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CG WATCH 2014

Dark shades of grey

Corporate governance and sustainability in Asia

Special report

September 2014

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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.

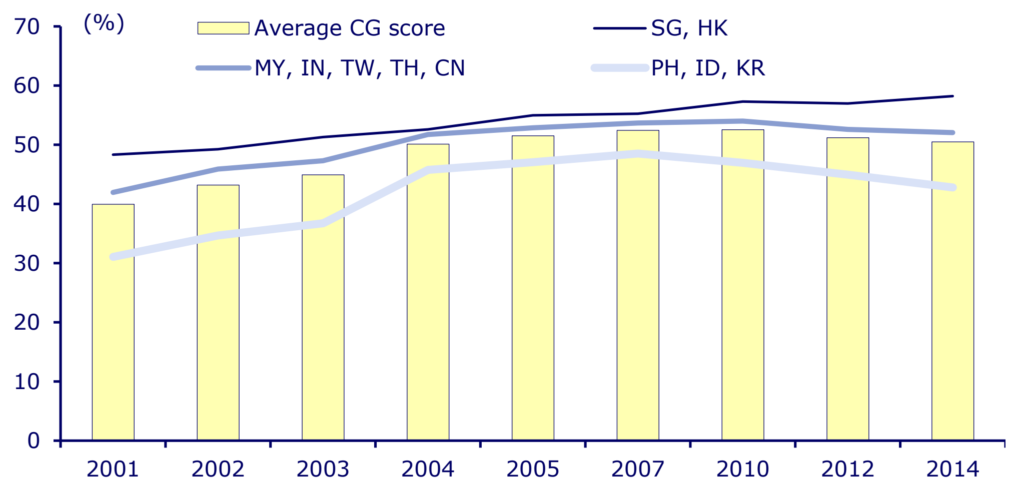
Our ninth *CG Watch* report ranks 944 firms in 12 Asia-Pacific markets

Dark shades of grey

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

Hong Kong versus Singapore: Trouble at the top

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

Hong Kong rated better than Singapore for:

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

Singapore rated better than Hong Kong for:

- 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).

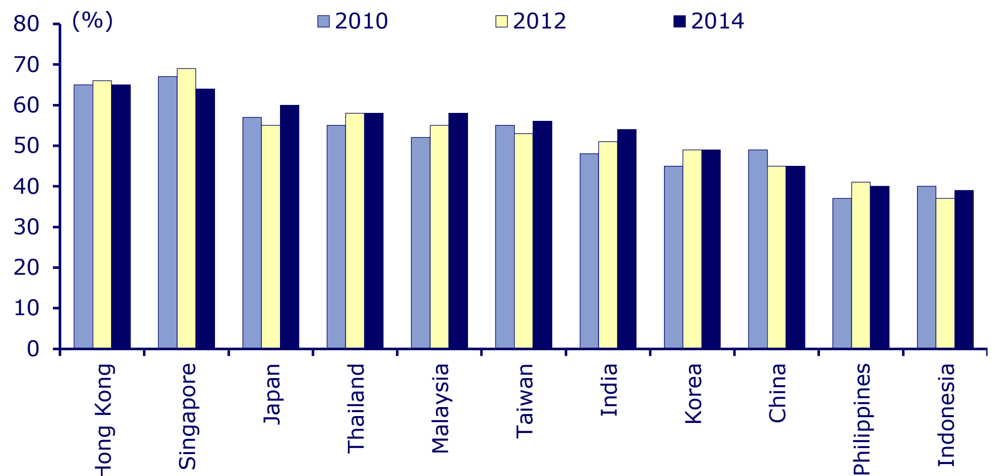
Low CG-culture scores suggest reform still top-down and state-led

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.

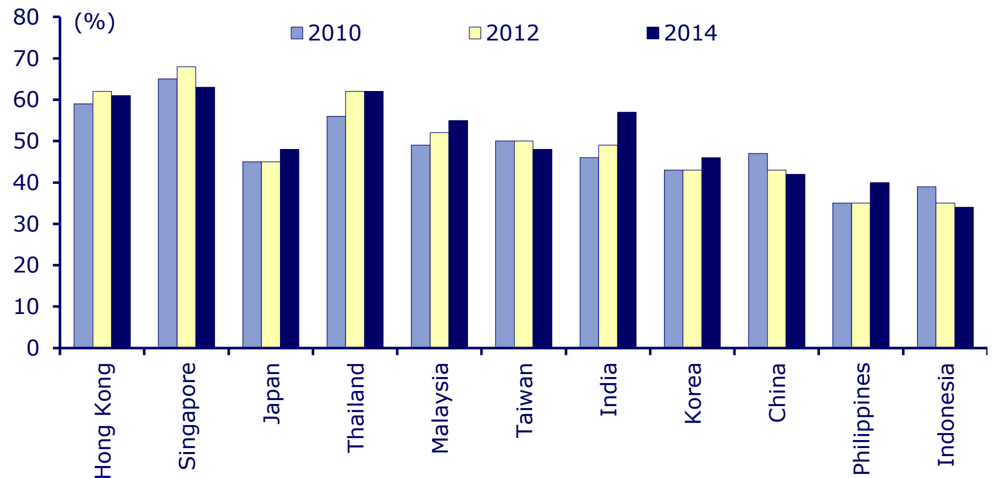
One reason for the slippage is that we have introduced three new questions on sustainability reporting and some markets rate less well here. We have also undertaken more detailed research on financial-reporting speeds and that led to some score adjustments for corporate practices.

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

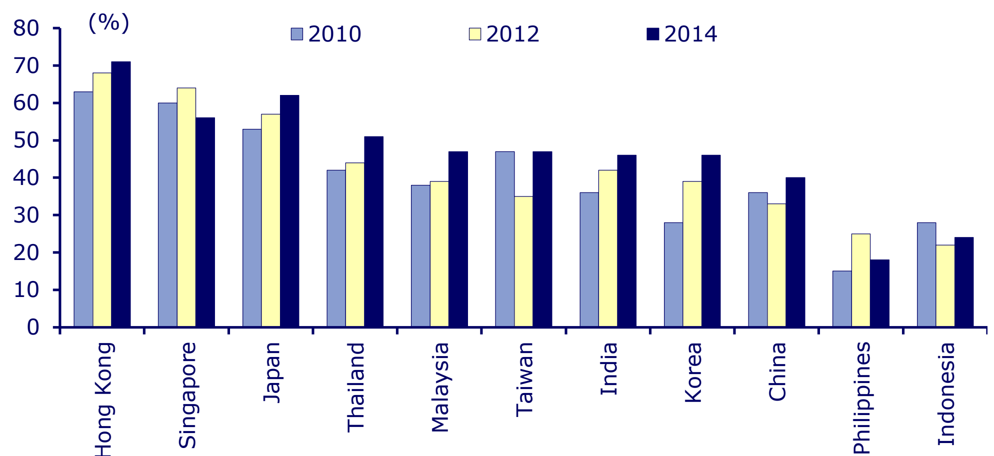
Enforcement

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

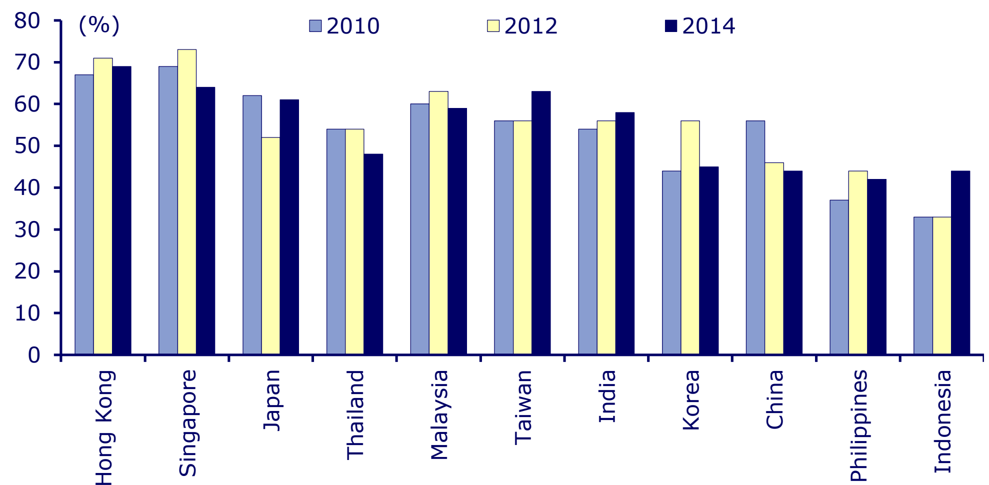
Political and regulatory environment

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

Scores mostly fall as our assessment of audit regulation gets tougher

IGAAP (accounting and auditing)

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.

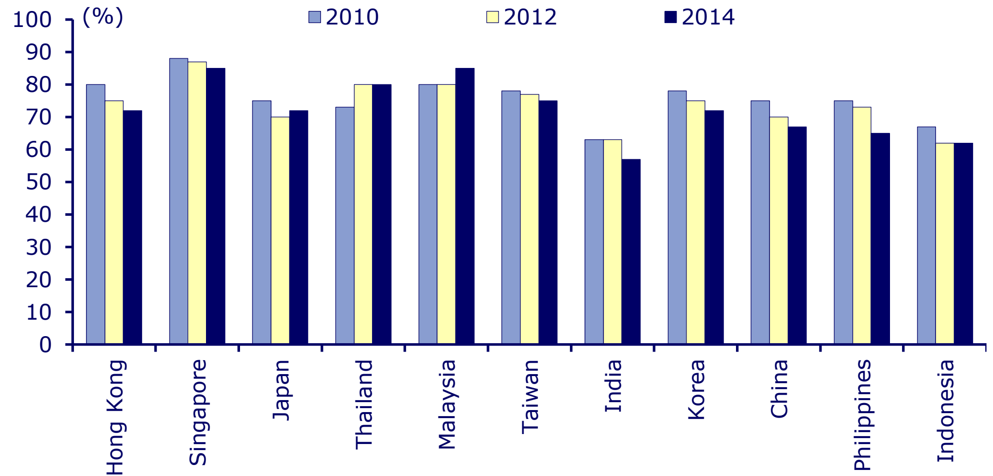
Pressure on audit fees a red flag for investors

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

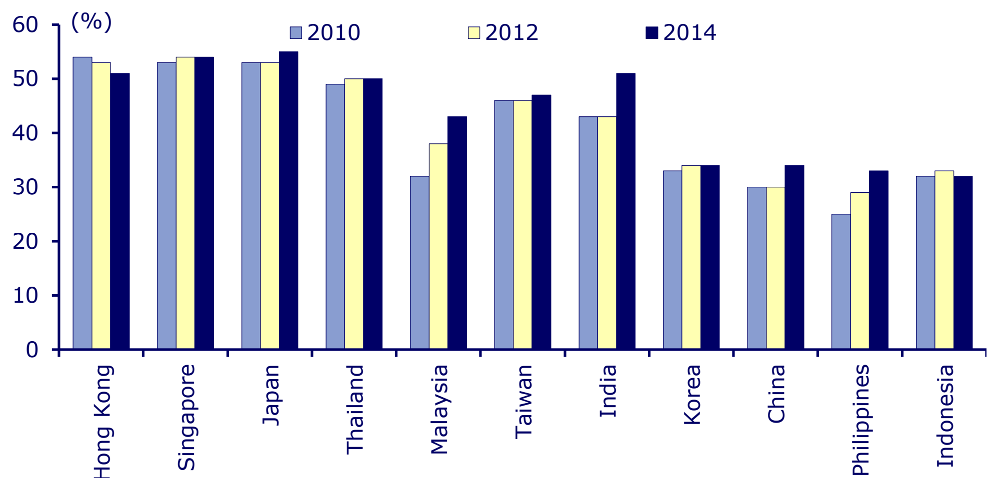
Yet again, the poor cousin

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!

Corporate slippage

Returns on above-average CG stocks inversely correlated with market direction

CG scores for stocks under our coverage have slipped somewhat. The biggest decline is in Korea due to more intergroup transactions and poorer disclosure. In other markets, the overall changes in scores have not been major. From our updated backtesting, we continue to find that better-CG stocks generally outperform in falling markets, but are more likely to underperform in market rallies. Stocks with better CG also lag in sectors where investors are chasing share prices, for instance internet as well as hotels and leisure, ie, gaming, in recent years. However within markets, companies with top-quartile CG have generally outperformed.

The market appears to be undervaluing quality as represented by CG

The performance is especially remarkable for high-CG stocks where a valuation overlay is applied. In the past five years, those with the top-quartile CG and the highest-quintile trailing FCF yield, and are trading at the lowest trailing PE, have outperformed by over 10ppts per year. Compounded, that is massive outperformance. This indicates that the returns on value stocks can be enhanced with a CG overlay. Higher return with lower CG risk theoretically is an anomaly but indicates that the market continues to underprice quality as represented by our CG rankings.

CG scores slipped

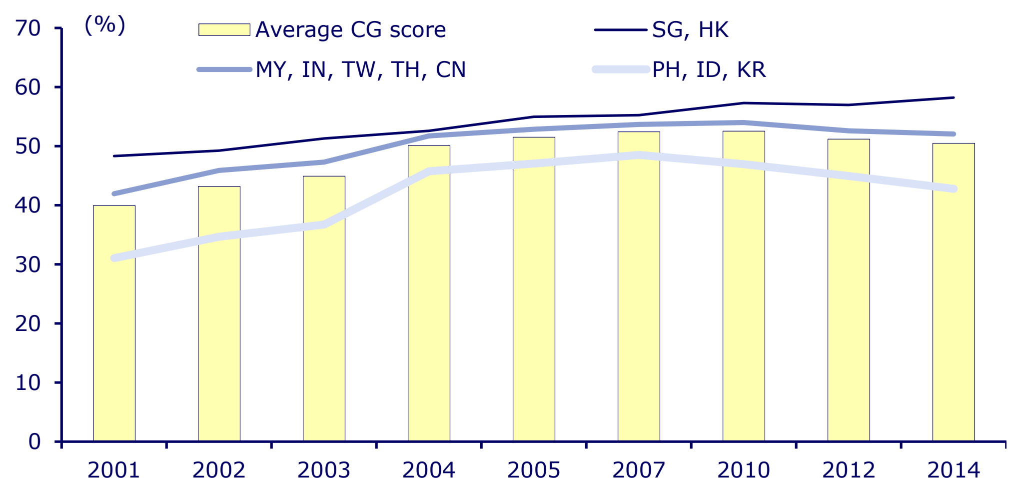
Average CG scores have slipped

Since our last report in 2012, CG scores for companies in Asia Pacific have edged lower. The better markets for CG, Singapore and Hong Kong, have seen their scores move up slightly. Of the developed markets, Japanese corporates' CG scores are up slightly and Australia's are flat. Averaging across the 12 markets, companies under our coverage have seen a 0.6ppt decline. Excluding the four developed markets - Japan, Hong Kong, Singapore and Australia - the average score across the emerging markets in our coverage is down on average 1.2ppts compared to 2012.

CG scores for companies down 0.6ppts, or 1.2ppts excluding developed markets

Figure 9

Average company CG scores



Source: CLSA

Fairly large drop in the scores for Korean corporates

We see some decline in average scores for Malaysia, where related-party transactions remain an issue, and India, where in the past two years royalty payments to parent companies have cropped up. The largest drop in corporate scores comes from Korea because of an increase in intergroup transactions for companies under our coverage as well as poorer disclosure. We delve into greater detail on the changes in the scores in the country sections.

CG stars

Our comparisons with 2012 scores excludes the new E&S category

Our scoring methodology for companies is detailed in Section 4. The main part is unchanged from our last report. Only the environmental and social (E&S) category, which makes up 10% of the overall score, has been revamped. In assessing changes since 2012, we exclude E&S and compare companies that were scored both in 2012 and 2014, on exactly the same criteria.

Larger caps have greater resources to provide recommended checks and balances

On average, large caps would generally be expected to have slightly better CG, as they have greater resources to put better governance in place, eg, hiring more independent directors, setting up the relevant committees and putting in place recommended checks and balances. Ex-Australia, companies with above US$10bn market cap on average score 54.9%, while those below US$10bn have an average score of 52%. The table below shows the CG stars of the large caps, ie, 20 companies that have scores of 75% or higher. Among them are TSMC as well as Standard Chartered and HSBC, which have gained in our scoring since 2012 and are now back among the top scoring of the names we cover. OCBC is also among the highest scoring as well as CSL, Amcor, IAG, Brambles and BHP Billiton from Australia. The top CG of large caps from Japan are Mitsubishi Corp, Mitsui, Tokyo Electron, Panasonic, Fujitsu and Honda.

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

Figure 10

Top CG companies among Asia-Pacific large caps (over 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

Australian companies dominate the list of midcaps with high CG

Some of the mid- and smaller caps also have good CG standards. Figure 11 shows the top 40 below-US$10bn companies with CG scores at 75% or higher. Quite noticeably, the top-ranked ones are dominated by Australian firms in our coverage, eg, Orica, ASX, Carsales.com and Cochlear. For the rest of Asia, among the highest-scoring midcaps on CG are J Front Retailing, Novatek, Techtronic, Chipmos, Daum, Del Monte, Sembcorp Marine and Bangkok Dusit Hospitals.

Japan, HK, Taiwan, Singapore also with some mid- and smaller caps that have high CG

Figure 11

CG stars of stocks with less than US$10bn market cap

Company	Code	Country	Sector
Orica	ORI AU	Australia	Materials
ASX	ASX AU	Australia	Financial services
Carsales.com	CRZ AU	Australia	Internet
Cochlear	COH AU	Australia	Healthcare
Sirtex Medical	SRX AU	Australia	Healthcare
Future Bright	703 HK	Hong Kong	Consumer
Ramsay Health Care	RHC AU	Australia	Healthcare
Treasury Wine	TWE AU	Australia	Consumer
Ansell	ANN AU	Australia	Healthcare
Incitec Pivot	IPL AU	Australia	Materials
Seek	SEK AU	Australia	Internet
Pax Global	327 HK	Hong Kong	Technology
Adelaide Brighton	ABC AU	Australia	Materials
J Front Retailing	3086 JP	Japan	Consumer
WorleyParsons	WOR AU	Australia	Petro/chems
ALS	ALQ AU	Australia	Materials
Fletcher Building	FBU AU	Australia	Materials
CSR	CSR AU	Australia	Materials
Orora	ORA AU	Australia	Materials
Tatts	TTS AU	Australia	Hotels & Leisure
Novatek	3034 TT	Taiwan	Technology
Sigma Pharma	SIP AU	Australia	Healthcare
Techtronic	669 HK	Hong Kong	Consumer
ChipMOS	8150 TT	Taiwan	Technology
Sonic Healthcare	SHL AU	Australia	Healthcare
Daum	035720 KQ	Korea	Internet
King Yuan	2449 TT	Taiwan	Technology
Del Monte Pacific	DMPL PM	Philippines	Consumer
Japan Exchange	8697 JP	Japan	Financial services
Isetan Mitsukoshi	3099 JP	Japan	Consumer
iiNet	IIN AU	Australia	Telecoms
Metcash	MTS AU	Australia	Consumer
Virtus Health	VRT AU	Australia	Healthcare
Ricoh	7752 JP	Japan	Technology
ResMed	RMD AU	Australia	Healthcare
Sembcorp Marine	SMM SP	Singapore	Capital goods
Vocus	VOC AU	Australia	Telecoms
Bangkok Dusit	BGH TB	Thailand	Healthcare
M1	M1 SP	Singapore	Telecoms
SGX	SGX SP	Singapore	Financial services

Source: CLSA

CG and stock performance

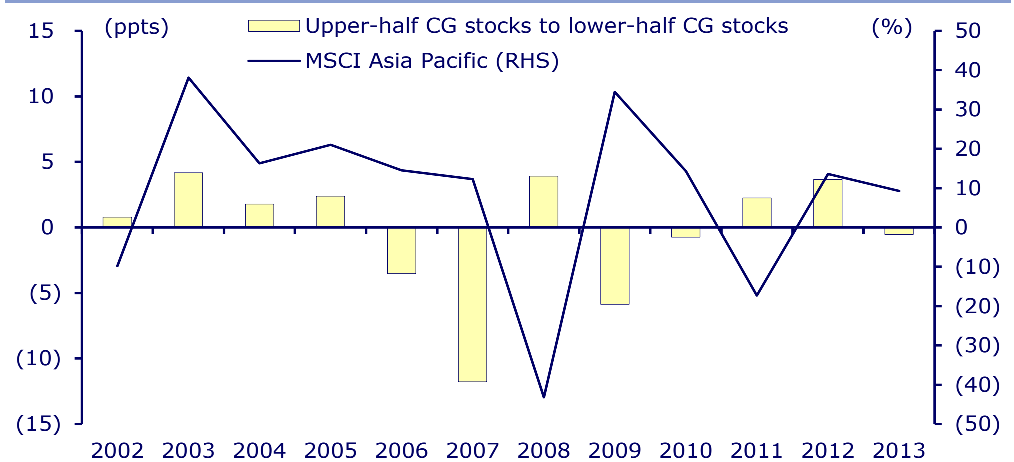
Upper-half CG stocks have outperformed the lower half in seven of the 12 years, but relatively small difference in performance

Figure 12 shows the performance of upper-half CG stocks relative to the lower half, which now has 12 years of historical data. We find that in 2012, the former outperformed the latter but in 2013 underperformed very slightly. Since 2002, upper-half CG stocks have outrun lower-half ones in seven of the 12 years. However, the difference in relative performance of the two groups in simple-average terms is quite small.

Upper-half CG stocks have tended to outperform when markets decline

Figure 12

Performance of upper-half CG stocks in Asia Pacific versus lower half



Source: CLSA

Performance of above-average CG stocks mixed when markets are rising

From a longer period of analysis, it is notable that better-CG stocks are much more likely to outperform when markets are down. In every one of the three years when the Asia-Pacific index fell, upper-half CG stocks outperformed. But when markets are rising, the record is much more mixed. Indeed, upper-half CG stocks outperformed in only four of the nine years since 2002 when the regional benchmark was up. The better-CG names have underperformed particularly at the tail end of the last major rally for Asian stocks, ie, 2006-07. The relative performance of better-CG stocks can be seen as inversely linked to risk appetite, which itself is a function of the direction of markets.

Top-quartile CG stocks' relative performance

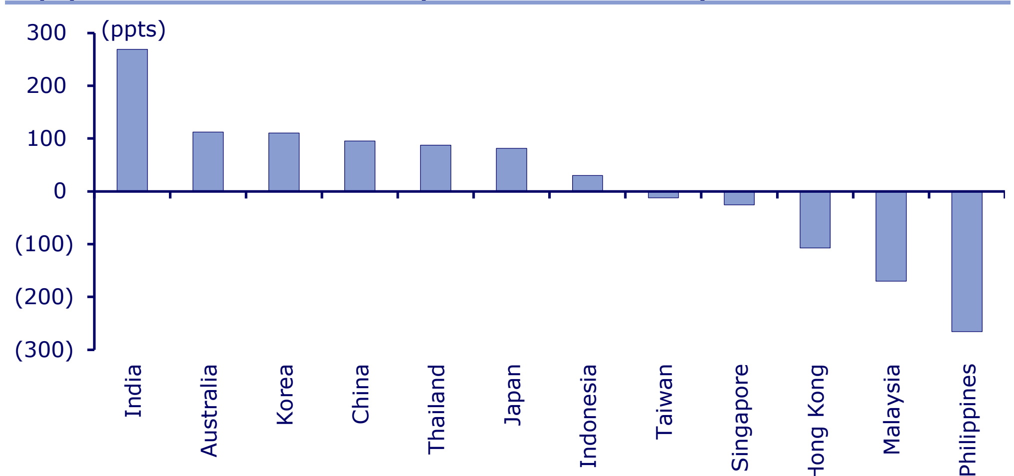
Top-quartile CG stocks over the past five years have provided on average 20% outperformance against other stocks in respective markets

Within the markets, the top quartile of CG stocks has done generally better. These have outperformed the lower three quartiles in seven of the 12 markets, with outperformance of 100ppts or greater against the poorer-CG stocks over the five years in India, China, Australia and Korea. A simple average of the top quartile outperformed the bottom three quartiles by 20ppts across the markets. Where the top quartile underperformed, eg, the Philippines, Malaysia and Hong Kong, it has been because some of the lower-CG stocks in our coverage happened to have had multibagger returns.

Top quartile performed especially well in India, China, Australia and Korea

Figure 13

Top quartile versus bottom three quartile CG stocks: five years to end 2013



Source: CLSA

Much weaker link between CG and stock performance by sector

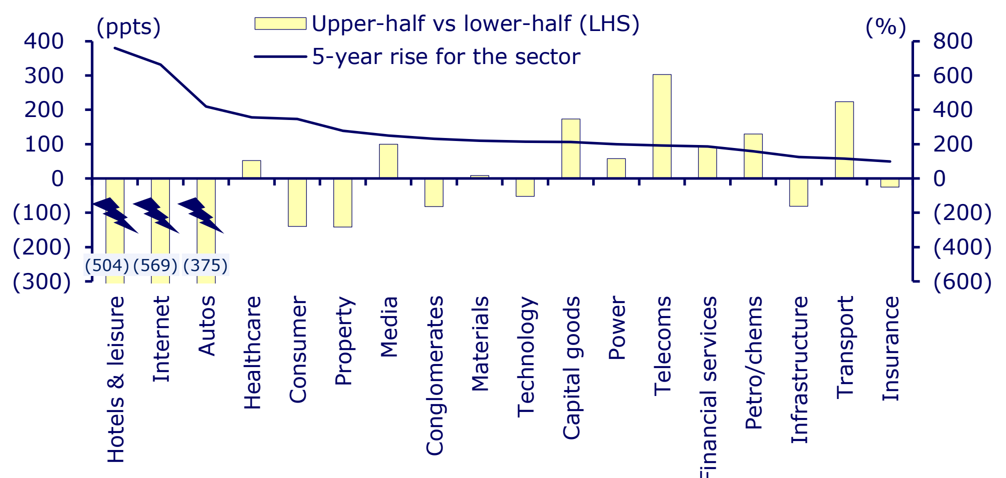
CG and stock performance by sector

There is notably a much weaker link between price performance and CG at the sector level. In only half of the sectors did the higher-CG stocks outperform the lower half in the past five years. Returns on high-CG stocks were significantly stronger than their low-CG counterparts for telecoms, transport, capital goods, petro/chems and media, outperforming the lower-half names by around 100ppts or more during the same period. However, for internet, hotels and leisure as well as autos, investors would have been much better off holding the lower-CG names.

