001 confidence level using two-tailed test			

As shown in Table 6.1 under Hypothesis (3), RSE firstly deteriorates as managerial ownership increases. When managerial ownership reaches 16.10%, RSE increases until managerial ownership reaches 62.73%. Thereafter, RSE decreases again with further increases in managerial ownership.

From the above findings, it can be noted that the relationship has elements of two functional forms: a linear and a cubic form of the relationship between RSE and managerial ownership. In general, managerial ownership is beneficial to firm performance as indicated by the significant positive linear relationship under Hypothesis (1) (p -value = 0.001). When the percentage of shares owned by managers in a company increases, firm performance as measured by RSE also increases.

However, it can also be seen from the regression results under Hypothesis (3) that the relationship can also take a cubic form. That is, at low levels of managerial ownership, the relationship between RSE and DIRSH is a negative one. This is consistent with my argument that in those companies which are not family-owned, the managers are very often employed personnel. If these managers own shares in the company concerned, their percentage shareholdings are likely not to be very high. These types of managers will usually tend to look out for their own interests (entrenchment effect) relatively more than aligning their interests with the company. The regression results show that at levels of managerial ownership below 16.10%, the relationship between RSE and managerial ownership is negative. These are likely to be the cases where the companies are not family-owned.

On the other hand, when the managerial ownership is between 16.10% and 62.73%, the relationship between RSE and managerial ownership becomes positive and more significant. These are likely to be the cases where the managers are also family members, as their percentage of shareholdings in the companies are higher. These types of managers will tend to align their interests with the company's interests since they are also the family owners. Hence, these results support the view that family-ownership is beneficial to corporate performance, due to the convergence of interests, in accordance with Jensen and Meckling (1976). Also, the results confirm my hypothesis that the range of alignment is much wider in the Hong Kong context due to the family form of ownership.

When managerial ownership further increases to high levels (beyond 62.73%) the managers appear to be exploiting their power to the detriment of the minority shareholders as the relationship between RSE and managerial ownership becomes negative again. This is consistent with the suggestion of La Porta et al. (1999) that in corporations with high ownership concentration, controlling shareholders' interests are very unlikely to be the same as those of the minority shareholders. Thus, there is a tendency for the controlling shareholders to expropriate the minority shareholders at high levels of ownership. This is the result of the central agency problem associated with high ownership concentration (La Porta et al., 1999). The overall behaviour is therefore "entrenchment-alignment-entrenchment". Although there are also two turning points, the pattern is opposite to the findings of "alignment-entrenchment-alignment" reported in the studies of Short and Keasey (1999) and Morck et al. (1988).

This is in line with my argument that a different type of relationship may be expected between managerial ownership and performance in Hong Kong due to the different form of corporate ownership in Hong Kong compared to the UK and US.

Given that the regression results lend support to both Hypotheses (1) and (3), this suggests that in Hong Kong corporations the convergence effect is very strong over a wide range of managerial ownership (that is, a positive linear relationship as supported by Hypothesis (1)); at the same time, there are some entrenchment effects at both ends of the managerial ownership ranges (that is, negative relationships at the very low and very high levels of managerial ownership, as supported by Hypothesis (3)). Hence, the functional form of the relationship between firm performance and managerial ownership in this study can be taken to be “non-linear and cubic”, with a pattern of “entrenchment-alignment-entrenchment”, with the range of alignment being very wide (between 16.10% and 62.73%).

Regarding the board structure variables, namely directors’ remuneration, board size and board composition, no significant relationships can be found from the regression results. These results are consistent with the findings of Baysinger and Butler (1985), Hermalin and Weisbach (1991), and Bhagat and Black (1997), who all find no meaningful relations between board composition and firm performance. Yermack (1996) also finds no association between the percentage of outside directors and firm performance. However, the results reported in the literature for these aspects are mixed. For example, Rosenstein and Wyatt (1990) provide evidence that shareholder wealth is affected by the proportion of outside directors and Yermack (1996) finds that

firm value and performance is a decreasing function of board size. Core et al. (1999) also find that board structure variables are somewhat more important than the ownership structure variables in predicting future performance, and that board and ownership structure are associated with the level of chief executives' compensation. In this study, it is found that managerial ownership is more important than the board structure and remuneration in explaining the accounting performance of firms.

Apart from managerial ownership, it is also found that under both Hypotheses (1) and (3), RSE is positively related to firm size and sales growth and is negatively related to the debt ratio. These results are consistent with prior research in that firm size, growth and the debt ratio have all been shown to have effects on firm performance. Hence, they are used as control variables in this study.

6.2.2 Market Measure of Performance

Table 6.2 presents the results of the relationship between firm performance as measured by the ratio of Tobin's Q (in fact an approximation referred to as ProxyQ) and managerial ownership (DIRSH) using the data from 1995 to 1998. Although the explanatory power of the regression model is still fairly satisfactory as the F-statistics are significant at the 0.001 level of confidence, the adjusted R-squared figures (1.4% to 1.5%) are not as good as those reported in the regressions of RSE against DIRSH as indicated in Table 6.1 (9.4% to 9.8%). It can also be seen from Table 6.2 that all the three hypotheses are not supported as all the coefficients of the variables DIRSH, DIRSH² and DIRSH³ are not significant.

The regression results show that there are no significant relationships between managerial ownership and the market performance of firms. This is in contrast to the findings of Morck et al. (1988) and Short and Keasey (1999). However, it is in line with some other studies, such as Core et al. (1999) which suggest that board and ownership structure more consistently predict accounting performance than stock market performance. Demsetz and Villalonga (2001) also suggest that when assessing the effect of ownership on performance, the accounting measure is superior when compared with the market measure. They suggest that it is more sensible to look at what management "has" accomplished rather than what management "will" accomplish. The accounting profit rate is backward-looking, while Q is forward-looking. They also point out that the accounting profit rate is not affected by the psychology of investors whereas Tobin's Q is affected by investor psychology.

Table 6.2 Relationship between ProxyQ and Managerial Ownership

Regression Results using the Data from 1995 to 1998 (n=1406)

Dependent variable (ProxyQ)	<u>Hypothesis 1</u>	<u>Hypothesis 2</u>	<u>Hypothesis 3</u>
	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic
Independent variables			
DIRSH	-0.144 -1.171	-0.632 -1.477	-1.848 -1.603 #
DIRSH ²	N/A	0.701 1.190	5.020 1.305 ##
DIRSH ³	N/A	N/A	-3.788 -1.136 ###
lnRem	0.061 2.231 **	0.067 2.404 **	0.067 2.432 **
BoardSize	0.020 1.675 *	0.019 1.608	0.020 1.699 *
PropNexe	0.114 0.585	0.131 0.673	0.147 0.752
lnSales	-0.067 -2.520 **	-0.069 -2.591 ***	-0.072 -2.689 ***
TD/TA	0.690 4.242 *****	0.698 4.287 *****	0.709 4.349 *****
Salesgrowth	0.015 0.510	0.015 0.489	0.014 0.485
Intercept	1.005 2.088 **	0.992 2.060 **	1.043 2.158 **
Adjusted R ²	0.014	0.014	0.015
F-statistic	3.688 ****	3.405 ****	3.171 ****
Inflection points	N/A	N/A	26.14%)see 62.21%)note
All the three Hypotheses are not supported because: All the t-statistics of DIRSH, DIRSH ² and DIRSH ³ are not statistically significant.			
Note: Although the result is not significant (weak relationship), the inflection points (26.14% and 62.21%) are computed assuming Hypothesis 3 holds: Hypothesis 3: $ProxyQ = -1.848DIRSH + 5.020DIRSH^2 - 3.788DIRSH^3$			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		
#	Significant at 0.11 confidence level using two-tailed test		
##	Significant at 0.19 confidence level using two-tailed test		
###	Significant at 0.26 confidence level using two-tailed test		

Despite the absence of significant results from the regression of ProxyQ and managerial ownership, the inflection points are still computed assuming that Hypothesis (3) holds. As shown in Table 6.2, the inflection points are 26.14% and 62.21%. Despite the weak relationship, the general pattern is still “entrenchment-alignment-entrenchment”. This is in line with the findings of the regression of RSE and managerial ownership. As shown in Tables 6.1 and 6.2, the range of alignment is wide (Table 6.1: 16.10% - 62.73%; Table 6.2: 26.14% - 62.21%). Also, it demonstrates the robustness of the results given that roughly the same point of change from alignment to entrenchment (62.73% and 62.21%) is obtained from both analyses. These results, in particular, the wide range of alignment, support the view that the family form of ownership² is beneficial to firm performance, in line with the “convergence of interest” hypothesis proposed by Jensen and Meckling (1976).

However, at a very high level of managerial ownership, the entrenchment effect becomes dominant. The central agency problem suggested by Fama and Jensen (1983) becomes material. Shleifer and Vishny (1997) and La Porta et al. (1999) focus on the central agency problem associated with high ownership concentration. They argue that the controlling family members might take advantage of the minority shareholders in order to maximize their own interests. The results of this study lend support to both the arguments above. A comparison of the findings of Short and Keasey (1999), Morck et al. (1988) and this study is summarised in Table 6.3.

² In this study, managerial ownership (DIRSH) is used as a surrogate for family ownership in Hong Kong. For details of the limitations of the data, please refer to section 5.6 in Chapter Five.

Table 6.3 Comparison of Findings on the Relationship between Firm Performance and Managerial Ownership

Empirical Study	Cubic Form of Relationship	Turning Points	Significant Result
<i>The United Kingdom – Short and Keasey (1999)</i>	Alignment – Entrenchment – Alignment (i.e. positive-negative-positive)	13-16% 42%	Accounting measure (RSE) and Market measure (VAL)
<i>The United States – Morck et al. (1988)</i>	Alignment – Entrenchment – Alignment (i.e. positive-negative-positive)	5% 25%	Market measure only (Tobin's Q) <i>(No significant result for the accounting measure of profit rate)</i>
<i>Hong Kong – This study</i>	Entrenchment – Alignment – Entrenchment (i.e. negative-positive-negative)	16% 62%	Accounting measure only (RSE) <i>(No significant result for the market measure of ProxyQ)</i>

6.3 Robustness of Results and Sensitivity Analyses

In order to determine the robustness of the significant results for the accounting measure of performance, further analyses are performed on the regressions of return on shareholders' equity (RSE) against managerial ownership (DIRSH) in this section.

6.3.1 Year and Industry Dummies

Dummy variables are added to the regression models to control for changes in the macro-economic environment and for possible industry effects on firm performance. The following three regression analyses are performed:

$$\text{RSE} = \alpha + \beta_1 \text{Managerial Ownership} + \gamma \text{Control variables}$$

$$+ \sum_{j=95}^{97} \delta_j \text{Dummy Year}_j + \sum_{k=1}^3 \lambda_k \text{Dummy Industry}_k$$

$$\text{RSE} = \alpha + \beta_1 \text{Managerial Ownership} + \beta_2 \text{Managerial Ownership}^2$$

$$+ \gamma \text{Control variables}$$

$$+ \sum_{j=95}^{97} \delta_j \text{Dummy Year}_j + \sum_{k=1}^3 \lambda_k \text{Dummy Industry}_k$$

$$\text{RSE} = \alpha + \beta_1 \text{Managerial Ownership} + \beta_2 \text{Managerial Ownership}^2$$

$$+ \beta_3 \text{Managerial Ownership}^3 + \gamma \text{Control variables}$$

$$+ \sum_{j=95}^{97} \delta_j \text{Dummy Year}_j + \sum_{k=1}^3 \lambda_k \text{Dummy Industry}_k$$

Dummy Year j is a dummy variable that equals one for year j , and zero otherwise, which is used to control for changes in the macro-economic environment over time. Dummy Industry k is a dummy variable to control for industry effects on firm performance. The regression results are presented in Table 6.4.

It can be seen from Table 6.4 that the regression results are similar to the findings presented in Table 6.1 where dummy variables are not included. Both Hypothesis (1) and Hypothesis (3) are supported. When dummy variables are included in the analyses, the adjusted R-squared figures improve (from 9.4% - 9.8% as shown in Table 6.1 to 10.8% - 11.2% as indicated in Table 6.4). The coefficients of DIRSH under Hypothesis (1) are similar (0.294 in Table 6.1 and 0.269 in Table 6.4). The inflection points under Hypothesis (3) are also very close to one another (16.10% and 62.73% in Table 6.1; 16.86% and 63.17% in Table 6.4). These findings demonstrate the robustness of the results. The relationship between RSE and DIRSH is non-linear and cubic in nature, with a pattern of “entrenchment-alignment-entrenchment”.

Additional findings are obtained from the regressions with the dummy variables. As shown in Table 6.4, the coefficients of the dummy variables, DUMConEnt, DUMProperties and DUMIndustrials³ are all statistically insignificant. This result indicates that industrial sectors do not have a significant impact on RSE.

³ When a qualitative variable has m categories, the number of dummy variables should be $(m - 1)$ (Gujarati, 1999). If this rule is not followed, there will be a problem of perfect multicollinearity. This is the reason why the utilities industry is not included as a dummy variable in the regressions. I have chosen to exclude the utilities industry from the list of dummy variables due to the relatively small number of observations of utilities in the sample.

Table 6.4 Relationship between RSE and Managerial Ownership
Regression Results including Dummy Variables (1995 – 1998) (n=1406)

Dependent variable (RSE) Independent variables	Hypothesis 1	Hypothesis 2	Hypothesis 3
	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic
DIRSH	0.269 3.075 ***	0.016 0.051	-1.985 -2.423 **
DIRSH ²	N/A	0.364 0.863	7.458 2.733 ***
DIRSH ³	N/A	N/A	-6.213 -2.631 ***
InRem	-0.002 -0.112	0.001 0.035	0.002 0.113
BoardSize	-0.009 -1.018	-0.009 -1.068	-0.007 -0.867
PropNexe	-0.028 -0.194	-0.020 -0.142	0.000 0.000
InSales	0.117 6.133 *****	0.116 6.069 *****	0.111 5.777 *****
TD/TA	-1.368 -11.168 *****	-1.366 -11.142 *****	-1.346 -10.986 *****
Salesgrowth	0.035 1.662 *	0.035 1.647 *	0.035 1.650 *
Intercept	-2.073 -5.325 *****	-2.066 -5.305 *****	-1.944 -4.968 *****
DUM95	0.239 3.987 *****	0.239 3.983 *****	0.238 3.967 *****
DUM96	0.202 3.382 ****	0.203 3.395 ****	0.201 3.357 ****
DUM97	0.190 3.179 ***	0.190 3.178 ***	0.190 3.174 ***
DUMConEnt	0.003 0.022	-0.011 -0.076	-0.041 -0.270
DUMProperties	-0.043 -0.282	-0.056 -0.364	-0.087 -0.564
DUMIndustrials	0.102 0.661	0.092 0.595	0.064 0.414
Adjusted R ²	0.108	0.108	0.112
F-statistic	13.355 *****	12.452 *****	12.136 *****
Inflection points	N/A	N/A	16.86% 63.17%
Hypothesis 1 and Hypothesis 3 are supported			
Assuming all other variables are constant:			
Hypothesis 1: RSE = 0.269 DIRSH			
Hypothesis 3: RSE = - 1.985DIRSH + 7.458DIRSH² - 6.213DIRSH³			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		

On the contrary, it is found that the coefficients of DUM95, DUM96 and DUM97⁴ are all statistically significant. This indicates that while the three years (1995, 1996 and 1997) have similar significant effects on RSE in the three years, the effect of 1998 may be different from that of the three years from 1995 to 1997. If this is the case, it is most likely due to the East-Asian financial crisis which took place in late 1997. In order to confirm that there is a significant difference between the three-year period (1995 to 1997) and the year of 1998, and that the difference is due to the effect of the financial crisis, a test is carried out to compare the means of RSE during the period from 1995 to 1998 with the means from each other year. The comparison results are reported in Table 6.5.

