CG WATCH 2014

Dark shades of grey

Corporate governance and sustainability in Asia

Special report

September 2014

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In collaboration with

ACGA
Asian Corporate Governance Association

Contents

All prices quoted herein are as at close of business 12 September 2014, unless otherwise stated

Acknowledgements and disclaimer

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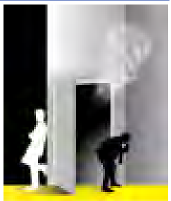
ACGA endorses the methodology used in the CLSA company survey and undertook the market rankings, with input from CLSA. ACGA did not participate in the assessments of companies, however, for which CLSA retains responsibility. ACGA bears final responsibility for the market rankings.



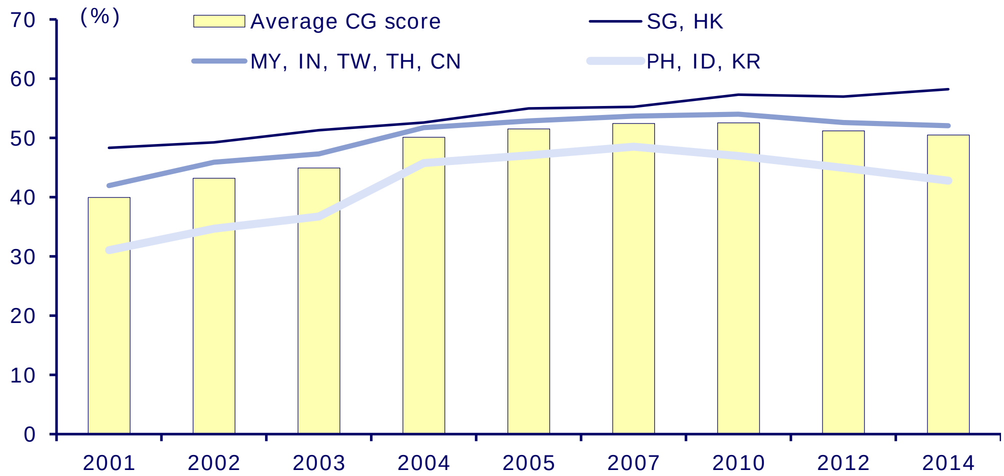
Dark shades of grey

Our ninth *CG Watch* report ranks 944 firms in 12 Asia-Pacific markets

In the ninth *CG Watch* report since our first in 2001, we have extended to rating 944 companies in our Asia-Pacific coverage. We incorporate market rankings by the Asian Corporate Governance Association (ACGA). This year, Japan has moved noticeably higher while the scores for Hong Kong and Singapore have edged lower. Bottom-up, the scores for corporations have slipped, in particular for Korea. We have revamped our environmental & social (E&S) assessment, making it sector-specific thus focusing on pertinent issues for investors and corporate managers to watch out for. Inclusive of E&S, the shades of grey reflected in the corporate-governance (CG) rankings can be coupled with valuation screens to identify stocks that are likely to give strong performance with reduced risk. Theoretically an anomaly, this indicates markets are not yet pricing in quality as determined by CG.

Overall CG scores of Asian corporates have slipped

Average company CG scores



Source: CLSA

Market rankings by ACGA - Synchronised swimming

ACGA has ranked the markets for CG. Ex-Australia, the ratings on the top-two markets, Singapore and Hong Kong, have slipped due to internal conflicts of interest, weak leadership and opposition to reform from various quarters. Japan has leapt to third position with more concrete efforts to improve governance. Malaysia, Taiwan and India have also moved up, but Indonesia and the Philippines remain at the bottom. The ACGA ranking also includes new questions pertaining to corporate social responsibility (CSR) as well as environmental, social and governance (ESG) disclosure: India, Malaysia and Thailand are generally ahead in this regard.

Corporate slippage

CG scores of companies under our coverage declined somewhat. The biggest drop was in Korea due to more intergroup transactions and poorer disclosure. In other markets, the overall changes have not been significant compared to our 2012 report on like-for-like questions. From our updated backtesting, we find better-CG stocks generally outperform when markets fall, but underperform when they rally. Stocks with good CG practices are also found to lag in sectors where investors are chasing share prices, for instance internet as well as hotels and leisure, ie, gaming. Within markets, however, companies with top-quartile CG have generally outperformed.

E&S - Winds of change

The enforcement and tightening of environmental and labour laws underscores that it is no longer “business as usual” in Asia. Beijing's declared war on pollution is the biggest example, with repercussions being felt across the region. The ante gets raised from January 2015 as China's new Environmental Law, 25 years in the making, takes effect and gives the traditionally toothless Ministry of Environmental Protection a set of fangs. To help identify winners and losers in this shifting landscape, we have revamped our E&S scoring, replacing one catch-all set of questions with 11 sector surveys. We focus on water access for materials stocks; emissions and fuel efficiency for autos; supply-chain sustainability for tech; and similarly for other sectors. E&S scoring has not historically been a good indicator of financial or share-price performance in the region. By contrast, studies have shown the opposite to be true in Europe and the USA. As reporting standards and enforcement improve, Asia is likely to move down the same path.