In sectors that performed strongly like internet, hotels & leisure and autos high-CG stocks underperformed

Figure 14

High-CG versus low-CG stock performance by sector



Source: CLSA

In sectors that have not seen as strong rerating, upper-CG stocks have generally outperformed

Figure 14 shows for five of the sectors that have seen the strongest share-price gains, the upper-half CG stocks significantly underperformed. Stocks in our coverage universe in the internet, hotels & leisure, autos, property and consumer sectors on average were up around 200% or more in the past five years. Upper-half CG stocks underperformed the lower half in each of these industries quite considerably. In the two sectors with the strongest performance, hotels & leisure and the internet, upper-half CG stocks underperformance was the greatest. Beyond these five sectors that enjoyed strong performance, for the other 13 under our coverage, upper-half CG stocks generally outperformed except for just four sectors, ie, conglomerates, infrastructure, technology and insurance.

Where investors are chasing up stocks, CG not a criterion for share-price performance

From this we conclude that in sectors where stocks are generally running hard and investors are chasing returns, CG standards of the companies are largely irrelevant as a criterion for stock performance. Indeed, lower-CG stocks that are higher risk are more likely to give higher returns in sectors where stocks are being chased up by investors. However, for sectors that are not going through a big rerating, higher-CG stocks tend to outperform.

Valuation filters give stronger returns on high-CG stocks

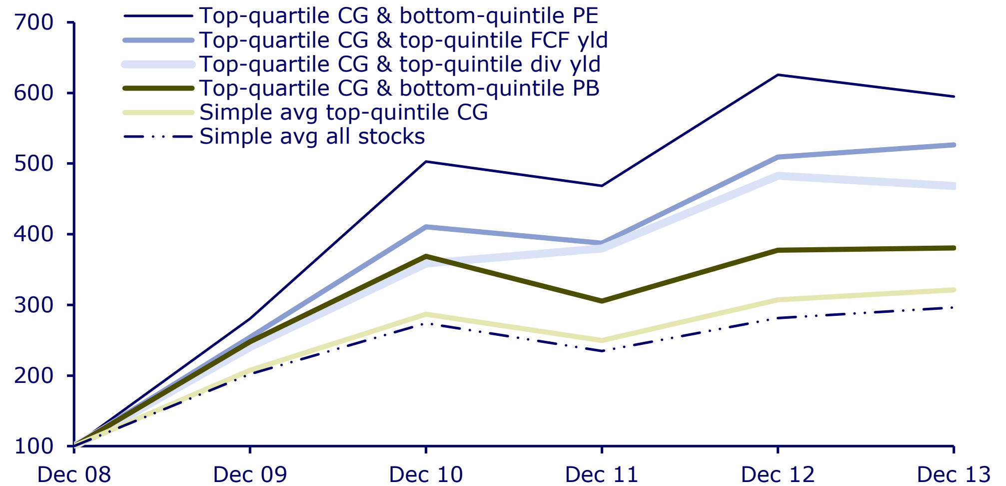
CG, valuations and performance

While upper-half CG stocks give some outperformance by markets (less clearly by sector), we find that combining better-CG stocks with valuation screens can give very strong performance, as shown in Figure 15.

PE and FCF yield the most effective filters for performance on top-quartile CG stocks

Figure 15

Performance of top-quartile CG stocks with trailing valuation screens



Source: CLSA

Simple-average comparison takes away the size bias of the index

We take as our universe the top-quartile CG stocks in each of the markets we cover. The MSCI Asia Pacific index was up 9.5% compounded in the five years to end-2013. A simple average of all the stocks in our universe (irrespective of CG ranking) provided a 24.3% compounded return, while a simple average of the top-quartile CG stocks gave a 2ppts higher compounded annual return. The higher performance of a simple average of stocks is pretty much the result of taking away the size bias that affects the performance of market cap-weighted indices.

Top-quartile CG with most attractive FCF and PE valuations gave a compounded return over 15ppts higher than the simple average of stocks

Of the top-quartile CG stocks, we screened those with highest-quintile FCF yield or dividend yield and those that are in the lowest quintile on PE and PB. We used trailing data for FCF, dividends, book value and EPS to reduce hindsight bias; and rebalanced at the start of each year from 2009 to 2013. We find that the high-CG stocks with a PE and FCF valuation overlay performed most strongly, giving a compounded return of 42.9% and 39.4% respectively. A filter for the stocks with the highest trailing dividend yield outperformed as well (compounded return of 36.2%), while PB as a valuation filter was less effective but still gave a 6ppt outperformance per year relative to the overall universe of stocks.

Excluding 2009, still provided 10ppts higher returns compounded

Much of the performance came in 2009 when markets had a strong bounce. Stripping out that year, the top-quartile CG stocks with the most attractive PE and FCF yield still gave about a 20% compounded return versus 10% for the overall basket (or just 4% compounded for MSCI Asia Pacific).

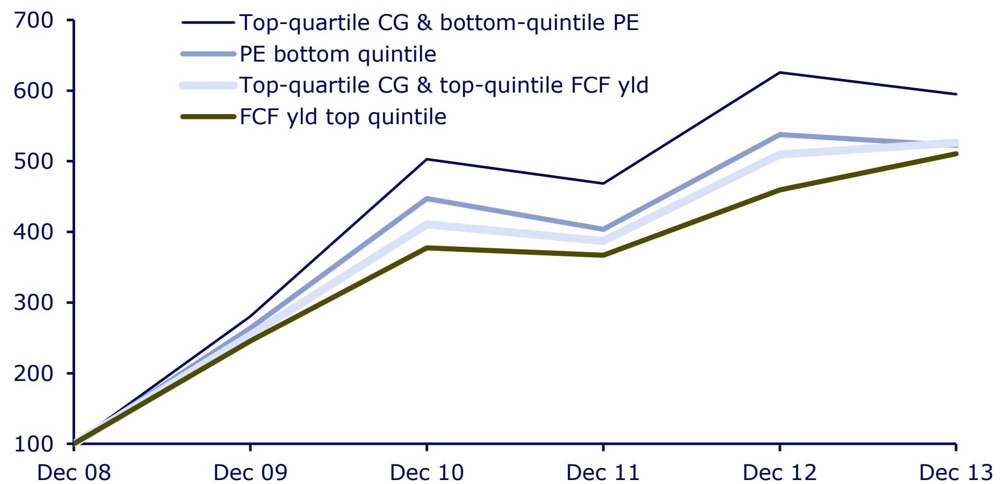
CG screen provides slightly higher returns on value screens

It might be observed that the performance is driven by the valuation screen more so than the CG ranking. That is, the return is much higher based just on the valuation screen without the CG filter versus the performance of the top-quartile CG stocks without any valuation filter. Nevertheless, Figure 16 shows that the top-quartile CG stocks gave slightly better performance compared to the basket of stocks by the valuation filter alone without any screening of CG quality. The additional performance with the filter of high-CG stocks is not large. Still, if investors can get similar or better returns focusing on above-average CG stocks on the back of appropriate valuation screens, it would certainly be worth the effort to improve the risk-return profile of the portfolio.

Top-quartile CG stocks as a filter gave slight outperformance on the trailing PE and FCF yield screens

Figure 16

Upper-half CG stocks vs all CG-ranked companies with prior-year FCF and div yield



Source: CLSA

CG change and stock performance

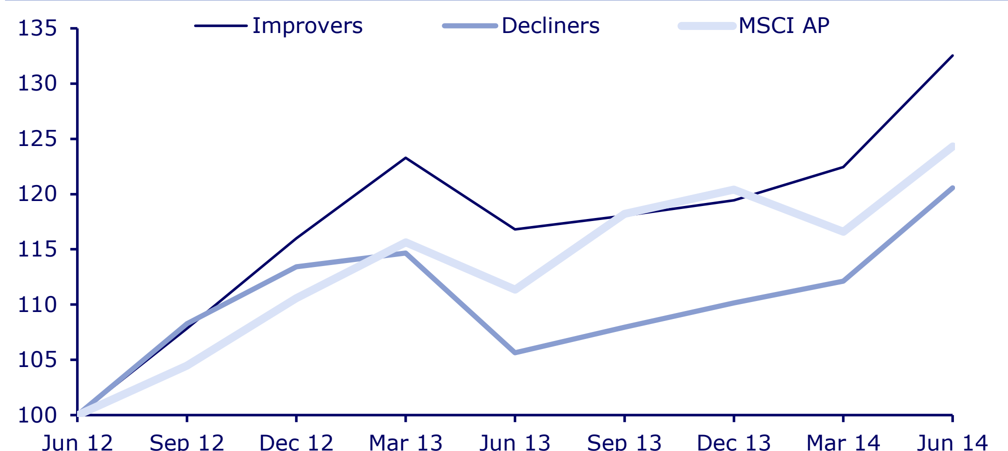
Improving CG tends to provide outperformance; vice versa for declining CG

As in our earlier reports, we find that stocks with improving CG have generally outperformed; vice versa, those with CG deterioration have tended to underperform. Since our last report in mid-2012, 68 stocks had CG improvement that pushed our score up by 7.1pts or higher, representing the top decile of CG change. These outperformed the MSCI Asia Pacific by 34%, ie, an average return of 32.5% over the period versus 24.3% for the regional index. Meanwhile, CG deterioration at 63 stocks pushed down their score by 8.4pts or more; these bottom-decile stocks for CG change lagged the regional index by 15% or approximately 4ppts over the two years to mid-2014.

Top-decile stocks for CG change outperformed the regional index by 34% while bottom-decile ones lagged by 15%

Figure 17

Performance of top/bottom-decile CG change relative to MSCI Asia Pacific



Source: CLSA

Deteriorating CG stocks underperformed in particular when markets were falling

As Figure 17 shows, the stocks with significant decline in CG underperformed significantly when markets in the region had a pullback in 2013. They only began to catch up after a number of quarters of the market rising, doing well in the recent 2Q14. The stocks with improving CG outperformed in particular during the quarters when the markets were rallying.

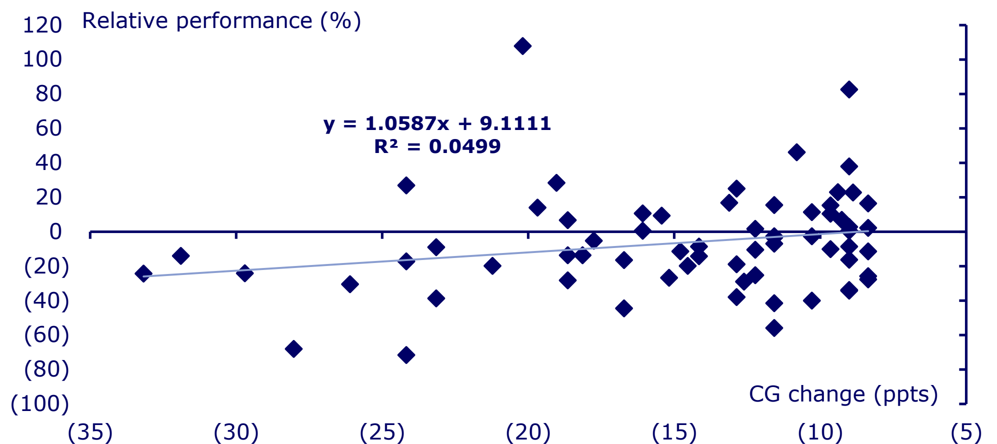
Bottom-decile CG decliners have seen share prices drop as much as 50% while markets are up

Of the 63 companies in the bottom decile for CG change, the reduction in their CG score from 2012 to our current assessment ranged from 9ppts to 33ppts. Most of these companies were in Korea, India and Malaysia. Of stocks in the bottom decile for CG change, two-thirds underperformed the MSCI index; 18 of the companies, or one-third of the ones with significant decline in CG score, had share prices that fell in absolute terms, by as much as 50% over the two years, in a period when the MSCI index for the region was up 24%.

Not a great correlation but some of the stocks with large CG declines have seen significant underperformance

Figure 18

Bottom-decile CG change and relative performance



Source: CLSA

Big fall in share prices for some of Korean stocks with lower CG

A notable example was GS E&C, which had a 28ppt reduction in its CG score owing to reduced transparency, directors' remuneration holding steady while earnings fell. Its stock price fell 46% in the period. Samsung Engineering saw a decline in CG score of 24pts for similar reasons; its stock price has halved.

Correspondingly some of CG gainers have seen good share-price upside

Some 68 companies in our coverage are in the top decile for CG change (see Appendix 5) ranging from 7ppts to 25ppts. Over half of them outperformed the MSCI index. Among the strongest performers were Antonoil, which had a 9.6ppt rise in its CG score with a strengthening of its audit committee; its stock price tripled in the past two years. Tencent's CG score improved by 9ppts given the relative change in directors compensation to net earnings from our 2012 previous assessment; its stock price has doubled. For Universal Robina in the Philippines, the divestment of its investment portfolio, which was 23% of book value, was a key factor of its CG score improvement; the stock has seen a 150% rise over the past two years.

High-CG stocks at attractive valuations

We look for top-CG stocks at highest FCF yield or lowest PE

It is impossible to identify stocks that are likely to see CG improvement or deterioration ex ante. To the extent that we get strong performance for above-average CG stocks with attractive valuations, we can use this to underscore some of our analysts' recommendations. Of the top-quartile CG companies in their respective markets, Figure 19 shows those in the top quintile for FCF yield on our current-year estimates while Figure 20 shows those that are in the top quintile on PE.

On FCF-yield screen, high-CG stocks include TSMC, Asustek, Lite-On Tech, Samsung, Agile, Conch, StarHub, HCL Tech

For Japan: Ricoh, Panasonic, Honda, Nissan, Nikon, Konica Minolta and Canon

Figure 19

Highest-quintile FCF yield (FY14) of top-quartile CG stocks

Company	Code	Country	Rec	Mkt cap (US$m)	FCF yld FY14 (%)
TSMC	2330 TT	Taiwan	BUY	107,928	6.8
Asustek	2357 TT	Taiwan	O-PF	7,717	6.6
Lite-On Tech	2301 TT	Taiwan	BUY	3,719	22.1
Powertech	6239 TT	Taiwan	U-PF	1,443	13.2
AUO	2409 TT	Taiwan	O-PF	4,743	35.7
VTech	303 HK	Hong Kong	O-PF	2,980	6.8
Agile Property	3383 HK	China	BUY	2,808	43.0
Lilang	1234 HK	China	SELL	815	7.5
Conch	914 HK	China	BUY	16,179	6.7
Lonking	3339 HK	China	SELL	806	16.0
HCL Tech	HCLT IB	India	BUY	18,680	6.9
eClerx	ECLX IB	India	O-PF	668	7.2
Idea Cellular	IDEA IB	India	U-PF	10,268	8.3
Ciputra Dev	CTRA IJ	Indonesia	U-PF	1,379	14.5
Samsung Electronics	005930 KS	Korea	BUY	169,524	11.8
KT&G	033780 KS	Korea	O-PF	11,957	7.1
Lotte Chemical	011170 KS	Korea	O-PF	5,560	10.9
D&L	DNL PM	Philippines	O-PF	992	9.9
Filinvest Land	FLI PM	Philippines	BUY	856	6.7
StarHub	STH SP	Singapore	BUY	5,649	6.7
Mapletree Log	MLT SP	Singapore	U-PF	2,290	7.7
LPN	LPN TB	Thailand	BUY	955	12.8
Thaicom	THCOM TB	Thailand	SELL	1,347	7.3
BEC World	BEC TB	Thailand	U-PF	2,817	7.1
Ricoh	7752 JP	Japan	BUY	8,444	8.7
Mitsui	8031 JP	Japan	U-PF	29,103	11.3
Panasonic	6752 JP	Japan	BUY	30,073	11.2
Honda Motor	7267 JP	Japan	BUY	61,962	10.6
Nissan Motor	7201 JP	Japan	BUY	44,468	14.5
Sumitomo Rubber	5110 JP	Japan	U-PF	3,785	12.8
Nikon	7731 JP	Japan	BUY	5,813	13.6
Konica Minolta	4902 JP	Japan	BUY	5,867	12.3
Canon	7751 JP	Japan	BUY	43,656	6.9
Teijin	3401 JP	Japan	U-PF	2,446	25.0
WorleyParsons	WOR AU	Australia	U-PF	3,632	9.1

Source: CLSA

Among the higher-CG stocks attractive on FCF yield as well, our BUY recommendations are underscored on TSMC, Lite-On Tech, Samsung Electronics, Agile, Conch, StarHub, D&L as well as Filinvest Land in the Philippines and HCL Tech of India. From Japan, Ricoh, Panasonic, Honda and Nissan Motor, Nikon, Konica Minolta and Canon are top-quartile CG stocks on attractive FCF-yield valuations.

Meanwhile, of the lowest-quintile PE of the top-CG stocks in the respective markets, our BUYs are reiterated on other names including Standard Chartered, Longfor, Agile, Weifu High-Tech, Ezion, Tata Motors, Marubeni, Bridgestone, Yokohama Rubber, Fujitsu and IAG.

Lowest-quintile PE of high-CG stocks include StanChart, Longfor, Agile, Weifu High-Tech, Ezion and Tata Motors

For Japan: Marubeni, Bridgestone, Fujitsu and Yokohama Rubber

Figure 20

Lowest-quintile FY14CL PE of top-quintile CG stocks

Company	Code	Country	Rec	Mkt cap (US$m)	FY14CL PE (x)
Asustek	2357 TT	Taiwan	O-PF	7,717	11.1
AUO	2409 TT	Taiwan	O-PF	4,743	10.4
Huaku Dev	2548 TT	Taiwan	U-PF	633	9.9
Standard Chartered	2888 HK	Hong Kong	BUY	49,919	10.3
Swire Pacific	19 HK	Hong Kong	U-PF	19,591	10.5
BEA	23 HK	Hong Kong	U-PF	9,917	11.4
Longfor	960 HK	China	BUY	6,790	6.2
Agile Property	3383 HK	China	BUY	2,808	4.5
Weifu High-Tech	200581 CH	China	BUY	4,288	11.1
Sinoma	1893 HK	China	BUY	899	7.4
Lilang	1234 HK	China	SELL	815	9.6
Shanshui Cement	691 HK	China	U-PF	1,097	9.5
Conch	914 HK	China	BUY	16,179	9.6
Huishan Dairy	6863 HK	China	BUY	3,290	11.1
Lonking	3339 HK	China	SELL	806	10.0
Sinopec	386 HK	China	U-PF	109,105	10.7
Tata Motors	TTMT IB	India	BUY	25,898	9.5
Tata Steel	TATA IB	India	O-PF	8,242	11.4
Ciputra Surya	CTRS IJ	Indonesia	O-PF	367	8.1
ITM	ITMG IJ	Indonesia	O-PF	2,490	9.7
Samsung Electronics	005930 KS	Korea	BUY	169,524	8.1
HMFI	001450 KS	Korea	U-PF	2,697	10.0
DGB Financial	139130 KS	Korea	O-PF	2,336	8.4
Hyundai Motor	005380 KS	Korea	O-PF	45,407	7.1
Korean Re	003690 KS	Korea	O-PF	1,377	8.0
AMMB	AMM MK	Malaysia	U-PF	6,610	10.7
AirAsia	AIRA MK	Malaysia	O-PF	2,223	9.8
Filinvest Land	FLI PM	Philippines	BUY	856	8.8
OCBC	OCBC SP	Singapore	U-PF	30,232	10.7
Ezion	EZI SP	Singapore	BUY	2,304	9.1
Asian Property	AP TB	Thailand	O-PF	668	9.3
Ricoh	7752 JP	Japan	BUY	8,444	10.0
Mitsubishi Corp	8058 JP	Japan	O-PF	33,952	8.9
Mitsui	8031 JP	Japan	U-PF	29,103	8.2
Fujitsu	6702 JP	Japan	BUY	13,452	10.6
Honda Motor	7267 JP	Japan	BUY	61,962	9.3
Marubeni	8002 JP	Japan	BUY	12,755	5.6
Bridgestone	5108 JP	Japan	BUY	28,071	9.2
Nissan Motor	7201 JP	Japan	BUY	44,468	9.9
Sumitomo Rubber	5110 JP	Japan	U-PF	3,785	8.4
Toyota Motor	7203 JP	Japan	BUY	198,442	11.4
West	1407 JP	Japan	BUY	362	6.9
Yokohama Rubber	5101 JP	Japan	BUY	2,956	6.5
IAG	IAG AU	Australia	BUY	13,125	11.1

Source: CLSA

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E&S - Winds of change

There is no more "business as usual" in Asia. A host of new reform-minded governments in the region are pushing through sweeping changes. Nowhere is this more evident than in new environmental and labour laws, except perhaps in the actual enforcement of those laws. In China, Xi Jinping and Li Keqiang's war on pollution is the biggest example, with repercussions being felt across the region.

Tighter regulations has certain tradeoffs

Clearer skies, cleaner water, safer food and better labour laws are obviously good for the people living in Asia. These things are also beneficial for the companies that help provide those services, and those that already operate to global environmental and social (E&S) standards. However, tighter regulations will also introduce a great degree of risk and potentially cost for the corporate sector as well as investors.

China has declared war on pollution

Figure 21

Beijing's Forbidden City

Source: Greenpeace China

E&S scoring is not a good indicator of financial or share-price performance

Historically, issues around pollution and decent working conditions could be swept under the rug. Infractions went unpunished, or so lightly punished as to be immaterial, while better operators were rarely rewarded for their efforts. Thus, it is no surprise that E&S scoring has not historically been a good indicator of financial or share-price performance in the region. By contrast, many studies have shown the opposite to be true in Europe and the USA. As reporting standards and enforcement improve, we believe that Asia will move down the same path, and there are some concrete examples of this happening already.

Revamped scoring

Our E&S scoring system for this year's CG Watch has been revamped

From an investor's standpoint, the biggest challenge is establishing the issues that matter and then actually finding useful data on them. Disclosure is still poor, and there is not even consensus on what exactly needs to be reported. To better help investors identify winners and losers in this shifting landscape, we have revamped our E&S scoring system for this year's *CG Watch*, four years after we originally introduced it.

We provided a complete description of the changes and rationale in our 27 June CLSA U Blue Book, *How big are yours?,* written with Ben McCarron of Asia Research and Engagement (ARE). The biggest difference is that there is no longer one E&S survey, but 11, broken out by sector. This different approach from our core CG survey is, we believe, necessary.

Focus on long-term trends in environmental and social issues

An independent board is equally important whether you are looking at a bank in Hong Kong, a garment manufacturer in Bangladesh or a coalminer in Indonesia. However, the types of environmental and social metrics that matter vary dramatically between these three different categories of businesses. Worker safety, as one obvious example, is much less of an issue at the bank than it is for the other two. Our new sets of questions are built around long-term trends in environmental and social issues, and cross-checked with our relevant sector analysts.

War on pollution will hit sectors in different ways

China's war on pollution, for example, will hit sectors in different ways:

- For **technology** and **consumer** stocks, we focus on sustainability factors in the selection of suppliers. After having its reputational risk exposed very publicly three years ago, Apple has worked its way to the top of the pack on this front. Within Asia, Panasonic, Samsung and Hitachi, all top-quartile stocks in our E&S ratings, come out on top for third-party supply-chain checks in China. With the exceptions of (despite the bad press) Foxconn, Huawei and Lenovo, Chinese and Taiwanese brands bring up the rear.

Tightening of emissions and fuel-efficiency standards

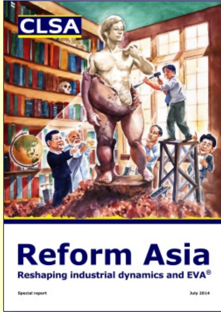
- For **autos**, emissions and fuel-efficiency standards are being tightened. Traditionally not a strong point for the big Chinese automakers, there is clear differentiation emerging. Guangzhou Automobile Group (GAC), Brilliance and Dongfeng score quite well on our questions about fuel efficiency, emissions and hybrids/electric vehicles (albeit not on par with the Japanese); Great Wall, less so.
- For **petro/chems**, we are already seeing more action on non-compliance to environmental rules in China. In August 2013, the environment ministry denied PetroChina and Sinopec any further licence approvals for new refinery capacity due to a poor record of violations in 2012. The ban on new sites lasted eight months and was lifted in April 2014, following significant improvements in emissions records at both companies. Sinopec stated that it invested Rmb5.15bn in environmental protection in 2013; PetroChina does not provide this estimate in its annual report.
- For **materials**, we focus on sufficient access to water. In China, 53% of coal reserves are in water-scarce regions (less than 1,000m^3 per capita) and 30% in water-stressed areas (less than 1,700m^3 per capita). Looking at Chinese coal producers' exposure to areas of water scarcity, China Coal, Yanzhou Coal and Fushan Energy look to face particular risk.