Table 6.5 Comparisons of RSE among the Years 1995 – 1998

Year (I)	Year (J)	Post Hoc Test (Bonferroni #)	
		Mean Difference in RSE (I – J)	p-value
1995	1996	0.0393	1.000
	1997	0.0142	1.000
	1998	0.2175 *	0.002
1996	1995	-0.0393	1.000
	1997	-0.0251	1.000
	1998	0.1782 *	0.017
1997	1995	-0.0142	1.000
	1996	0.0251	1.000
	1998	0.2033 *	0.004
1998	1995	-0.2175 *	0.002
	1996	-0.1782 *	0.017
	1997	-0.2033 *	0.004

The Bonferroni test is more powerful than the other types of Post Hoc tests in comparing small number of pairs. It has the advantage of adjusting the observed significance level for the fact that multiple comparisons are made. The overall error rate is controlled (Norusis, 1996).

* The mean difference is significant at the 0.05 level.

⁴ Year 1998 is excluded from the dummy variable list in order to avoid the problem of perfect multicollinearity. I propose that the effect of Year 1998 on RSE, if any, should be different from 1995, 1996 and 1997 due to the East-Asian financial crisis.

The results in Table 6.5, where the Post Hoc (Bonferroni) pairwise multiple comparison test is performed on the mean values of RSE, confirm that the mean value of RSE in 1998 is significantly less than those in the years 1995 to 1997. Further analyses on the relationship between RSE and managerial ownership before and after the East-Asian financial crisis are performed in section 6.4.

6.3.2 Alternate Accounting Measures of Performance

To further test the robustness of the results, other accounting measures of performance are used as the dependent variable in the regression analyses. The accounting measures employed include the ratios of return on capital employed (ROCE) and return on total assets (ROA). Regressions are run for the three hypotheses for the whole period under study (1995-1998). The regressions produce similar results to those obtained when RSE is used as the dependent variable. All the independent and control variables, which show significant results when RSE is used as the dependent variable in the regressions, also give significant results when ROCE or ROA is replaced as the dependent variable. Table 6.6 summarises and compares the regression results when different accounting measures are used in the regressions against managerial ownership, board structure variables, other control variables and the dummy variables.

Table 6.6 Relationship between Different Accounting Measures and Managerial Ownership**Extract of Regression Results for Comparison (1995 – 1998) (n=1406)**

	<u>Hypothesis 1</u> Coefficient t-statistic	<u>Hypothesis 2</u> Coefficient t-statistic	<u>Hypothesis 3</u> Coefficient t-statistic
<u>Dependent variable (RSE)</u>			
Independent variables			
DIRSH	0.269 3.075 ***	0.016 0.051	-1.985 -2.423 **
DIRSH ²	N/A	0.364 0.863	7.458 2.733 ***
DIRSH ³	N/A	N/A	-6.213 -2.631 ***
Adjusted R ²	0.108	0.108	0.112
F-statistic	13.355 *****	12.452 *****	12.136 *****
Inflection points	N/A	N/A	16.86% 63.17%
<u>Dependent variable (ROCE)</u>			
Independent variables			
DIRSH	0.202 3.904 *****	0.046 0.256	-1.162 -2.392 **
DIRSH ²	N/A	0.224 0.896	4.509 2.787 ***
DIRSH ³	N/A	N/A	-3.753 -2.680 ***
Adjusted R ²	0.114	0.114	0.118
F-statistic	14.100 *****	13.148 *****	12.809 *****
Inflection points	N/A	N/A	16.14% 63.96%
<u>Dependent variable (ROA)</u>			
Independent variables			
DIRSH	0.093 5.711 *****	0.092 1.611	-0.276 -1.799 **
DIRSH ²	N/A	0.002 0.021	1.308 2.559 ***
DIRSH ³	N/A	N/A	-1.144 -2.586 ***
Adjusted R ²	0.171	0.170	0.173
F-statistic	21.987 *****	20.401 *****	19.570 *****
Inflection points	N/A	N/A	12.65% 63.57%
Hypothesis 1 and Hypothesis 3 are supported when different accounting measures are used as the dependent variable in the regressions against managerial ownership and other control variables			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		

Table 6.6 shows that F-statistics increase when ROCE and ROA are used (for RSE: 12.136-13.355; for ROCE: 12.809-14.100; for ROA: 19.570-21.987). The adjusted R-squared figures also improve (for RSE: 10.8%-11.2%, for ROCE: 11.4%-11.8%, for ROA: 17.0%-17.3%). The results also show that both Hypothesis (1) and Hypothesis (3) are supported. This supports the robustness of the findings as indicated in Table 6.4.

As shown in Table 6.6, the positive linear relationship between the accounting measure of performance and managerial ownership under Hypothesis (1) is even more strongly significant when ROCE and ROA are used as the dependent variable. Regarding the cubic form of relationship under Hypothesis (3), the results show that the relationship between the accounting measure of performance and managerial ownership also follows an “entrenchment-alignment-entrenchment” pattern. The range of alignment is similar under alternate specifications (for RSE: 16.86%-63.17%; for ROCE: 16.14%-63.96%; for ROA: 12.65%-63.57%). All of these findings demonstrate the robustness of results, which further confirms that the relationship between RSE and DIRSH is non-linear and cubic in nature, with a pattern of “entrenchment-alignment-entrenchment”.

6.3.3 Heteroskedasticity and Outliers Tests

To further test the robustness of the results, the regressions of RSE against managerial ownership are re-run using the White’s (1980) procedure to correct for heteroskedasticity (Gujarati, 1999). All the variables that show significant

relationships with RSE in the original regressions also give significant results and with the same signs of the coefficients under the heteroskedasticity test. Table 6.7 presents the results of the regressions with the adjusted t-statistics after checking for heteroskedasticity.

OLS regressions are also re-run by eliminating observations in the 99th percentile in order to control for the possible influences of outliers on the results. All the variables that show significant relationships with RSE in the original regressions also give significant results in the re-run regressions where the 99th percentile observations are excluded⁵. Table 6.8 presents the results of the regressions based on 1386 observations. Adjusted R-squared figures improve after the outliers are eliminated (Tables 6.4 and 6.7: 10.8%-11.2%; Table 6.8: 16.2%-16.5%). Both Hypothesis (1) and Hypothesis (3) are supported. These re-run regressions are also checked using the heteroskedasticity test. The adjusted t-statistics show that the relationships are even more significant than the original regressions. Similar inflection points are obtained under Hypothesis (3) (Tables 6.4 and 6.7: 16.86% and 63.17%; Table 6.8: 16.30% and 63.59%). All of the above findings demonstrate the robustness of the results.

⁵ While all the variables that show significant results in the original regressions also give significant results in the re-run regressions where outliers are excluded, an additional finding from the outliers test is that the relationship between PropNexe and RSE is negative, which is contrary to expectations. However, as the coefficients are not statistically significant we cannot conclude that the proportion of non-executive directors on the board (PropNexe) has a negative impact on firm performance (RSE). This result nevertheless casts some doubt on the effectiveness of non-executive directors as effective corporate governance mechanisms in Hong Kong.

Table 6.7 Relationship between RSE and Managerial Ownership
Heteroskedasticity Test on Full Sample (1995 – 1998) (n=1406)

Dependent variable (RSE)	Hypothesis 1	Hypothesis 2	Hypothesis 3
	Coefficient Adjusted t-statistic	Coefficient Adjusted t-statistic	Coefficient Adjusted t-statistic
DIRSH	0.269 2.847 ***	0.016 0.079	-1.985 -1.157 #
DIRSH ²	N/A	0.364 1.030	7.458 1.688 *
DIRSH ³	N/A	N/A	-6.213 -1.686 *
lnRem	-0.002 -0.170	0.001 0.051	0.002 0.160
BoardSize	-0.009 -1.157	-0.009 -1.183	-0.007 -1.061
PropNexe	-0.028 -0.175	-0.020 -0.126	0.000 0.000
lnSales	0.117 4.096 *****	0.116 4.154 *****	0.111 4.332 *****
TD/TA	-1.368 -3.702 ****	-1.366 -3.716 ****	-1.346 -3.775 ****
Salesgrowth	0.035 2.410 **	0.035 2.398 **	0.035 2.386 **
Intercept	-2.073 -3.200 ***	-2.066 -3.212 ***	-1.944 -3.340 ****
DUM95	0.239 2.949 ***	0.239 2.951 ***	0.238 2.966 ***
DUM96	0.202 2.469 **	0.203 2.464 **	0.201 2.473 **
DUM97	0.190 2.564 **	0.190 2.563 **	0.190 2.572 **
DUMConEnt	0.003 0.053	-0.011 -0.200	-0.041 -0.756
DUMProperties	-0.043 -0.580	-0.056 -0.811	-0.087 -1.447
DUMIndustrials	0.102 0.890	0.092 0.843	0.064 0.664
Adjusted R ²	0.108	0.108	0.112
F-statistic	13.355 *****	12.452 *****	12.136 *****
Inflection points	N/A	N/A	16.86% 63.17%
Hypothesis 1 and Hypothesis 3 are supported			
Assuming all other variables are constant:			
Hypothesis 1: RSE = 0.269 DIRSH			
Hypothesis 3: RSE = - 1.985DIRSH + 7.458DIRSH² - 6.213DIRSH³			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		
#	Significant at 0.11 confidence level using two-tailed test		

Table 6.8 Relationship between RSE and Managerial Ownership**Outliers Test: Outliers Excluded from the Sample (1995 – 1998) (n=1386)**

Dependent variable (RSE)	Hypothesis 1	Hypothesis 2	Hypothesis 3
	Coefficient t-statistic Adjusted t-statistic	Coefficient t-statistic Adjusted t-statistic	Coefficient t-statistic Adjusted t-statistic
Independent variables			
DIRSH	0.187 3.327 **** 4.149 *****	0.037 0.187 0.209	-1.163 -2.208 ** -2.092 **
DIRSH ²	N/A	0.216 0.796 0.797	4.470 2.548 ** 2.353 **
DIRSH ³	N/A	N/A	-3.726 -2.454 ** -2.294 **
lnRem	-0.013 -1.025 -1.204	-0.011 -0.877 -1.077	-0.010 -0.807 -1.005
BoardSize	-0.004 -0.815 -1.072	-0.005 -0.864 -1.145	-0.004 -0.678 -0.901
PropNexe	-0.174 -1.916 * -1.788 *	-0.170 -1.860 * -1.763 *	-0.157 -1.717 * -1.621 #
lnSales	0.102 8.348 ***** 5.734 *****	0.102 8.289 ***** 5.790 *****	0.099 8.020 ***** 5.723 *****
TD/TA	-1.091 -13.767 ***** -5.535 *****	-1.090 -13.749 ***** -5.556 *****	-1.078 -13.609 ***** -5.550 *****
Salesgrowth	0.024 1.789 * 2.896 ***	0.024 1.772 * 2.881 ***	0.024 1.786 * 2.863 ***
Intercept	-1.567 -6.256 ***** -6.135 *****	-1.564 -6.242 ***** -6.155 *****	-1.494 -5.935 ***** -5.948 *****
Adjusted R ²	0.162	0.162	0.165
F-statistic	20.493 *****	19.069 *****	18.269 *****
Inflection points	N/A	N/A	16.30% 63.59%
Hypothesis 1 and Hypothesis 3 are supported			
Assuming all other variables are constant:			
Hypothesis 1: RSE = 0.187 DIRSH			
Hypothesis 3: RSE = - 1.163DIRSH + 4.470DIRSH² - 3.726DIRSH³			
Year and industry dummies are included in the regressions though not reported for simplicity.			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		
#	Significant at 0.11 confidence level using two-tailed test		

6.4 Effect of the East-Asian Financial Crisis on the Relationship

From the regression results as presented in sections 6.2 and 6.3 of this chapter, it is evident that the relationship between the accounting measure of firm performance and managerial ownership in Hong Kong takes the non-linear, cubic form of “entrenchment-alignment-entrenchment”. The results also show that both board structure variables and the industry variable do not have significant impacts on firm performance. However, it is noted that the macro-economic environment over time may affect firm performance. This section aims to find out whether macro-economic conditions and, in particular, the East-Asian financial crisis that commenced in late 1997, had any impact on the relationship between corporate performance and managerial ownership in Hong Kong.

Before carrying out the regression analyses, it is necessary to review the economic conditions, both before and after the financial crisis. Particular reference will be made to the economic condition over the four years 1995 to 1998, which is the sampled period in this study, in order to facilitate explanation of the regression results.

6.4.1 Economic Conditions Before and After the East-Asian Financial Crisis

The year 1997 was an eventful year for the Hong Kong economy. On 1 July 1997 the sovereignty of Hong Kong was returned by the British Government to the People’s Republic of China. With the establishment of the Hong Kong Special Administrative

Region and the implementation of the “One Country, Two Systems” policy. Hong Kong remained as a productive and prosperous region until it was affected by the East-Asian financial turmoil, in late 1997.

Before the East-Asian financial crisis, Hong Kong had a prosperous economy. Gross Domestic Product (GDP) registered accelerated growth of 6.8% in the second quarter of 1997. The property and stock markets were also booming so much that there was, it is now clear, “a bubble economy” in Hong Kong. The Hang Seng index expanded to a then record level of 16,820 in August 1997. The average property price went up by 48% during the period from January to October 1997. With the East-Asian financial turmoil, which first broke out in Thailand in July 1997 and then extended to other economies in the region, Hong Kong, as a global financial centre, could not remain immune from the disaster. The Hong Kong dollar came under a major speculative attack in October 1997 and local interest rates became subject to strong upward pressure. This event, together with the overheating bubble economy, contributed to the fast rate of collapse of the stock and property markets and the Hong Kong economy as a whole.