CG - What matters in Asia?

Even in Asia, markets with better CG are valued at a higher PE. The upper half for CG of the emerging markets here are at a 19% premium to the lower half. They also have a higher payout ratio, thus give investors a slightly higher dividend yield. At the stock level, CG issues investors have to watch out for have less to do with compensation, but rather potential conflicts of interest of controlling shareholders and the lack of independence of the board. Less than one-third of companies in the region have a strong audit committee, a reflection of the only token CG commitment that we find.

Valuation overlay on high-CG stocks provides superior returns

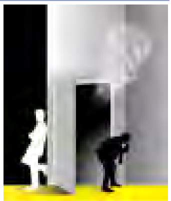
A valuation overlay applied on good-CG stocks can provide very striking performance. Of stocks with top-quartile CG scores, those with the highest-quintile trailing free-cashflow (FCF) yield, and also those at the lowest trailing PE, have outperformed by over 10ppts per year against a simple average of our coverage and by 16ppts compounded over the MSCI. The returns on value stocks thus appear to be enhanced with a CG overlay. Higher return with lower CG risk is theoretically an anomaly but indicates that the market continues to underprice quality as represented by our CG rankings. TSMC, Standard Chartered, HCL Tech, Tata Motors, Samsung Electronics, Conch, Honda, Nissan, Canon, Marubeni and Bridgestone are among the large-cap stocks with good CG that are also attractive on FCF yield and/or PE valuations.

TSMC, StanChart, CSL, Amcor, OCBC, IAG, HSBC among highest scoring on our CG ranking

Top CG companies among Asia Pacific large caps (above US$10bn)

Company	Code	Country	Sector
TSMC	2330 TT	Taiwan	Technology
Standard Chartered	2888 HK	Hong Kong	Financial services
CSL	CSL AU	Australia	Healthcare
Amcor	AMC AU	Australia	Materials
OCBC	OCBC SP	Singapore	Financial services
IAG	IAG AU	Australia	Insurance
HSBC	5 HK	Hong Kong	Financial services
Hang Seng Bank	11 HK	Hong Kong	Financial services
UOB	UOB SP	Singapore	Financial services
Brambles	BXB AU	Australia	Transport
Siam Cement	SCC TB	Thailand	Materials
Mitsubishi Corp	8058 JP	Japan	Conglomerates
Mitsui	8031 JP	Japan	Conglomerates
BHP Billiton	BHP AU	Australia	Materials
Tokyo Electron	8035 JP	Japan	Technology
Wesfarmers	WES AU	Australia	Consumer
Panasonic	6752 JP	Japan	Technology
Fujitsu	6702 JP	Japan	Technology
Honda Motor	7267 JP	Japan	Autos
Delta	2308 TT	Taiwan	Technology

Source: CLSA



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Markets - Synchronised swimming

Whereas the main story of *CG Watch 2012* was one of contrasting states of reform in North and Southeast Asia, with the latter showing more verve than the former, the past two years have brought a more mixed outcome: problems at the top of the rankings in the region's two international financial centres; marked improvements in all but one of the five in the middle tier; a degree of stasis in layer three; and then the bottom two markets converging on the same point (one up, one down). It feels like one is watching a massive regional exercise in synchronised swimming.

Singapore and Hong Kong come equal first, but scores for both are down

More specifically, scores for both Singapore and Hong Kong have fallen (Figure 1), largely the result of internal conflicts over CG regulation, institutional structures that are showing their age and opposition to reform from the usual suspects. Singapore has fallen by more - from 69% to 64% - due also to less impressive progress on enforcement and certain contradictions in its governance policies. Hong Kong has slipped from 66% to 65%, for the same reasons as in 2012: weak governmental leadership on CG and, among other things, the continuing absence of an independent audit regulator. Both are ranked equal first, however, because the difference in their scores is merely an illusion created by rounding - Hong Kong is only marginally above 64.5%, while Singapore marginally below it.

Figure 1

Market scores: 2010 to 2014

(%)	2010	2012	2014	Chg 2012 to 2014 (ppts)	CG reform trend
1 = Hong Kong	65	66	65	(1)	Weak leadership, tough enforcement
1 = Singapore	67	69	64	(5)	International versus local contrast continues
3 Japan	57	55	60	5	Landmark changes, can they be sustained?
4 = Thailand	55	58	58	-	Improving, but new legislation needed
4 = Malaysia	52	55	58	3	Improving, but still too top-down
6 Taiwan	55	53	56	3	Bold policy moves, can they be sustained?
7 India	48	51	54	3	Bouncing back, Delhi more supportive
8 Korea	45	49	49	-	Indifferent leader, more active regulators
9 China	49	45	45	-	Focus on SOE reform, enforcement
10 = Philippines	37	41	40	(1)	Slow reform, improved company reporting
10 = Indonesia	40	37	39	2	Big ambitions, can they be achieved?