Water could prove a dark horse impacting the power sector as well

- While we focus on emissions standards for the **power** sector, water could prove a dark horse impacting this sector as well. Big-5 generation companies Datang Power was recently rewarded with a one-day 23% stock-price pop when it reduced its water risk with an announcement that it was offloading its thirsty coal-to-chem projects.

E&S questions and scores meant as both a screen and a discussion point with management

We look at these case studies and scores in more detail below. Ultimately, though, our E&S questions and scores are meant both as a screen and a starting point for discussions with company management that, we hope, will lead to new insight about long-term strategic thinking (or the lack thereof).



Changes you can see

As chronicled in our July 2014 *Reform Asia* report, 'Major political-economic reforms happening in Asia Pacific concurrently are unprecedented. Japan, China, India and Indonesia - arguably the four most important markets in the Asian universe - have all had political leadership changes within about 18 months. In each country, the reshaping of policy is leading to radical alteration in the way business is done.'

Li Keqiang's address regarding the War on Pollution

A war to end all wars

> The government will take strong measures to prevent and control pollution with the focus on mega cities and regions with frequent occurrence of smog. The government will also implement a clean-water action plan, strengthen the protection of drinking-water sources, prevent and control water pollution in key river basins and carry out land restoration. We will resolutely declare war against pollution as we declared war against poverty.
>
> We will . . . apply the strictest possible oversight, punishment and accountability to prevent and control food contamination and ensure that every bite of food we eat is safe.
>
> Premier Li Keqiang in his address at the 18th National People's Congress

The single-biggest driver for change across Asia is China's war on pollution

From an E&S standpoint, the single-biggest driver for change across Asia is China's war on pollution, which literally is rewriting the rules for "business as usual". The country's new environmental law, which was 25 years in the making and goes into force on 1 January 2015, at last gives the famously toothless Ministry of Environmental Protection (MEP) a set of fangs with which to go after offenders. Polluters that have historically gotten away with slaps on the wrist or less will now face prison terms, stunted careers and meaningful uncapped fines.

The environmental law is part of a comprehensive set of measures established to clean up the country's notoriously filthy air and water. Beijing's Airpocalypse in January 2013, when the capital's average daily PM2.5 level hit an all-time high of 755ug/m³ (more than 30 times World Health Organisation safety levels), was the catalyst that drove the environment to the centre of Xi and Li's agenda. But this is ultimately a populist move.

According to Nankai University in Tianjin, environmental concerns sparked 90,000 "mass incidents" in 2011[1]. In 2013, a Pew Research Center report[2] noted that environmental issues such as safety of food, medicine and the air quality were three of top five items that saw the greatest jump in concern by Chinese citizens from 2008 to 2013. And in 2014, the Chinese Academy of Social Sciences Institute of Law published data showing that environmental issues were the most important impetus for the largest public protests[3].

Rights to protest - albeit limited - are now enshrined in the new environmental law

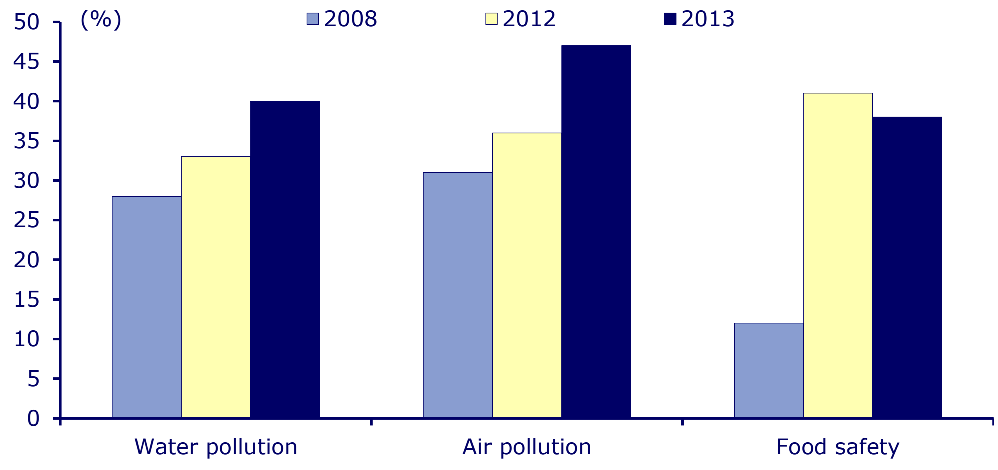
We wrote in detail on the growing success of rightful resistance in *CG Watch 2012*. This has gone a step further in 2014. No longer do protestors have to rely entirely on tacit approval of the central government (ie, *not* shutting down search terms or speaking out against the protestors), but their rights to protest - albeit limited - are now enshrined in the new environmental law.

[1] http://chinawaterrisk.org/resources/analysis-reviews/the-rise-of-protests-and-reputational-risk/
[2] http://www.pewglobal.org/files/2013/09/Pew-Global-Attitudes-Project-China-Report-FINAL-9-19-132.pdf
[3] http://www.bjnews.com.cn/graphic/2014/02/24/306216.html#rd

Mounting concerns

Figure 22

Share of respondents in China that view environment as a major problem



Source: Pew Research Center

Air pollution is the most visible battlefield, but certainly not the only one

It is beyond the scope of this report to detail all of the new measures that China is taking to wage its war on polluters. The administration's battle tactics for air pollution have been steadily evolving from its groundbreaking September 2013 Air Pollution Plan, which sets tough targets for 2017 and breaks out key initiatives to achieve them. Air pollution is the most visible battlefield, but certainly not the only one. The theatre of battle is, if anything, even more intense in water. We look at the impact of specific regulations within these broader initiatives in the individual sector sections.

Unintended consequences, inside and outside China

China's push to clean up wealthy coastal provinces has significant impact

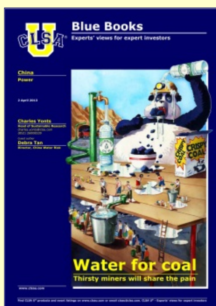
China's push to clean up its wealthy coastal provinces obviously has serious implications for power, resources and heavy industries in those areas. We look at the impact in more detail later in this report. However, the effects extend far beyond those specific industries and regions, both within China and beyond its borders. We can see this in polluted water in Xinjiang, drought in Thailand, forest fires in Indonesia and building collapses in Bangladesh.

Western water

Insourcing and Xinjiang's water

China's water problem arguably even trumps its air-pollution challenges in severity. The response is exemplified by the "3-Red Lines" policies[4] heralded in 2012, committing provinces to meet water consumption, intensity and quality targets by 2017. Despite setting a 2015 water cap for Xinjiang at 51.56bn m^3 in 2013[5], Xinjiang breached this cap a full two years ahead of schedule, consuming 61.7bn m^3 last year[6].

Xinjiang's water predicament has been exacerbated by new developments in coal-derived synthetic natural gas (SNG) production, which is billed as replacement fuel for coal in China's air-pollution plan. The government is targeting for 32bn m^3 of water and carbon-intensive[7] coal-derived SNG to be produced by 2017, thus transforming a solution for air pollution in the eastern provinces into a water-scarcity problem in Xinjiang.

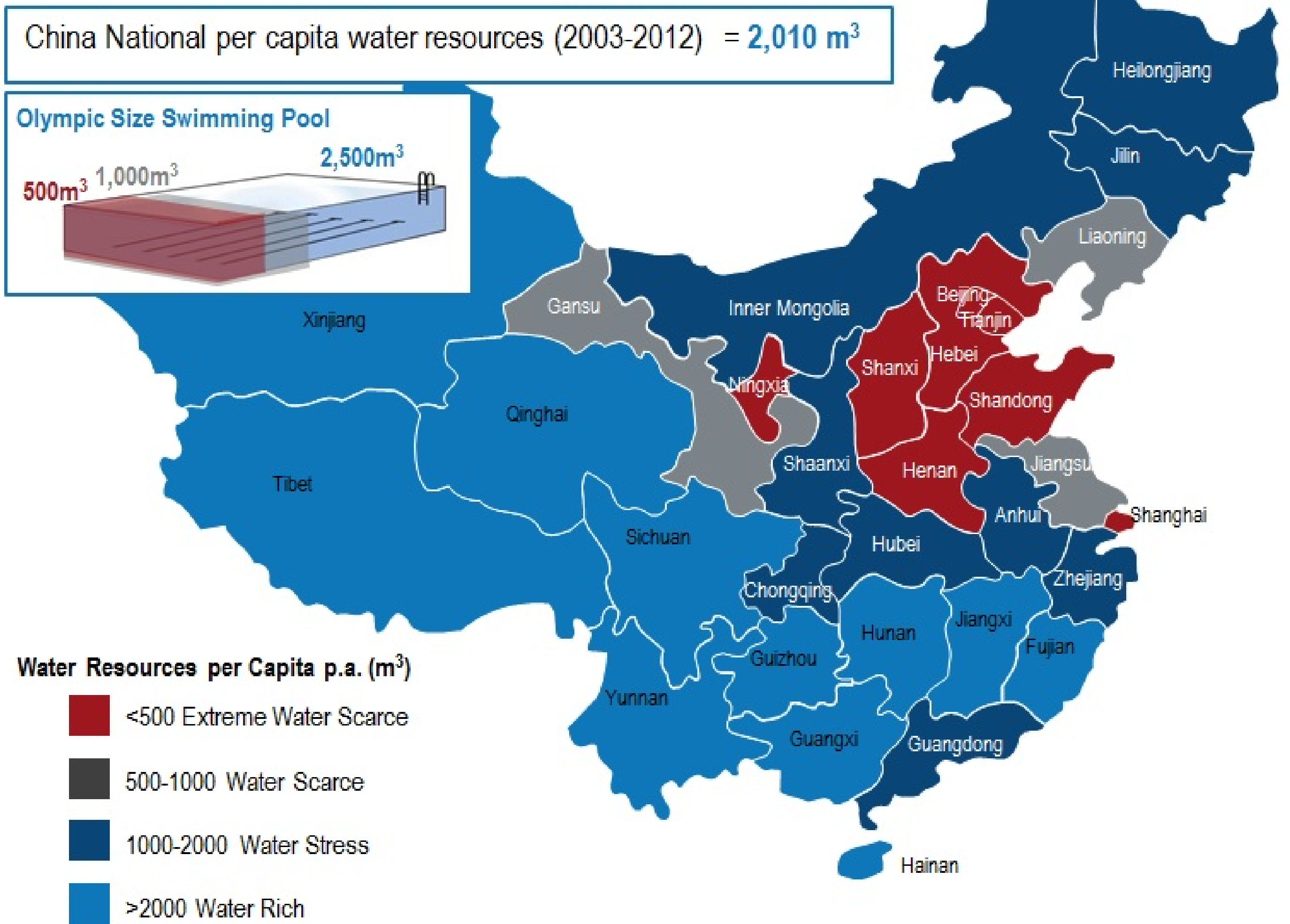


***Water for coal*, on coal's startling thirst**

[4] http://www.china.org.cn/china/2012-02/17/content_24664293.htm
[5] 2015 water cap: 51.56bn tonnes, 2020 water cap: 51.59bn tonnes, 2030 water cap 52.67bn tonnes
[6] http://www.gov.cn/gzdt/2014-01/06/content_2560419.htm
[7] http://www.sciencedirect.com/science/article/pii/S0301421512010786

Figure 23

China provincial water resources



Source: China Water Risk, China Statistical Year Book

This drive has important implications for our E&S ratings of materials companies, which we look at in more detail in the materials section on page 50. The breached water caps in Xinjiang specifically have major implications for another sector that is often left off the list of "high-impact" industries, but should not be . . .

Fashion faux pas

The fashion industry is trying to reduce its dependence on China

The fashion industry has been trying for some time to reduce its dependence on China, where it has faced tightening labour supply, rising wages and thus rising costs. Veteran labour consultant Rosey Hurst, from Impactt, details the latest trends and developments on page 43. This headlong rush into Bangladesh was partly responsible for the disastrous Rana Plaza building collapse that killed 1,138 people in April 2013.

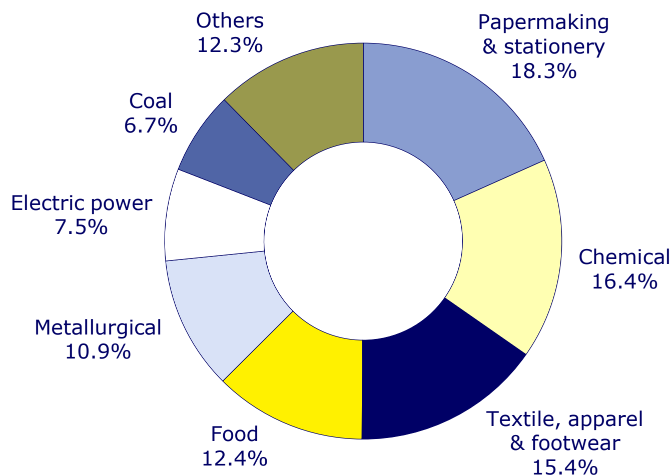
Fashion is also the second most polluting industry in the world behind energy

As we detail in our new CLSA U Blue Book, *Dirty thirsty fashion,* China's war on pollution will force more of an exodus. On some measures, fashion is also the second most polluting industry in the world behind energy. Within China, which produces 50% of the world's textiles, this is one of the top three industries both for water pollution and water intensity. Fashion is a key battleground in the current administration's war on pollution, with textiles and leather both on the Ministry of Environmental Protection's (MEP) watch list of 16 heavily polluting industries.

Third place in discharge

Figure 24

Industrial wastewater discharge tonnage by sector, 2011



Source: China Water Risk, MEP Environmental Statistical Yearbook

It is not a good time to get on MEP's naughty list

It is not a good time to get on MEP's naughty list, with the new environmental law (25 years in the making) taking effect from January 2015 and giving the famously toothless ministry a set of fangs. Just as the new law comes into effect, the textile, dyeing and finishing industries will start to face much tighter discharge standards. Doubly so in wealthy, coastal provinces, four of which - Zhejiang, Jiangsu, Guangdong and Shandong - account for almost half of China's yarn production, two-thirds of cloth and close to 80% of chemical-fibre production.

Fashion is also thirsty

Fashion is also thirsty. Some 13.5 bathtubs of water go into the production of one cotton t-shirt. Almost half of the world's cotton comes from China and India, two of the world's most parched nations, with 42% of China's cotton coming from areas in the country's bread basket with water resources on par with those of the Middle East. If push comes to shove, and it could, the argument for choosing cotton over wheat or corn, which requires less than one-sixth as much water, will be tenuous.

We look closer at the implications and relevant questions in the part on the consumer sector later in this section.

Rainforests

The country has been rightfully lauded for its massive afforestation programme, through which it is trying to stave off desertification in its arid northern plains.

Afforestation and forest protection in China forced Chinese to look overseas

Success in its primary goals is debatable, in large part due to the relatively fragile monoculture nature of the new forests. We had a closer look at the issue with Jonathan Watts of *The Guardian* in our 1 November 2010 CLSA U Speaker Series, *Green leap forward*. This afforestation and forest protection in China also forced Chinese to turn overseas more to meet their needs.

Knock-on effects are large. The weaker remaining forests are more susceptible to sickness and fires. To be fair, the most severe rainforest fires we have seen in recent years were driven by not just Chinese demand, but rising Asian demand for palm oil. We look at the environmental impact of Asia's insatiable hunger for palm oil in more detail on page 55.

Air pollution is not just a problem in China

Figure 25

Beijing again? No, Singapore . . .

Source: CLSA (Susan Chan, sales)

New ESG assessment framework

There are countless other environmental and social issues across Asia

China's war on pollution, as important as it is, is still only one theme. Of course, there are countless environmental and social issues across Asia that have little or nothing to do with China. And each of these themes and issues will impact different sectors in different ways. These data are generally not (yet) captured in financial statements, and reporting overall is still very spotty (see page 33 for more).

Against this backdrop, we ran a major overhaul of the E&S portion of the questionnaire, originally introduced four years ago, for this year's *CG Watch*. We provided a complete description of the changes and rationale in our June 2014 *How big are yours?* report.

Our new sets of questions are built around long-term trends in environmental and social issues, and cross-checked with our relevant sector analysts. In this new iteration of E&S ranking, we have also shifted towards more qualitative questions, and are relying on the analysts (rather than the companies) to fill in the survey. Ultimately, a lot of these data points (eg, carbon emissions) should be quantitative, but reporting is still too inconsistent to rely upon hard figures.

The new sector framework has three main components

The new sector framework has three main components: megatrend/ sustainability; sector-specific ESG; and general ESG factors. The first gets, by far, the heaviest weighting.

Megatrend/sustainability

The first is a set of questions that addresses the identified sustainability factors or megatrends. As each of these factors affects different industries in different ways, the questions tend to vary by sector.

Megatrends affect different companies in different ways

These megatrends affect companies from every sector, but they express themselves in different ways. For example, resource constraints are clear for oil producers (the International Energy Agency states oil & gas sectors in India and China will need US$2tn by 2035). Whereas in the auto industry, hybrid and electric vehicles are a new avenue of competition that may reduce dependence on oil and address carbon issues. Among materials companies, uncontested access to land and increasingly water represent key resource challenges.

Population growth is about ageing, not births

The demand side of the equation is also changing. Increased longevity, rather than new births, is now the main driver of global population growth. Population pyramids have turned into columns. For example, Japan has had four decades of declining births. Healthcare and finance are set to benefit.

Income distribution a factor for social stability

Income distribution is also key for demand and potentially for social stability, with inequality cited as one of the World Economic Forum's key global risks. The stage is set for a new aspirational Asian middle class to fashion the next consumer-led phase of growth. Will it benefit the poorest? What about the environment?

In addition, there are company- and sector-specific environmental, social and governance (ESG) issues. These include the well-known cases of supplier standards that were breached so badly at Rana Plaza in Bangladesh, food-safety issues in China, and data protection and privacy for online companies.

Megatrends have different relevance for different sectors

Figure 26

Sector exposure to sustainable development factors

	Resource constraints	Carbon abatement	Climate-change adaptation	Environmental pollution	Population columns	Income distribution
Auto	High	High	Low	High	Low	High
Capital goods	High	High	High	High	Low	High
Consumer	Medium	Low	Medium	Low	High	High
Financials	Medium	Low	Low	Low	High	High
ICT	Medium	Low	Low	Low	Low	Medium
Materials	High	High	Medium	High	Low	Low
Petrochem	High	High	Medium	High	Low	Medium
Power	High	High	Medium	High	Low	High
Property	Medium	Medium	Medium	Medium	Medium	High
Transport	High	High	Medium	High	Medium	High
Conglomerates	Varies	Varies	Varies	Varies	Varies	Varies

Source: ARE, CLSA

Sector-specific ESG

The next element includes issues that are more industry-specific

The next element includes issues that are more industry-specific. For example, the question of prudential and systemic risk applies to financial services, but not to auto manufacturing. On the other hand, questions around privacy and data protection apply to some information, communications and technology (ICT) companies.

Overall reporting is still limited

It is no secret that reporting on ESG factors is still full of holes, not just in Asia but globally. Bloomberg measures disclosure levels as part of its ESG effort. According to its numbers, 79% of global stocks report on ESG on a market-cap-weighted basis (just 17% on number of stocks), with an average disclosure score of 32 out of 100.

In terms of the share of companies that report on ESG metrics, HK, Australia, Japan and India score above the global average. In terms of scoring for the companies that do report, Northeast Asia (Japan, Taiwan and South Korea) and Australia bat above the global average.

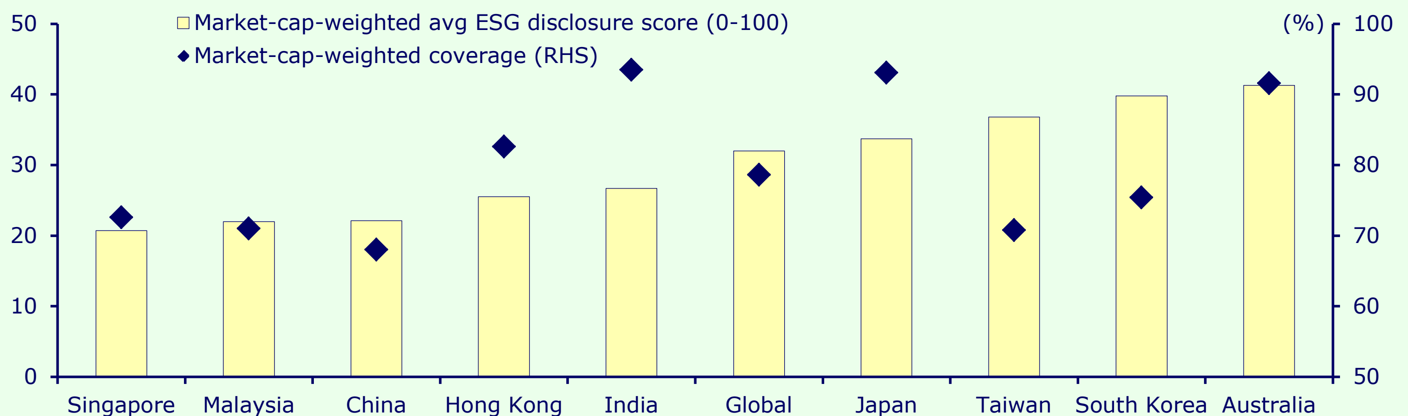
Bloomberg also breaks out reporting on Environmental, Social and governance scores separately.

1. For **environmental** metrics, Northeast Asia (South Korea, Taiwan and Japan) score above the global norm. As with social metrics, China and Japan have a much higher share of reporting companies.
2. For **governance**, Singapore, Malaysia, Hong Kong, Taiwan and Australia all score above the global average in terms of disclosure.
3. For **social** metrics, South Korea, Taiwan, Malaysia and Australia score above the global average. Neither China nor Japan score well, but both have a much higher reporting rate in terms of number of companies than the global average.

At first glance, China's high share of reporting could be surprising. Maybe it should not be, but it could be misleading. According to a recent report by sustainability consultant Syntao, 1,722 Chinese companies issued corporate social responsibility (CSR) reports in 2012, a large increase from just one in 2006. Yet, questions remain over whether this trend indicates increased transparency or just a form of greenwashing (or, less nefariously, box-ticking).

A few leading CSR companies in China have already adopted internationally accepted frameworks. For example, Baosteel, a state-owned iron and steel company based in Shanghai, has disclosed information according to Global Reporting Initiative (GRI) standards since 2006 and even reported information beyond the standard requirements. But based on Syntao's 2012 reports, only 17% supplied such critical information.

ESG disclosure scores and coverage by market cap



Source: Bloomberg

ESG disclosure scores by environmental, social and governance

	Environment		Social		Governance	
	Average score	% of companies	Average score	% of companies	Average score	% of companies
Australia	16.0	8	25.8	11	47.5	18
South Korea	20.5	7	24.4	11	43.3	12
Taiwan	26.5	5	34.6	5	46.6	11
Japan	27.5	27	21.5	31	44.6	50
India	11.2	12	12.6	9	43.3	22
Hong Kong	14.4	7	19.2	12	49.0	16
China	9.9	24	22.8	28	43.2	33
Malaysia	15.3	3	25.1	4	51.3	8
Singapore	14.9	5	18.3	7	47.4	10
Global	20.3	7	23.3	9	45.7	17

Note: As of 3 July 2014. Source: Bloomberg

Identify those that are more proactive in general

General ESG factors

The third component relates to general E&S management, to identify those companies that are more proactive in general in this area, irrespective of their exposure to the underlying issues. These are captured under the following headings: management; policy areas; targets; and incidents. These are broader-based issues that apply to all companies or catch specific incidents that are unique to the company, rather than trends across the sector.

Figure 27

General ESG factors applied to all sectors

Human-capital management	1. Does the company disclose staff turnover and how does this compare to peers?
	2. Have there been any significant labour-relations issues?
Policy areas	3. Does the company have a publicly stated policy on bribery and corruption?
	4. Does it consider social factors - such as carbon efficiency or labour standards - in selecting its suppliers?
Targets	5. Does it disclose CO_2-reduction targets?
	6. Does it disclose occupational health & safety (OHS) incident-reduction targets?
Incidents	7. Has the company been involved in any major incidents, where it had some responsibility, not covered in answers to previous questions?
	8. Has it received any major fines, or is there a track record of violations leading to smaller fines?

Source: ARE, CLSA

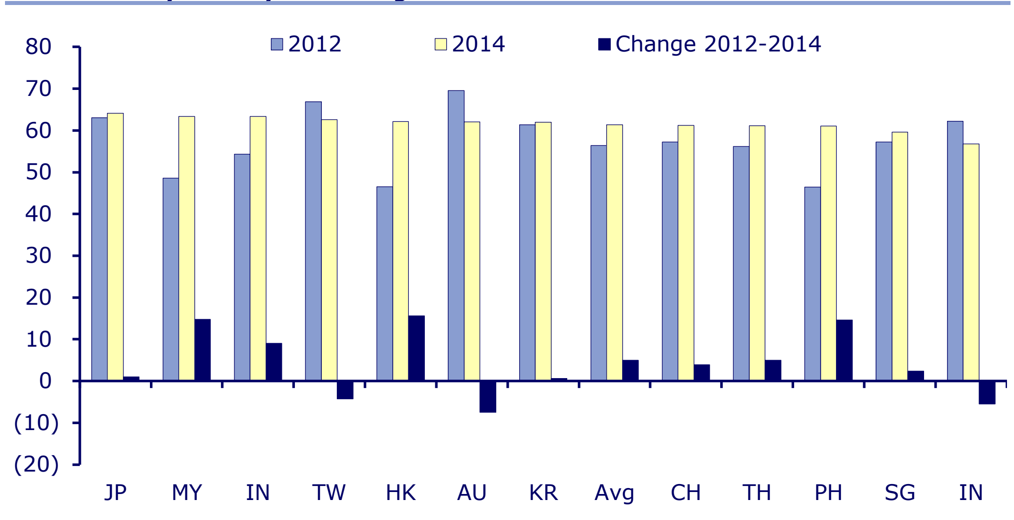
Japan comes out on top of the group

Scores by country

By country, Japan comes out on top of the group followed by Malaysia, India and Taiwan. Indonesia and, surprisingly, Singapore are laggards.