Hong Kong’s GDP growth dropped tremendously from 5% in 1997 to -5.3% in 1998. There was a major decline in the inflation rate from 5.8% in 1997 to 2.8% in 1998. From 1999 onwards, Hong Kong has experienced deflation (1999: -4%, 2000: -3.8%, 2001: -1.6%). The unemployment rate increased sharply after 1997 and reached a record high level of 7.8% in July 2002. Figures 6.1 to 6.3, below, report the values of the major economic performance indicators during the years 1995 to 2001 - i.e. the

period of study (1995-1998) and the three years following 1998. Figures 6.4 and 6.5 show the property and rental prices of residential properties and office premises in Hong Kong from 1995 to 2000.

Figure 6.1 GDP Growth (in Percentage)

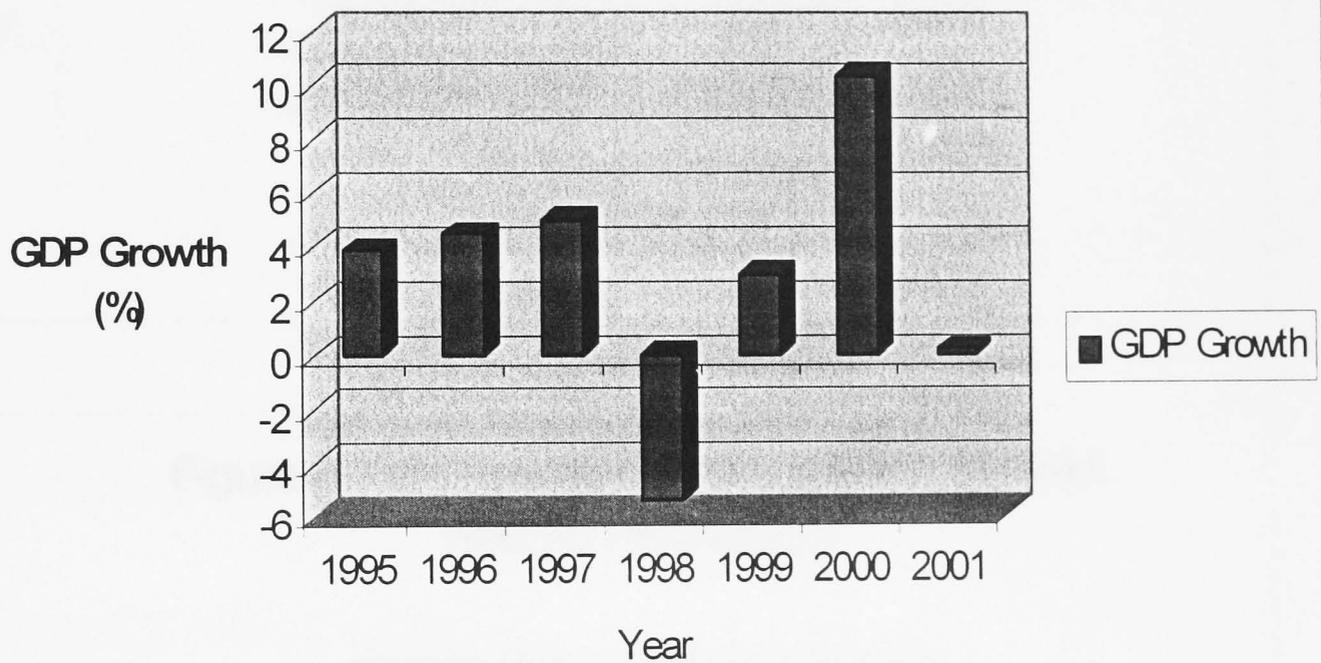


Figure 6.2 Inflation Rate (in Percentage)

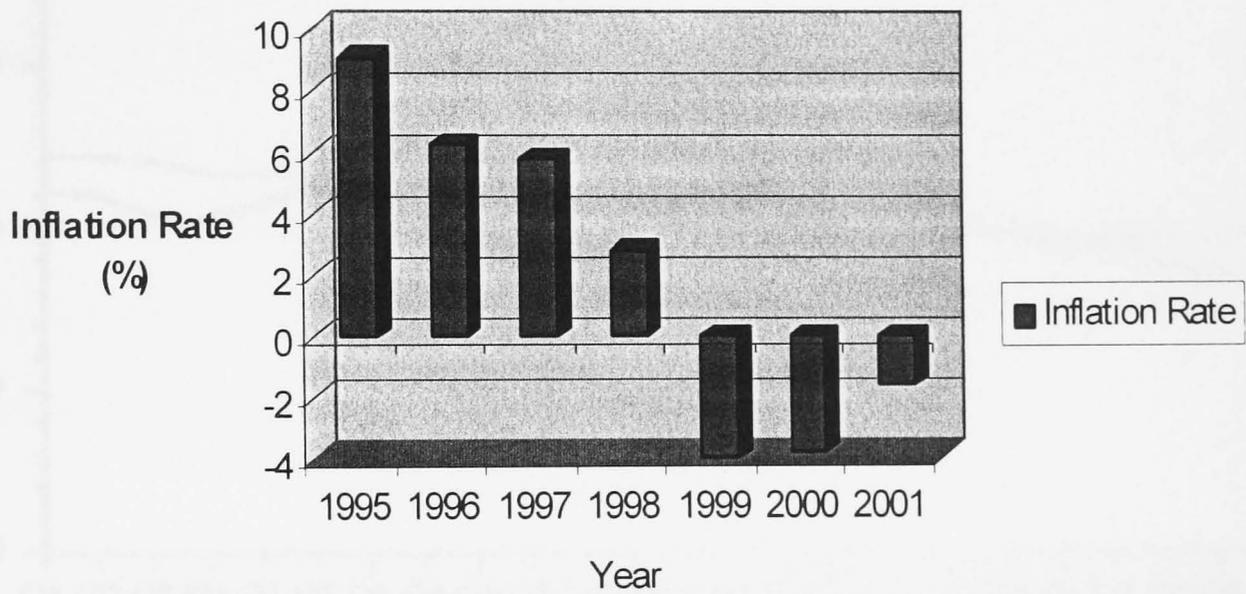
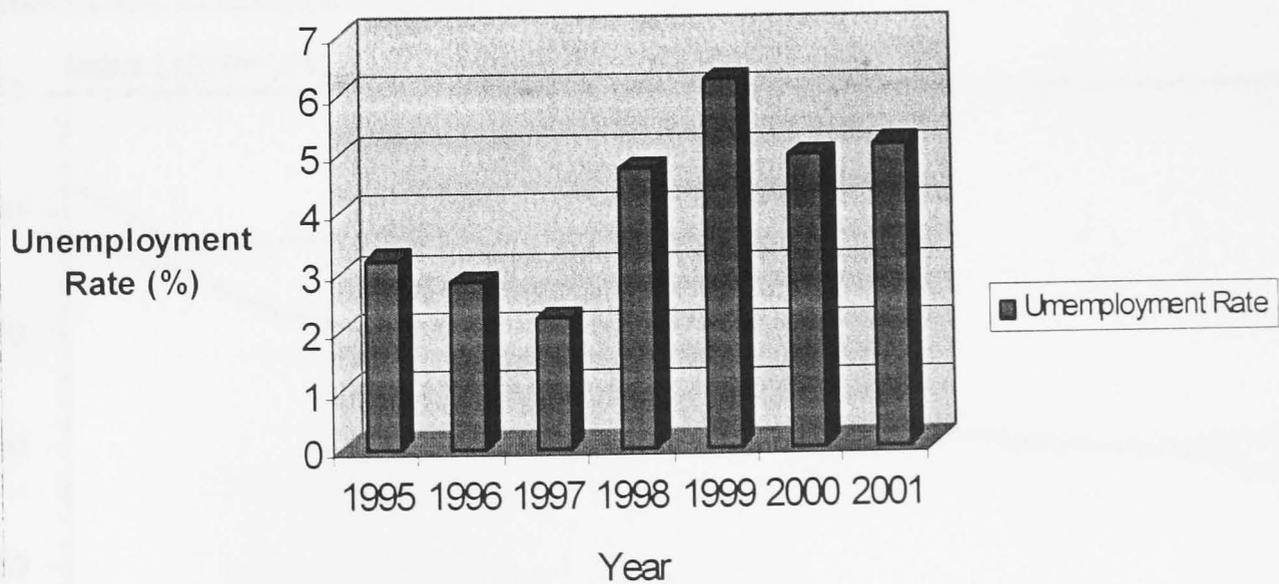


Figure 6.3 Seasonally Adjusted Unemployment Rate (in Percentage)



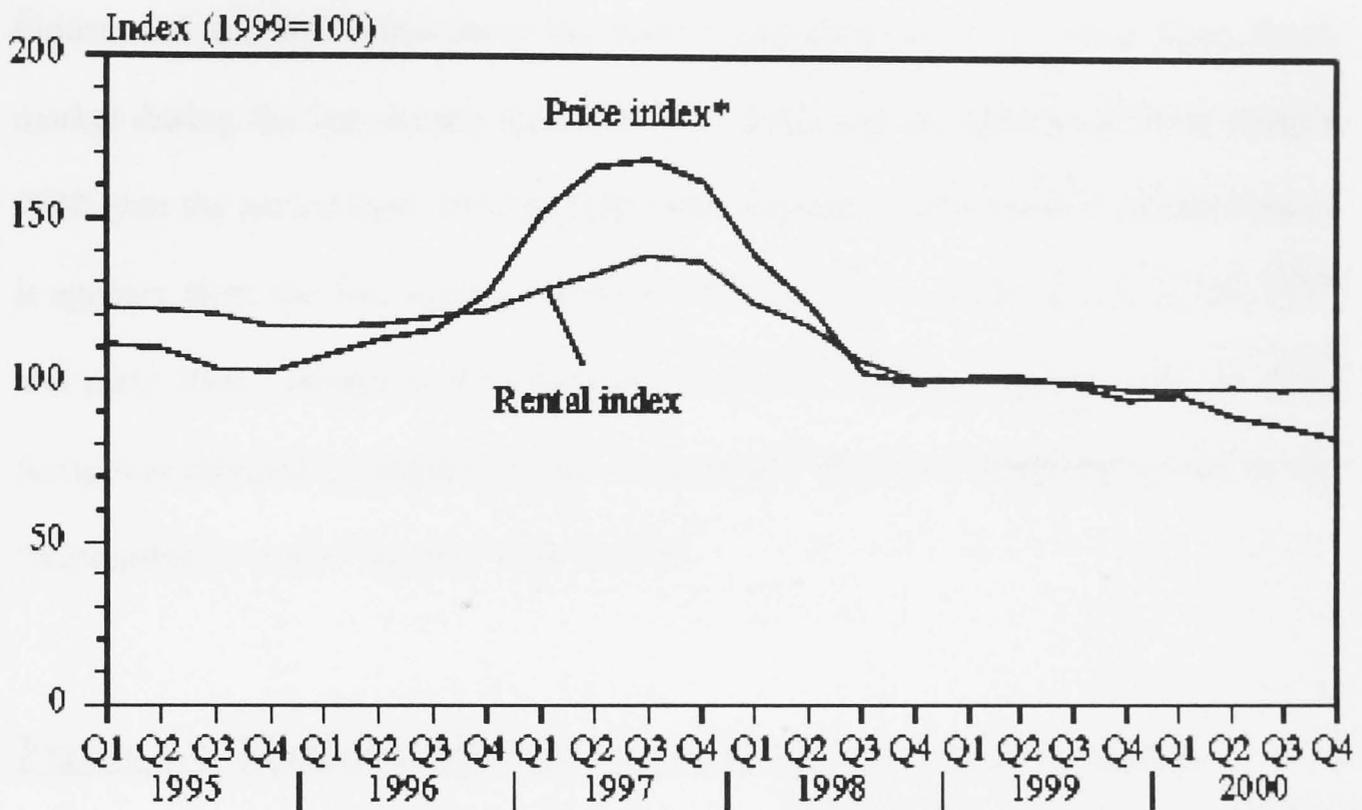
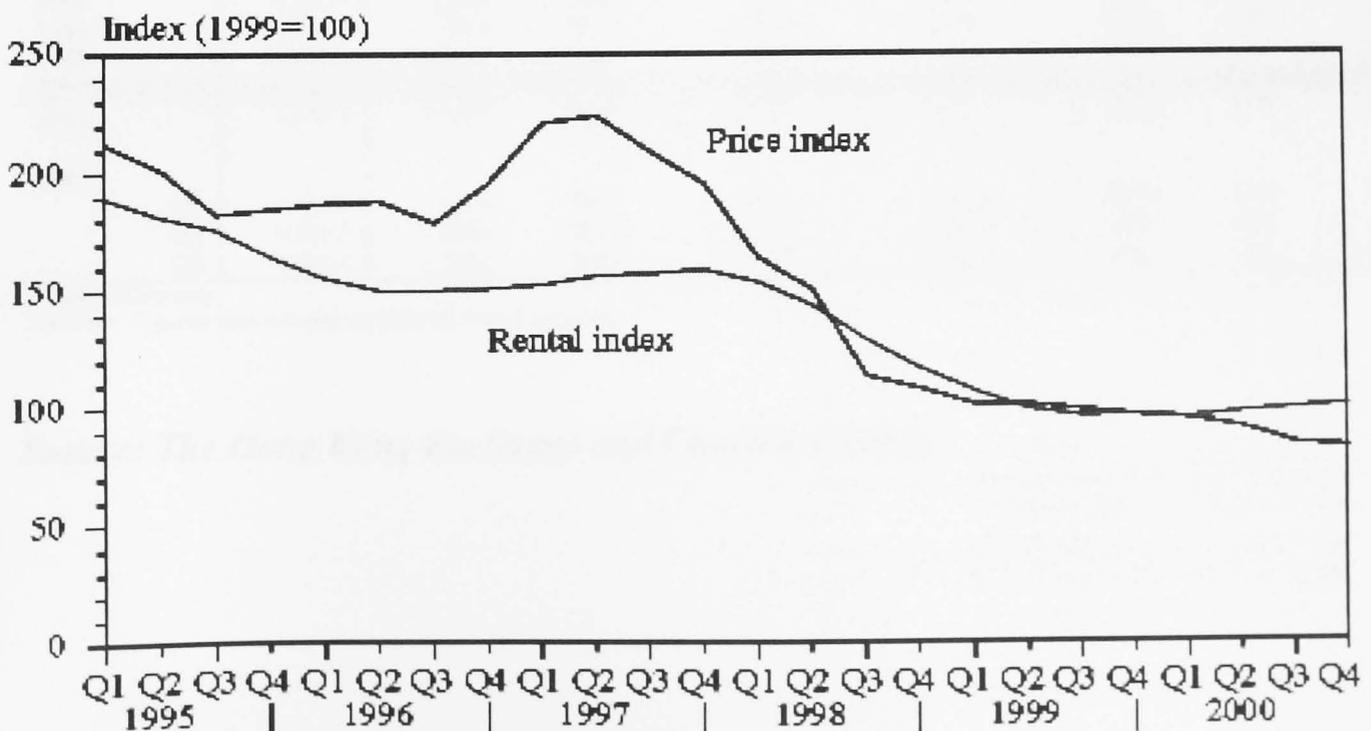


Figure 6.4 Residential Property Prices and Rentals

* Covering all completed flats, but excluding pre-completion flats.