Note: Hong Kong and Singapore are ranked equal first because the actual difference in their scores is minimal. The 1ppt difference is purely due to rounding. The Philippines and Indonesia are ranked equal 10th for the same reason. Source: ACGA

Middle markets all move up in score, except Thailand

It is the middle markets that give more cause for hope. To our surprise, Thailand has not fallen in score, as we initially thought it would. Japan has leapt into third (again) for the first time since 2010. Malaysia has improved in score, but not rank, and is now equal fourth with Thailand. And a similar pattern holds for Taiwan and India - higher scores, no change in rank.

With the exception of Japan, regulators in the other four markets may be disappointed that their ranking has not improved. We would argue that this would be the wrong reaction. Not only has Thailand managed to maintain its score in the face of political upheaval and bouts of political and parliamentary dysfunction - an admirable result - but regulators in Malaysia, Taiwan and India have all shown persistence in pursuing reform in the face of domestic apathy. If this commitment can be sustained, we believe it will do much to build investor confidence and genuine governance among local firms over the longer term.

Korea and China stay flat, but CG better in areas

Korea and China both stayed put in score and ranking, an outcome that may appear to suggest nothing has changed. In fact, their flat scores belie improvement in several areas. Their problem is that as regional benchmarks rise for many CG standards, the gap between them and the best markets is widening. While they gain points on some questions, they lose on others, leaving them unchanged overall.

Philippines slips, Indonesia rises

And finally, Indonesia and the Philippines, where the metaphor of a see-saw might be more apt: they have been going up and down in tandem in our survey for several years, and now meet at a middle point. Like our top two markets, we have ranked them equally because the one-percentage-point difference in their scores is solely due to rounding. Had the Philippines scored only 0.02ppt less, it would also have finished with 39%.

Market total scores based on 94 questions in five categories

Figure 2

Market category scores (2014)

(%)	Total	CG rules & practices	Enforcement	Political & regulatory	IGAAP	CG culture
1 = Hong Kong	65	61	71	69	72	51
1 = Singapore	64	63	56	64	85	54
3 Japan	60	48	62	61	72	55
4 = Thailand	58	62	51	48	80	50
4 = Malaysia	58	55	47	59	85	43
6 Taiwan	56	48	47	63	75	47
7 India	54	57	46	58	57	51
8 Korea	49	46	46	45	72	34
9 China	45	42	40	44	67	34
10 = Philippines	40	40	18	42	65	33
10 = Indonesia	39	34	24	44	62	32

Source: ACGA

Market survey improved this year: three questions dropped, one moved, and seven new questions

A note on methodology - ACGA market questionnaire

We have amended and updated the content of our market questionnaire this year to remove questions we felt had become redundant or no longer of comparative value, and to add questions that highlight some newer issues. The total number of questions has increased from 90 to 94, with three dropped, one moved to a different section, and seven new ones.

In **CG rules and practices**, we added three new questions on sustainability reporting standards (as promulgated by regulators) and practices (actual reporting by large and midcaps). These questions were formerly included in three other questions on non-financial reporting about corporate-governance standards and practices, but we felt they deserved to be separated given the rising importance of sustainability reporting and the fact that most markets have distinct rules for non-financial reporting on CG and CSR. We also dropped a question on class-action lawsuits because we felt the underlying issue was better covered by a similar question in **Political and regulatory environment** on the legal remedies available to minority shareholders.

In **Enforcement**, we moved a question on the existence and effectiveness of an independent commission against corruption to the **Political and regulatory environment** section, where we felt it fitted better.

In **Political and regulatory environment**, we also added two new questions on whether the media was skilled at reporting on corporate governance, and whether the government was showing leadership in raising standards of public governance within the civil service.

In **IGAAP (accounting and auditing)**, we dropped two questions that no longer provided much analytical distinction: on consolidated accounts and share-based payments. We added two on audit regulation: whether or not the audit regulator produced an annual report on audit industry capacity and its inspection activity; and whether there was an extensive programme of CPA education.

We made no changes to the **CG culture** section.

Acknowledgements

Research on *CG Watch 2014* was carried out over February to August 2014 by a team that included five senior research directors, one supporting analyst, two consultants and four research assistants. We would like to acknowledge the fine support of the following people: Li Rui, Rebecca Jarvis, Ben McCarron, Alfred Li, Billy Su, Jenny Fang and Ioana Economos.

Hong Kong versus Singapore: Trouble at the top

Hong Kong and Singapore both struggling to balance 'growth vs reform' – a false dichotomy

We no longer see any substantive difference in the overall CG quality of Hong Kong and Singapore. Both are struggling to balance "international standards" with "market competitiveness" - a false dichotomy in our view. Where is the evidence that the creation of an entirely new CG regime over the past 15 years has harmed market development in Asia? On the contrary, we believe that improving regulation strengthens markets, because it gives investors hope that their interests will be protected. Judging by the problematic IPOs that both Hong Kong and Singapore have allowed in recent years, and the numerous corporate scandals that have harmed minority investor interests, it is hard to argue that either city's CG standards are too high.