Figure 28

E&S scores by country and changes over 2012-14



Source: CLSA

We take a look at the E&S scores by sector next.

Yeah, but does it work?

Ultimately, what do ESG scores tell us about investment decisions? In a comprehensive 2010 study for the New York Society of Security Analysts (link here), Indrani De and Michelle Clayman showed that they are predictive for ROE performance and share-price returns. The study endeavoured to assess whether the various aspects of responsible investing were equally important for stock analysis. They also analysed ROE as a dependent variable, since investment managers often use it as an indicator of a firm's business performance.

Key findings

1. ESG scores have predictive power over total stock returns and financial performance measured by ROE. Companies with more strengths than weaknesses in the various ESG fields, tend to have higher medium to long run (three- to five-year) returns and ROE. These results hold even after controlling for the sector effect.
2. In keeping with our findings, De and Clayman found that among the subcomponents of the overall ESG score, governance (G) is the best predictor of stock returns, and the predictive power of this score was highest over the longer three- to five-year horizons. Even controlling for the sector effect, corporate governance scores had the highest predictive power for stock returns in the medium to long run, followed by the overall ESG score.
3. The social (S) scores have a greater positive impact on subsequent operational results in terms of ROE. The same predictive relationship continues even after controlling for the well-known size effect.
4. Investment managers can add alpha by incorporating extra-financial factors like the overall ESG score and, more specifically, the CG practices into their investment process.

Using CLSA's E&S data

We have run our companies' E&S performance against various financial and share-price metrics. Based on our findings, though, these factors do not consistently show any meaningful correlation to key financial metrics across sectors and countries.

It is still early days in terms of sustainability reporting in Asia. And, even when reporting is comprehensive, environmental and labour issues could easily be brushed aside for little or no money. However, reporting standards and enforcement are improving, and much faster. China's new environmental law taking effect in 2015 will push these changes into hyperdrive.

The key takeaway for us, though, is still that the greatest value in our database of ESG scores is as a starting point for sussing out companies' long-term strategic thinking. It is also useful as a screen to weed out the outliers ahead of black swan type events.

By country

In Malaysia, Taiwan, Thailand, Singapore, and Korea, absolute returns from top quintile scorers outperformed on both a five- and 10-year basis. Other countries are mixed. Top-quintile scorers tend to have higher ROEs, and also higher (14CL) PB. The difference between top/bottom quintiles is greatest for both in the Korea, Thailand, Taiwan and Singapore. E&S scores have been a poor predictor of net-profit growth, with higher scorers outperforming in around half the countries (led by Korea), and underperforming in the other half (Malaysia at the bottom).

By sector

Correlation of our E&S scores to share-price performance and financial metrics is mixed on a sector basis.

Where E&S works

Absolute returns for hotels & leisure, capital goods, healthcare, transport, insurance and power outperformed on both five-year and 10-year bases. Top-quintile names tend to have higher PB (14CL). Overall, we don't see a clear correlation for PE, ROE and net-profit growth with a few exceptions, most notable of which is healthcare.

Top-quintile transport, telecoms, insurance, capital goods, materials and healthcare stocks have had higher five-year ROE and net-profit Cagr than their bottom-quintile counterparts. Of these, transport, insurance, materials and healthcare were trading on lower PE valuations. Healthcare was also lower on a PB basis.

Where E&S doesn't work

Absolute returns for bottom-quintile companies outperformed in telecoms, conglomerates, autos, petro/chems, property, technology and consumer industries over five-year and 10-year periods.

Bottom-quintile stocks in autos, technology, petro/chems, and property sectors have had higher five-year ROE and net-profit Cagr. Of these sectors, petro/chems was also cheaper on a PE/PB basis compared to top-quintile companies. Property and consumer were cheaper on PB basis.

Correlation of E&S score to performance by country

	5Y US$	10Y US$	5Y ROE	14F PE	14F PB	14F ROIC	14F FCF yld	5Y net-profit Cagr
Diff- TopQ vs botQ	0.6	0.2	(0.8)	(0.2)	(0.5)	(0.1)	0.1	0.2
TopQ	0.0	(0.4)	(0.7)	0.1	(0.5)	0.0	0.2	(0.2)
BotQ	(0.6)	(0.3)	(0.3)	0.2	0.3	0.3	0.1	(0.5)

Source: CLSA

Correlation of E&S score to performance by sector

	5Y US$	10Y US$	5Y ROE	14F PE	14F PB	14F ROIC	14F FCF yld	5Y net-profit Cagr
Diff- TopQ vs botQ	0.2	0.0	0.0	0.0	0.0	(0.3)	0.4	0.3
TopQ	0.0	(0.3)	0.2	(0.3)	0.0	(0.2)	0.3	0.2
BotQ	(0.2)	(0.1)	0.1	(0.2)	0.0	0.2	(0.1)	(0.2)

Note: TopQ = Top quintile. BotQ = Bottom quintile. Source: CLSA

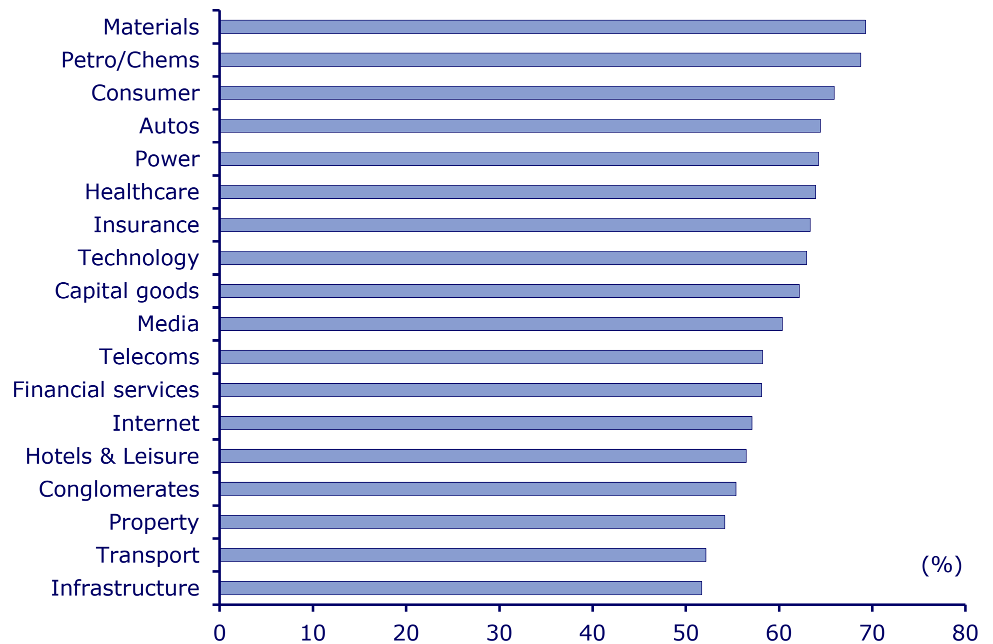
Scores by sector

Under the new scoring, the high-impact sectors have come out on top again, led by materials and petro/chems. This is initially counterintuitive, as these are, arguably, the two sectors most at risk from major E&S issues (oil spill, mine collapse, etc). As we have seen over the past four years, though, precisely because E&S issues pose so much more potential risk, investors and exchanges have pushed these companies for better disclosure on them, and earlier. This shows in the scores.

The high-impact sectors have come out on top again

Figure 29

CLSA E&S scores by sector (2014)



Source: CLSA

Autos

For the full list of questions and rationale by sector, please see our *How big are yours?* report. To give a feel for the rationale, we have included our summary of key issues for the auto sector in Appendix 6. The specific questions are broken down by sector below.

The auto sector is highly exposed to sustainability megatrends

In short: the autos industry is highly exposed to sustainability megatrends. Resource constraints and carbon abatement are already major considerations in R&D spending and in some cases revenue. On the societal side, income thresholds, urbanisation and wealth generation are primary demand drivers for the industry. Sector-specific issues include vehicle safety and industrial relations.

We list the top-quartile E&S scorers in the autos sector for which our analysts have positive recommendations in the following pages. The obvious standouts are Japan's big carmakers, with generally good labour relations and product safety. But their performance delta with other automakers is really driven by answers to the questions on the company's strategy regarding fuel efficiency (Q2, Q3) and alternative transport (Q5).

Japan's big players stand out

Figure 30

Top-quartile ESG scores in autos

Company	Code	Rec	ESG score (%)
Honda Motor	7267 JP	BUY	83.3
Toyota Motor	7203 JP	BUY	75.0
Bridgestone	5108 JP	BUY	72.9
Daihatsu	7262 JP	BUY	72.9
Tata Motors	TTMT IB	BUY	70.8
Nissan Motor	7201 JP	BUY	70.8
Minth	425 HK	BUY	68.8
Motherson Sumi	MSS IS	BUY	68.8
Denso	6902 JP	BUY	68.8
Hyundai Mobis	012330 KS	BUY	68.8

Source: CLSA

Japanese focus on efficiency 'is driven partly by their early moves into alternative drivetrains'

As analyst Chris Richter explains, the Japanese focus on efficiency 'is driven partly by their early moves into alternative drivetrains, as exemplified by the Prius hybrid. Partly, this was a strategic decision indicative of far-sighted management, and indeed, they found going down this road a source of product differentiation. In addition, there has been a bit of a snowballing effect. As green cars became more popular in Japan, tax benefits were rolled out for bona-fide green vehicles to encourage more use of them in their lineups. Moreover, what gets sold in Japan also reaches the four corners of the world, because it makes their products distinctive.

Majority of Honda sales are hybrids

Honda. Honda says that the majority of sales for the Fit subcompact and Vezel crossover SUV - its two most popular products - are for the hybrid versions, greatly increasing hybrid penetration. Incidentally, these same two products are what are being made in Honda's new manufacturing plant in Mexico, although Honda is not yet sure if American consumers will pounce on the hybrids, or go for the cheaper non-hybrid versions, so they are playing it safe. In addition, Honda's new plants, including a new facility in Japan, achieve best-in-class carbon emissions from an innovative paint system are showcased. Its other new plants in India, Indonesia and Mexico feature similar systems.

Toyota continues to spread hybrids out further across its lineup

Toyota. Toyota, which still enjoys a big lead in hybrids, continues to spread these models out further across its lineup. Indeed, the company has three models in its US lineup bearing the Prius name, making it more of a brand - a brand known for greenness - than a specific model. The automaker plans to take it one step further next year as it rolls out the world's first commercially available fuel-cell vehicle. While it is expected to be pricey, at approximately US$55,000 per unit, the carmaker has been working with governments in deploying a nascent hydrogen-fuelling infrastructure in Japan and California.

Nissan continues to advance its electric-vehicle programme

Nissan. The automaker continues to advance its electric-vehicle (EV) programme. Having finished a large addition of battery capacity in the US state of Tennessee, Nissan can now sell as many EVs as the market can bear. And interestingly, despite the hype, it sells more EVs than Tesla. The company has expanded its EV lineup to include a commercial vehicle, and are working on a new battery chemistry to increase range, with an eye of

putting it in an Infiniti-branded model. Nissan continues to focus on prismatic lithium-ion cells, which cost the company on range, but are inherently safer than actively cooled systems, relying on passive air-cooling of the cells to avoid overheating.'

Newer technologies have caught up to mini-vehicles in terms of efficiency

Daihatsu. Daihatsu and its mini-vehicle rivals realise that they cannot just sit on their laurels just because they produce 660cc mini-cars. That is true, especially as some of the newer technologies have caught up to mini-vehicles in terms of efficiency and because the authorities do not simply put the mini-vehicles into the eco-car category. Both have developed mini-vehicles with quasi-hybrid systems that keep the pint-sized vehicles affordable for low-income consumers, but achieve fuel economies in excess of 30km/L (70mpg).'

Figure 31

Prius plug-in hybrid

Source: Toyota Motor

Figure 32

Autonomous driving prototype Nissan Leaf

Source: Nissan Motor

Is China ready?

Beijing is driving up fuel efficiency more aggressively

As part of its air-pollution action plan, Beijing is driving up fuel efficiency more aggressively, naturally with implications for the automakers. Revisiting the survey questions about fuel efficiency, emissions and hybrids/EVs, GAC, Brilliance and Dongfeng score quite well. As analysts Scott Laprise and Geoff Boyd explain, this makes a lot of sense.

GAC is geared to Toyota, Brilliance is geared to BMW, and Dongfeng is geared to Nissan/Peugeot and Honda, though in-house capabilities are less clear. Interestingly, Prius sales in China have not taken off yet as they are not produced there and the government doesn't seem to be promoting them enough. It would, though, be easy for Toyota to move production over if they think there is a market.

Great Wall is behind the curve

As a pure Chinese maker, Great Wall is behind the curve and scores at the bottom of the group overall for E&S as well as the three focus questions. Although they are buying some technology from foreign suppliers, environmental metrics are not a top priority.

Chinese auto-components maker Minth also hits top quartile

Minth has very strict controls on production process

Analyst Timothy Lee explains autoparts company Minth's high E&S score: Minth has very well-managed production sites with good controls on materials and resources utilisation. Basically the key production process that generates pollution is electroplating, but the company has very strict controls on the process. We are not aware of any incidents of waste leakage, accidents, etc. On the other hand, the business is related to the auto industry, which benefits from the emerging middle class in Asia.

Figure 33

Autos ESG checklist

Megatrend/sustainability	Questions
Resource depletion	❑ Does the company's profitability or growth depend on high-resource-intensity products (eg, motorbikes versus cars versus SUVs)?
	❑ Does the company have a convincing story on fuel efficiency?
	❑ Does it disclose fleet average mileage statistics?
	❑ Is it experimenting with business models offering mobility as a service?
Carbon abatement	❑ At what stage is the company on alternative energy sources (fuel cells, hybrids, EV) - nowhere, relevant R&D, commercial trials, viable product?
Climate-change adaptation	❑ Are its manufacturing operations in areas likely to be hurt by climate change?
Environmental pollution	❑ Does the company sell into markets where there is potential for significantly tighter environmental regulation?
	❑ Is it well positioned on particulate-emissions abatement?
	❑ Has it been subject to incidents or enforcement actions relating to its manufacturing?
Population columns	❑ To what extent is the company exposed to increased/reduced demand due to an ageing population?
	❑ Does it face the risk of falling productivity due to an ageing workforce?
Income distribution	❑ To what extent is it positioned to take advantage of the emerging middle class in Asia?
Sector-specific ESG	
Customer safety	❑ What is the company's record on product recalls?
Labour relations	❑ What is its record on industrial relations?
	❑ What is the employee turnover rate relative to industry?

Source: ARE, CLSA

Capital goods

Main exposure for capital-goods companies is through changing demand patterns for its products

The main exposure for capital-goods companies is through changing demand patterns for its products. Those selling equipment to obtain resources, to improve resource efficiency, or to reduce environmental pollution are likely to be well positioned for changing market conditions. This is a more important factor than companies' direct footprints. Capital-goods players can also benefit where wages rise steeply, creating demand for automation. The safety record is a factor within a company's control that can be highly significant.

Question: To what extent is the company exposed to end-markets that stand to gain in resource-constrained scenarios? (Q1)

Figure 34

Top quartile ESG scores in Capital goods

Company	Code	Rec	ESG score (%)
Komatsu	6301 JP	BUY	75.6
Hyundai E&C	000720 KS	BUY	71.1
Airtac	1590 TT	BUY	68.9

Source: CLSA

'Komatsu is generally the technological leader globally for construction machinery'

Analyst Ed Bourlet writes of Komatsu, which scores at the top of the group: 'As a leader in cost cutting within machinery, it has put immense amount of focus on reducing electricity consumption, both in and out of the production process. With energy efficiency in mind, it was the first to commercially introduce hybrid excavators. With safety (and cost savings for the end-user) in mind, it has commercialised autonomous dump trucks (no one else has) and has refused to get involved with underground mining, which it deems too dangerous an activity for it to promote through providing machinery. Komatsu is generally the technological leader globally for construction machinery.'

Figure 35

Capital-goods ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ To what extent is the company exposed to end-markets that stand to gain in resource-constrained scenarios?
	❑ Is the company investing in reducing its direct resource usage?
Carbon abatement	❑ To what extent is the company innovating to deliver enhanced efficiency through its offering?
	❑ To what extent is it investing in carbon efficiency in its production?
Climate-change adaptation	❑ To what extent is it a potential beneficiary of climate-adaptation-related spending?
Environmental pollution	❑ To what extent is the company exposed to end-markets that are likely to suffer from higher levels of regulation?
	❑ To what extent is it likely to be subject to increasing SOx, NOx, noise, or particulate-emissions regulation that could drive up capital and/or operational costs?
	❑ To what extent is it providing solutions to pollution problems?
	❑ Has it been involved in spills or violations?
Population columns	❑ To what extent is it exposed to increased/reduced demand due to an ageing population?
Income distribution	❑ To what extent is the company positioned to benefit from accelerating substitution of capital for labour?
Sector-specific ESG	
Safety record	❑ Does the company provide credible evidence that it is managing safety (strong policy, incident rates, etc)?
	❑ What is its safety track record?

Source: ARE, CLSA

Conglomerates

Proactive identification and management of key ESG risks is the main differentiator

Conglomerates hold assets in multiple sectors with multiple risks. The key question is whether they are systematic and proactive in identifying risks at their portfolio companies. While they have little direct competition between their subsidiaries, Swire Pacific and Jardines (group companies score in the bottom half of our E&S rankings) occupy opposite ends of the spectrum in terms of their approach to ESG management.

Japan is well represented in the top quartile

Japan is well represented in the top quartile, as detailed below. Singapore's Sembcorp Industries also scores near the top, with major businesses focused on waste-to-resource and recycling, but did not make the table as it is currently (as of production date) ranked an Underperform.

Figure 36

Top-quartile scores in conglomerates

Company	Code	Rec	ESG score (%)
Larsen & Toubro	LT IB	BUY	73.2
Kawasaki Heavy	7012 JP	O-PF	68.3
IHI	7013 JP	O-PF	65.9
Ayala Corp	AC PM	O-PF	65.9

Source: CLSA

Japanese conglomerates have improved all around

On the Japanese conglomerates, analyst Ed Bourlet says: 'This is traditionally a sluggish subsector to get its act together, but over the past five years, these heavies had improved all round, including governance as well as return focus. They emphasise clean energy on multiple levels, employ for life and take pride in internal training.

As a leading Japanese heavy, Kawasaki Heavy manufactures and continues to research into a plethora of environmentally friendly products that range from more-efficient jet engines to power-generating equipment, engines, waste-incineration plants and motorbikes. An internal coup in 2013 has refocused its attention on restructuring and focusing on products where it can add value.

Another major theme is turbochargers

Another leading Japanese heavy, IHI, has a focus on the latest and best energy-efficient airplane jet engines. Another major theme is turbochargers where it is among the top four global players. Turbochargers allow for engine downsizing while maintaining power levels, thereby reducing pollution in and increasingly regulated market. IHI is a global leader in ultrasupercritical coal boilers as well.'

Figure 37

Conglomerates ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ To what extent does the company's sector or concentration present risks or opportunities in relation to resource constraints?
Carbon abatement	❑ To what extent does its sector or concentration present risks or opportunities in relation to carbon abatement?
Climate-change adaptation	❑ To what extent does its sector or concentration present risks or opportunities in relation to climate-change adaptation?
Environmental pollution	❑ To what extent does its sector or concentration present risks or opportunities in relation to environmental pollution?
Population columns	❑ To what extent does its sector or concentration expose the company to increased/reduced demand due to an ageing population?
Income distribution	❑ To what extent does its sector or concentration present risks or opportunities in relation to income distribution?
Sector-specific ESG	
Other ESG areas	❑ To what extent does its sector or country concentration expose it to other areas of ESG risk or opportunity?

Source: ARE, CLSA

Consumer

Middle-class growth and ageing consumer are two key demand drivers

The key question for companies in the sector is how well they are positioned to benefit from the structural growth themes of the Asian middle-class consumer and the ageing population. This is clearly fundamental to top-line expansion for consumer companies.

Resource constraints are less relevant for consumer sectors

Generally, resource constraints and environmental issues are less directly relevant for the sector, with food-related industries the notable exception, where supply factors are critical. The main issues are consequently the relationship with the consumer - responsible marketing and product safety - and a growing awareness of the importance of managing both environmental and labour standards in the supply chain.

Relationship with the consumer is important

Figure 38

Top-quartile scores in consumer

Company	Code	Rec	ESG score (%)
Unicharm	8113 JP	BUY	86.5
Shiseido	4911 JP	BUY	80.8
CP All	CPALL TB	BUY	78.8
Kao	4452 JP	BUY	76.9
Kose	4922 JP	BUY	76.9
Lion	4912 JP	BUY	76.9
Giant Mfg	9921 TT	BUY	76.9
Ajinomoto	2802 JP	BUY	75.0
CP Foods	CPF TB	BUY	75.0
Emperador	EMP PM	BUY	73.1

Source: CLSA

There is a broad cross-section of consumer companies across the region represented in the top quartile.

Analyst Oliver Matthews argues that Japan's heavy presence at the top of the group is not accidental.

Shiseido, Unicharm and Kao all have good environmental policies

'Shiseido, Unicharm and Kao all compete in the consumer goods and all sell items that have contact with your body. As a result, all have clear policies about environmental impact that can be a positive factor in the brand, as media do routinely explore these areas of the companies. This is especially true in Japan, where we have had major environmental issues with radiation in recent years.

Kao responded to Kanebo's 2013 incident appropriately

Kao had a major product incident in 2013 with one of its cosmetics brands, Kanebo, which led to skin burns of 18,000 consumers. However, while initially the media focused attention on malpractice, the parent company Kao provided medical treatment to each victim, and is now involved in a case-by-case compensation programme. While the incident was highly damaging to the Kanebo brand, and sales did decline, the company's overall strong reputation and ability to respond to such a terrible incident appropriately remind us the importance of having a strong code of conduct.'

Supplier standards

Question: How does the company ensure that its suppliers are not cutting corners in a way that could affect its reputation?

Incidents such as Rana Plaza collapse drive consumer awareness of supplier standards

Consumer-product supply chains are long and complicated, with many steps between producers and end-users. Every now and then that gap closes. The Rana Plaza collapse on 24 April 2013 in Bangladesh was once such occasion that clearly established the link in consumers' minds between cut-price clothes and hazardous worker conditions in developing countries. This followed a fire at the Tazreen factory on 24 November 2012. The death tolls of the two incidents were 1,138 at Rana Plaza and 112 at Tazreen.

The deadliest accidental structural failure in modern history

Figure 39

Dhaka Savar building collapse

Source: Rijans, Flickr

Li & Fung's sourcing business came under the spotlight

Li & Fung is one of the largest global-sourcing companies in the world, acting as a buyer for many of the world's leading consumer retail brands. While the brands took the brunt of the criticism, Li & Fung was also considered at fault in failing to ensure adequate safety standards at its suppliers.

Supplier standards are now under the chairman's watch

The compliance and sustainability team now reports through group chairman, William Fung. The company participates in the US-based Alliance for Bangladesh Worker Safety and is an adviser to the European-based Accord on Fire and Building Safety. In addition, the company is setting up a vendor-services consultancy to provide advisory services on health and safety. It remains to be seen whether such steps will be enough to reposition Li & Fung as a solution to the challenges of managing supplier ESG standards.

With the changes, Li & Fung scores just outside the top quartile for consumer stocks. Notably, it scores high marks on questions 18 ('Does the company provide a credible story on how it maintains supply chain standards?'), and 22 ('Does the company consider . . . labour standards in the selection of its suppliers?'). With the push towards consolidation in the supply chain following the Rana Plaza disaster, sector leader Li & Fung has benefitted, as has its share price.

What you see isn't necessarily what you get

Rosey Hurst, Impactt founder

As fashion OEMs come under ever-increasing price pressure from international brands and retailers, they should be investing in efficiencies to secure long-term partnerships. However, a propensity for poor planning has pushed them down other less salubrious paths. In China, we are seeing mass fraudulent use of the benefits system to boost cashflow and reduce expenses - we estimate 30% of workers do not receive social-insurance benefits, which would add an estimated US$35,448m to the yearly wage bill - 1.64% of national export value.

We are noting the rise of zombie factories that are gradually run down so as to avoid the costs of retrenchment, while assets are leached away. Springing up in their stead are tens of thousands of small and semi-formal manufacturing units where costs are lower at the expense of legal compliance. In Impactt's 2014 data set, failure to pay the minimum wage, forced labour, incidence of child labour and lack of freedom of association are all significantly more prevalent in these smaller units. But even this doesn't mean a return to cheap labour in China: in 2014, Impactt noted a real rise in take-home wages for production workers in China of 13% to US$477 per month.