Source: Hong Kong Year Book – Year 2000, The Hong Kong Government

Figure 6.5 Office Premises Prices and Rentals



Source: Hong Kong Year Book – Year 2000, The Hong Kong Government

Figures 6.6 and 6.7 below show the market capitalization of the Hong Kong Stock market during the last decade (from 1991 to 2002) and the growth of Hong Kong's GDP over the period from 1997 to 2002 (with quarterly and seasonally adjusted data). It appears from the two figures' statistics that there was a slight revival in late 1999 and early 2000. However, the economic conditions worsened again in 2001 as Hong Kong was affected by negative spillovers from the world economy, aggravated by the "September 11 event" in New York in 2001.

Figure 6.6 Market Capitalization of Hong Kong Listed Shares

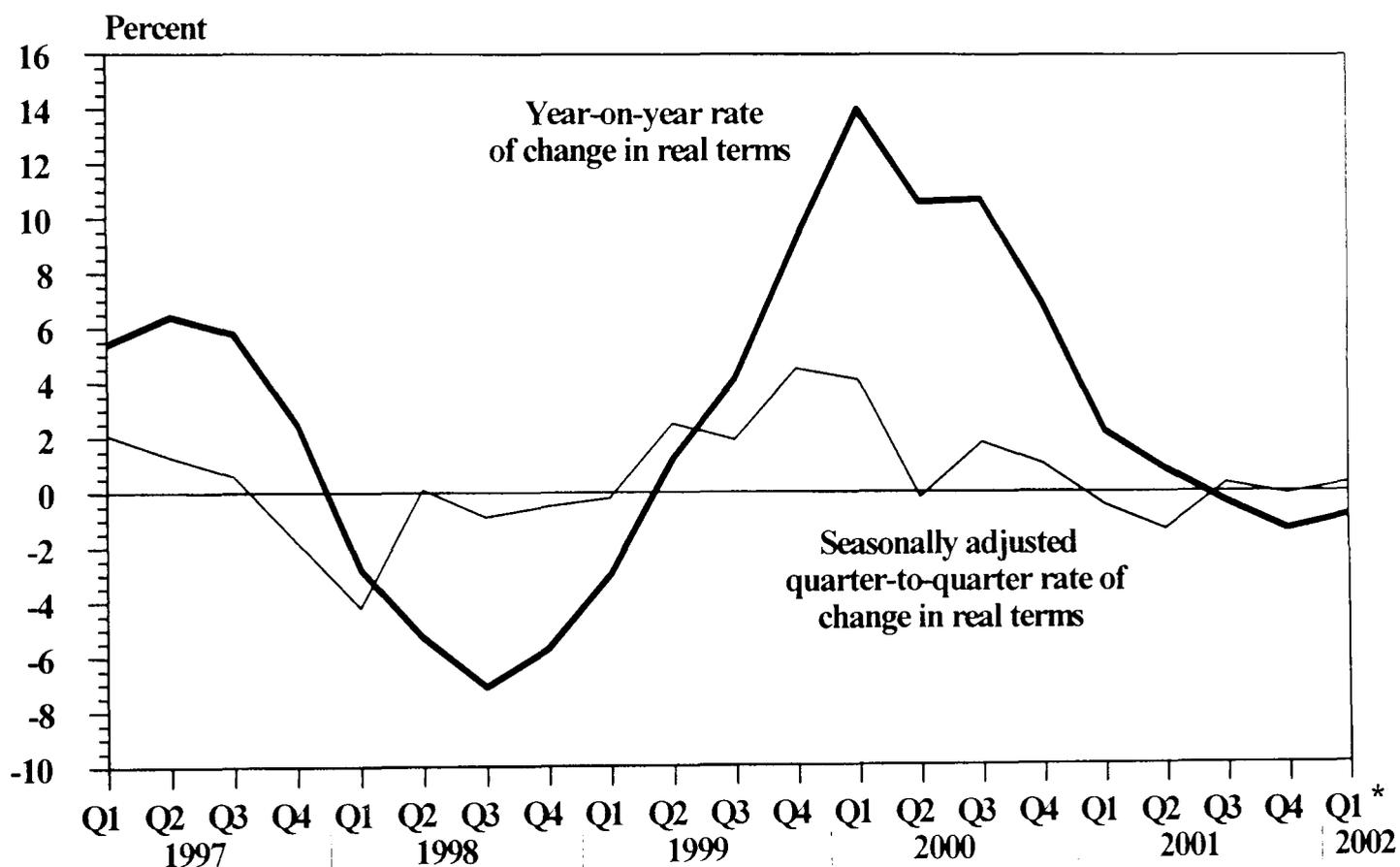
Market Capitalisation by Industry* (HK\$ billion)								
As at end	Total	Finance	Utilities	Properties	Consolidated Enterprises	Industrials	Hotels	Others
1991	949.2	154.0	175.7	255.6	270.7	65.9	20.8	6.3
1992	1,332.2	297.9	222.8	332.7	352.3	92.6	28.1	5.8
1993	2,975.4	599.7	420.7	856.7	828.8	186.7	73.6	9.1
1994	2,085.2	452.4	321.7	533.3	581.4	128.7	59.1	8.6
1995	2,348.3	570.0	328.0	621.1	634.9	137.3	52.1	5.0
1996	3,476.0	805.5	357.5	1,079.4	903.1	252.0	68.8	9.6
1997	3,202.3	864.0	598.9	679.3	674.8	320.0	48.2	17.4
1998	2,661.7	787.4	527.7	562.6	528.0	217.0	31.6	7.5
1999	4,727.5	1,224.2	1,132.5	773.5	1,170.7	377.5	40.0	9.2
2000	4,795.2	1,441.1	290.0	698.4	1,968.4	333.8	34.6	28.8
2001	3,885.3	1,142.4	265.6	576.6	1,435.1	431.3	28.0	6.4
2002								
Q1	3,855.3	1,133.4	286.2	535.1	1,367.8	500.4	28.9	3.4
Q2	3,791.7	1,130.0	286.5	530.6	1,286.3	525.5	29.7	3.0
Q3	3,327.1	1,102.4	288.0	414.5	1,036.8	458.2	24.2	2.9

* Main Board only

Remark: Figures may not add up to totals due to rounding

Source: The Hong Kong Exchange and Clearing Limited

Figure 6.7 Hong Kong's Change in Gross Domestic Product



* Preliminary figures

Source: *First Quarter Economic Report 2002, The Hong Kong Government*

6.4.2 Regression Results

In this section, analyses are performed to determine whether the East-Asian financial crisis that took place in late 1997 has any impact on the relationship between firm performance (RSE) and managerial ownership (DIRSH). The sample and the variables used in the regressions are the same as those used for the study reported in previous sections. That is, it is based on 1406 firm-year observations during the period 1995 to 1998. The three hypotheses are also the same, as follows:

$$\text{RSE} = \alpha + \beta_1 \text{ Managerial Ownership} + \gamma \text{ Control variables}$$

$$\begin{aligned} \text{RSE} = \alpha + \beta_1 \text{ Managerial Ownership} + \beta_2 \text{ Managerial Ownership}^2 \\ + \gamma \text{ Control variables} \end{aligned}$$

$$\begin{aligned} \text{RSE} = \alpha + \beta_1 \text{ Managerial Ownership} + \beta_2 \text{ Managerial Ownership}^2 \\ + \beta_3 \text{ Managerial Ownership}^3 + \gamma \text{ Control variables} \end{aligned}$$

Since it is found from the results in Table 6.5 that the mean value of RSE in 1998 is significantly less than those in the years 1995 to 1997, two separate regressions are run: one for the period 1995 to 1997 (pre-crisis) and one for the year 1998 (post-crisis). The aim is to determine whether there are any differences in the pattern of the relationship between RSE and managerial ownership from the findings reported in Table 6.4 above. The regression results are presented in Table 6.9 (pre-crisis) and Table 6.10 (post-crisis) respectively.

Table 6.9 Relationship between RSE and Managerial Ownership**Regression Analysis (Pre-crisis: 1995 – 1997) (n=1061)**

Dependent variable (RSE) Independent variables	Hypothesis 1	Hypothesis 2	Hypothesis 3
	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic
DIRSH	0.167 2.961 ***	-0.032 -0.163	-0.822 -1.547 #
DIRSH ²	N/A	0.286 1.055	3.080 1.743 *
DIRSH ³	N/A	N/A	-2.444 -1.600 #
lnRem	0.004 0.326	0.006 0.494	0.007 0.526
BoardSize	-0.006 -1.029	-0.006 -1.085	-0.005 -0.940
PropNexe	-0.073 -0.809	-0.067 -0.742	-0.058 -0.636
lnSales	0.078 6.300 *****	0.077 6.231 *****	0.075 6.040 *****
TD/TA	-0.847 -10.678 *****	-0.844 -10.648 *****	-0.836 -10.527 *****
Salesgrowth	0.020 1.619	0.020 1.593	0.020 1.585
Intercept	-1.264 -4.998 *****	-1.258 -4.976 *****	-1.211 -4.761 *****
DUM95	0.038 1.146	0.038 1.142	0.038 1.132
DUM96	0.002 0.048	0.002 0.069	0.001 0.044
DUMConEnt	-0.042 -0.436	-0.053 -0.549	-0.063 -0.654
DUMProperties	-0.111 -1.119	-0.120 -1.211	-0.131 -1.314
DUMIndustrials	-0.033 -0.330	-0.040 -0.401	-0.049 -0.495
Adjusted R ²	0.127	0.127	0.128
F-statistic	13.079 *****	12.160 *****	11.492 *****
Inflection points	N/A	N/A	16.64%) See 67.38%) Note
Hypothesis 1 is supported			
Assuming all other variables are constant:			
Hypothesis 1: RSE = 0.167 DIRSH			
<i>Note: Not very significant results:-</i>			
Hypothesis 3: RSE = - 0.822DIRSH + 3.080DIRSH² - 2.444DIRSH³			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		
#	Significant at 0.11 to 0.122 confidence level using two-tailed test		

Table 6.10 Relationship between RSE and Managerial Ownership**Regression Analysis (Post-crisis: Year 1998) (n=345)**

Dependent variable (RSE)	Hypothesis 1	Hypothesis 2	Hypothesis 3
Independent variables	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic
DIRSH	0.476 1.601 #	-0.046 -0.044	-5.769 -2.078 **
DIRSH ²	N/A	0.764 0.521	21.144 2.278 **
DIRSH ³	N/A	N/A	-17.921 -2.224 **
lnRem	-0.016 -0.227	-0.009 -0.130	0.000 0.006
BoardSize	-0.024 -0.763	-0.025 -0.801	-0.023 -0.728
PropNexe	0.051 0.103	0.067 0.133	0.088 0.177
lnSales	0.214 3.291 ****	0.212 3.243 ****	0.196 3.005 ***
TD/TA	-2.864 -6.783 *****	-2.861 -6.766 *****	-2.823 -6.712 *****
Salesgrowth	0.185 1.573	0.187 1.582	0.193 1.648
Intercept	-3.532 -2.704 ***	-3.516 -2.688 ***	-3.161 -2.414 **
DUMConEnt	0.226 0.441	0.194 0.375	0.083 0.162
DUMProperties	0.227 0.431	0.197 0.372	0.070 0.132
DUMIndustrials	0.456 0.871	0.430 0.816	0.316 0.601
Adjusted R ²	0.127	0.125	0.136
F-statistic	5.770 *****	5.258 *****	5.292 *****
Inflection points	N/A	N/A	17.56% 61.10%
Hypothesis 3 is supported			
Assuming all other variables are constant:			
Hypothesis 3: $RSE = -5.769DIRSH + 21.144DIRSH^2 - 17.921DIRSH^3$			
<i>Note: Not very significant results:-</i>			
<i>Hypothesis 1: $RSE = 0.476 DIRSH$</i>			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		
#	Significant at 0.11 confidence level using two-tailed test		

Table 6.9 shows that the relationship between RSE and DIRSH is linear for the period of 1995-1997. This is robust to the findings as shown in Table 6.4. The pattern of the cubic relationship (entrenchment-alignment-entrenchment) can also be observed (with inflection points 16.64% and 67.38%) but the relationship is not as significant as the findings for the whole period under study (1995-1998) as shown in Table 6.4. This shows that during the period of 1995-1997 (that is, before the East-Asian financial crisis), accounting performance (RSE) appears to have a strong positive linear relationship with managerial ownership (DIRSH). The entrenchment effect appears not to be so significant in the “prosperous” years (i.e. 1995-1997).

The situation is just the reverse for the year 1998 as indicated by the regression results in Table 6.10. After the financial crisis, the relationship between RSE and DIRSH is in a cubic form (entrenchment-alignment-entrenchment). The range of alignment (17.56% - 61.10%) becomes narrower, but it is still similar to the findings as shown in Table 6.4 (16.86% - 63.17%). The linear relationship can still be observed though it is not as significant as that for the period of 1995-1997.

The findings of the two regressions (Tables 6.9 and 6.10) not only indicate the robustness of the results as presented in Table 6.4, they also show that the pattern of the relationship is more positive and linear in nature in the “prosperous” years and takes a more non-monotonic form (entrenchment-alignment-entrenchment) during “difficult” times. It is found that macro-economic condition does affect the relationship between corporate performance and managerial ownership. A summary

of the results for the whole period of study (1995-1998), pre-crisis (1995-1997) and post-crisis (1998) is presented in Table 6.11.

Table 6.11 Comparison of Relationship between RSE and Managerial Ownership

<i>Dependent Variable: RSE</i>	Significant Result Found (Yes/No)		Turning Points (Compute when or assume that Hypothesis 3 holds)
	Hypothesis 1: Linear Relationship	Hypothesis 3: Cubic Form of Relationship	
1995 – 1998 (Whole period)	Yes RSE=0.269DIRSH (significant positive linear relationship)	Yes Entrenchment – Alignment – Entrenchment	16.86% 63.17%
1995 – 1997 (Pre-crisis)	Yes RSE=0.167DIRSH (significant positive linear relationship)	No (not very significant “Entrenchment – Alignment – Entrenchment” relationship)	16.64%) not very 67.38%) significant results
Year 1998 (Post-crisis)	No (not very significant positive linear relationship)	Yes Entrenchment – Alignment – Entrenchment	17.56% 61.10%

6.4.3 Robustness of Results and Sensitivity Analyses

To further test the robustness of the results, other accounting measures of performance are used as the dependent variable in the regression analyses. The accounting measures employed include the ratios of return on capital employed (ROCE) and return on total assets (ROA). Regressions have been run for the three hypotheses for the whole period under study (1995-1998) in section 6.3.2 already (Table 6.6). In this section, additional regressions are run for the period of 1995-1997 (pre-crisis) and the year 1998 (post-crisis). These regressions produce similar results to those obtained when RSE is used as the dependent variable. All the independent and control variables, which show significant results when RSE is used as the dependent variable in the regressions, also give significant results when ROCE or ROA is replaced as the dependent variable.