Despite the same score, the two markets reached it by very different paths

What is fascinating is that each has arrived at the same destination through quite different routes. In our survey of 94 questions, Singapore and Hong Kong scored differently on 41 of them. The biggest differences in terms of the scores on individual questions were in CG rules/practices and enforcement. The fewest number of differences was in IGAAP (accounting and auditing).

In just the first category, scores differed on 11 questions out of 27

To give a flavour of how extensive these differences are, we will compare just the first section of the survey, CG rules and practices, where Hong Kong and Singapore achieved quite similar overall scores: 61% versus 63%.

Hong Kong rated better than Singapore for:

Hong Kong rates better for PSI disclosure, shareholder rights, insider trading controls and other factors

- Disclosure of price-sensitive information;
- A strong legal regime governing insider trading and market manipulation;
- Voting by poll at shareholder meetings;
- Disclosure of the exact remuneration of directors and senior executives;
- Release of annual general meeting (AGM) agendas at least 28 days before the meetings.

Singapore rated better than Hong Kong for:

Singapore rates better for speed of reporting, removal of directors for fraud and nomination of independent directors

- Disclosure of audited annual statements within 60 days;
- Mandatory quarterly reporting;
- Whether minority shareholders can nominate independent directors;
- Statutory removal of directors for fraud;
- Protection of the pre-emption rights of minority shareholders.

Similarities include content of reports, CG Code, audit committees and disclosure rules

But as the numbers suggest, Hong Kong and Singapore also scored the same on 53 of the 94 questions. Here we would point to such similarities as the content of financial and non-financial reports (as opposed to the speed or frequency of reporting), disclosure of 5% ownership stakes, disclosure by directors of their own share dealing, the existence of an internationally aligned code of corporate governance, a requirement for audit committees, and so on. Again, this is just from the first section of the survey.

Singapore wins hands down for audit regulation

The small number of differences in scores for accounting and auditing is something of an anomaly and requires explanation, since the total scores for each jurisdiction in this section are far apart: Singapore is at 85% and Hong Kong at just 72%. The fact is that Hong Kong scores much worse than Singapore for its audit regulatory regime. Hence, while the number of different scores may be few, the impact is considerable.

Hong Kong wins hands down for securities enforcement

The other section where the total scores - and the number of different scores - are significantly different was enforcement. This category has 17 questions, yet the scores for as many as 11 varied. As Figure 2 shows, Hong Kong achieved 71% overall (an improvement from 2012), while Singapore gets 56% (a fall from 2012). The main reason for the gap is the quality and vigour of regulatory enforcement in Hong Kong. Singapore did, however, do better on two questions: whether minority shareholders ever nominate independent directors; and whether retail shareholders participate actively in AGMs.

The rising middle

Middle markets actively seeking to improve their CG regimes

The view from the middle of our survey is considerably more uplifting. All five markets - Japan, Thailand, Malaysia, Taiwan and India - have made a concerted effort to strengthen their CG policies, regulations and enforcement. Two of them - Japan and Taiwan - have produced major new CG policy initiatives. Thailand and Malaysia are essentially moving ahead with pre-existing plans. And India has shown a resurgent interest in company-law reform and corporate governance. These are the markets in our survey that are the most motivated to achieve higher scores and have responded actively to recommendations made in our previous *CG Watch* reports. Indeed, one of them, Malaysia, is quite candid about its objective to do better in international CG ratings! (See the statement on the Bursa Malaysia website under CG Initiatives.)

All have made an effort to improve enforcement

Looking more closely at the section scores, some other themes are interesting in this middle group. All have made an effort to improve regulatory enforcement - hence their scores all rise here - and appreciate that the credibility of their financial regulatory system depends in large part on how effective they are in ensuring that listed companies and market participants follow the rules.

But CG rules in these five markets could be better

At the same time, the actual CG rules in these markets could be better. As a group, their highest score is 62% (Thailand) and the lowest is 48% (Japan and Taiwan). While neither Hong Kong nor Singapore produced a stellar performance either, this suggests that CG rule-making in Asia still has some way to run. Key areas for improvements mostly involve some form of disclosure: non-financial, sustainability reporting, price-sensitive information, executive remuneration, voting by poll and AGM agendas. True, some of the middle markets do well on some of these issues, but all suffer from another dilemma that is equally shared by all Asian markets: the contrast between the quality of corporate reporting of large-cap companies compared to small and midcaps. For as long as this distinction persists, it will act as a deadweight on the performance of markets in our CG rules and practices section.

Except for Thailand, political and regulatory scores on the rise - a good base for future reform?

As Figure 2 also shows, there is not a great deal of difference in the scores for political and regulatory environment among our middle group; the exception being Thailand because of its recent political instability. This suggests that there is a stronger political basis for further reform and CG improvement in future. However, our fear here is that some of these markets will not be able to sustain the pace - principally, Japan, Taiwan and India. Japan, because so much depends on the success of the Abe government's monetary, fiscal and structural reforms - and things are looking a little uncertain right now. Taiwan, because its new and impressive CG Roadmap was in large part a determined reaction to respond to criticism of its CG system - and whether the political energy will still be there in two years' time seems a reasonable question to ask. And India, because the new Modi government is an unknown quantity and already some of the detailed rules to implement the landmark new Companies Act have been disappointing.