So where is labour cheap? Bangladesh has been the answer to that question for the past 10 years. But the Rana Plaza tragedy and fires at Tazreen Fashions and others are proving costly to clean up. We estimate that the costs for remedying failures across the Bangladesh garment industry will amount to 18% of export value. Bangladesh isn't looking so very cheap any more. So who is paying for low retail prices?

We live in an age of the free movement of capital, and of restriction in the movement of labour. The rise in people trafficking and modern-day slavery, with its links to organised crime, is supplying cheaper labour to maintain low retail prices. Trafficked people are all-pervasive in supply chains. They are to be found processing prawns in Thailand, assembling telephones in China and Malaysia, in printing and packaging in Singapore, picking apples in the USA; gathering hazelnuts in Turkey, making garments in the UK and harvesting carrots in Spain. This is the darker side of the much-vaunted "return home" of manufacturing industry.

Retailers and brands are lobbying governments to increase regulation, which even in the West is woefully inadequate. In Europe, the rise of UKIP and other anti-federalists is sending clear signals to the Centrist parties on curbing immigration for work and increasing regulation and enforcement. This dual pressure may lead to increased regulation and enforcement, which, if ineffective, risks driving the problem further underground, promoting a dual labour market - a smaller number of high-cost, high-quality jobs available to citizens, and underground, cheap and nasty jobs for those outside the pale.

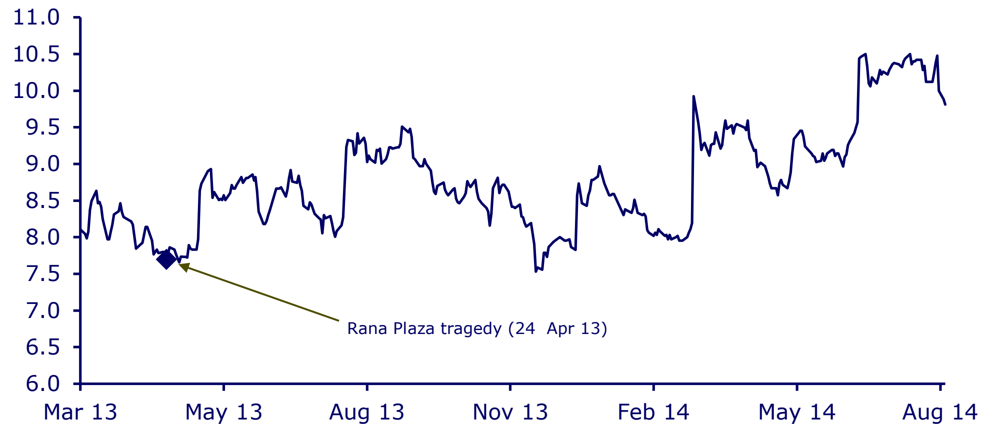
This scenario begs some questions for us to ponder over the coming months:

- Should this matter to investors at all - especially since economists tell us that, under the right conditions, slavery is good for efficiency!
- Can brands have their cake (legal labour conditions) and eat it (cheap prices) with government picking up the bill? Who will bear the costs of regulation, if that is the way the cookie crumbles?
- Will this mean that "good brands" price themselves out of the market?
- What does this mean for less mobile and more visible sectors, for example tech and automotive? Will they suffer more price inflation than more portable sectors?

Has benefited from push towards consolidation in the supply chain post incidents

Figure 40

Li & Fung's share-price performance



Source: Bloomberg

Figure 41

Consumer ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ To what extent is the company exposed to resource constraints in it supply chain, including water or agricultural product constraints?
	❑ Has the company invested in supply-chain diversification or resilience to mitigate potential sourcing problems?
	❑ To what extent is it making use of recycled product?
	❑ To what extent is it investing in new products that are efficient to use?
Carbon abatement	❑ Is the company investing in reducing manufacturing-related emissions or packaging?
Climate-change adaptation	❑ Is it operating in areas likely to be increasingly affected by climate change in a way that could disrupt operations (eg, beachside resorts)?
Environmental pollution	❑ Has it been involved in any water or air-pollution-related incidents or violations?
Population columns	❑ To what extent is the company exposed to increased/reduced demand due to an ageing population?
	❑ Has it developed products to address the growth in older consumers?
Income distribution	❑ Are the company's product areas set to participate in growth in disposable income and is the company likely to benefit?
Sector-specific ESG	
Product safety	❑ Does the company have a credible story on how it maintains product-safety standards?
	❑ Has it suffered any product-safety incidents?
Responsible marketing	❑ Are there significant social costs associated with consumption or overconsumption of the company's products?
	❑ Does the company face potential risk from regulation/taxes, etc, on account of these social issues?
	❑ Is it taking steps to mitigate these risks?
	❑ Is it factoring these issues into product innovation (eg, healthy foods)?
Supply-chain standards	❑ Has the company been involved in any supply-chain incidents?
	❑ Does it provide a credible story on how it maintains supply-chain standards?

Source: ARE, CLSA

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Financials

(This subsection is written with help from Jan van der Schalk)

Following the global financial crisis (GFC), a major question for financial-services companies has become the extent to which they are exposed to systemic or prudential risk-management issues. Financial institutions' exposure to changing customer demographics can be a major revenue driver, including both ageing populations and the development of the Asian middle class.

Social factors such as systemic and prudential risk are more important since the financial crisis

While banks have a relatively low direct environmental footprint, they can be exposed to ESG risk through their lending portfolios. This presents a concern where lending portfolios are concentrated in high-risk areas or where there is little consideration of ESG risks in credit/asset-management processes.

However bank funding of environmentally destructive projects remains a concern

Figure 42

Top-quartile scores in financials

Company	Code	Rec	ESG (%)
MUFG	8306 JP	BUY	70.0
SMFG	8316 JP	BUY	70.0
CCB	939 HK	BUY	67.5
HDFC	HDFC IB	BUY	65.0
77 Bank	8341 JP	BUY	65.0
BDO	BDO PM	BUY	65.0
E.Sun FHC	2884 TT	BUY	65.0
Bangkok Bank	BBL TB	BUY	65.0
Krung Thai Bank	KTB TB	BUY	65.0

Source: CLSA

Regulatory interference, country and global oversight has increased markedly

Banks, however, have suffered significantly from reputational risk that has led to invasive measures being introduced, particularly in Europe and the USA, around pay structures, very much in attempt to align remuneration with risk-taking behaviour. From this perspective, regulatory interference, country and global oversight has increased markedly and, we believe, is set to continue.

Part of this oversight comes in the form of banks being designated as "systemically important": this will set in train a series of drivers where transparency of exposure and risks will be considered as paramount. Consequently, when we look at governance trends in the banking world, we see increased pressure to separate various elements of banking, where "exotic" business lines, like investment banking and asset management, are likely, over time, to be separated from the straightforward activities of personal and commercial lending.

Banks tend to derive value from running a "vertically integrated" model where they obtain deposit funding from the customers, provide them with loans and manage their capital and assets. It might therefore even be the case that over time, the world reverts to a model of personal and commercial banks.

Link between performance and growth of FUM to break down over the long term

Wealth management. Without fail all wealth managers will emphasise the link between performance and growth of funds under management (FUM), and while this relationship is undeniable, we think it is starting to dilute and, over the long term, break down. Investors are increasingly aligning themselves with the "brands" of wealth managers, not just with their returns. Returns and how they are generated are starting to become interconnected.

Leading hedge funds becoming more "activist" in their approach

While fund managers and funds that focus on governance are now commonplace, increasingly ethical screens and styles are being sought and demanded by clients. A mantra of "wealth worth having" is becoming a serious consideration for retail investors. As an interesting corollary of this trend, hedge-fund strategies are associated with the heyday of pre-GFC investing and, at a minimum, the nomenclature needs to be changed. In fact, the hedge-fund industry has adapted and transformed itself, with the leading exponents becoming more "activist" in their approach and many emphasising the long-term nature of some of their holdings in combination with being unflinching in exposing corporations that are, in a myriad of ways, guilty of harbouring "lazy capital".

Furthermore, over the shorter term, we see a market where expensive index-hugging funds/investment styles become obsolete: index-tracking is cheap and, at the other end of the spectrum, those funds that can consistently produce alpha will flourish.

Insurance scores climbed the most of any subsector in 2014

Insurance. Life: Longevity (the risk of retirees outliving their assets) is becoming a serious concern in the developed world. Not only does this long-term risk put a greater demand on governance, it also requires life insurers to seek out new assets that provide the kind of regular, steady and long-term returns to satisfy the liabilities they have taken on. Long-term trends like climate change could materially impact these assets.

Natural disaster: General insurers need to be thinking about how to respond, in terms of pricing risk to climate change. Better still, responsible insurers are already thinking about how to be actively involved in risk-mitigation measures and programmes.

Reinsurance sits at the "pointy end" of climate change

Reinsurance: This sits at the "pointy end" of climate change - while catastrophic occurrence might not, of late, have occurred as frequently as in the periods of 1978-2001, their severity has increased. Can this risk be managed in the private sector? Is it appropriate for this kind of risk to be subject to market forces?

Insurance's ESG scores climbed the most of any subsector in 2014. This is largely a reflection of our new scoring system, which focuses on positive exposure to environmental and social trends as opposed to just negative (as was the case). Specifically, insurance companies score well for their servicing of evolving consumer needs, especially in emerging middle class and ageing populations. With a large contingent of big state-owned enterprise (SOEs), insurance companies and other financial-services companies tended to score well as being "systemically important".

Insurance's ESG scores climbed the most of any subsector in 2014

Figure 43

Top-quartile scores in insurance

Company	Code	Rec	ESG score (%)
Samsung F&M	000810 KS	O-PF	77.5
AMP	AMP AU	BUY	77.5
Dongbu Insurance	005830 KS	O-PF	75.0
IAG	IAG AU	BUY	72.5
Samsung Life	032830 KS	O-PF	70.0

Source: CLSA

Figure 44

Financials ESG checklist

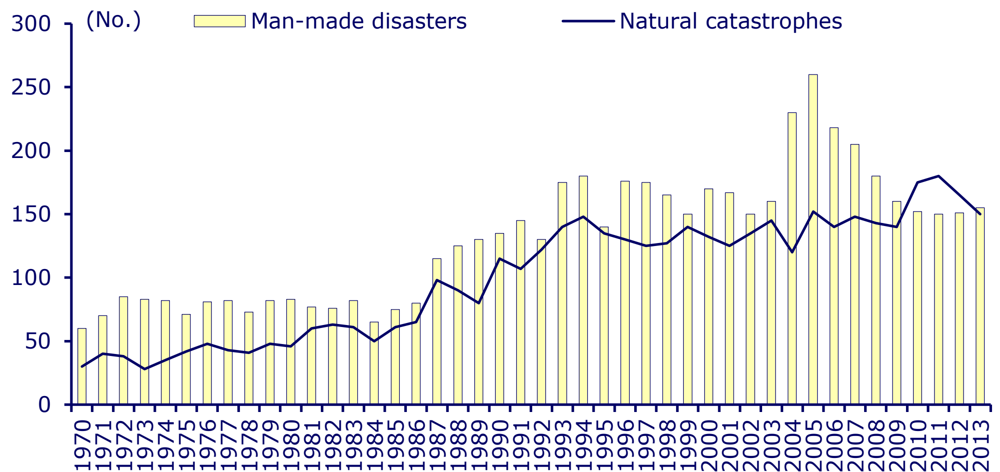
Megatrend/sustainability	Questions
Resource constraints	❑ Does the company have concentrated exposure to industries/assets with significant resource risk or other supply-chain dependencies (fossil fuels, water, mining, agriculture, forestry)?
Carbon abatement	❑ Does the company have significant exposure to high-carbon infrastructure, particularly coal?
	❑ To what extent is the company positioned to benefit from financing low-carbon infrastructure?
Climate-change adaptation	❑ To what extent is the company positioned to benefit from adaptation-related infrastructure?
Environmental pollution	❑ To what extent is it financing highly polluting industries?
	❑ Is the company a signatory to the Equator Principles, the Green Bond Principles, or the Banking Environment Initiative?
Population columns	❑ To what extent is the company positioned to meet the evolving needs of consumers in its target geographies - particularly for ageing consumers?
Income distribution	❑ To what extent is the company positioned to meet the evolving needs of consumers in its target geographies - specifically where there is an emerging middle class?
Sector-specific ESG	
Systemic/prudential risk management	❑ How systemically important is this financial institution?
	❑ How is the company managing its systemic risk profile (eg, capital adequacy, liquidity and overall risk management)?
ESG credit/asset-management risk	❑ To what extent is the company demonstrating an assessment of ESG risks in its credit and/or portfolio-management processes?
Appropriate products	❑ Has the institution been involved in any particular product-related controversies?

Source: ARE, CLSA

Catastrophic occurrence might not have occurred as frequently as in 1978-2001, but their severity has increased

Figure 45

Number of man-made disasters and natural catastrophes



Source: SwissRe

Information, communications and technology (ICT)

ICT offers significant opportunities to reduce resource intensity

ICT products and services - spanning technology, consumer electronics, telecoms, internet and media companies - offer significant opportunities to reduce resource intensity. The sector also creates wealth, opportunity and empowerment through broader access to information. Direct resource and operational efficiencies and health and safety are also relevant. Worker standards can cause reputational issues. Questions around privacy and data protection are gathering momentum and it is unclear how these will resolve in the future.

We break out top-quartile companies in technology and consumer electronics in Figure 46.

TSMC ends up at the top of the list . . .

Figure 46

Top-quartile scores in ICT

Company	Code	Rec	ESG score (%)
TSMC	2330 TT	BUY	82.7
Hitachi	6501 JP	BUY	78.8
Canon	7751 JP	BUY	78.8
Nikon	7731 JP	BUY	75.0
Sharp	6753 JP	BUY	75.0
Fujitsu	6702 JP	BUY	73.1
Novatek	3034 TT	BUY	73.1
HMI	3658 TT	BUY	73.1
Toshiba	6502 JP	BUY	71.2
SPIL	2325 TT	BUY	71.2

Source: CLSA

For core tech, perennial blue chip TSMC ends up at the top of the list, which should come as no huge surprise given well-established sustainability and governance initiatives.

. . . joined by a number of Japanese companies

TSMC is joined by a number of Japanese companies. Analyst Christian Dinwoodie explains Canon's high scores: 'Canon thrives on a culture of sustainability across its product and corporate strategies. The company has been a leader in developing innovative recycling technology for office equipment. Canon's capability to innovate and acquire new health and factory-related technologies has also helped to reduce waste and improve health delivery. Canon also spreads best sustainability practices from Japan to its overseas production and sourcing locations.'

War in tech

The global tech sector and China don't always see eye-to-eye

The global tech sector and China don't always see eye-to-eye. There is no shortage of conflict issues around intellectual property (IP) and labour (think Foxconn), among other things. All of these areas do feature prominently in our new E&S questions for tech. In the context of China's war on pollution, though, the key questions are around water availability and quality (Question 3), involvement in spills or violations (Question 8); or, given the share of outsourced (and sub-outsourced) production, whether the company considers sustainability factors in the selection of suppliers (Question 22).

There are also very good third-party verification checks

In assessing Chinese tech supply chains, there are also very good third-party verification checks. Chief among these is Institute of Public and Environmental Affairs (IPE), founded by CLSA U author (among many other things) Ma Jun. Ma and IPE have been at the forefront of pushing pollution-data transparency in China. IPE also ranks IT brands according to environmental performance for both their own factories, as well as suppliers.

Apple comes out on top

Apple comes out on top, after huge amounts of engagement and a reputational risk-driven about-face by Tim Cook. Within Asia, Panasonic, Samsung Electronics and Hitachi, all top-quartile stocks in our E&S ratings, come out on top. With the exceptions of (despite the bad press) Foxconn, Huawei and Lenovo, Chinese and Taiwanese brands bring up the rear.

Figure 47

IPE Green Supply Chain - Ranking of IT brands

	Brand	Total	Communication and follow-up		Compliance and corrective action			Extend green supply-chain practices		Data disclosure		Responsible recycling
			Basic communication	Discuss industry pollution problems	Establish screening mechanism	Correctiv e actions	Self-monitoring data	Identify main polluting sectors	Extend management upstream	Energy and emissions targets	PRTR	Recycling used products
1	Apple	65.5	10.0	10.0	12	12	2	7.5	5.0	2.5	3	1.5
4	Panasonic	52.5	10.0	10.0	6	12	0	5.0	0.0	5.0	0	4.5
5	Samsung	51.5	10.0	10.0	9	9	0	5.0	2.5	0.0	6	0.0
7	Hitachi	45.5	10.0	10.0	9	9	0	2.5	0.0	5.0	0	0.0
8	Huawei	45	10.0	10.0	9	6	0	5.0	5.0	0.0	0	0.0
9	Foxconn	39.5	10.0	7.5	6	6	0	5.0	0.0	5.0	0	0.0
11	Toshiba	36.5	7.5	7.5	6	9	0	0.0	0.0	5.0	0	1.5
13	Lenovo	34.5	10.0	10.0	6	3	0	2.5	0.0	0.0	0	3.0
15	Sony	31.5	10.0	10.0	3	6	0	2.5	0.0	0.0	0	0.0
16	Canon	31.5	10.0	10.0	3	6	0	0.0	2.5	0.0	0	0.0
19	Sanyo	18	7.5	7.5	3	0	0	0.0	0.0	0.0	0	0.0
20	LG	17.5	7.5	10.0	0	0	0	0.0	0.0	0.0	0	0.0
24	Sharp	12.5	7.5	5.0	0	0	0	0.0	0.0	0.0	0	0.0
29	BYD	10	5.0	5.0	0	0	0	0.0	0.0	0.0	0	0.0
30	TCL	10	5.0	5.0	0	0	0	0.0	0.0	0.0	0	0.0
31	HTC	10	7.5	2.5	0	0	0	0.0	0.0	0.0	0	0.0
32	ZTE	9.5	5.0	0.0	3	0	0	0.0	0.0	0.0	0	1.5
36	Haier	5	2.5	2.5	0	0	0	0.0	0.0	0.0	0	0.0
37	Xiaomi	0	0.0	0.0	0	0	0	0.0	0.0	0.0	0	0.0

Source: IPE

Figure 48

ICT ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ To what extent is the company investing in energy efficient operations?
	❑ To what extent is the company investing or likely to benefit from smart solutions/machine-to-machine networking?
	❑ For hardware/manufacturing, is the company located in areas where water availability/quality could present challenges?
Carbon abatement	❑ Is the company investing in alternative energy solutions at its sites - base stations, datacentres, or manufacturing centres?
	❑ For print media, does the company use sustainably sourced paper?
Climate-change adaptation	❑ Does the company have operations in areas that are at potential risk from changing climate patterns?
Environmental pollution	❑ Does the company address reduction of toxic materials in its sourcing policies?
	❑ Has the company been involved in spills or violations?
	❑ For hardware/manufacturing, to what extent is the company administering programmes to recycle or re-use old products?
	❑ For hardware/manufacturing, to what extent is the company designing products with reduced toxic chemical content?
Population columns	❑ To what extent is the company exposed to increased/reduced demand due to an ageing population?
Income distribution	❑ Is the company positioned to benefit from the rise in disposable income of Asian middle-class consumers?
Sector-specific ESG	
Data protection & privacy	❑ Have there been incidents in which the company has failed to protect customer data?
Independent news content	❑ For internet/media, to what extent is the company able to set its own independent editorial policies?
EMFR	❑ For telecoms companies, has the company taken steps to minimise the potential health impact of electro-magnetic fields?
Safety record	❑ For hardware/manufacturing, does the company provide credible evidence that it is managing safety (strong policy, incident rates, etc)?
	❑ What is the company's safety track record?

Source: ARE, CLSA

Materials

The materials sector is central to many sustainability considerations

The materials sector is central to many sustainability considerations. Resource constraints are the major factor, with questions of ore qualities, extraction rates and energy intensity of production directly affecting financial performance. Less obvious is the extent to which many companies are also dependent on large volumes of water.

As a sector, it scores higher than any other

Given the particularly clear link between environmental and social factors in the resources sector and financial performance, it is somewhat surprising that materials as a sector scores higher than any other. We see a couple explanations for this.

- First, the highest scoring companies are mostly materials producers rather than extractors. With a few exceptions, the miners and soft commodities score at the bottom half of the group.
- Second, the very fact that E&S issues are critical to financial performance means that investors and regulators have pushed companies in the sector much earlier towards better disclosure in these areas. While we try to focus on substance over form, rather than vice versa, there are still a number of disclosure questions (OHS incidents, CO2 reduction targets, etc).

Mostly materials producers rather than extractors

Figure 49

Top-quartile scores in materials

Company	Code	Rec	ESG score (%)
Fujifilm	4901 JP	BUY	88.6
D&L	DNL PM	BUY	86.4
Amcor	AMC AU	BUY	84.1
UltraTech	UTCEM IS	BUY	81.8
Indocement	INTP IJ	BUY	81.8
BlueScope	BSL AU	BUY	81.8
Shree Cement	SRCM IB	BUY	79.5
Incitec Pivot	IPL AU	BUY	79.5
Xinyi Solar	968 HK	BUY	77.3
ACC	ACC IB	BUY	77.3

Source: CLSA

Fujifilm has a 'culture of sustainability'

Analyst Christian Dinwoodie explains that for Fujifilm, the group's top scorer, 'the culture of sustainability shoots across its corporate, community and product strategies. The company uses the same robust R&D capabilities to enter new markets that benefit society, such as pharmaceuticals and medical solutions, which it has used to manage its own social footprint with sustainable printing technologies. Some of the company's positive social achievement may be due to its position as a major blue-chip company in environmentally friendly Japan but the company appears to spread its best practices to overseas production and sales also.'

Xinyi Solar takes numerous measures to reduce CO_2 and other emissions

Analyst Timothy Lee explains how Xinyi Solar got on the leader board: 'It is mainly engaged in the production of solar glass, which the company uses cleaner natural gas as fuel, rather than the dirty heavy oil/coke gas/petroleum coke used by its peers, thus generating lower emissions. The company has also installed its own rooftop solar projects for generating electricity for self-use, and is spreading out to larger solar-farm operations, further reducing CO_2 and other emissions.'

Company uses natural gas in its production of solar glass

Figure 50

Part of Xinyi's 20MW rooftop solar project

Source: CLSA

Indocement actively pursues the use of alternative energy for its cement plants

Analyst Sarina Lesmina explains Indocement's inclusion on the list: 'The company has been quite active in pursuing the use of alternative energy from waste for its cement plants. Having Heidelberg (a large European cement producer) as a parent company gives it access to new technology capability that enables the use of waste as a source of energy, hence reducing reliance on coal and diesel fuel. Moreover, the company has been very careful in making sure that its production plants do not create environmental issues. It is also active in supporting local community through various CSR programmes.'

Impact of China's cleanup push

Question: Has the company disclosed significant investments in water and air-pollution management?

Overcapacity and environmental regulation are central to Chinese steelmaker's prospects

China's Hebei province is at the heart of Chinese steel production. It has promised output cuts. New regulation is coming at a time the industry faces a glut of overcapacity, stemming from the post-financial-crisis period in which capital discipline was set aside in an effort to boost growth.

The effects of regulation on competitive position are not yet clear

It is unclear yet whether larger steel companies will be able to act as consolidators as has happened in the cement sector, or whether the efficiencies of smaller furnaces will continue to create favourable opportunities for smaller private players.

But some of the majors are already closing facilities

At the majors, one early indication came from Magang. Citing inevitable phase-out of inefficient and obsolete facilities, it is closing a smelting plant owned by subsidiary Ma Steel (Hefei) Iron and Steel, leading to an associated writedown of Rmb1.2bn. This followed an administrative penalty at the subsidiary announced in December.

Resource constraints

Question: How is the company ensuring it has sufficient access to raw materials, particularly access to water?

Coal is coming under increasing pressure from regulators due to pollution and carbon

Coal is under significant pressure. It is a source of significant local air pollutants, it is at the sharp end of climate-change concerns, and - less well-known - its production requires significant access to increasingly stressed supplies of water. Unlike the first two issues, water availability is not a

question of will to regulate, rather an issue that directly affects the ability of coal assets to operate. This is an increasing quandary for the companies, as coal mines are often located in water-scarce regions.

But water access is a less obvious challenge that is not a question of political will to regulate

Water scarcity is a particular problem in China, where 53% of coal reserves are in water-scarce regions (less than 1,000m^3 per capita) and 30% in water-stressed areas (less than 1,700m^3 per capita). Overall, 39% of reserves lie in Shanxi, with water resources of around 251m^3 per capita, well below Syria's 348m^3 per capita.

Some Chinese companies will find water access particularly challenging

Figure 51 shows Chinese coal producers' exposure to areas of water scarcity, highlighting China Coal, Yanzhou Coal and Fushan Energy as being at particular high risk.