Table 6.12 summarises the regression results when RSE, ROCE and ROA are employed as the dependent variable in the regressions for the period from 1995 to 1997. The results show that the positive linear relationship between the accounting measure of performance and managerial ownership under Hypothesis (1) is even more strongly significant when ROCE and ROA are used as the dependent variable. This is robust to the results as shown in Table 6.6 and Table 6.9.

Table 6.12 Relationship between Different Accounting Measures and Managerial Ownership**Extract of Regression Results for Comparison (1995 – 1997) (n=1061)**

	<u>Hypothesis 1</u> Coefficient t-statistic	<u>Hypothesis 2</u> Coefficient t-statistic	<u>Hypothesis 3</u> Coefficient t-statistic
<u>Dependent variable (RSE)</u>			
Independent variables			
DIRSH	0.167 2.961 ***	-0.032 -0.163	-0.822 -1.547 #
DIRSH ²	N/A	0.286 1.055	3.080 1.743 *
DIRSH ³	N/A	N/A	-2.444 -1.600 #
Adjusted R ²	0.127	0.127	0.128
F-statistic	13.079 *****	12.160 *****	11.492 *****
Inflection points	N/A	N/A	16.64%) See 67.38%) Note
<u>Dependent variable (ROCE)</u>			
Independent variables			
DIRSH	0.131 3.832 *****	-0.049 0.412	-0.417 -1.292 ##
DIRSH ²	N/A	0.259 1.574	1.558 1.453 ##
DIRSH ³	N/A	N/A	-1.137 -1.227 ##
Adjusted R ²	0.136	0.138	0.138
F-statistic	14.136 *****	13.259 *****	12.426 *****
Inflection points	N/A	N/A	16.29%) See 75.06%) Note
<u>Dependent variable (ROA)</u>			
Independent variables			
DIRSH	0.072 4.536 *****	0.015 0.272	-0.216 -1.442 ##
DIRSH ²	N/A	0.082 1.070	0.901 1.807 *
DIRSH ³	N/A	N/A	-0.717 -1.662 *
Adjusted R ²	0.137	0.137	0.139
F-statistic	14.219 *****	13.215 *****	12.491 *****
Inflection points	N/A	N/A	14.50%) See 69.27%) Note
Hypothesis 1 is supported when different accounting measures are used as the dependent variable in the regressions against managerial ownership and other control variables			
Note: Not very significant results for Hypothesis 3			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		
#	Significant at 0.11 to 0.122 confidence level using two-tailed test		
##	Significant at 0.146 to 0.22 confidence level using two-tailed test		

Regarding the cubic form of the relationship under Hypothesis (3), the results show that the relationship between the accounting measure of performance and managerial ownership is not very significant but the “entrenchment-alignment-entrenchment” pattern can still be observed. This, again, is robust to the results as indicated in Table 6.6 and Table 6.9. The turning points are computed assuming that Hypothesis (3) holds. The range of alignment is also fairly similar under alternate specifications (for RSE: 16.64%-67.38%; for ROCE: 16.29%-75.06%; for ROA: 14.50%-69.27%).

Table 6.13 summarises the regression results when RSE, ROCE and ROA are employed as the dependent variable in the regressions for the year 1998. The results show that when ROCE is used as the dependent variable, both Hypotheses (1) and (3) are supported. The relationship between ROCE and DIRSH has elements of both the functional forms: a positive linear relationship as supported by Hypothesis (1); and a cubic form of the relationship (entrenchment-alignment-entrenchment) as supported by Hypothesis (3) with turning points of 16.54% and 60.46%. When ROA is used as the dependent variable, Hypothesis (1) is supported while Hypothesis (3) is only supported in the second and third range of the “entrenchment-alignment-entrenchment” pattern of the relationship. The second turning point (58.50%) computed under Hypothesis (3) is comparable to the findings in earlier regressions. All the above results in general demonstrate the robustness of the regression results.

Table 6.13 Relationship between Different Accounting Measures and Managerial Ownership

Extract of Regression Results for Comparison (Year 1998) (n=345)

	<u>Hypothesis 1</u> Coefficient t-statistic	<u>Hypothesis 2</u> Coefficient t-statistic	<u>Hypothesis 3</u> Coefficient t-statistic
<u>Dependent variable (RSE)</u>			
Independent variables			
DIRSH	0.476 1.601	-0.046 -0.044	-5.769 -2.078 **
DIRSH ²	N/A	0.764 0.521	21.144 2.278 **
DIRSH ³	N/A	N/A	-17.921 -2.224 **
Adjusted R ²	0.127	0.125	0.136
F-statistic	5.770 *****	5.258 *****	5.292 *****
Inflection points	N/A	N/A	17.56% 61.10%
<u>Dependent variable (ROCE)</u>			
Independent variables			
DIRSH	0.365 2.080 **	0.224 0.362	-3.482 -2.128 **
DIRSH ²	N/A	0.207 0.238	13.406 2.450 **
DIRSH ³	N/A	N/A	-11.607 -2.443 **
Adjusted R ²	0.122	0.119	0.133
F-statistic	5.550 *****	5.036 *****	5.186 *****
Inflection points	N/A	N/A	16.54% 60.46%
<u>Dependent variable (ROA)</u>			
Independent variables			
DIRSH	0.148 3.370 *****	0.305 1.971 **	-0.462 -1.125
DIRSH ²	N/A	-0.229 -1.056	2.502 1.823 *
DIRSH ³	N/A	N/A	-2.401 -2.015 **
Adjusted R ²	0.172	0.172	0.180
F-statistic	7.790 *****	7.186 *****	6.989 *****
Inflection points	N/A	N/A	10.96% 58.50%
<p>When RSE is used as the dependent variable, Hypothesis 3 is supported. When ROCE is used as the dependent variable, both Hypotheses 1 and 3 are supported. When ROA is used as the dependent variable, Hypothesis 1 is supported while Hypothesis 3 is supported in the second and third range of the “entrenchment-alignment-entrenchment” pattern of relationship.</p>			
<p>* Significant at 0.1 confidence level using two-tailed test ** Significant at 0.05 confidence level using two-tailed test *** Significant at 0.01 confidence level using two-tailed test **** Significant at 0.001 confidence level using two-tailed test ***** Significant at 0.0001 confidence level using two-tailed test</p>			

6.5 Individual Year Analyses

While it is found that the relationship between firm performance (RSE) and managerial ownership (DIRSH) has a more positive linear nature during the pre-crisis period of 1995-1997, further analyses are performed in this section to ascertain whether the relationship is similar in each of the individual years 1995, 1996 and 1997. The regression results show that in 1995, only Hypothesis (3) is supported, denoting a cubic (entrenchment-alignment-entrenchment) relationship. For 1996 and 1997, Hypothesis (1) is supported which shows that the relationship between RSE and DIRSH is positive and linear in nature.

Table 6.14 summarises the regression results for the individual years 1995, 1996 and 1997. Only the hypotheses which give significant results are presented in Table 6.14 for simplicity and ease of comparison.

Table 6.14 Relationship between RSE and Managerial Ownership**Individual Years Regression Analyses (Year 1995, 1996 & 1997)**

Year	1995	1996	1997
Dependent variable (RSE)	(n=361)	(n=353)	(n=347)
Independent variables	Hypothesis 3	Hypothesis 1	Hypothesis 1
	Coefficient t-statistic	Coefficient t-statistic	Coefficient t-statistic
DIRSH	-1.470 -1.738 *	0.198 1.764 *	0.206 2.244 **
DIRSH ²	5.241 1.876 *	N/A	N/A
DIRSH ³	-4.381 -1.825 *	N/A	N/A
lnRem	-0.011 -0.519	0.015 0.581	0.017 0.869
BoardSize	-0.013 -1.475	-0.002 -0.200	-0.001 -0.058
PropNexe	-0.209 -1.412	0.039 0.226	-0.042 -0.278
lnSales	0.114 5.839 *****	0.057 2.358 **	0.054 2.610 ***
TD/TA	-0.945 -7.205 *****	-0.787 -5.248 *****	-0.774 -5.872 *****
Salesgrowth	0.019 1.339	0.019 0.565	0.013 0.486
Intercept	-1.495 -3.631 ****	-1.116 -2.272 **	-1.049 -2.578 **
DUMConEnt	-0.031 -0.193	-0.030 -0.161	-0.107 -0.674
DUMProperties	-0.172 -1.056	-0.083 -0.434	-0.109 -0.671
DUMIndustrials	-0.032 -0.193	-0.082 -0.429	-0.032 -0.194
Adjusted R ²	0.190	0.085	0.106
F-statistic	7.512 *****	4.095 *****	4.920 *****
Inflection points	18.16%) See 61.59%) Note	N/A	N/A
Note: Hypothesis 3 is supported in 1995			
Assuming all other variables are constant:			
Hypothesis 3: RSE = - 1.470DIRSH + 5.241DIRSH² - 4.381DIRSH³			
Hypothesis 1 is supported in 1996			
Assuming all other variables are constant: Hypothesis 1: RSE = 0.198 DIRSH			
Hypothesis 1 is supported in 1997			
Assuming all other variables are constant: Hypothesis 1: RSE = 0.206 DIRSH			
*	Significant at 0.1 confidence level using two-tailed test		
**	Significant at 0.05 confidence level using two-tailed test		
***	Significant at 0.01 confidence level using two-tailed test		
****	Significant at 0.001 confidence level using two-tailed test		
*****	Significant at 0.0001 confidence level using two-tailed test		

From the regression analyses shown in Table 6.14, the general robustness of results is demonstrated. While the regression of the pre-crisis period from 1995 to 1997 supports Hypothesis (1) as indicated in Table 6.9, (that is, the relationship between RSE and managerial ownership is in general positive and linear in nature); the regression analyses of individual years' data also show that Hypothesis (1) is supported in the two years of 1996 and 1997 (Table 6.14).

However, it is found that in the year of 1995, Hypothesis (3) is supported as the coefficients of the managerial ownership variables ($DIRSH$, $DIRSH^2$ and $DIRSH^3$) are all significant and the signs of the coefficients are “negative-positive-negative”. The relationship between RSE and $DIRSH$ is cubic (entrenchment-alignment-entrenchment) in nature in 1995. The range of alignment is wide (Table 6.14: 18.16% - 61.59%) and is very close to the findings of the full sample (Table 6.4: 16.86% - 63.17%) and the year of 1998 (Table 6.10: 17.56% - 61.10%) respectively.

Table 6.15 summarises and compares the findings of the regressions for whole period and individual years in this study.

Table 6.15 Comparison of Relationship between RSE and Managerial Ownership (Overall and Yearly Data)

<i>Dependent Variable:</i> RSE	Significant Result Found		Turning Points (Compute when Hypothesis 3 holds)
	Hypothesis 1: Linear Relationship	Hypothesis 3: Cubic Form of Relationship	
Overall period: 1995 – 1998 (Table 6.4)	Yes RSE=0.269DIRSH (significant positive linear relationship)	Yes Entrenchment – Alignment – Entrenchment	16.86% 63.17%
Year 1995 (Table 6.14)	No	Yes Entrenchment – Alignment – Entrenchment	18.16% 61.59%
Year 1996 (Table 6.14)	Yes RSE=0.198DIRSH (significant positive linear relationship)	No	N/A
Year 1997 (Table 6.14)	Yes RSE=0.206DIRSH (significant positive linear relationship)	No	N/A
Year 1998 (Table 6.10)	No (weak positive linear relationship)	Yes Entrenchment – Alignment – Entrenchment	17.56% 61.10%

The results reported above can be explained by reference to the condition of the Hong Kong economy as presented in section 6.4.1. In 1995, the GDP growth rate was 3.9% with a relatively high inflation rate of 9.1%. Compared with 1996 and 1997 in which the GDP growth rates were higher (1996: 4.5%, 1997: 5.0%) and the inflation rates were lower (1996: 6.3%, 1997: 5.8%), 1995 was less prosperous than 1996 and 1997 (Figures 6.1 and 6.2). In addition, the unemployment rate in 1995 (3.2%) was higher than that in 1996 (2.8%) and 1997 (2.2%) (see Figure 6.3). From the above statistics, it is noted that the economy in 1995 was not as prosperous as it was in 1996 and 1997. In addition, both the property and the stock markets were more buoyant in 1996 and 1997 as reflected by the property prices and the market capitalization of the stock market (see Figures 6.4 – 6.6).

The regression results show that in 1995 the relationship between RSE and DIRSH is cubic (entrenchment-alignment-entrenchment) in nature, which is similar to the findings for the year 1998 after the East-Asian financial crisis. This reflects and confirms that macro-economic conditions affect the pattern of the relationship between managerial ownership and firm performance. When the economy is prosperous and booming (1996 and 1997), the relationship is more positively linear in nature because of the convergence of interests. However, during less prosperous periods (1995) or difficult times (1998), the relationship becomes a non-linear one (entrenchment-alignment-entrenchment) due to the entrenchment of interests at high levels of managerial ownership.

On the whole, the regressions findings (positive linear relationship between RSE and DIRSH in prosperous years and a wide range of alignment in the cubic relationship even during difficult times) confirm that the family form of ownership in Hong Kong supports the “convergence of interest” hypothesis of Jensen and Meckling (1976). This can also be related to the Chinese culture of the Hong Kong people, as Hofstede’s work on the “long-term orientation” dimension indicates that this dimension can explain the fast economic growth experienced by the East-Asian countries in the last few decades of the twentieth century. Both ownership structure and culture affect the relationship between corporate performance and managerial ownership.

Although the study provides evidence supportive of the view that the family form of ownership and the cultural background in Hong Kong are beneficial to firm performance, there are times where, at a very high level of managerial ownership, especially when the economic condition is less buoyant or is deteriorating, the entrenchment effect becomes more dominant. Yet, it is found that the range of alignment is still wide under such situations, roughly between the 17% and 62% range of managerial ownership.