Middle markets mostly improving on audit regulatory systems

On IGAAP (accounting and auditing), three of the middle markets have largely converged with IFRS accounting standards (Japan and India being the exceptions), all follow international standards of auditing, and most of them have got religion on the need for a strong independent audit regulator (Taiwan has one, but it is the least active; while India's plans are still on the drawing board).

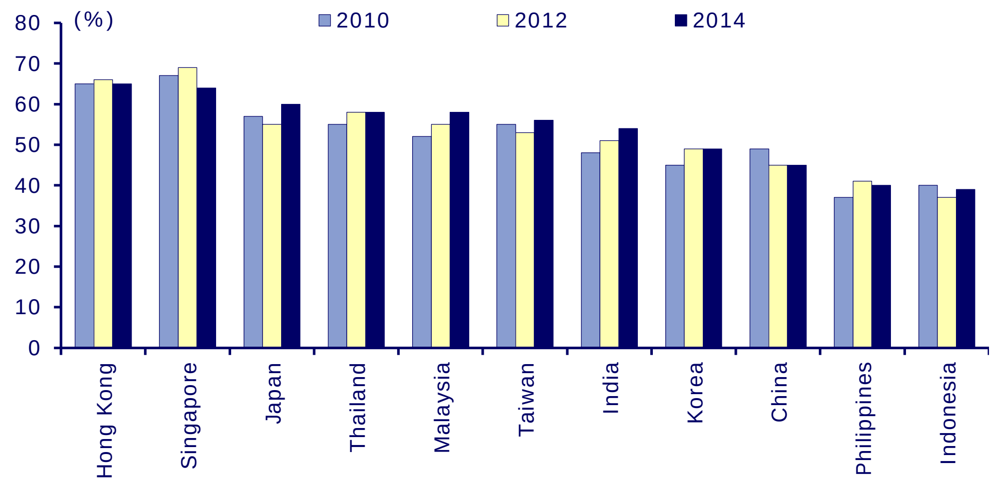
Low CG-culture scores suggest reform still top-down and state-led

On CG culture, three of the five markets score 50% or slightly higher (the exceptions being Taiwan at 47% and Malaysia at 43%). Perhaps most striking is the difference between these scores and the total score for each market (the same pattern is repeated across the region). This is a clear indication that CG reform in Asia is still largely a top-down, state-led project and that the majority of listed companies, investors and other market participants remain ambivalent. One explanation is that this is because CG reform requires stamina and a long-term view, something that governments and policymakers tend to be better at than most market participants whose businesses are more susceptible to short-term shocks. Another factor is that the majority of listed companies have little incentive to improve their governance, because they are not attractive or big enough for mainstream institutional investors, brokers and bankers to follow. A third reason is that the majority of investors are paid on a short-term basis and run diversified funds, hence have little incentive or time to invest in CG research and engagement. Of course, there are exceptions to all the above and from a bottom-up perspective the picture looks more positive.

Rising and falling market scores show that CG reform is rarely linear

Figure 3

Market scores



Source: ACGA

The bottom four

Korea and China improving in some areas, despite flat scores

Despite their scores staying flat, some aspects of the governance systems of Korea and China have improved. We give higher scores for enforcement in both markets and this is almost entirely due to the efforts of regulators; we do not see institutional or retail investors playing a particularly strong role, although there is the potential for this in China over the longer term. Korea also does slightly better on CG rules and practices (a beneficiary of our new questions on CSR/ESG reporting), while China has earned a higher score for CG culture (due to a slightly more open attitude on the part of listed companies, mostly the larger state enterprises, to engage on CG issues).

Korea held back by weak political leadership

Korea has been held back by a fall in its score for political and regulatory environment, primarily because of the lack of leadership on CG policy from the current Park administration. Having started well with plans for "economic democratisation", which it was hoped would include plans for a more level playing field for minority shareholders and higher CG standards, the new government's energy petered out in the face of strong and predictable opposition from the family conglomerates that dominate Korean business.

China continues to lose ground to other markets

China saw marginal falls in three categories: CG rules and practices; political and regulatory environment; and IGAAP (accounting and auditing). However, the issue here was not a regression in China's performance, but rather that relative to other markets China has lost some ground. For example, a factor for its fall in the political and regulatory environment section was the lower quality and usefulness of its regulatory communication and websites.

Philippines continues to disappoint, despite some bright spots

Meanwhile, the Philippines slid one percentage point in this survey because the impetus for CG reform there has been quite weak over the past two years, certainly relative to other markets. There are some bright spots in its landscape, such as the Securities and Exchange Commission's (SEC) requirement for an Annual Corporate Governance Report (ACGR), financial reporting of a high standard, and some improved enforcement by the Philippine Stock Exchange. Largely as a result of the ACGR, the Philippines saw an improved score in CG rules and practices. It also gained points in CG culture thanks to some improved corporate communications and the creation of a new retail shareholder group, SharePhil. But in other areas the country fell in score. Enforcement and accounting/auditing dived, largely the result of weak regulators and limited disclosure of enforcement activity. Meanwhile, it slipped in political and regulatory environment, since we see no obvious CG champion in the government.