Figure 51

Exposure of listed coal companies to water risk

(%)	Shenhua Energy	China Coal	Yanzhou Coal	Fushan Energy	Hidili Industry	South Gobi[1]	Winsway[2]	Status	Water resources per capita pa (m^3)
Coals produced/washed in									
Shanxi	3.6	87.8	2.9	100				Scarce	347
Shandong			86.8				18	Scarce	362
Jiangsu		7.1						Scarce	625
Liaoning							9	Scarce	673
Shaanxi	29.3	1.8						Stress	1,617
Inner Mongolia	67.1	3.3	10.3			100	73	Stress	1,692
Guizhou					30.1			Stress	1,802
Sichuan					40.7			Rich	2,783
Yunnan					29.2			Rich	3,207
China production (m tonnes)	281.4	102.8	42.6	6.4	4.1	4.6	9.6		

[1] South Gobi's production is in Mongolia, but since the coal is washed in Inner Mongolia, 100% exposure to Inner Mongolia is indicated. [2] Winsway does not own coal mines in China; exposure indicated is that of its coal-processing plants. Source: China Water Risk estimates, NSBC 2012, various companies' annual reports (excludes coal produced from overseas operations)

Shenhua is better positioned to deal with water problems than China Coal

Taking two examples, our resources research head Andrew Driscoll sees water risk for both Shenhua and China Coal. China Coal scores lower on Question 2 ('To what extent is the company operating in water stressed areas?'), and Shenhua also scores better on Question 7 ('Has the company disclosed significant investments in water and air pollution management?'). Overall, Shenhua definitely will face water challenges (see 'Coal to chemicals' on page 57), but is better positioned to deal with them than China Coal.

Vedanta Group

Question: How is it handling its relations with communities in its operating areas?

Another consideration is how it is becoming increasingly hard for mining and plantation companies to find uncontested land/resources with access rights. This is driving up the importance of community relations.

Vedanta's failed plans in Odisha highlight the financial risks

Vedanta Group saw aluminium in the Nyamgiri Hills of India's Odisha state. The local people revered the hills as a god and vowed to fight to protect them, rather than let them be desecrated. In January 2014, the environment ministry sided with village-level governance bodies. Vedanta has already invested US$8.1bn to build a smelter, a refinery and a power plant near the area. There is no clear path to returns in sight. This is a clear example of the importance of winning free, prior and informed consent form local communities.

Local community resists any attempt to mine

Figure 52

Not to be messed with

Source: Survival International

Plantations

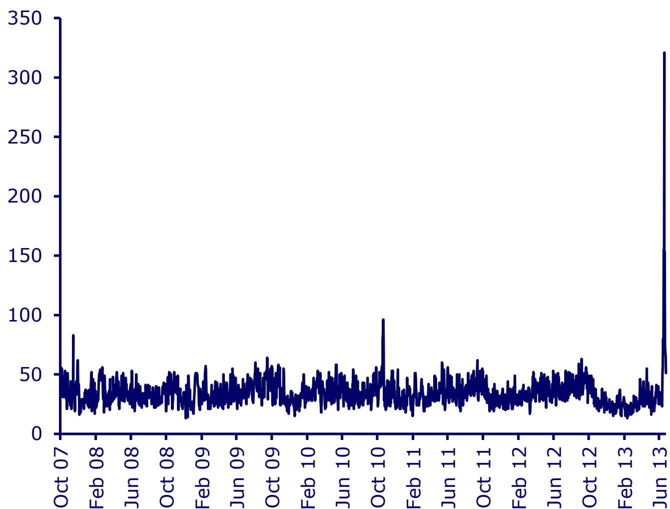
In June 2013, pollution-weary inhabitants of Hong Kong (and more so, we suspect, in Shanghai and Beijing) enjoyed a couple weeks of Schadenfreude as squeaky-clean Singapore suffered air pollution worse than any Chinese city. The culprit was a particularly bad rash of forest fires across the water in Indonesia.

Problem stemmed from enforcement of no-burn rules in Indonesia

The problem stemmed from enforcement of no-burn rules in Indonesia, and thus the country bears the brunt of the blame, but there are plenty of outstanding questions about who owns the land being burnt.

Figure 53

Singapore PSI score peaked at above 300 . . .



Note: Daily average peaked out at 321 on June 19; intraday was higher. Source: Bloomberg

Figure 54

. . . making it "hazardous"

PSI	Descriptor	General health effects
0 - 50		None
51 - 100	Moderate	Few or none for the general population
101 - 200	Unhealthy	Mild aggravation of symptoms among susceptible; transient symptoms of irritation, eg, eye irritation, sneezing or coughing in some of the healthy population.
201 - 300	Very Unhealthy	Moderate aggravation of symptoms and decreased tolerance in persons with heart or lung disease; more widespread symptoms of transient irritation in the healthy population.
301 - 400	Hazardous	Early onset of certain diseases in addition to significant aggravation of symptoms in susceptible persons; and decreased exercise tolerance in healthy persons.
Above 400	Hazardous	PSI levels above 400 may be life-threatening to ill and elderly persons. Healthy people may experience adverse symptoms that affect normal activity.

Source: Singapore National Environment Agency

The truth is, of course, more complicated

All of the major plantation operators have "'zero burn" policies, and would not be directly implicated. But the truth is, of course, more complicated.

Plantations are a high-impact sector

Scoring

The fires last summer were a reminder of something that should be obvious. Plantations are a high-impact sector, and E&S issues can have meaningful direct effects on financials. Within our coverage, Sime Darby scores at the top of the group. KL Kepong, which was implicated in the burning last year, scores at the bottom. According to plantation analysts Chuanyao Lu and Anand Pathmakanthan, key E&S questions to look at in assessing plantations risk, and the more specific associated implications for plantations are as follows:

- Has the company been subject to incidents or enforcement actions relating to manufacturing or mining or growing?
  - Has the plantation company been accused/convicted of using slash & burn methods of clearing their forestry? (KL Kepong has been accused, but not formally convicted so far).
  - Is the company actively planting on peat land? (Most of the East Malaysian companies are guilty of this, so the question is whether to distinct it with continued planting, or if they have ever done peat land then they are guilty for life?)
- Does the company consider social factors - such as carbon efficiency or labour standards or sustainability - in the selection of its suppliers?
  - Has the plantation company committed to sourcing their third-party crude palm oil (CPO) from sustainable sources? (Wilmar and Golden Agri have made a commitment to achieving this, no one else in the listed space has committed to that).

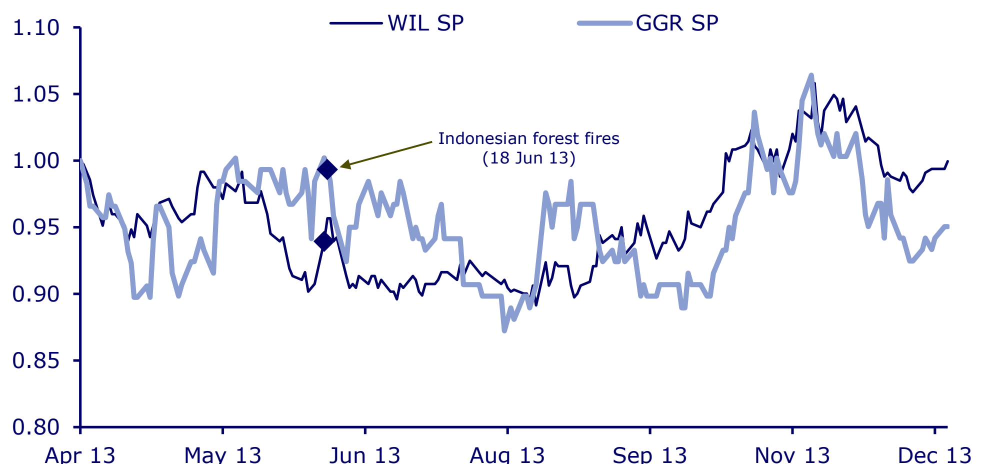
None of them have achieved 100%

Another aspect that is important, but only indirectly captured in our survey is the Roundtable on Sustainable Palm Oil (RSPO). The question to consider is, using RSPO as a benchmark, whether the plantation company is fully sustainable in terms of its palm-oil production? If not, how far is it to completing this exercise? None of the companies surveyed have achieved 100%, but Sime Darby is closest. Bumitama is the furthest away, given that it is still growing.

Key stocks experienced a brief sell-down around the June burn

Figure 55

Wilmar and Golden Agri



Source: Bloomberg, CLSA

Figure 56

Materials ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ Does the company have uncontested access to its production areas?
	❑ To what extent is the company operating in water-stressed areas?
	❑ Is the company maintaining its reserve-replacement ratio at higher than one, without dramatic increases in expenditure?
Carbon abatement	❑ Has the company invested in energy/carbon-efficient production methods/facilities?
Climate-change adaptation	❑ Is the company operating in water-stressed areas that may suffer further due to climate change?
	❑ Are the company's operations in areas at risk of extreme weather events?
Environmental pollution	❑ Has the company disclosed significant investments in water and air-pollution management?
	❑ Has the company been subject to incidents or enforcement actions relating to manufacturing or mining?
Population columns	❑ Does it face risk of staff shortages due to an ageing workforce?
Income distribution	na
Sector-specific ESG	
Occupational health and safety	❑ Does the company provide credible evidence that it is managing safety (strong policy, incident rates, etc)?
	❑ What is the company's safety track record?
Community relations	❑ Has the company faced stoppages at its operations due to community complaints?

Source: ARE, CLSA

Oil and gas are central to questions of sustainability

Petro/chems

As fossil fuels, oil and gas are central to questions of sustainability. They are depleting resources and highly constrained, and use results in carbon emissions. OHS/pollution and community relations are also key issues.

Figure 57

Top quartile scores in petro/chems

Company	Code	Rec	ESG score (%)
Bharat Petroleum	BPCL IB	BUY	80.0
ONGC	ONGC IB	BUY	77.5
KrisEnergy	KRIS SP	BUY	75.0
SK Innovation	096770 KS	BUY	72.5

Source: CLSA

Stop the burning

This is an excerpt from a June 2013 call we did with Dr Simon Lord, Head of Sustainability at New Britain Palm Oil Limited (NBPOL) and an architect of the global standard for sustainable palm oil, to learn what they are doing to promote sustainability and what needs to be fixed.

CLSA: What and who are behind the burning that has caused so much pollution in Singapore and Malaysia (not to mention parts of Indonesia) over the past couple weeks?

Lord: Greed. The reality is that many Singaporean investors are funding these plantations. In all, 27% of the fires are attributable to oil palm. The RSPO has named them; the European Union has good satellite monitoring system, as does World Resources Institute.

CLSA: Why burn?

A: Laziness. Plenty of studies have shown that burning is actually no cheaper than conventional clearing. The environmental impact is also exacerbated by what you don't see. A lot of these fires go underground and stay alive in the peat. They are like coal-pit fires. NBPOL has had a zero burn policy since 1967.

CLSA: What can be done to prevent the burning from recurring?

A: RSPO firms should be held to account at the highest possible level once concessions are updated. Concession maps held by government/companies are fluid. They are not that accurate, and not necessarily up to date. Also, within the concessions are enclaves that may not be part of the plantation owners' land. It could be independently owned.

Deepwater Horizon oil spill has thus far cost BP over US$40bn

BP's Texas City Refinery explosion killed 15 and injured more than 170 others

An explosion in a Sinopec oil pipeline killed 35 people in the coastal city of Qingdao

Majors faced bans for poor environmental records

OHS/pollution

Question: What is the company's track record on OHS/pollution?

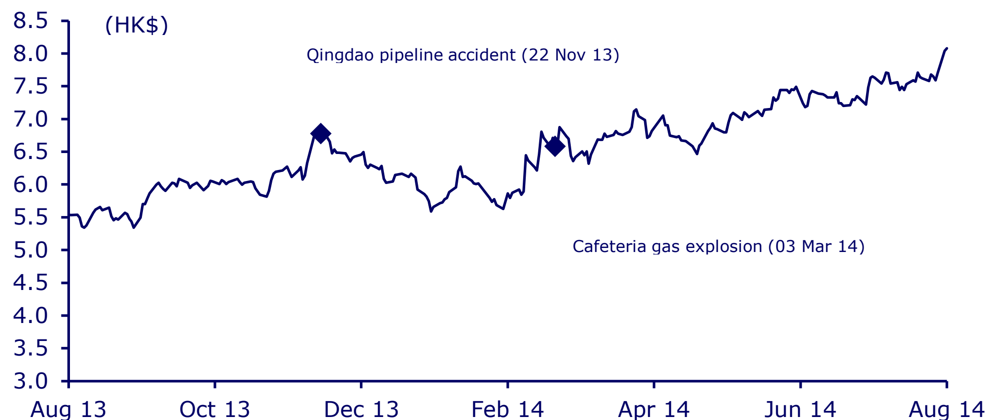
Oil companies face pollution issues when their product is used, through factory emissions and incidents, and when it spills. For incidents and spills, there has not yet been anything akin to BP's 2006 Deepwater Horizon oil spill, the environmental disaster that has thus far cost BP over US$40bn.

However, there have been a number of accidents, of course, with some roughly anomalous in cost - economic, environmental and human lives to an accident one year before Deepwater at BP. On 23 March 2005, a hydrocarbon vapour cloud explosion occurred at BP's Texas City Refinery, killing 15 workers and injuring more than 170 others[8/9]. BP paid more than US$1.6bn in compensation to victims, and on 30 October 2009, the Occupational Safety and Health Administration (OSHA) imposed an US$87m fine on the company for failing to correct safety hazards revealed in the 2005 explosion.

In Asia, an explosion in a Sinopec Corp oil pipeline killed 35 people in the coastal city of Qingdao in November 2013.

Figure 58

Sinopec's share-price performance



Source: Bloomberg, CLSA

Sinopec has pledged to pay compensation for the disaster, the economic cost of which is estimated to be around Rmb752m (link here). In the context of the company's Rmb107bn 14CL operating profit, this does not move the needle, but regulatory actions have been stepped up. The accidents are, of course, not entirely anomalous. But there would clearly be some risk that the gap between the price paid per life lost in China versus that in the USA would close somewhat (USA is 33x China based on these incidents).

Meanwhile, we are already seeing more action on non-compliance to environmental rules in China. In August 2013, the environment ministry denied PetroChina and Sinopec any further licence approvals for new refinery capacity due to their poor records of violations in 2012. The ban on new sites lasted eight months and was lifted in April 2014, following significant improvements in emissions records at both companies. Sinopec stated that it invested Rmb5.15bn in environmental protection in 2013; PetroChina does not provide this estimate in its annual report.

[8] https://www.osha.gov/dep/bp/bp.html
[9] http://en.wikipedia.org/wiki/Texas_City_Refinery_explosion#Aftermath

A series of gas explosions in Kaohsiung killed 25 people and injured 267 others in August 2014

LCY Chemical

Sinopec has ably bounced back from a short-term selloff after the Qingdao explosion. Things look more onerous for LCY Chemical across the Taiwan Strait. A series of gas explosions in the southern city of Kaohsiung killed 25 people and injured 267 others in August 2014. The Kaohsiung city government has blamed LCY Chemical for the explosions, saying around 10 tonnes of propene may have leaked from pipelines operated by the company in the hours before the first explosion. Two weeks later, at least 15 people were injured in a gas explosion near Taipei, also blamed on LCY (link here).

Coal to chemicals

As China's leaders try to replace coal-fired power plants along the coast with cleaner-burning gas-fired plants, they are running up against a serious resource problem. Simply put, China doesn't have enough gas. As part of the solution, they are driving the development of a massive coal-to-SNG (synthetic gas) industry in China.

In an April sector study, *Coal-to-SNG*, China Reality Research (CRR) found 28 such projects in operation or under construction. In all, these are projected to raise cumulative operating capacity of coal-to-SNG projects in China from 3.4bn m^3 today to 35.7bn m^3 by end-2015, and 96bn m^3 before 2018. While this would help the attempt to clean up coastal cities' air, the plan is controversial, as coal-to-chemical processes require both a great deal of energy and a great deal of water.

Goliath submits to David

While water problems around major coal-related projects have generally been swept under the rug in China, a high-profile case from August 2012 to April 2014 demonstrated that things really are changing.

In April 2014, the local government in Baotou, Inner Mongolia, announced that Shenhua would stop pumping groundwater for its coal-chem projects over the course of the year. This was the culmination of a campaign started by Greenpeace in August 2012, and represented a major about-face for the coal giant, who initially denied the charges.

A key point here is that Shenhua's general performance on ESG metrics is actually substantially better than peers. And, in fact, according to our conversations with Greenpeace, a big part of the reason that it targeted Shenhua's plant wasn't that it was the worst example, but rather that they felt Shenhua was more likely to engage and consider change if proven necessary.

If even Shenhua, with its system of due diligence, could be blindsided by water issues, problems will certainly be more severe for many of the other operators. And most will be caught off guard. According to coal-to-SNG developers surveyed by CRR, only 30% see water supply as a limiting factor to full completion of the proposed capacity.

Timeline of Shenhua and Greenpeace

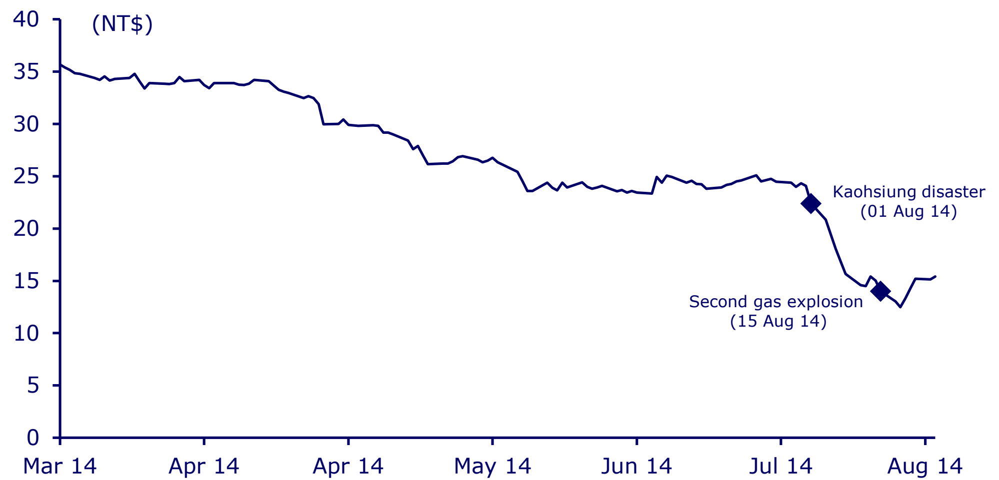
	Summary
2006	Shenhua starts pumping groundwater for its Baotou coal-chem plant in Inner Mongolia
Aug 12	Greenpeace publishes its *Thirsty coal* report detailing how expanding coal chemical operations in the west of China were competing with locals and the ecology for water resources.
2012	Beijing-based NGO, the Centre for Legal Assistance to Pollution Victims, gets involved in the case
mid-July 2013	Environmental impact assessment states that waste-water dumped by Shenhua CTL near the plant may pollute the soil, and that pumping has led to a significant drop in groundwater levels.
23 Jul 13	Greenpeace report *Thirsty coal 2* reaches similar conclusion
end-July 2013	Shenhua meets with Greenpeace
Aug 13	Shenhua admits falling groundwater levels but responds that 'no actual excess extraction of groundwater was found, either in legal or technical terms'
2013	Greenpeace publishes both text and images exposing illegal dumping of waste-water by Shenhua
2013	Shenhua denies deliberate pollution, saying that the water was 'stored temporarily' due to technical problems
Apr 14	Local government tells herders living near water sources in Haolebaoji Township that they will be paid 20,000 yuan (US$3,200) per person, plus 20,000 yuan per household, as compensation for loss of water resources to industry, to be paid over three years. It is also confirmed that Shenhua's pumping stations will be shut down.

Source: Greenpeace, media

Things look more onerous for LCY Chemical across the Taiwan Strait

Figure 59

LCY Chemical's share-price performance



Source: Bloomberg, CLSA

Figure 60

Petro/chems ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ Is the company maintaining its reserve-replacement ratio at higher than one without dramatic increases in expenditure? ❑ Does the company have uncontested access to its production areas? ❑ Does the company operate in locations with sufficient access to water?
Carbon abatement	❑ Has the company invested in energy/carbon efficient production methods/facilities?
Climate-change adaptation	❑ Are the company's operations in areas at risk of extreme weather events?
Environmental pollution	❑ Has the company disclosed significant investments in water and air-pollution management? ❑ Has the company been subject to incidents or enforcement actions relating to its manufacturing?
Population columns	
Income distribution	❑ Is the company operating in markets where wealth creation is presenting strong and growing demand for its products?
Sector-specific ESG	
Occupational health and safety	❑ Does the company disclose OHS statistics? ❑ Do these indicate any OHS issues? ❑ Have there been any major incidents?
Community relations	❑ Has the company faced stoppages at its operations due to community complaints?

Source: ARE, CLSA

The power sector is at the heart of sustainability issues

Power

The power sector is at the heart of sustainability issues, particularly climate change. The fundamental requirements for energy are that it should be secure, affordable and clean. Resource access, the security part of the equation, is a significant issue at the national level and sets the direction of national policies. For example, Korea and Japan have limited access to fossil fuels, resulting in significant use of nuclear, whereas China and India both have large coal deposits, albeit they both import more.

Is the energy secure, affordable and clean?

Figure 61

Top-quartile scores in power

Company	Code	Rec	ESG score (%)
Power Grid	PWGR IB	BUY	84.2
HN Renewables	958 HK	BUY	76.3
Huadian Fuxin	816 HK	BUY	73.7
Petronet LNG	PLNG IB	BUY	73.7

Source: CLSA

Question: What is the company doing to mitigate environmental emissions and what are the implications for returns?

Huaneng Renewables is a beneficiary of China's policy push to wean itself off coal

As a pure-play renewable-energy operator, Huaneng Renewables is a beneficiary of China's policy push to wean itself off coal. The company's wind and solar farms receive preferred tariffs (Question 6), and stand to gain from China's nascent carbon trading scheme. The lack of exposure to thermal power means that Huaneng Ren does not face liabilities to clean up its fleet of power plants (Question 6), and also does not face water risk (for cooling) as regulations tighten (Question 1).

Huadian Fuxin is similar on most counts

Huadian Fuxin is similar on most counts, with the bulk of capacity and all capacity growth based on renewables. However, it scores slightly lower due to continued risk stemming from its shrinking exposure to thermal coal. The company also operates small-scale hydroplants that expose it to water risk, particularly if climactic shifts lead to reduced rainfall in southeastern Fujian province.

China's IPPs - Shades of grey

Restructuring the nation's power generation and distribution system is key to clearing the air

Restructuring the nation's power generation and distribution system is one of the key planks in Beijing's attempt to clear the air. Thus the big independent power producers (IPPs), reliant primarily on coal-fired power for income, are naturally at centre-stage in China's war on pollution. The challenge is differentiating them.

All five H-share listed IPPs score at the bottom half of the power sector

All five H-share listed IPPs score at the bottom half of the power sector, which is no great surprise. They all have high CO_2 emissions (highest in the world), operate in water-stressed areas and face regulatory risk around emissions. Conversely, all five are central SOEs, and adhere to state-mandated reporting guidelines. Thus, they do tick the boxes for efficiency and emissions targets, declining CO_2 intensity, OHS targets and so on.

The outliers are China Power International, which boasts a larger share of (CO_2-free) hydro in its portfolio; China Resources Power, which boasts a larger share of (CO_2-free) wind; and Huaneng Power, which, due to its expanding fleet of gas turbines, relies more on fuel that needs to be imported (although it is still almost entirely coal).

The most interesting deviation has not yet happened, but the share price has already moved.

Exits appreciated

Baotou is a tiny share of assets and also profitable

On page 57, we look at the water risk inherent in coal-chem projects. In the case of Shenhua, Baotou is both a tiny share of its assets and also profitable. It is impossible to accurately break out the perceived value of its coal-chem business to the overall value of the list firm. Such is not the case for Datang Intl, which has three coal-to-chem plants under construction or in operation.

Datang Power plans to reorganise its coal-to-chemical business

Datang Power announced on 7 July 2014 that it has signed a reorganisation framework agreement with state-owned China Reform Corp for the proposed reorganisation of its coal-to-chemical business, which it had entered in 2006, and related projects. China Reform Corp will, through the reorganisation, acquire the assets or equity interests of Datang's coal-to-chemical business segment and related projects. Despite a total lack of details around pricing (1x PB? 0.5x PB?) or timeline, the stock immediately popped 23%, and has subsequently climbed another 13% (as of 28 August 2014).

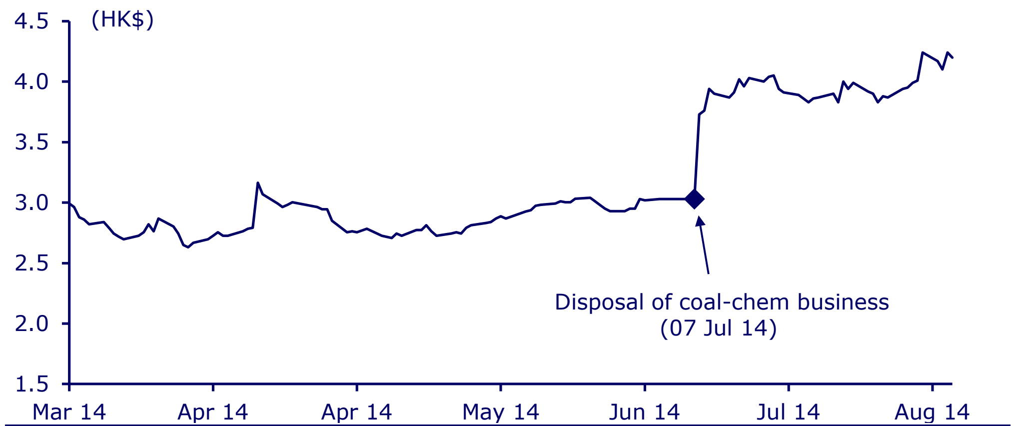
This disposal has obviously positive implications for governance

This disposal has obviously positive implications for governance (sticking to a core business), but also will improve the company's score on E&S questions pertaining to water (especially Questions 1 and 4), and carbon (Question 3), and reduces risks of future negative scores on involvement in fines and incidents (Questions 20 and 21).