6.6 Summary and Conclusions

This chapter presents and analyses the regression results of the relationship between firm performance and managerial ownership of Hong Kong listed companies. Significant results are obtained for the regression analyses of the accounting measure of performance (RSE) and managerial ownership (DIRSH). The relationship between RSE and DIRSH has elements of two functional forms: a positive linear and a cubic (“entrenchment-alignment-entrenchment”) relationship for the full sample under study (1995-1998). The cubic pattern of the relationship is the reverse of the findings (“alignment-entrenchment-alignment”) of Morck et al. (1988) and Short and Keasey (1999). This finding supports the view that studies based on UK and US evidence are not necessarily applicable to East-Asian corporations due to the differences in the degree of ownership concentration (Fan and Wong, 2002).

These findings indicate that in Hong Kong corporations the convergence effect is very strong over a wide range of managerial ownership (a positive linear relationship as supported by Hypothesis (1)). At the same time, there are some entrenchment effects at both ends of the managerial ownership ranges (negative relationships at the very low and very high levels of managerial ownership, as supported by Hypothesis (3)). Hence, the functional form of the relationship between firm performance and managerial ownership in this study can be taken to be “non-linear and cubic”, with a pattern of “entrenchment-alignment-entrenchment”, with a very wide range of alignment (between 16.10% and 62.73%) for the full sample.

The regression results also find that board size, directors' remuneration and board composition do not have any significant relationships with RSE. All of the above results are robust when dummy year and industry variables are added to the analyses to capture the possible macro-economic environment and industry effects. It is found that while industry does not have a significant impact on RSE, the macro-economic environment does have an effect on RSE.

Sensitivity analyses are performed on the relationship between accounting measures of performance and managerial ownership. Alternate accounting measures of performance, ROCE and ROA, are employed to re-run the regressions with dummy variables. The results are robust to the regressions of the full sample when RSE is used as the accounting measure of performance.

In addition, though significant results cannot be obtained for the relationship between the market measure of performance (ProxyQ) and managerial ownership, a general pattern of "entrenchment-alignment-entrenchment" is found to exist during the period of study, with a wide range of alignment. As indicated in Table 6.2, the range of alignment is 26.14% to 62.21% when ProxyQ is used as the dependent variable. This is comparable to the significant result obtained when RSE is used as the dependent variable (16.10% to 62.73%) as indicated in Table 6.1.

Further regression analyses are performed to analyse the possible impact of the East-Asian financial crisis on the relationship between firm performance and managerial

ownership in Hong Kong corporations. The empirical results confirm that the macro-economic environment does affect RSE. Regression analyses on the sampled companies for the period 1995-1997 and the year 1998 reveal that the relationship between RSE and DIRSH is of a more positive linear character during the pre-crisis period of 1995-1997. Regarding the year 1998, the relationship is more non-monotonic (“entrenchment-alignment-entrenchment”) in nature. Yet, despite the cubic form of relationship in 1998, the range of alignment is still very wide (17.56% to 61.10%), which is similar to the findings of the regression for the whole period of the study (16.86% to 63.17%) (Table 6.15).

To further test the robustness of the results, sensitivity analyses are performed. Alternate accounting measures of performance, ROCE and ROA, are employed to re-run the regressions with dummy variables, both for the pre-crisis period (1995-1997) and the post-crisis year (1998). The results are in general robust to the regressions when RSE is used as the accounting measure of performance. The relationship between accounting measures of performance and managerial ownership has a more positive linear character during the pre-crisis period. For the year 1998, the cubic (“entrenchment-alignment-entrenchment”) relationship becomes more dominant.

Further analyses are performed by running regressions for each of the years 1995, 1996 and 1997 respectively. The results reveal and confirm that the relationship between RSE and managerial ownership is affected by macro-economic conditions. In 1995, when the economy was not as prosperous and buoyant as in 1996 and 1997, the relationship has a cubic rather than a positive linear character.

On the whole, the empirical results suggest that the relationship between managerial ownership and performance in Hong Kong supports the classical “convergence of interest” hypothesis of Jensen and Meckling (1976). The Chinese culture in most Hong Kong corporations is also beneficial to performance, as suggested by Hofstede’s cultural study of “long-term orientation” dimension. The relationship between RSE and DIRSH is a positive linear one during the prosperous years. However, there are times when, at very high levels of managerial ownership, the entrenchment effect becomes dominant, as denoted by the non-monotonic relationship during less prosperous periods. This may be attributed to the central agency problem associated with high ownership concentration, as argued by Shleifer and Vishny (1997) and La Porta et al. (1999). The results of this study support all of the arguments cited above. Controlling family members are more likely to take advantage of minority shareholders in order to maximize their own interests at very high level of managerial ownership. The present study further finds that this type of behaviour appears more likely to take place during less prosperous periods. This finding is also supported by the recent study of Lemmon and Lins (2003) who suggest that during times of declining investment opportunities (the East-Asian financial crisis in their study) there are increases in the incentives of controlling shareholders to expropriate the minority shareholders, resulting in declines in firm value, as measured by Tobin’s Q and stock returns in their study.

In summary, this study finds that under a family-owned corporate structure, managerial ownership is a useful predictor of the accounting performance (RSE) of firms and that macro-economic condition affects the pattern of this relationship. The results suggest that if managerial ownership could be modified in an appropriate way (for example, if managerial ownership was to be maintained at, say, somewhere between 17% and 62%), then corporate performance would be optimized due to the convergence of managerial interests. However, due to the strong family-owned nature of Hong Kong companies altering the level of managerial ownership is not a task which could easily be undertaken.

Chapter Seven

Conclusions and Recommendations

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7.1 Summary and Conclusions

This thesis investigates empirically the relationship between corporate performance and managerial ownership under the family-owned corporate structure in Hong Kong, using a dataset of companies listed on the Hong Kong Stock Exchange (HKSE). It also investigates the impact of macro-economic conditions, in the form of the East-Asian financial crisis, on the relationship between corporate performance and managerial ownership in Hong Kong. In addition, it conducts a qualitative analysis of the development of corporate governance regimes in selected countries, the impact of efforts by international organisations to improve global corporate governance practices, and the way in which corporate governance in Hong Kong has been affected by these developments. This chapter summarizes and concludes the thesis. Recommendations are then made for structural improvements to the corporate governance regime in Hong Kong.

Following the well-publicized demise of a number of large corporations in late 1980s and early 1990s, the importance of corporate governance became widely recognized by investors, corporations, professional bodies, governments and international organizations. Increasing demands for market transparency and accountability in the UK led to the publication of the Cadbury Report in 1992, which is generally regarded as a milestone in the development of corporate governance, both in the UK and elsewhere. The subsequent publication of the Greenbury Report, the Hampel Report, the Combined Code and the Turnbull Guidance further enhanced the recommendations of the Cadbury Committee in developing an effective corporate

governance system in the UK. These efforts are perceived to have been successful, as evidenced by the results of various surveys and analyses conducted by specialists and research consultants in corporate governance.¹ For example, as noted in the comparison study in Chapter Two, the UK is ranked at the top of the list of countries by both the US-based Davis Global Advisors (DGA) and the Belgian-based Déminor in their analyses of five developed nations and seventeen European countries in 1999 and 2000 respectively (DGA, 1999; Déminor, 2001).

At an international level, various organisations such as the OECD, the International Corporate Governance Network, the World Bank and the Asian Development Bank have organised forums, roundtables and conferences to discuss issues related to corporate governance principles and practices. The issues debated have included ways of improving the effectiveness of the board, enhancing the transparency of disclosures in financial statements, encouraging more timely disclosures of various financial and non-financial transactions, and of improving the effectiveness of the audit committee and the remuneration committee.

It is noted from Chapter Three of the thesis that the problem in most Asian countries is one of enforcement and of how to strengthen corporate governance regulations to facilitate enforcement, rather than with the regulations per se. Many Asian countries

¹ The UK authorities, however, in common with authorities in many other countries, instigated reviews, in 2002, of their corporate governance rules as a result of the Enron scandal and related developments in the US.

have the rules in place but do not always have the capacity, in terms of human capital and institutional arrangements, to enforce them (Company Secretary, 2000).

As a colony of the UK for one and a half centuries, the Hong Kong legal system was greatly influenced by the UK law, and Hong Kong's corporate governance code of best practice is based on the UK's voluntary corporate governance code. However, given the Chinese cultural background of Hong Kong and the fact that share ownership is characterized by a high degree of concentration, much of it in family hands, its corporate governance rules are not an exact copy of the UK's Combined Code. For example, as noted in Chapter Two, while UK companies are required to have nomination and remuneration committees, Hong Kong is still only considering the possibility of introducing such committees.

Despite the fact that Hong Kong's corporate governance system still has much room for improvement, it is nevertheless regarded as one of the major financial centres in the world. Although the East-Asian financial crisis brought about many corporate collapses in the region from late 1997 onwards, in the eyes of many investors and expatriates Hong Kong is still regarded as a place with a reasonable degree of transparency for business and investment, as evidenced by the 1999 survey results of the Political and Economic Risk Consultancy Limited (PERC, 1999) noted in section 2.6.4, Chapter Two. In analyzing the reasons behind the East-Asian financial crisis and associated corporate failures, many commentators cite deficiencies in corporate governance systems as a contributory factor, in addition to financial attacks by

speculators. Therefore, if Hong Kong can further develop and improve its corporate governance system, investors' confidence will be further enhanced, benefiting its economic development. At present, although the Hong Kong corporate governance system is perceived as a fairly good benchmark for some countries in the Asian region, there are nevertheless some areas which lag behind other countries. For example, as noted from the comparison study in Chapter Two, the code of best practice in Hong Kong is not regarded as being comprehensive enough by the Asian Corporate Governance Association (ACGA, 2000).

Apart from the breadth of the code of best practice, improvements are also required in a number of other areas, especially the role of audit committees, remuneration committees and the transparency of disclosures. These areas for improvement mainly stem from the weaknesses brought about by the family-dominated corporate structure in Hong Kong. Directors or managers with substantial shareholdings are typically reluctant to delegate authority to independent officers and executives. They also tend to keep their decisions and business information as secret as possible and do not like the idea of "transparency". These characteristics are not unique to Hong Kong; they are common in other East-Asian countries. Hence, adoption of corporate governance rules in themselves may not be enough to improve corporate performance in Hong Kong and in the East-Asian region. There is arguably a greater need to improve the infrastructure in order to ensure effective implementation of the rules, for example by improving the capacity of the judiciary and the regulatory authorities, and

by providing training and continuing education to directors, without whom corporate governance reforms may never become effective.

Given the unique historical background and ownership structure of Hong Kong companies, the corporate governance models that are applicable in international jurisdictions may not be suitable and effective in Hong Kong. The models in the UK and the US cannot be applied blindly to Hong Kong. It is necessary to ascertain the relationship between various corporate governance variables (such as managerial ownership and board composition) and corporate performance before the principles can be applied correctly and sensibly.

Reviewing the academic literature on the relationship between managerial ownership and firm performance, it is evident that this relationship can take a number of forms. However, most of the empirical studies to date have been performed using US or UK data. To my knowledge, no study has ever been performed to find the relationship between ownership and performance under a family-ownership structure. The empirical part of this thesis is performed by running OLS multiple regressions on a set of panel data which consists of 1406 observations from companies listed on the HKSE for the period from 1995 to 1998.

The study finds significant results for the regression analyses of managerial ownership (DIRSH) on the accounting measure of performance (RSE). The relationship between RSE and DIRSH for the full sample period (1995-1998) has

elements of the two functional forms: a positive linear form and also a cubic form (“entrenchment-alignment-entrenchment”). The alignment range in the cubic relationship is very wide (16.86%-63.17%). However, the pattern of the cubic relationship is opposite to the pattern (“alignment-entrenchment-alignment”) reported by Morck et al. (1988) and Short and Keasey (1999). In addition, board size, remuneration and composition are not found to have a significant relationship with RSE in this study.

The study results also show that while industry does not have any significant impact on RSE, the macro-economic environment does affect RSE. The relationship is more positive and linear in nature during the pre-crisis period of 1995-1997. Regarding the year 1998, the relationship between RSE and DIRSH is more non-monotonic (“entrenchment-alignment-entrenchment”) in nature. Individual year analyses also confirm the findings that the relationship between RSE and managerial ownership is affected by macro-economic conditions. In 1995, when the economy was not as prosperous and buoyant as in 1996 and 1997, the relationship has a cubic (“entrenchment-alignment-entrenchment”) rather than a positive linear character as in 1996 and 1997.

In addition, though significant results are not obtained for the relationship between the market measure of performance (ProxyQ) and managerial ownership, a general pattern of “entrenchment-alignment-entrenchment” is also found to exist during the period of the study, with a wide range of alignment (26.14%-62.21%). This is

comparable to the significant result obtained when RSE is used as the dependent variable in the regressions utilising the full sample (range of alignment: 16.86%-63.17%).

The overall results (a positive linear relationship in prosperous years and a wide range of alignment in the cubic relationship even during difficult times) demonstrate that the relationship between managerial ownership and firm performance in Hong Kong supports the classical “convergence of interest” hypothesis of Jensen and Meckling (1976). In addition, the family-oriented Chinese culture in Hong Kong is beneficial to firm performance as evidenced by the fast rate of economic growth in most of the East-Asian countries, including Hong Kong, in the latter part of the twentieth century (Hofstede, 2001). As suggested by Hofstede, this is brought about by the “long-term orientation” of the “five cultural dimensions”, though he also recognises that it is difficult to definitively prove this link (Hofstede, 2001). The suggestion of Hofstede, however, is supported by the finding in this research that there is a wide range of alignment between managerial ownership and firm performance: under the family-owned corporate structure, firm performance improves when managerial ownership increases, and this occurs at most of the ownership levels (approximately from 16% to 62%). The aggregate result of individual firms’ improvement in performance is economic growth. The relationship between managerial ownership and firm performance is therefore a positive linear one during prosperous years and this “convergence of interest” effect is still very significant, as demonstrated by the wide range of alignment even during difficult periods.

However, there are when times the entrenchment effects become dominant, as denoted by the entrenchment ranges in the cubic relationship, during difficult times. This is due to the entrenchment effects at the lower levels of ownership and the central agency problem associated with high ownership concentration, as suggested by Fama and Jensen (1983), Shleifer and Vishny (1997) and La Porta et al. (1999). Controlling family members might take advantage of minority shareholders in order to maximize their own interests at very high levels of managerial ownership. This study finds that this type of behaviour appears more likely to take place during less prosperous periods. This finding is also supported by the recent study of Lemmon and Lins (2003) who suggest that during times of declining investment opportunities (the East-Asian financial crisis in their study) there are increases in the incentives of controlling shareholders to expropriate the minority shareholders, resulting in declines in firm value, as measured by Tobin's Q and stock returns in their study.