Indonesia finds new energy for CG reform

In contrast, Indonesia is making a big effort to champion CG reform. Tired of doing poorly in CG surveys, and spurred on by the new Asean CG Scorecard ratings, Indonesia has developed a CG Roadmap that envisages widespread rule changes in many areas and a revised and more practical CG Code. The country has a new super regulator, the OJK, which should be a catalyst for sustained reform and improved enforcement. And some progress is also apparent in audit regulation. Unlike the Philippines, Indonesia does have an independent audit regulator with a fairly clear strategy of what needs to be done. How well all this proceeds depends hugely on the political will and support of the government, having sufficient resources, and ensuring the right people are in place to execute the new strategy. This will be no easy task, but Indonesia deserves credit for starting the ball rolling.

Category trends: 2010-14

CG rules and practices

New questions drive down scores in CG rules for some markets

Almost half the region has shown some improvement over the three surveys (2010, 2012 and 2014) in CG rules and practices. The top two markets have both slipped, as have Taiwan, China and Indonesia. Thailand stays the same.

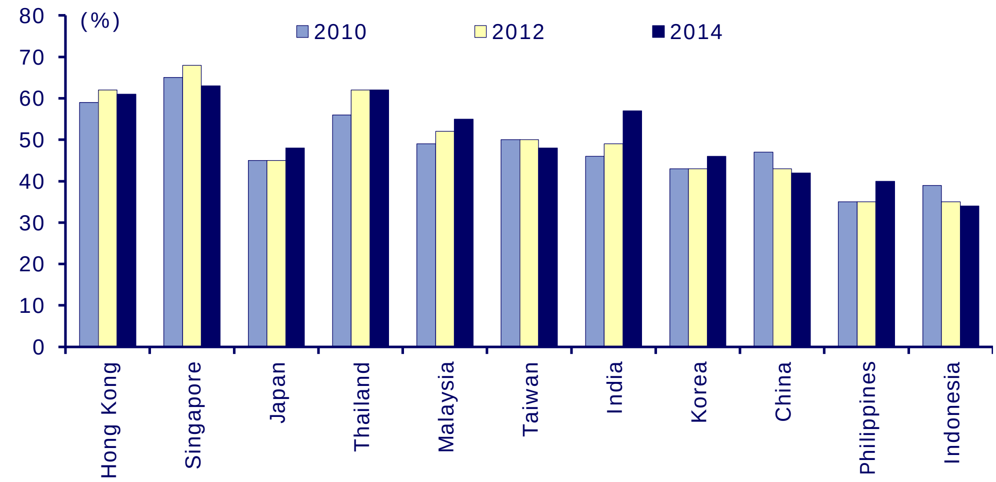
One reason for the slippage is that we have introduced three new questions on sustainability reporting and some markets rate less well here. We have also undertaken more detailed research on financial-reporting speeds and that led to some score adjustments for corporate practices.

Still considerable room for improvement in CG rules in Asia

The results also show that Asia still has much room for improvement on its basic CG rules and practices. This should be a warning flag for investors.

Figure 4

CG rules and practices



Source: ACGA

Regulators continue to increase enforcement effort

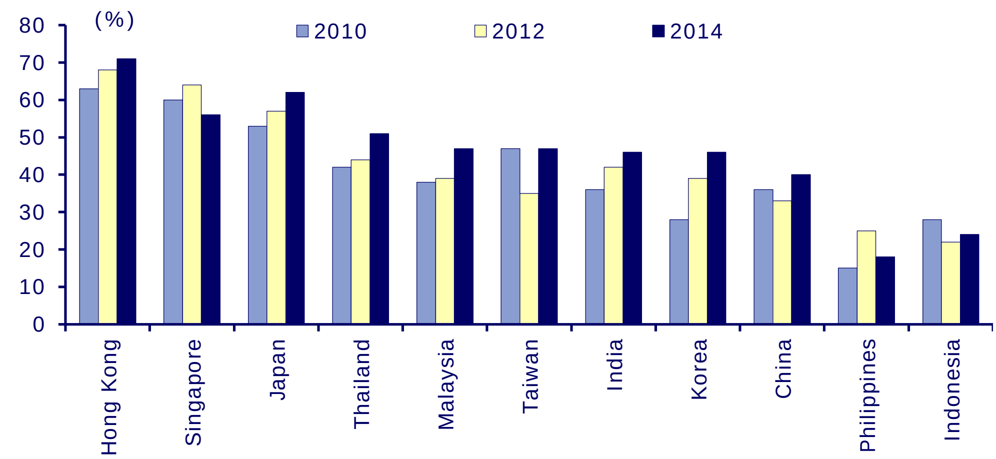
Enforcement

Once again, this is the most encouraging part of the survey - even if the absolute scores could be much better. With rising scores in nine of the 11 markets, regulators increasingly see the value of good enforcement to investor confidence and market credibility. Improved scores in Japan, Malaysia and, to a lesser degree, Thailand, also take into account efforts by governments and/or institutional investors to develop “stewardship codes”. Taiwan’s higher score is partly the result of more engaged foreign institutional shareholders, while India’s has risen with the help of more active participation from domestic institutional shareholders.