Investors not missing coal-chem

Figure 62

Datang's share-price performance



Source: Bloomberg, CLSA

Figure 63

Power ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ Does the firm have significant generating assets that rely on water in water-stressed areas?
	❑ To what extent is the company reliant on fuel that needs to be imported?
Carbon abatement	❑ How CO_2-intensive is the company's fuel source (eg, coal, oil, gas, nuclear, solar)?
Climate-change adaptation	❑ Is the firm operating in water-stressed areas that may suffer further due to climate change?
	❑ Are the company's operations in areas at risk of extreme weather events?
Environmental pollution	❑ Will new regulation create significant costs for the firm that it is not fully able to recoup?
	❑ Has the firm been subject to incidents or enforcement actions relating to their operations?
Population columns	❑ Does the company face risks of staff shortages due to an ageing workforce?
Income distribution	❑ Is it primarily operating in areas that stand to gain from increased economic activity?
	❑ To what extent is the company at risk of regulation on price increases that reduce economic returns to maintain affordable power supply?
Sector-specific ESG	
Occupational health and safety	❑ Does the company disclose OHS statistics?
	❑ Are these on a declining trend?
Community relations	❑ Has the company faced stoppages at its operations due to community complaints?

Source: ARE, CLSA

Property

Consider energy use and recycling of materials in construction

Reducing building energy use and recycling of materials help reduce costs, while high environment, health and safety standards in construction reduce costs and delays from incidents. Companies that have considered approaches to managing these issues are likely to provide superior returns over time.

Singapore's developers and landlords perform particularly well

Singapore's developers and landlords perform particularly well in the segment. As analyst Yew Kiang Wong explains: 'City Developments (CDL), Keppel Land and CapitaLand are driving a lot of CSR and green initiatives with their new developments and buildings. CDL developed one of the first landed housing that recycles rainwater into storage tank for watering the garden and car-washing. It also includes solar panels. These efforts are undertaken despite the fact that they raise construction costs by about 6-8% with no guarantee of recouping them in higher rents.'

Reducing building energy use and recycling of materials help reduce costs

Figure 64

Top-quartile scores in property

Company	Code	Rec	ESG score (%)
Keppel Land	KPLD SP	BUY	78.9
IJM Land	IJMLD MK	BUY	73.7
Hongkong Land	HKL SP	BUY	71.1
Sobha	SOBHA IS	BUY	68.4

Source: CLSA

The incredible returns from energy retrofits are a primary driver

As part of our ESG call series, we hosted a call with City Developments' Heads of CSR and Green Buildings in 2013. We focused on the business case for green buildings, which is just gaining momentum nearly 20 years after CDL began focusing on sustainability. The incredible returns from energy retrofits three-year payback period) are a primary driver, followed by tightening regulations and increasing awareness. (Read our 29 April 2013 *Ahead of the curve* note.)

Figure 65

Property ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ Does the firm disclose the steps it takes to manage energy consumption in construction?
	❑ Does it disclose energy-use intensity for its buildings?
	❑ Does it provide water-use intensity for its buildings?
	❑ Does it outline systematic steps to reduce waste at its buildings?
	❑ Does it outline systematic steps to increase the proportion of recycled, locally sourced or certified materials?
	❑ Does it disclose the proportion of the portfolio comprising resource-efficient/green buildings?
	❑ Does the company participate in the Global Real Estate Sustainability Benchmark (GRESB)?
Carbon abatement	❑ Does it systematically invest in site level renewables?
Climate-change adaptation	❑ Does the company describe steps it takes to ensure that it is not developing in exposed areas and that buildings are protected from changing weather patterns/sea level rise?
Environmental pollution	❑ Has it been involved in any major incidents or violations?
Population columns	❑ To what extent is it exposed to increased/reduced demand due to an ageing population?
	❑ Does the company face risks of staff shortages due to an ageing workforce?
Income distribution	❑ Are its development areas set to participate in growth in disposable income and is the company likely to benefit?
Sector-specific ESG	
Safety record	❑ Does it provide credible evidence that it is managing safety (strong policy, incident rates, etc)?
	❑ What is its safety track record?
Labour relations	❑ What is its record on industrial relations?
	❑ What is the employee turnover rate relative to industry?

Source: ARE, CLSA

Transport

As the main user of oil, the transport sector is central to a range of sustainability concerns

As the main user of oil, the transport sector is central to a range of sustainability concerns, particularly around energy and carbon. Within the subsectors, public-transport solutions have favourable dynamics, while aviation is one of the most significant users of resources and energy that is supported by discretionary spending. Most companies in the sector are driven by growth in the Asian middle class.

Public-transport solutions have favourable dynamics

Figure 66

Top quartile scores in transport

Company	Code	Rec	ESG score (%
AirAsia	AIRA MK	O-PF	68.0
Asia Aviation	AAV TB	O-PF	64.0
Brambles	BXB AU	BUY	62.0
Ezion	EZI SP	BUY	60.0

Source: CLSA

These two events rapidly negated what had been an exemplary safety record

The biggest stories around transport in Asia have been the dual tragedies of the disappeared Malaysian Airlines Flight MH370 to Beijing (March 2014) and, soon after (July), the crash of another Malaysian Airlines Boeing 777 after it was believed to have been hit with a surface-to-air missile over eastern Ukraine.

Question: What is the company's safety track record and what steps is it taking to address passenger safety?

Our 2011 report navigates the serious issue of marine environmental pollution

These two events rapidly negated what had been an exemplary safety record, and have driven the airline into government arms. Another Malaysian airline, AirAsia, actually came out at the top of the group for E&S issues. Analyst Indar Dhaliwal explains why both AirAsia and AirAsia X (also Asia Aviation, which is the listed Thai entity) score so well:

1. They have young fleets - AirAsia has an average fleet age of 3.5 years while AirAsia X has an average fleet age of seven years. They also have strong safety track records.
2. They are investing in aircraft that reduce fuel burn via Airbus' new A320/A330 New Engine Option, which claims to be able to reduce fuel burn by up to 14%, and other small innovations like sharklet wing-tips, which also cut on fuel consumption.
3. They operate in Southeast Asia where they are likely beneficiaries of the rising income thematic that will drive discretionary spending on travel.

Figure 67

Transport ESG checklist

Megatrend/sustainability	Questions
Resource constraints	❑ Is it relatively well placed or poorly placed longer term on energy (ie airlines poor, rail better)?
	❑ Is it investing in fuel efficiency across its fleet - or is its fleet relatively new and hence efficient?
Carbon abatement	❑ To what extent is the company investing in carbon efficiency across its operations and fleet?
	❑ For airlines, has the company experimented with biofuels?
	❑ For shipping, has the company experimented with alternative energy sources, eg sails?
	❑ For logistics companies, does the company offer its customers low-carbon solutions?
Climate-change adaptation	❑ Does the company operate in areas where projected increases in extreme weather conditions could lead to more frequent disruption to service?
Environmental pollution	❑ To what extent is the company likely to be subject to increasing SOx, NOx, noise, or particulate-emissions regulation that could drive up capital and/or operational costs?
	❑ To what extent could air pollution in the company's operating areas result in measures that help the company - eg more passengers on public transport if cars are taxed?
	❑ Has the company been involved in spills or violations?
Population columns	❑ To what extent is it exposed to increased/reduced demand due to an ageing population?
	❑ To what extent is it taking steps to provide services to older passengers?
Income distribution	❑ Are its operating areas particularly exposed to growth in disposable income and is it likely to benefit?
Sector-specific ESG	
Labour relations	❑ Does the company have a track record of labour-relations incidents?
Safety record	❑ Does it provide credible evidence that it is managing safety (strong policy, incident rates, etc)?
	❑ What is the company's safety track record?

Source: ARE, CLSA

Top scorers are diversified

More at the infrastructure end of the sector, top scorers are diversified.

Figure 68

Top quartile scores in infrastructure

Company	Code	Rec	ESG score (%)
Jasa Marga	JSMR IJ	BUY	70.0
CCCC	1800 HK	BUY	62.0
China Merchants	144 HK	BUY	62.0

Source: CLSA

Analyst Sarina Lesmina ranks Jasa Marga, the largest tollroad operator in Indonesia, near the top of the group on the strength of its energy-saving roadmap and ambitious afforestation programme.

China's growth in disposable income should benefit China Merchants

Analyst Ansel Lin scores China Merchants highly: 'China Merchants' Shenzhen West terminals were the first in China to implement diesel-to-electricity conversion on its cranes, which is cost-efficient and environmentally friendly. China's growth in disposable income should lead to growth in import and domestic trade, which benefits the company. China Merchants has a track record of good safety management, and has not had any labour-relations incidents. In addition, it is working closely with its logistics providers to establish best practices for environmental performance.

Evolution of ESG

Ben McCarron of Asia Research and Engagement (ARE) helped us redesign the E&S questionnaire. He has grappled with these issues as head of research at Singapore-based consultancy Responsible Research, and before moving to Asia in 2011, incorporating environmental, social and governance (ESG) into fund management in the UK. We get Ben's view - as both a producer and consumer, of how ESG data and incorporation are evolving.

How is availability of data evolving in Asia?
Disclosure of data is generally behind developed markets but improving. Sometimes this is just about disclosure as firms have the data but do not provide it publicly. In other areas, data are simply not available. But Asian firms can move quickly when they set their mind to it. For example, the Global Real Estate Sustainability Benchmark, where firms fill in a survey, found a 23% gain in scores of Asian respondents in 2014 over 2013. The overall performance for Asia is now higher than that of North America.

What are the challenges of quantification?
One challenge is data. Even where there is data, that doesn't mean you can change the valuation model. For example, if you have carbon-emissions data, you still need a carbon price - this may come in 2016 in China, next year in South Korea, and other markets are looking at it. But you can't just multiply carbon emissions by price and take it off earnings. That's way too simple.

It depends where in the supply chain the carbon is and also on pricing power. If the company has pricing power, it will simply pass on the cost. If a company has a relatively lower carbon product, it may gain more in turnover - cheaper and attracts green customers. So investors need to analyse how this newly explicit cost changes competitive positioning for products and identify where there are risks and opportunities - just like any other investment issue. Porter for some, SWOT for others.

Challenges to analyst/investor engagement?
Honestly, it's a challenge to get investors interested in any topic - unless it's hot and the market is moving. And analysts just want something they can drop straight into their DCF model. But joking aside, the main reasons investors look at these issues are impact on firm value; client demand; and regulation/best practices.

We have covered firm value. Client demand is a driver from the EU, Australia, Canada and increasingly the USA. Asset managers in the EU usually have to have a story on ESG to get shortlisted for mandates, or even longlisted. On best practices, there are new stewardship codes in Asia, such as in Japan and Malaysia, while in India mutual funds now have to disclose voting direction. In other regions, the Principles for Responsible Investment has increased investor focus.

For more, read our 27 June 2014 *How big are yours?* report.

CG - What matters in Asia?

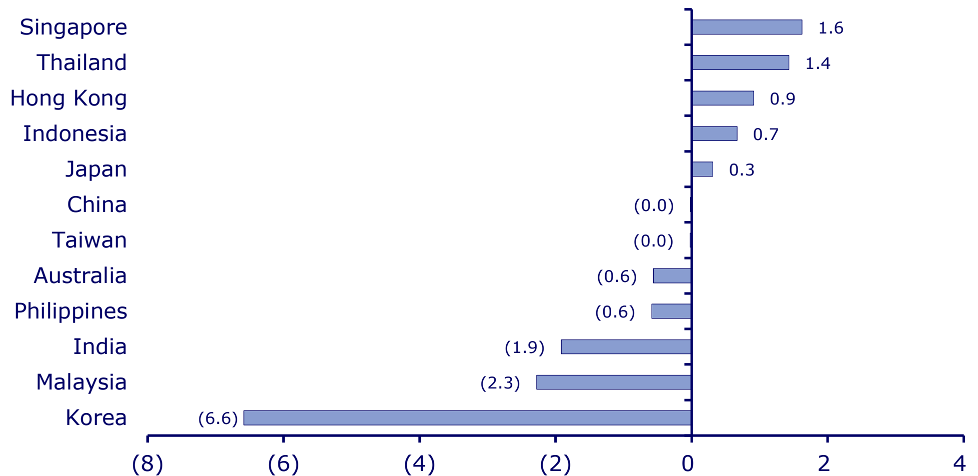
E&S assessment changed, but 90% of the CG criteria remain the same

Although we have revamped the E&S category this year, 90% of the overall CG score is still based on exactly the same criteria as two years ago. On the unchanged criteria, our average score for Korean companies has tumbled by 6.6ppts since 2012. Other markets are within plus or minus 2ppts of their previous average corporate scores.

Improvements in our scores for Singapore, Thailand, HK

Figure 69

Change in CG scores between 2012 and 2014 on comparable questions



Source: CLSA

Our CG scoring is independent of ACGA, but the rankings are similar

Our bottom-up CG scores are independent of the ACGA's market rankings. However, a stronger regulatory and top-down environment can be expected to have positive impact on the CG of the corporates. Thus, the top two markets with scores that are almost exactly the same by ACGA, Singapore and Hong Kong, are also the top by our rankings after Australia (which is not ranked by ACGA). Thailand does well by ACGA's rankings and similarly on our scoring of the corporates. Japan's scoring of corporates places it lower than the top-down market ranking of ACGA. At the bottom of ACGA's market rankings are Philippines and Indonesia which is also similar to our corporate rankings. Our score for Korean corporates now place them at the bottom on average against other markets; ACGA similarly has Korea in the lower rung of its market rankings.

Board independence is the main area of weakness in Asia

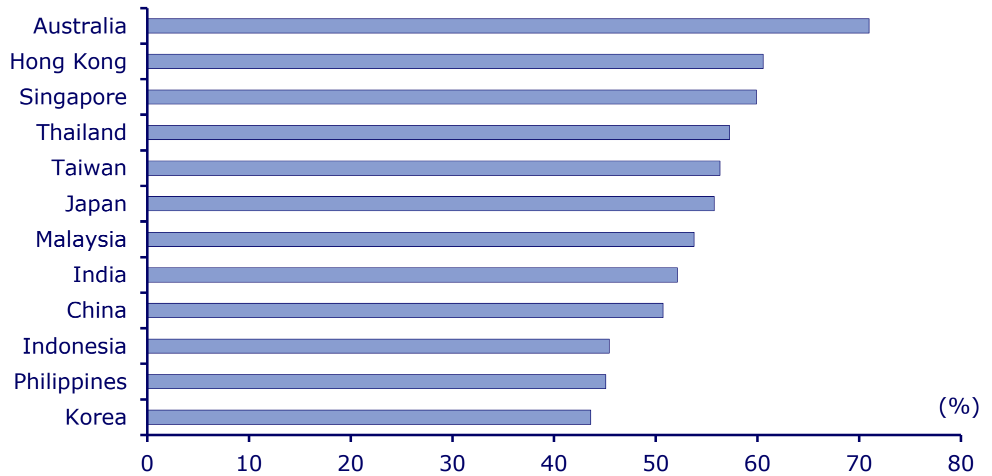
Lack of a strong audit committee indicates poor CG commitment

Markets with better CG tend to have a higher PE: the top half of Asian emerging markets on CG are at a 19% PE premium to the lower half. These markets also have higher payout ratios, giving investors a slightly higher dividend yield. In terms of CG issues, compensation is not a major concern for emerging markets, unlike in the developed world. Rather, potential conflicts of interest of the controlling shareholder as well as lack of board independence are of greater concern. Less than one-third of Asian companies in have a strong audit committee in our assessment - a warning of only token CG commitment and other potential governance issues.

Australia, Hong Kong and Singapore are ahead of other Asian markets

Figure 70

Average CG scores by market



Source: CLSA

Criteria used in CG scoring

Other than E&S, five core sections in the CG scoring

Other than revamping our E&S scoring, which replaces our former C&G/CSR section, the other five sections in the core CG scoring remain the same: discipline, transparency, independence, responsibility and fairness. Each category has four to seven questions, which together make up 18% weight for each of the five categories in our overall CG score. Our current questionnaire is provided in Appendix 3. The main issues under each category are as follows.

Discipline

Does the firm stick to core businesses, understand its cost of equity, etc?

- Management sticks to clearly defined core businesses.
- Management has a realistic estimate of its cost of equity.
- The company has not issued equity when it was questionable whether it was necessary. And options or shares to staff have not increased the share base at a rate higher than 5% over three years.
- The company has not increased cash on its balance sheet and thus brought down its ROE.
- The company does not have a history of restructurings that reflect mismanagement or abandoning earlier strategies.
- There is no undue political interference in the company's ability to maximise shareholder value.
- Management discloses ROA or ROE targets.

Transparency

Are results announced promptly?

Are other announcements also timely?

- The company publishes half full-year results within two months of the end of the financial year.
- The company announces semi-annual and quarterly results within 45 days of the end of the period.
- The company announces results within two working days of the board meeting to approve them; and share-price movements do not anticipate the results.
- Financial reports are clear and informative.

- Accounts are free of controversial interpretations of IFRS and do not adopt dubious accounting policies.
- The company discloses major market-sensitive information punctually.
- Analysts and investors have good access to senior management.

Independence

Is the chairman an independent director?

Does the company have a proper audit committee, etc?

- The chairman is an independent, non-executive director.
- The company has an audit committee chaired by an independent director. More than half of the audit committee members are independent directors and all members have financial expertise.
- External auditors are in other respects unrelated to the company. The auditors provide a breakdown of audit and non-audit fees. And the audit partner or auditing firm is rotated every five years.
- Independent directors make up more than half of the board.
- Whether there has been any increase or decrease in the number of directors over the past three years.
- The company has voting by poll at AGMs and EGMs, with detailed results released by the next day.
- The board composition reflects an attempt to bring diverse talents onto the board. Family members account for no more than two members of the board.

Responsibility

Do independent directors attend board meetings?

Does any senior figure have a criminal conviction, etc?

- The company discloses whether independent directors have attended at least three-quarters of all board meetings over the past fiscal year.
- There is nobody with a criminal conviction reflecting negatively on integrity either on the board or holding a senior executive position.
- The company does not engage in material related-party transactions.
- The controlling shareholder is not known to be highly geared.
- The company represents the controlling shareholder's primary financial interest.

Fairness

Have there been any controversial decisions disadvantaging minorities, on placement of shares, etc?

- There has been no controversy over whether the board or senior management have made decisions in the past five years that benefitted them at the expense of investors.
- The company has not issued non-voting common shares.
- There has been no controversy about share trading by board members. Placements by the company have been fair, fully transparent and well-intentioned.
- Directors' remuneration has not increased faster than net profit after exceptionals over the past five years.

Governance of companies

Market rankings are based on ACGA criteria

We use ACGA ratings for market rankings (see Section 2), rather than the bottom-up average of the company scores. The ACGA's ratings are much more comprehensive, encompassing regulatory, enforcement, accounting

and auditing practices and CG culture, all of which are assessed in its scoring metric (Appendix 2). The company scores are based on our coverage of stocks. While we have a bigger sample this year than in our previous report, there is sampling bias as our coverage is tilted toward larger companies as well as those that we believe have better businesses. These are likely on average to have better CG than other companies in the market not under our coverage.

Clear distinction between top and bottom markets for corporate CG scores

However, the bottom-up tally of company CG scores in each market helps to indicate the likely extent of CG issues among stocks that represent the main investment universe for international investors. From Figure 71, Australia is notably ahead with an average score of 71%, while Hong Kong and Singapore are at the top for the rest of Asia with an average corporate score of approximately 60%. Korean, Indonesian and Philippine firms are at the other end of the scale, with average CG scores of approximately 45%. The CG averages for other markets are fairly close at 54-57%, although China and India's average corporate score is lower at just over 50% on our metric.

Korea, Philippines and Indonesia are at the bottom by average score

Figure 71

Overall CG scores and by category for companies

(%)	Discipline	Transparency	Independence	Responsibility	Fairness	E&S	Overall CG
Australia	63.7	79.2	51.7	83.2	81.9	62.0	71.0
China	49.8	62.6	19.3	45.2	70.9	61.1	50.7
Hong Kong	63.9	75.9	22.8	65.7	73.6	62.1	60.6
India	49.4	80.4	12.7	50.4	61.6	63.3	52.1
Indonesia	48.1	64.9	10.3	38.4	59.5	56.2	45.4
Japan	51.3	88.6	5.7	68.4	59.9	64.1	55.7
Korea	38.5	64.6	8.1	39.0	57.6	62.0	43.6
Malaysia	57.1	81.6	14.8	47.1	63.0	63.4	53.8
Philippines	48.5	72.7	7.9	38.2	50.0	59.6	45.1
Singapore	56.8	94.6	29.0	38.3	82.6	56.7	59.9
Taiwan	48.1	67.8	16.0	75.5	70.7	62.6	56.3
Thailand	53.3	92.6	30.1	44.1	64.1	61.4	57.3
Average	52.4	77.1	19.0	52.8	66.3	61.2	54.3
Average ex-Aus	51.3	76.9	16.0	50.0	64.9	61.1	52.8

Source: CLSA

Hong Kong CG score moved up relative to Singapore

With an average CG score of 60.6%, our Hong Kong coverage has moved marginally ahead of Singapore companies, which score an average of 59.9%. The Hong Kong score has been pulled up by CG improvements at some consumer companies such as Li & Fung, Prada, Samsonite and Chow Tai Fook, as well as at the bigger banks Standard Chartered and HSBC.

Japanese firms score only average relative to the rest of the region

Japanese companies, with an average score of 55.7%, are just slightly better than the regional average. They do generally better on transparency but score poorly on independence. Malaysian and Indian companies are slightly below the average.

Korea now at the bottom, slightly below Indonesia and the Philippines

China's corporate average at 50.7% is dragged by lower scores on transparency and responsibility compared to other markets. As in our previous survey, Indonesian and Philippine companies on average come close to the bottom of our CG rankings. However, this year our score for Korean corporates is down 6.6ppts compared on a like-for-like basis with 2012, with more companies now scoring negatively for management actions that disadvantage minorities and on timely disclosure of relevant information. The average for Korean companies now comes in right at the bottom, but there is less than 2ppts difference between the average corporate CG scores for Korea, Indonesia and the Philippines, the bottom three markets.

Independence is where Asian firms are weakest

Similar to 2012, independence has the lowest average score across all markets at just 17%. This category scores companies on board independence, audit committee composition, whether the company has voting by poll at AGM/EGMs, etc. Thailand, Singapore, Hong Kong and Australia's average scores for this category are higher, but still no more than 30%. Other Asian markets fare much worse, with Japanese and Korean companies on average getting only single-digit scores.

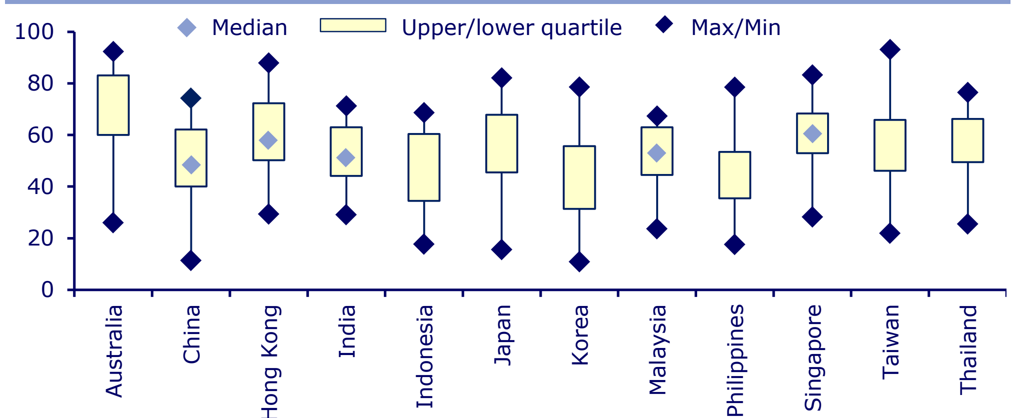
Wide range of CG scores within markets . . .

Averages often hide more than they reveal. The range of CG among companies in any given market is generally wide, particularly in Taiwan, Korea, Japan, Philippines and Australia (see Figure 72). Australia has the highest CG-scoring companies in our coverage, including some at 90%, but also includes companies with scores as low as 26%. Taiwan has the highest-scoring company on our CG criteria (TSMC), but it also has other companies where the CG is as poor as in most other markets. The perception on CG is usually coloured by the lowest-scoring companies, so it is not surprising that investors find major CG issues in Korea, China, Japan and Indonesia, which have the lowest-scoring companies on our CG rating. More detail on these scores is available from our research heads or through our evalu@tor database.

. . . particularly in Taiwan, Korea, Japan, the Philippines and Australia

Figure 72

Dispersion of company CG scores



Source: CLSA

Market valuations and CG

We take out Singapore and Hong Kong from developing Asian markets

In Figure 73, we segment the Asia ex-Japan markets by CG score. We consider the financial centres of Hong Kong and Singapore separately, then divide the rest into top and bottom halves.