On the whole, the results of this study show that the relationship between managerial ownership and firm performance corresponds in general to a cubic form, with a pattern of "entrenchment-alignment-entrenchment", and that the range of alignment is very wide (approximately between 16% and 62%). The findings support all of the arguments concerning "convergence of interests", the "entrenchment effects" and the "central agency problem" associated with high ownership concentration. The findings suggest that in Hong Kong managerial ownership has some value as a predictor of the accounting measure (RSE) of firm performance and that macro-

economic conditions affect the pattern of the relationship. The fact that the pattern found from this study (“entrenchment-alignment-entrenchment”) is the reverse of that found in the UK and the US studies (“alignment-entrenchment-alignment”) of Short and Keasey (1999) and Morck et al. (1988) also confirms my suggestion that ownership structure and culture do affect the nature of the relationship between managerial ownership and firm performance. This conclusion is supported by Fan and Wong (2002) who suggest that studies based on UK or US data are not necessarily applicable to East-Asian corporations due to differences in the degree of ownership concentration.

The findings from both the qualitative and quantitative studies in this thesis are interrelated in a number of aspects. They both lend support to the view that differences in historical background, culture and legal systems are reflected in different corporate governance policies and practices. As a consequence, it may be argued that there is no single corporate governance model that can be applied universally. In the Hong Kong context, there are particular weaknesses in terms of the adequacy of disclosures in annual reports, the independence of non-executive directors, the comprehensiveness of the code of corporate governance, the effectiveness of the audit committee and the absence of remuneration and nomination committees. These characteristics are consistent with Chinese culture and the concentrated form of family-ownership structure. Chinese family owners tend to keep control in their own hands and do not like to delegate their authority. However, at the same time, the research reported here finds that family ownership is beneficial to

performance, which may be explained by the convergence of interests since there is no separation of ownership and control. Therefore, if the family form of ownership can be controlled at a certain level (for example, at say, between 16% and 62%), corporate performance may be optimized due to the convergence of interests. However, due to the strong family-owned nature of Hong Kong companies, altering the level of managerial ownership may not be an easy task. Under such circumstances, if a company's managerial ownership is very highly concentrated (say, more than 62%), the company should pay even more attention to improving its corporate governance practices in order to enhance its performance. The recommendations for improvements are further discussed in the next section.

7.2 Recommendations

Based on the findings of the qualitative and quantitative analyses performed in the previous chapters, there are a number of areas in which Hong Kong can make improvements in its corporate governance system.

I would suggest the following ways to improve the corporate governance regime in Hong Kong:

(a) Frequency of board meetings

From the comparative study performed in Chapter Two, it is noted that in the UK, full board meetings are required to be held regularly. However, the Listing Rules in Hong Kong only require full board meetings to be held no less than once every six months. It is important for the directors, who manage the affairs and operation of companies, to meet regularly to discuss the current business situation and determine the future plans of their company. During the process of data collection from annual reports as part of the empirical study, it was noted that a number of annual reports do not disclose the number of board meetings held each year. From the above observations, my recommendation is that full board meetings should be held more frequently (say, at least once every quarter). In addition, disclosure of the frequency of board meetings should be made mandatory in companies' annual reports.

(b) Number and quality of independent non-executive directors on the board

The comparative study in Chapter Two notes that in the UK, at least one-third of the board must be comprised of non-executive directors. However, every listed company

in Hong Kong is only required to have two independent non-executive directors. During the data collection process for the empirical study, it was found that the disclosures about independent and non-executive directors are not standardised and are not widespread. The empirical study, reported in Chapter Six, also finds that there is no significant relationship between the proportion of non-executive directors on the board and firm performance in the Hong Kong context, though significant results are found in a number of foreign studies. This finding indicates that there may be deficiencies in this corporate governance variable in the Hong Kong context, which may account for the absence of any apparent relationship with firm performance. Based on the above findings, my recommendation is that the proportion of independent non-executive directors on the board should be increased. This would bring about more balanced decision-making. Furthermore, if the independent non-executive directors are from different business sectors, they will bring in different ideas and enable greater sharing of valuable experiences. The regulatory authorities should also revise the Listing Rules or the relevant regulations in order to encourage and ensure full disclosure of the number and types of non-executive and independent non-executive directors on the board. The rules and regulations should also work to ensure the “independence” of the independent non-executive directors. This is necessary in Hong Kong where, as a result of the family-owned and controlled corporate structure, “independent” non-executive directors might be related directly or indirectly to the family owners. It should be noted that independent non-executive directors can only perform the corporate governance function effectively if they are truly independent.

(c) Composition of the board and audit committee

While independent non-executive directors are an effective mechanism for improving corporate governance if they can function properly, I would also recommend that, apart from independent non-executive directors, representatives from institutional investors and minority shareholders be elected to the board or the audit committees. This would allow different groups of shareholders' views to be expressed and considered. Also, under this board structure, shareholders would have a more timely awareness of the situation of the company and would be able to participate better in decision-making processes.

(d) Qualification requirements of directors

I would suggest that the deficiencies of the board structure, as highlighted by both the qualitative and the quantitative studies, are not only related to the relatively low number of, or inadequate disclosure concerning independent non-executive directors, but are also related to the quality of the other board members. It is vital for all the directors, whether executive or non-executive, to possess the ability to carry out their duties effectively and efficiently. However, there are no qualification requirements of directors in Hong Kong corporations, except that they must be at least 18 years of age and that they are not disqualified from acting as directors. Examples of disqualification include bankruptcy and insanity. In my view, these are not enough to ensure that directors have the abilities to run and control companies. My recommendation is that the Listing Rules should set out the qualification requirements

of directors. Training can also be provided to individuals before they take up directorships. In addition, guidelines on ethical issues and corporate governance should be provided to directors regularly. These can help to improve the quality and integrity of directors. The professional organisations can contribute to these areas of improvement by providing training courses to directors and issuing guidance notes on ethical issues and corporate governance practices.

(e) Frequency of published accounts and reports

As suggested by various international and professional organisations reported in Chapter Three, the level of disclosure in financial reports in Hong Kong needs to be further strengthened. Annual reports and accounts are important sources of information for shareholders and investors. Timely and accurate information provided by the published annual reports and accounts can assist investors in making their investment decisions. At the moment, listed companies on the Main Board of the Stock Exchange in Hong Kong are required to publish accounts twice in each year, that is, the annual report and the interim report. For the companies listed on the Growth Enterprise Market, quarterly reports are required. My recommendation is that the companies listed on the Main Board should also produce quarterly financial reports. With more frequent and timely disclosure of financial information, directors and managers can be more effectively monitored and the corporate governance of listed companies in Hong Kong can be further improved.

(f) Formation of remuneration committee

Chapters Two and Three note that, while the UK listed companies are required to have remuneration committees to oversee matters relating to the remuneration of directors, there is no such requirement in Hong Kong. During the data collection process for the empirical part of the study, it was found that the level of disclosure concerning directors' remuneration is less than adequate. For example, the option benefits of directors are not clearly disclosed. In Chapter Six it is found that directors' remuneration does not exhibit any significant relationship with firm performance, though significant results are obtained in many other foreign studies. It may be the case, however, that the quality of the data concerning this variable in Hong Kong is insufficient to allow a conclusion to be reached as to whether it constitutes an effective corporate governance mechanism. It follows that if the disclosures about directors' remuneration can be improved and that if the remuneration policy can be monitored, corporate governance and performance in Hong Kong may be improved. The remuneration committee can help to achieve this outcome.

In fact, in November 1999, the HKSA had already published a report entitled *Directors' Remuneration: Recommendations for Enhanced Transparency and Accountability* which aimed to encourage the setting up of remuneration committees and to improve disclosures of directors' remuneration. It is now the time for the regulatory authorities to consider requiring the compulsory formation of remuneration committees in listed companies. This would achieve both the aim of monitoring the

directors' remuneration policy and enhancing the level of disclosures of directors' remuneration.

(g) Formation of nomination committee

As reported in Chapter Two, it had been suggested in the First Report of the Working Group on Corporate Governance ("First Report") of the HKSA in December 1995 that nomination committees and remuneration committees were impractical or incompatible with the corporate governance environment in Hong Kong at that time. According to the First Report, due to the existence of dominant shareholders in Hong Kong corporations, it was believed that a nomination committee would not serve an effective purpose. It is now time to re-consider the possibility of introducing nomination committees in listed companies. This may help to improve the quality of the directors appointed.

(h) The role played by company secretaries

Company secretaries play an important role in companies as, inter alia, they assist the board in compliance with various disclosure requirements. At present, the Listing Rules require that company secretaries in listed companies must possess relevant professional qualifications to ensure that they have the ability to perform their duties. My recommendation is that regulatory bodies should define with better terms of reference the duties and authority of company secretaries and, in particular, encourage them to take a more proactive role in addressing corporate governance matters. The Hong Kong Institute of Company Secretaries can assist in this exercise and continue

to provide training and seminars for company secretaries in order to maintain and further upgrade their professional standards.

(i) The role played by professional bodies

While Chapter Three of the thesis reports the fact that various professional bodies have attempted to enhance corporate governance practices in different ways, I would suggest that they could still contribute more in a number of areas. For example, they can provide more training courses for company directors and managers on their duties and on ethical issues. The importance of business ethics increased as the result of concerns about the types of corporate fraud perpetrated by Enron directors in 2001. Through better training, directors and managers can understand better their responsibilities to protect the interests of their investors. The professional organisations can also take a more active step to advise the regulatory authorities on their proposals to enhance corporate governance. A good example is to encourage the regulatory authorities to consider formulating policies on the formation of remuneration committees, as discussed above.

(j) Comprehensiveness of the Code of Best Practice

In the comparative study in Chapter Two, it was noted from the analysis of ACGA that the Code of Best Practice in Hong Kong is small in size when compared with other East-Asian countries such as Korea and Japan. The Code of Best Practice in Singapore, though also small in size, is very comprehensive as far as the role of audit committees is concerned. In addition, Singapore is now working on a more

comprehensive code. My recommendation is that the regulatory authorities in Hong Kong should improve the comprehensiveness of the Code of Best Practice and define more clearly the standard requirements in the Code. This is an essential step to further enhance corporate governance standards in Hong Kong.

(k) Corporate governance in highly concentrated family businesses

The results of the empirical study reported in Chapter Six suggest that the family form of ownership, as proxied by managerial ownership, is beneficial to performance. This is apparent from the positive linear relationship between RSE and managerial ownership during the pre-crisis period and, in particular, the relatively more prosperous years of 1996 and 1997. However, the results also show that the relationship between RSE and managerial ownership takes on a cubic form, represented by “entrenchment-alignment-entrenchment” in 1998 after the East-Asian financial crisis, and also during the relatively less prosperous year of 1995. Although the range of alignment in this cubic relationship is still very wide (approximately between 16% and 62%), controlling family members appear to be able to take advantage of minority shareholders at times of economic difficulties, and this behaviour is most pronounced at managerial ownership levels above 62%, which results in deteriorating firm performance.

The results suggest that in order to maximise firm performance, managerial ownership should ideally be controlled (for example, between 16% and 62%). However, this is easier “said” than “done” given that family shareholdings are not easily changed. It

follows that, should a company's managerial ownership be highly concentrated (say, more than 62%), the company would need to be more vigilant about the quality of its corporate governance practices in order to enhance its performance. The areas for attention include all of the recommendations made above; for example, improving the effectiveness and quality of the board, in general, and of the board's audit committee. The proportion of independent non-executive directors on the board should also be increased and their independence ensured. Companies should also consider setting up a remuneration committee. Improving the board structure and the remuneration policy are possible ways to enhance performance in this type of company. This opinion and recommendation arises directly from the empirical part of this study, which revealed that board structure variables (board size, board composition and directors' remuneration) are not significantly related to firm performance in Hong Kong. The absence of any relationship may reflect a number of possible factors: poor board quality arising from domination by family members or related persons; inadequate numbers of independent non-executive directors; lack of independence of non-executive directors (as very often they are friends of the executive directors); lack of oversight of directors' remuneration by board committees. These factors may explain why some board structure variables found to be significantly related to firm performance in other countries are not significantly related to firm performance in Hong Kong. If Hong Kong companies can improve their board structures as well as their directors' remuneration policies, I believe that corporate performance can be further improved, even for those companies which have very high levels of managerial ownership and in which control is concentrated in the hands of substantial

family owners. However, this would also require an understanding of the importance of corporate governance by these family owners together with a commitment by them to improve upon the present situation.

7.3 Limitations of the Study

There are a number of limitations of the study, which mainly arise from the availability of data. These are summarised as follows:

(a) Limitation of the study period to four years from 1995 to 1998

As explained in Chapter Five, financial data were only available from the Pacap database up to the year 1998, at the time of data collection in 2000 and 2001. In addition, given that the collection of managerial ownership data was conducted manually observation by observation, the data collection process was very time-consuming. Thus, generating more data covering the years after 1998 would not only have involved much more time in the collection of the ownership data, but would also have involved more time in the collection of financial data from sources other than the then available Pacap database. Matching data from other sources with data obtained from the Pacap database is also a significant problem. Having considered the above costs and the incremental benefits that would have been obtained from getting one or two more years' data, it was decided that the sample period for this study would consist of the four years from 1995 to 1998. However, it is recognised that if it had been practical to further extend the period of study, then the reliability of the results might have be improved, especially as there is only one year's data available (the year 1998) for the 'post-crisis' analysis in this study.

(b) Measurement of family ownership

As explained in Chapter Five, managerial ownership is used as a surrogate measure of family ownership in this study. Initially my intention was to collect

data on family shareholdings and use these data in this study, given that a key objective is to determine the impact of the concentrated family ownership structure in Hong Kong on firm performance. However, it was noted during the manual data collection process that it is impossible and impracticable to collect data on family ownership. Although the annual reports of Hong Kong companies disclose directors' shareholdings, there are no disclosures of shares held by family shareholders. To determine precisely the number of shares held by family shareholders is not possible because very often shares are held by nominees or by holding companies or related companies. Since it is impractical to measure family shareholdings accurately in Hong Kong, I have therefore used managerial ownership as the explanatory variable in this study. In order to ascertain whether managerial ownership can be used as a surrogate for family ownership, I collected data on family ownership for 53 companies that did report this information, and then ran a Pearson correlation test to determine the correlation between managerial ownership and family shareholdings, in this sub-sample. A correlation coefficient of 0.978 (p-value<0.0001) was found. With this high correlation, it is plausible to suggest that managerial ownership can be regarded as a surrogate for family ownership in Hong Kong.

(c) Omission of certain corporate governance variables

Some important corporate governance variables are missing in the regression model. For example, the presence of an audit committee and a remuneration committee in the companies, and whether the same person acts as the CEO and the chairman of the board. Initially, it was intended that these variables would be included among the

control variables in the regression model to test their possible impact on firm performance. However, during the data collection process, it was found that information concerning these variables are inadequately disclosed or sometimes are not even mentioned in the audited reports. This inadequate disclosure, or non-disclosure, in company reports made it impossible to use these variables. Hence, they were dropped from the regression analyses.