Nine of 11 markets earn higher scores for enforcement

Figure 5

Enforcement



Source: ACGA

Weak CG leadership, corruption, poor public governance all drive down scores

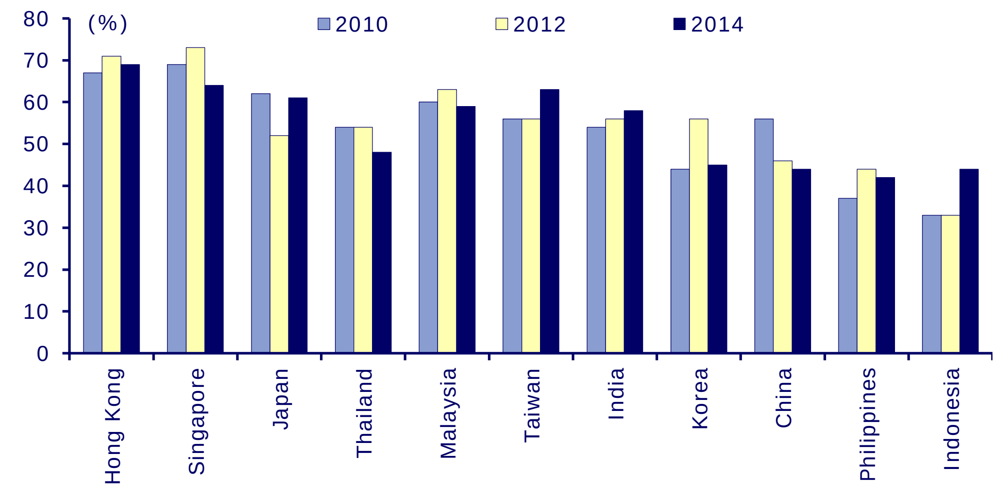
Political and regulatory environment

It's a mixed picture. Scores have fallen in seven markets, and up in four. In addition to weak or uneven leadership on corporate governance in many markets, hence the lack of a clear and consistent strategy, scores have been undermined by corruption and the inadequate attempts being made to control it. We also added a new question on government leadership regarding public governance and civil-service ethics, and many markets score poorly.

Seven markets fall, four rise

Figure 6

Political and regulatory environment



Source: ACGA

IGAAP (accounting and auditing)

Scores mostly fall as our assessment of audit regulation gets tougher

Apart from two markets that are doing better (Japan and Malaysia) and two staying the same (Thailand and Indonesia), scores have weakened across the board as we get tougher on assessing audit regulation. Hong Kong, India and the Philippines all lack a proper independent audit regulator, hence the reason for the more noticeable decline in their scores. While Singapore has an effective and independent audit regulator, the Accounting and Corporate Regulatory Authority (ACRA), the lower score represents the fact it still lacks disciplinary powers against CPA firms. Malaysia's score has risen due to its active audit regulator, the Audit Oversight Board (AOB), which does have a full suite of powers against both firms and individual auditors.

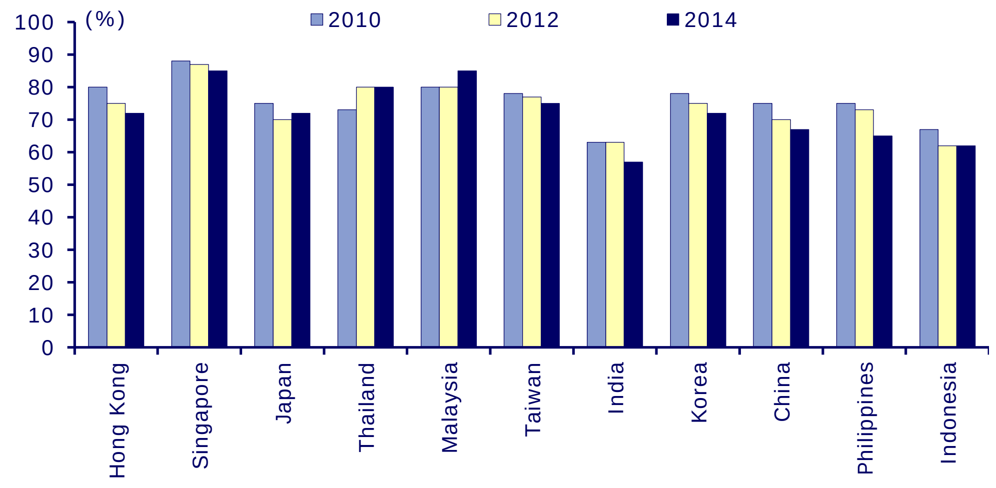
Pressure on audit fees a red flag for investors

We remain concerned about the pressure on audit fees that one hears repeatedly across the region. A preliminary review by ACGA found an inconclusive picture: some audit fees among the top 25 companies in each market (where they are available) are rising, others are falling or staying the same. However, lower fees are often the result of audit firm rotation, hence could be an unintended consequence of policies to enhance auditor independence. Our concern is about audit quality, which will most likely suffer if fees fall. We are also dismayed that independent directors, audit committees and even minority shareholders seem little interested in this issue, apparently happy to see costs fall on principle. Yet lower fees should be a red flag for investors.