(d) Deficiencies in the board structure and remuneration variables

As explained in Chapter Five, I originally intended to collect data on both the number of independent non-executive directors and the number of non-executive directors on the board so as to examine them as two separate variables. However, since the disclosures of these variables are not adequate and not standardised in most of the company annual reports, the only solution was to aggregate the disclosed numbers of independent non-executive directors and non-executive directors of each firm, and then divide this aggregate number by the board size of the firm, in order to obtain the variable PropNexe, the proportion of non-executive directors on the board (whether they are independent or not). This is certainly a limitation as the separate effect of each of the two types of non-executive directors (independent or not) on firm performance cannot be determined individually.

Another deficiency concerns the measure of directors' remuneration. Given that disclosure of directors' remuneration in annual reports is inadequate, the variable is measured by taking the natural logarithm of the aggregate value of directors' fees.

emoluments and bonuses received during the financial year concerned. The values so obtained do not measure the full remuneration of directors, as very often they also derive other benefits, such as share options, which are not properly disclosed in annual reports. This limitation may affect the results of the empirical analyses as far as this variable is concerned.

It is evident from the discussion above that most of the limitations of this study arise from inadequate disclosure in company annual reports. Hence, improving disclosure of company information is of the utmost importance if corporate governance is to be enhanced.

7.4 Directions for Future Research

In this last section of the thesis, a number of possible future research avenues related to this study are discussed, as follows:

(a) Further extension of the study period to years after 1998

Given the constraint of data availability, explained in Chapter Five and section 7.3 above, the sample period in the empirical study is limited to four years, from 1995 to 1998. It is suggested that this study can be repeated with further yearly observations, in particular, including several more years after 1998. In this study, the pre-crisis period encompasses three years from 1995 to 1997 inclusive. However, the post-crisis period only consists of one year's data for 1998. Extending the study period to include the years after 1998 will increase the reliability of the regression results concerning the effect of the East-Asian financial crisis on the relationship between managerial ownership and firm performance. This will also reveal whether the results reported in the present study also apply for a more sustained period.

(b) Include additional or alternative corporate governance variables

Additional corporate governance variables can be included in the present regression model. For example, as reported in previous chapters, audit committees were only made a requirement for Hong Kong listed companies with effect from 1 January 1999. Given that the audit committee is regarded as an important corporate governance mechanism, the presence of it might positively affect firm performance. Hence, it can be included as a dummy (control) variable in future research (by including data from 1999 onwards) so as to control for its possible effect on firm performance. Apart

from adding new control variables, alternative measures of existing control variables could also be adopted. For example, alternative measures of the debt ratio and of firm growth could be used.

(c) Exploring alternative non-linear relationships

Apart from repeating the same regression model using an extended time period or with more, or alternative, corporate governance variables, another possibility is to explore other forms of the non-linear relationship. In Davies et al (2002), where 752 firms listed on London Stock Exchange during 1995 are analysed, the relationship between managerial ownership and firm value is found to be of a quintic form, which suggests that the relationship is represented by “a double humped curve”. This is in contrast to studies, including the present one, that assume a cubic specification and, by construction, only one hump. Hence, it is of interest to test for other possible forms of the non-linear relationship by exploring alternative specifications of the regression models.

(d) Considering the endogeneity issue

Given that most companies in Hong Kong are founded by families who are also major shareholders, and that they are involved in the management of their companies, it is reasonable to conclude that the nature of share ownership is not influenced by firm performance to the same extent as it would be in the UK or the US, where family ownership is less prevalent. Hence, there is reason to believe that the ownership structure of Hong Kong companies is exogenously rather than endogenously

determined. Managerial ownership is thus taken as exogenous throughout the whole study in this thesis. A possible future avenue for research is to consider the endogeneity issue by carrying out simultaneous equations analyses, on a system of equations using the two stage least squares method. This will help to ascertain whether or not managerial ownership is exogenously determined under the concentrated family-owned corporate structure in Hong Kong.

Appendices

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Appendix 1 – The Code of Best Practice

Cadbury Report, the United Kingdom

1 The Board of Directors

- 1.1 The board should meet regularly, retain full and effective control over the company and monitor the executive management.
- 1.2 There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognised senior member.
- 1.3 The board should include non-executive directors of sufficient calibre and number for their views to carry significant weight in the board's decisions.
- 1.4 The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.
- 1.5 There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.
- 1.6 All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole.

2 Non-Executive Directors

- 2.1 Non-executive directors should bring an independent judgement to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
- 2.2 The majority should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgement apart from their fees and shareholding. Their fees should reflect the time which they commit to the company.

- 2.3 Non-executive directors should be appointed for specified terms and reappointment should not be automatic.
- 2.4 Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.

3 Executive Directors

- 3.1 Directors' service contracts should not exceed three years without shareholders' approval.
- 3.2 There should be full and clear disclosure of directors' total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.
- 3.3 Executive directors' pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

4 Reporting and Controls

- 4.1 It is the board's duty to present a balanced and understandable assessment of the company's position.
- 4.2 The board should ensure that an objective and professional relationship is maintained with the auditors.
- 4.3 The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.
- 4.4 The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.
- 4.5 The directors should report on the effectiveness of the company's system of internal control.
- 4.6 The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

Footnote

The company's statement of compliance should be reviewed by the auditors in so far as it relates to paragraphs 1.4, 1.5, 2.3, 2.4, 3.1 to 3.3, and 4.3 to 4.6 of the Code.

Appendix 2 – The Code of Best Practice (Hong Kong)

Appendix 14 of the Listing Rules in Hong Kong

The following guidelines are intended to form the skeleton of a code of best practice to which listed issuers should aim. The following items are not intended to be rules which are to be rigidly adhered to. All issuers are encouraged to devise their own codes of practice in the interests not only of their independent non-executive directors, but of the board of directors as a whole.

1. Full board meetings shall be held no less frequently than every six months. “Full” board meetings means meetings at which directors are physically present and not “paper” meetings or meetings by circulation.
2. Except in emergencies an agenda and accompanying board papers should be sent in full to all directors at least 2 days before the intended date of a board meeting (or such other period as the board agrees).
3. Except in emergencies adequate notice should be given of a board meeting to give all directors an opportunity to attend.
4. All directors, executive and non-executive, are entitled to have access to board papers and materials. Where queries are raised by non-executive directors, steps must be taken to respond as promptly and fully as possible.
5. Full minutes shall be kept by a duly appointed secretary of the meeting and such minutes shall be open for inspection at any time in office hours on reasonable notice by any director.
6. The directors' fees and any other reimbursement or emolument payable to an independent non-executive director shall be disclosed in full in the annual report and accounts of the issuer.
7. Non-executive directors should be appointed for a specific term and that term should be disclosed in the annual report and accounts of the issuer.
8. If, in respect of any matter discussed at a board meeting, the independent non-executive directors hold views contrary to those of the executive directors, the minutes should clearly reflect this.

9. Arrangements shall be made in appropriate circumstances to enable the independent non-executive directors of the board, at their request, to seek separate professional advice at the expense of the issuer.
10. Every non-executive director must ensure that he can give sufficient time and attention to the affairs of the issuer and should not accept the appointment if he cannot.
11. If a matter to be considered by the board involves a conflict of interest for a substantial shareholder or a director, a full board meeting should be held and the matter should not be dealt with by circulation or by committee.
12. If an independent non-executive director resigns or is removed from office, the Exchange should be notified of the reasons why.
13. Every director on the board is required to keep abreast of his responsibilities as a director of a listed issuer. Newly appointed board members should receive an appropriate briefing on the issuer's affairs and be provided by the issuer's company secretary with relevant corporate governance materials currently published by the Exchange on an ongoing basis.
14. This board should establish an audit committee with written terms of reference which deal clearly with its authority and duties. Amongst the committee's principal duties should be the review and supervision of the issuers' financial reporting process and internal controls. For further guidance on establishing an audit committee listed issuers may refer to "A Guide For The Formation Of An Audit Committee" published by the Hong Kong Society of Accountants in December 1997. Listed issuers may adopt the terms of reference set out in that guide, except that the committee may have a minimum of two members, or they may adopt any other comparable terms of reference for the implementation of audit committees. The committee should be appointed from amongst the non-executive directors and a majority of the non-executive directors should be independent.

Appendix 3 – Table 1: Statement on Corporate Governance, Corporate Governance Disclosure in Annual Reports

STATEMENT ON CORPORATE GOVERNANCE

Directors

- number of board meetings
- attendance of directors at meetings
- responsibilities of the board
- contribution and role of non-executive directors
- committees of the board
- policy on executive directors' remuneration and share options
- details of how, and by whom, the fees and other benefits of non-executive directors are determined
- directors' appointment and termination arrangements
- any other relevant additional information

Audit committee

- composition
- role and function
- number of meetings
- attendance at meetings
- statement on its independence
- report of work done and significant issues addressed including in respect of review of financial reports and internal reports
- any other relevant additional information

Remuneration committee

- composition
- role and function
- number of meetings
- attendance at meetings
- report of work done and significant issues addressed
- any other relevant information

Investor relations

- process of communication

Other matters

- social responsibility (e.g. environmental protection)
- human resources and internal management structure and workplace development initiatives
- relations with employees, creditors, suppliers and other significant parties
- contribution to community service
- any other relevant additional information

Appendix 4 – Terms of Reference of the Directors Sub-Committee, Corporate Governance Review

1. In the light of –
 - the predominance of controlling shareholder groups and the rights and interests of controlling shareholders;
 - the lack of shareholder activism as a natural force for improving corporate governance;
 - the domiciling of a significant proportion of listed companies outside Hong Kong,

to review the current statute law, administrative rules and regulations and codes of practice relevant to the directors and boards of all companies incorporated or registered in Hong Kong with the objective of enhancing genuine accountability, disclosure and transparency, and thereby further improving corporate governance standards.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –
 - (a) The structure of the board including the establishment, where appropriate, of audit, executive, nomination and remuneration committees;
 - (b) The roles and functions of the Chairman and Chief Executive Officers;
 - (c) The roles and functions of the executive directors;
 - (d) The roles and functions of the non-executive directors;
 - (e) The composition of the board with particular reference to achieving an appropriate balance between executive and non-executive directors;
 - (f) The appropriate procedures for the appointment, re-election and resignation of directors, including the establishment of a nomination committee (where appropriate);
 - (g) The appropriate procedures for undertaking the business of the board;
 - (h) The development of a statutory statement of principles on directors' duties;

- (i) The development of coherent proposals on how to deal with directors' conflicts of interest including –
 - the question of self-dealing; and
 - the establishment of a register of directors' interests
 - (j) The development of appropriate training programmes and qualifications for directors;
 - (k) The development of appropriate principles and procedures regarding setting and approval of the levels and composition of directors' remuneration, including contracts and compensation, the establishment of a remuneration committee (where appropriate), disclosure and shareholder involvement;
 - (l) The roles and functions of Audit Committees;
 - (m) The necessary regulatory framework and best practice to ensure that directors and boards are encouraged to comply with their statutory and non-statutory obligations.
3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.
 4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

Appendix 5 – Terms of Reference of the Shareholders Sub-Committee, Corporate Governance Review

1. In the light of –

- the predominance of controlling shareholder groups and the rights and interests of controlling shareholders;
- the existence of corporate groups;
- the lack of shareholder activism as a natural force for improving corporate governance;
- the domiciling of a significant proportion of listed companies outside Hong Kong,

to review the current statute law, administrative rules and regulations and codes of practice relevant to the shareholders of all companies incorporated or registered in Hong Kong with the objective of enhancing genuine accountability, disclosure and transparency, and thereby further improving shareholder democracy and communications.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –

- (a) The definition, timing, notice, agenda (including resolutions) of, and conduct and voting (including the rights of proxies) at, company general meetings, having regard to the use of audio-visual communication and electronic voting;
- (b) The possible development of institutional investors as a force for promoting shareholder democracy and good corporate governance;
- (c) The development of a proxy system, having regard to the rights of persons other than registered shareholders, particularly given the need to ensure genuine shareholder democracy in the context of the Central Clearing and Systems System (CCASS);
- (d) Restraints on controlling shareholders' voting having regard to the following considerations –
 - transactions in which controlling shareholders have an interest different from that of other shareholders should be subject to approval by shareholders, with the controlling shareholder abstaining from voting;

- adequate exceptions should be made available to accommodate immaterial transactions and bona fide transactions in the ordinary course of business on arm's length terms;
 - compliance with rules stipulated by securities regulators shall be deemed to be compliance with the law;
 - private companies may include exemptions in their articles;
- (e) Improved accessibility to corporate records by shareholders;
- (f) The variation of class rights;
- (g) The suitability of judicial control, multiplicity of provisions and class votes;
- (h) The circumstances in which it would be appropriate for minority shareholders to take action against the company or its directors and officers;
- (i) The types of action which can be taken by minority shareholders against the company or its directors and officers.
3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.
4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

Appendix 6 – Terms of Reference of the Corporate Reporting Sub-Committee, Corporate Governance Review

1. In the light of the role of disclosure as one of the key elements in corporate governance to review –
 - the existing level and nature of information, both financial and non-financial, which all companies incorporated or registered in Hong Kong need to disclose to their shareholders; and
 - the existing processes by which this information is prepared, vetted and approved.

with the objective of enhancing the standard of corporate disclosure, transparency and accountability.

2. Having regard to the above, to make specific recommendations, inter-alia, in respect of –
 - (a) Reforming and strengthening the statutory disclosure requirements in Part IV of and the Tenth and Eleventh Schedules to the Companies Ordinance, taking account of –
 - Possible further modification and extension of the simplified disclosure requirements in Part IV of and the Eleventh Schedule to the Companies Ordinance;
 - The possibility of mandatory publication and filing of financial statements by private companies.
 - (b) Reforming and strengthening the non-statutory disclosure requirements in respect of listed companies promulgated in the Listing Rules issued by the Stock Exchange of Hong Kong;
 - (c) Improving compliance with the accounting standards as promulgated by the Hong Kong Society of Accountants, with particular reference to sanctions;
 - (d) The use of information technology to report and distribute, among other things, the annual reports and accounts of companies to enhance timeliness of provision of corporate information;
 - (e) Strengthening the internal controls in companies with particular reference to internal audit functions;

- (f) The roles and functions of Audit Committees;
 - (g) The responsibilities, liabilities and independence of external auditors;
 - (h) The necessary regulatory framework to ensure efficient and effective monitoring of compliance with reporting requirements.
3. To commission research projects regarding specific areas, including those mentioned above, in order to obtain empirically derived data to provide a firm basis for recommendations.
 4. To report to the Standing Committee on Company Law Reform on the Sub-Committee's work and recommendations at regular intervals.

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