Only two markets earn higher scores for IGAAP

Figure 7

IGAAP (accounting and auditing)



Source: ACGA

CG culture

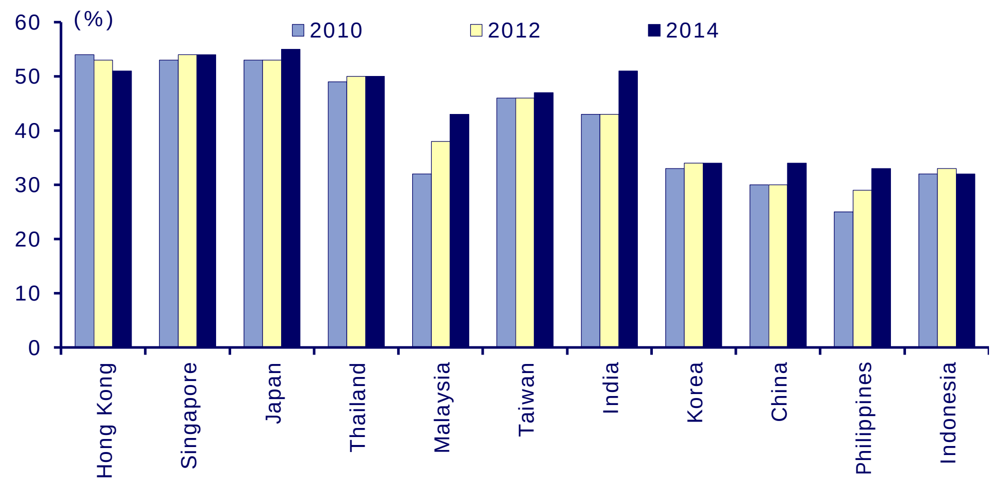
Yet again, the poor cousin

Once again, CG culture is the poor cousin of the survey, with scores flat or slightly declining in five of the 11 markets, and slight increases in two others (Japan and Taiwan). Malaysia stands out due to its new institutional investor code, some voluntary voting by poll and improved communication by companies. India's score jumps because voting by poll is now effectively mandatory and domestic institutions are more active. China does a bit better because its larger state enterprises are showing more interest in CG as a result of renewed SOE reform. And the Philippines gets a bump, as noted earlier, due to better communication by companies and the new shareholder group, SharePhil.

But scores do rise in six of the 11 markets

Figure 8

CG culture



Source: ACGA

Where are we after 15 years?

CG regimes in Asia today are markedly different from 15 years ago

Our survey this year effectively represents a report card on where CG reform in the region stands 15 years after the Asian financial crisis of the late 1990s. A considerable amount has changed in that time and the region has a very different financial regulatory philosophy, not to mention a large body of new laws, regulations, CG codes and guidelines. In relative terms, this has been great progress. In absolute terms, and if measured against “world class” benchmarks, not quite so impressive.

Creating good regulation a tougher exercise than most appreciate

While we remain critical of the quality and content of many CG rules in Asia - and believe that higher standards would genuinely benefit companies even if there is a cost - we also recognise that amending regulation is often a tough and difficult process that inevitably gets caught up in local politics and depends to a large extent on the degree of support financial regulators get from their own governments (often not a great deal). This is reflected in the generally disappointing scores that most markets receive in the political and regulatory environment category and what we perceive as a lack of clear, consistent and credible government strategies on CG. It is probably reflected as well, indirectly, in the low scores for CG culture. For without strong support from the market, regulators will face limits in how far they can push the rules.

Regulatory innovation on enforcement a positive, but disclosure often poor

More positively, securities commissions in many markets are taking enforcement seriously and achieving some good results despite limited resources, staffing capacity and political constraints. Disclosure of these efforts leaves a lot to be desired and is often frustratingly obtuse. Hopefully, over time, regulators will also see the value in being more transparent and to discussing their wins and losses, as well as resource challenges, more openly.

What should investors be worried about?

Finally, what should investors be most worried about? There is a long list. These include the account preparation that goes into financial statements, especially among state enterprises and smaller issuers. Conflicts of interest in the role of stock exchanges and how they manage “frontline enforcement” - which is of far lower quality than the work done by securities commissions in most cases. “Regulatory risk”, in the sense of weak shareholder rights in different markets, especially relating to takeovers and major or related-party transactions. Companies that claim to have sound corporate governance, but will not count votes at their general meetings. And audit quality, fees and audit industry capacity - the three are linked. The best way we know to get comfort, or insight, on these issues is to meet companies, auditors and regulators in person. Time to buy that plane ticket!