Top markets on CG have higher PE, better overall yield

Figure 73

Markets valuations ranked by CG score

Market valuations	PE (x)	ROE (%)	Div yld (%)	Net gearing (%)	CG score (%)
Hong Kong	14.8	10.2	3.9	16.8	60.6
Singapore	14.2	10.3	3.3	32.5	59.9
Avg HK, SG	**14.5**	**10.3**	**3.6**	**24.6**	**60.2**
Thailand	13.9	15.8	3.1	53.1	57.3
Taiwan	14.1	14.8	3.6	(0.2)	56.3
Malaysia	17.1	13.9	3.1	22.3	53.8
India	18.9	15.3	1.4	51.3	52.1
Avg upper-half CG mkts (ex HK, SG)	**16.0**	**15.0**	**2.8**	**31.6**	**54.9**
China	7.4	17.4	4.7	33.7	50.7
Indonesia	15.8	20.7	2.3	22.1	45.4
Philippines	20.0	13.8	2.1	51.8	45.1
Korea	10.5	10.7	1.3	14.9	43.6
Avg lower-half CG mkts	**13.4**	**15.7**	**2.6**	**30.6**	**46.2**

Source: CLSA

Payout ratios higher in the better CG markets

We find that the top-half CG markets, excluding Hong Kong and Singapore, on average are at a 19% PE premium to the bottom half. Yet despite their higher PE and lower ROE, they pay out more in dividends and thus have an overall dividend yield that is slightly higher than the bottom half. Thus, we find that better-CG markets have higher valuations, yet offer investors marginally higher yields than lower-CG ones.

Snapshot across markets

The following snapshots of how Asian companies perform on some of the more objective CG criteria illustrate some of the strengths and weaknesses in governance typically found in the region.

Compensation is not a major issue

Directors' remuneration is a much bigger issue in the West, where CEOs and senior management are given generous options and run the company without a significant controlling shareholder to rein in compensation. In Asia, one benefit of family or individual-controlled companies is that compensation to senior executives is kept in check. For example, Li Ka-shing received a director's fee of HK$5,000 (less than US$1,000) and no salary from Cheung Kong in 2013. However, he picked up HK$10.5bn (US$1.4bn) in dividend income, including a special dividend that was paid last year.

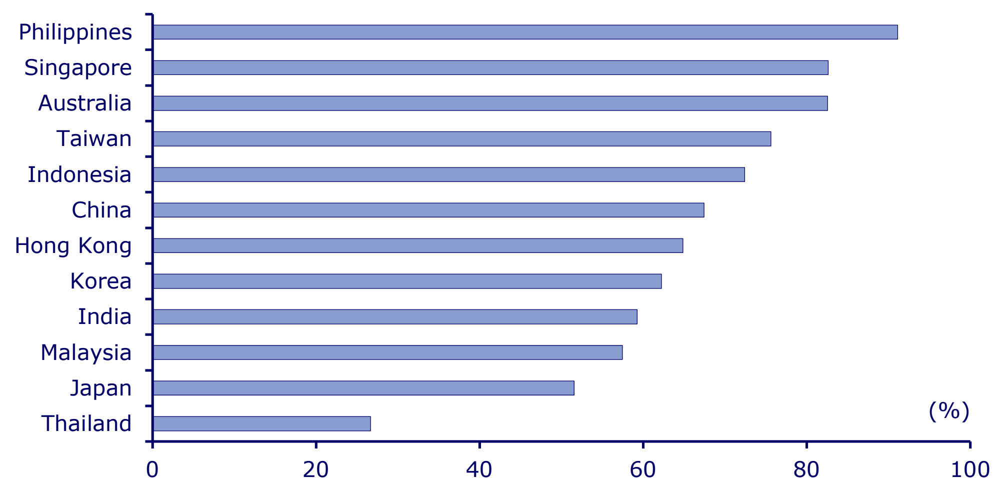
Several Asian CEOs have small salaries and large dividend income

Other corporate leaders in the region have moderate salaries and take most of their income in dividends, including Terry Gou of the Hon Hai group: while his salary last year was US$70,000, he received US$70m in dividend income. The salary of Barry Lam of Quanta was a reasonable US$0.5m, but he also picked up US$60m in dividends from the company. With new laws requiring companies to disclose remuneration of directors, Samsung group's chairman Lee Gun Hee reduced his salary to zero last year but got over US$100m in dividends from the various Samsung listed companies. In India, returning Infosys chairman Narayanan Murthy took no salary last year but received dividend income of US$42m, while new Tata Sons chairman Cyrus Mistry had a nominal Rs0.1m (US$3,000) salary but would have received US$155m from his family's share of the group's dividends.

In most markets, directors' remuneration lags net-profit growth

Figure 74

Companies where directors' remuneration has not increased faster than earnings



Source: CLSA

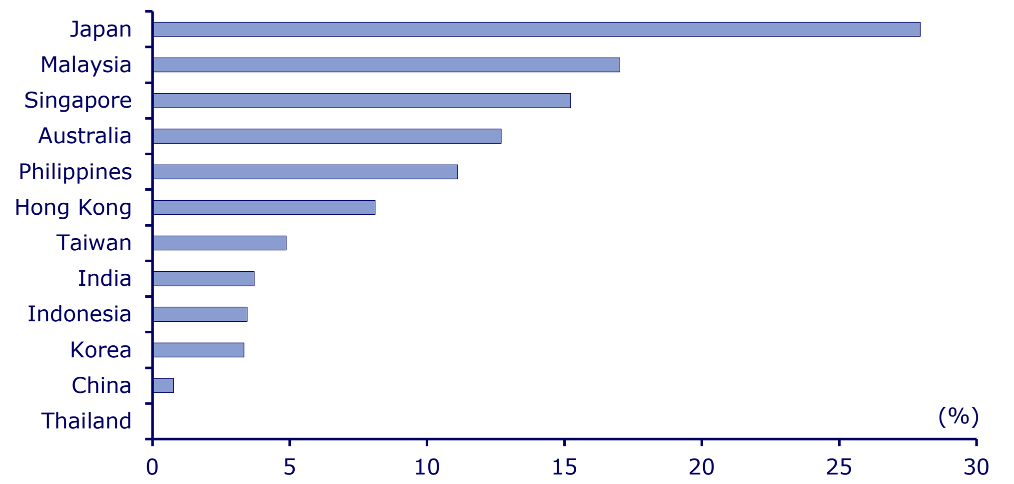
Directors' fees tend to be sticky

Where directors' remuneration has risen faster than company earnings over the past five years, it is generally because of a decline in profit when directors' fees might have been somewhat sticky. Thus, Thailand has done worst on this criterion with many companies seeing earnings decline but directors' fees not falling equally. In Japan, Malaysia and India, more than 40% of our coverage have seen directors' fees rise faster than earnings over the past five years.

On average, only 10% of firms publicly disclose ROA or ROE targets

Figure 75

Companies that disclose three- or five-year ROA or ROE targets



Source: CLSA

None in Thailand provide targets for financial returns

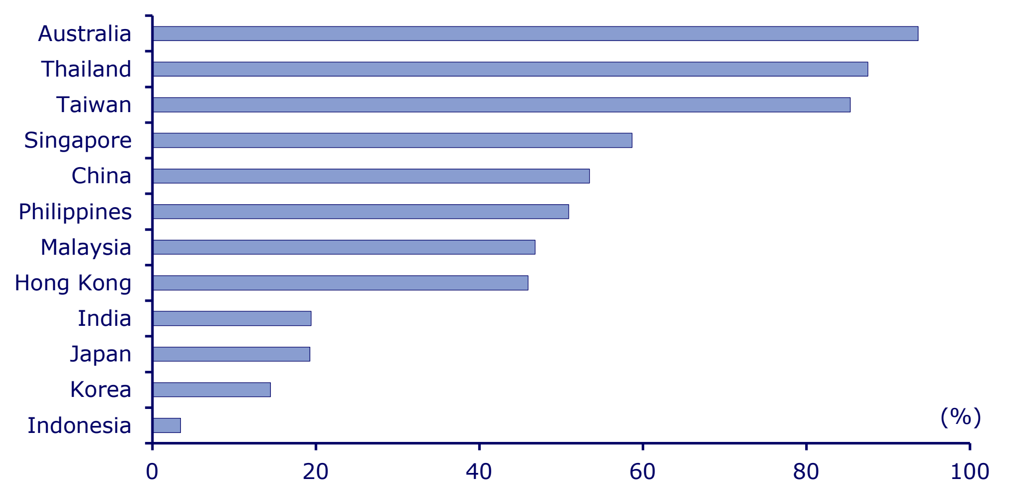
However, other areas of CG are more of a concern for Asia. Financial discipline involves having an appropriate cost of capital estimate and ROA and ROE targets that shareholders can use to determine if management is executing as expected. Across our sample in Asia Pacific, only about one-tenth of companies publicly disclose ROA or ROE targets. Less than 10% of our sample in Hong Kong, Taiwan, India, Indonesia, Korea and China - and none in Thailand - provide any return targets. Separately, only around half the companies across the region give reasonable estimates of cost of capital, ie, within 10% of our estimates (see Figure 76). Less than half of Malaysian, Hong Kong, Indian, Japanese and Korean firms provide reasonable estimates of cost of capital; and in Indonesia, almost none do.

Less than half of HK and Malaysian firms give appropriate cost of capital estimates

Hardly any do in Indonesia

Figure 76

Companies that disclose an appropriate cost of capital

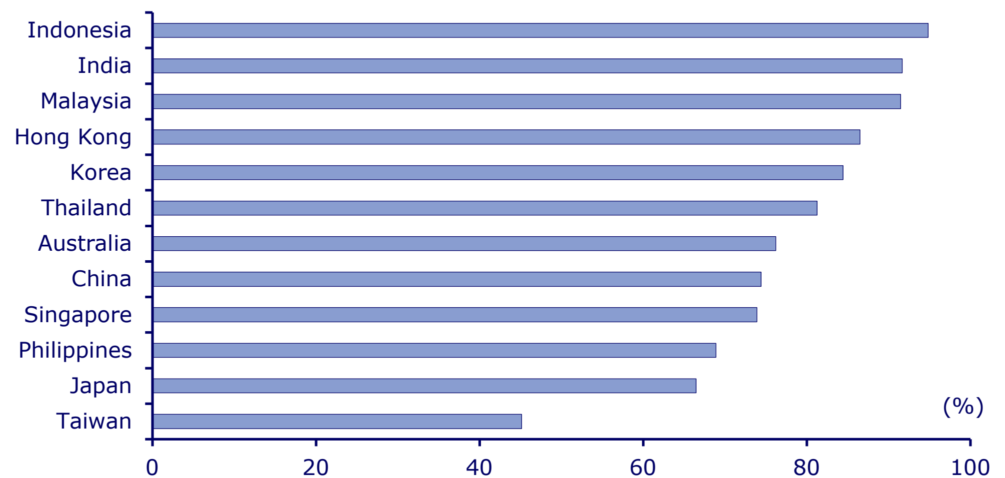


Source: CLSA

Dilutive equity issuance a problem in Taiwan, Japan, the Philippines and other markets

Figure 77

Companies that have not engaged in dilutive issuance



Source: CLSA

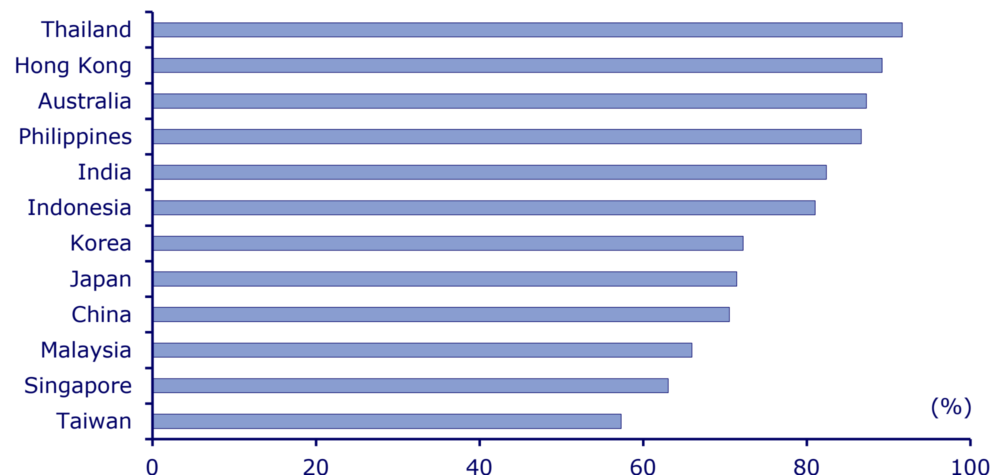
Around 25% of Asian companies diluting shareholders

About a quarter of the companies across our sample in all markets have had questionable or dilutive equity issuance in the past five years. This is a greater concern in Taiwan, Japan, the Philippines, Singapore and China, where more than 20% of our coverage is seen to be diluting existing shareholders. However, Indonesian and Indian companies appear much better at not diluting existing shareholders.

In Taiwan and Singapore, around 40% of firms have built up excess cash

Figure 78

Companies that have not built up cash and diluted ROE



Source: CLSA

Building up excess cash is an issue in a number of markets

A lazy balance sheet with excess cash buildup is another way companies dilute returns to shareholders. This is an issue for one-third or more of companies we cover in Taiwan, Singapore, Malaysia, China, Japan and Korea.

Strong audit committee needs all members to have financial expertise

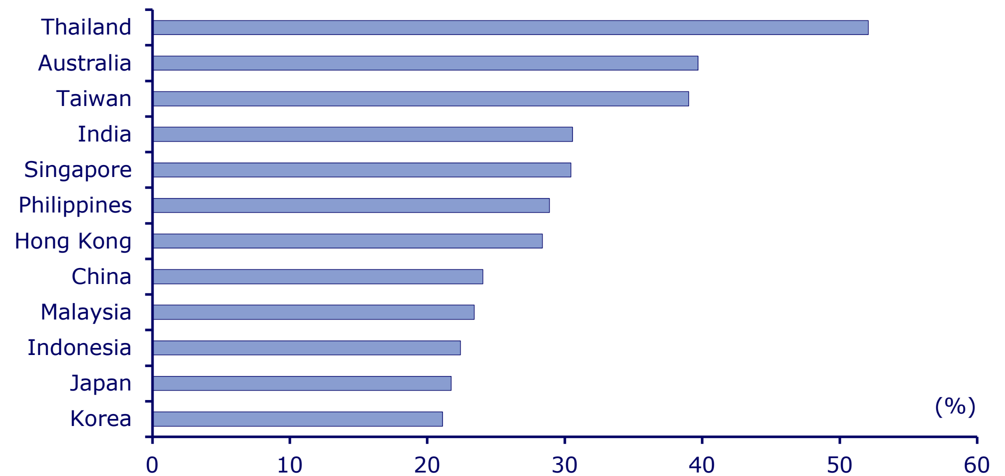
Most companies have an audit committee as it is a requirement of the listing rules. But in Asia, less than 30% of the companies in our sample meet our requirement for a strong audit committee - ie that *all* members of the committee have financial expertise. Thailand and Australia do better on this criterion, but even here only 40-50% of audit committees are made up

Only 29% of our overall coverage has a strong audit committee

entirely from directors with financial expertise. Korea, Japan, Indonesia, China and Malaysia score worst: only about one-fifth of their companies meet our criteria for a strong audit committee.

Figure 79

Companies with properly constituted audit committees



Source: CLSA

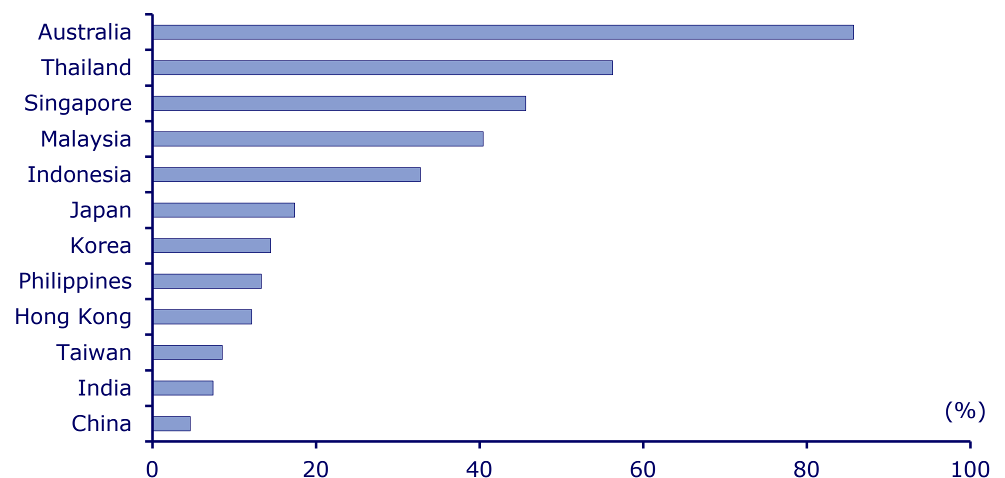
Composition of audit committee is a good signal of CG commitment

We believe this is a good signal for real CG commitment. While it is not a requirement in any market for all members to have financial expertise, if a company appoints persons without financial expertise to the audit committee, investors can validly ask whether its commitment to good CG is genuine.

Less than 20% of Asian sample (ex-Australia) have an independent non-executive chairman

Figure 80

Companies with an independent chairman



Source: CLSA

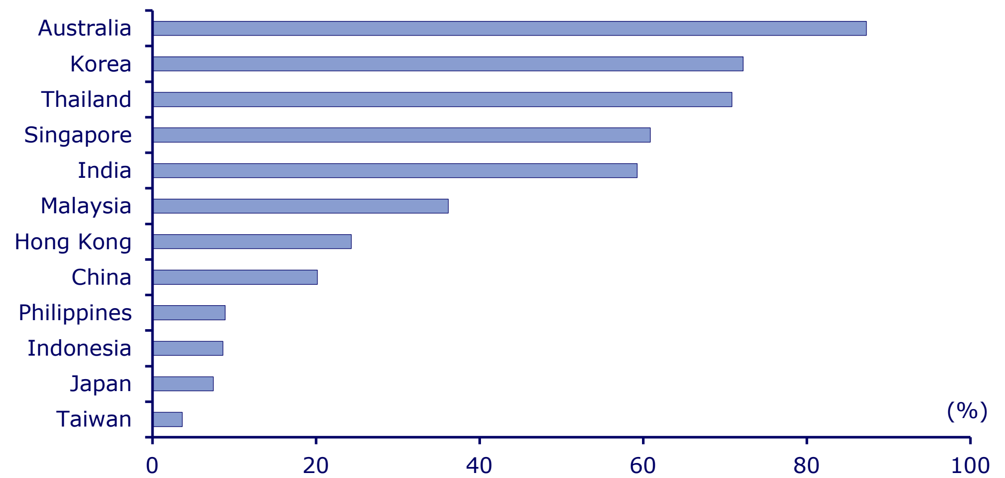
Less than one-fifth of the companies in our entire sample (ex-Australia) have a separate and independent chairman running the board. The board would be in a better position to exert real oversight over management when the chairman is not the same person as the chief executive. This is especially rare in China, India, and Taiwan, where over 90% of the boards do not have an independent chairman.

Independent directors a majority of the board at two thirds of Australian, Korean and Thai firms . . .

. . . but at less than 10% of companies in Taiwan, Japan, Indo and Phils

Figure 81

Companies where over half the board are independent directors



Source: CLSA

Independent directors are usually a minority on the board

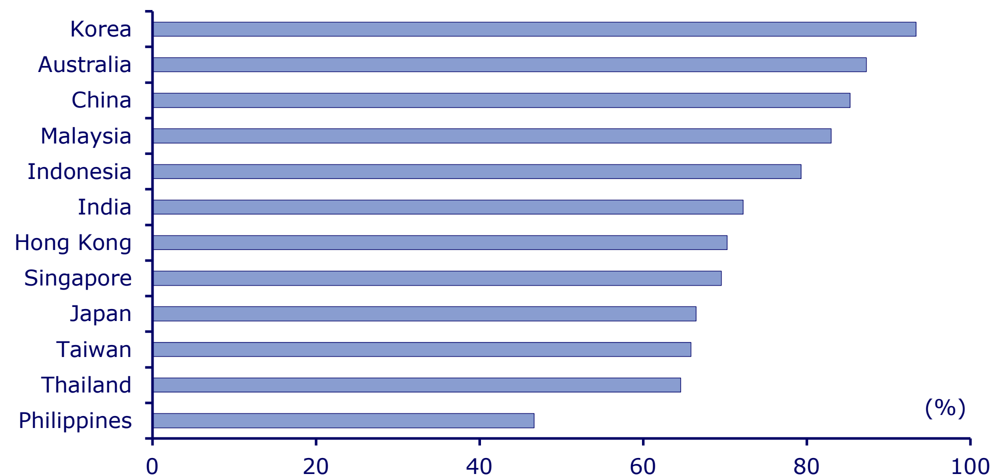
A measure of having a properly functioning board, exercising oversight over management, is for independent, non-executives to be at least half of the board. This is largely the case in Australia. Korean companies appear to score favourably on this question, but whether the directors are truly independent remains an issue. Around 60% of the Singaporean and Indian companies have boards where independent directors are more than half of the total. In other markets in Asia, this is not yet the norm. Less than 10% of the companies in our Taiwan, Japan, Indonesian and Philippine coverage have boards where independent directors are the majority.

More than two family members on board at over 50% of Philippine firms

And at one third of companies in Thailand Taiwan, Japan

Figure 82

Companies with no more than two family members on the board



Source: CLSA

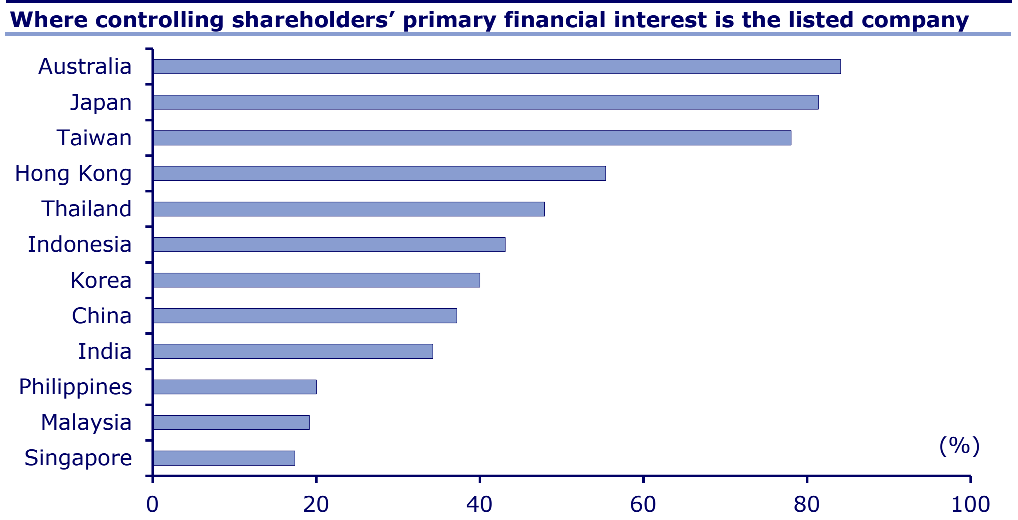
Quite common to have a number of family members on the board

Where there are three or more family members on the board of directors, it is valid to be concerned whether the board will be sufficiently independent to exercise proper checks on management. Approximately half of our coverage in the Philippines and 30-35% of our coverage in Thailand, Taiwan, Japan and Singapore have three or more family members on the board.

Most firms in Singapore, the Philippines and Malaysia are not the controlling shareholder's main financial interest

Figure 83

Where controlling shareholders' primary financial interest is the listed company



Source: CLSA

Conflict of interest is a major concern

Controlling shareholders having a conflict of interest has been a major source of CG risk in Asia. They might have a diluted stake in the company, or other businesses might dominate as their main financial concern. Of our Asia-Pacific coverage, 52% have controlling shareholders whose primary financial interest is not the listed company. We score negatively on this question if the company is held via a convoluted shareholding structure, or is a subsidiary of another listed company, or the controlling shareholder is the government.

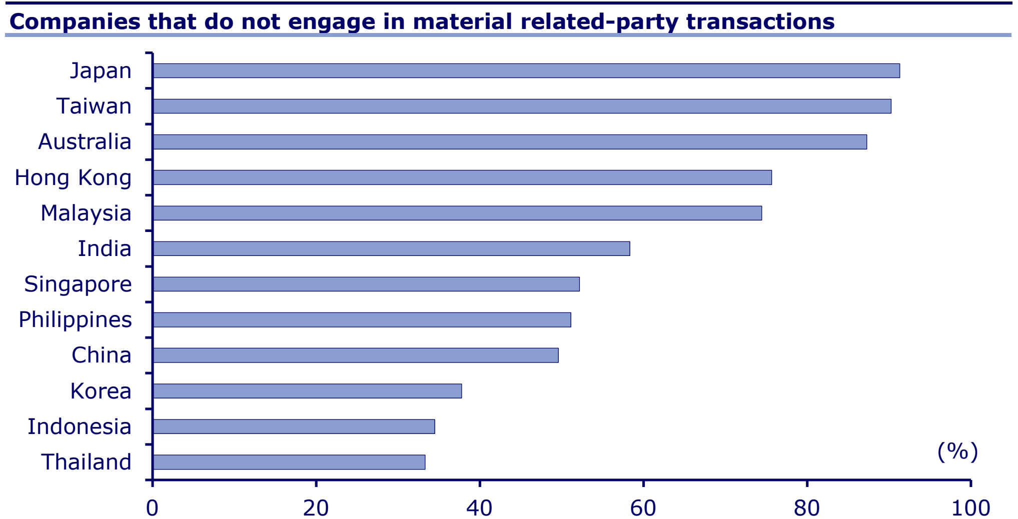
GLCs not usually main financial interest of the government

For around two-thirds of our coverage in Singapore, the Philippines and Malaysia, the controlling shareholder's primary financial interest does not appear to be the listed company. In Singapore and Malaysia, the large number of government-linked companies (GLCs) in our coverage brings down the score on this question. Even in Hong Kong, Taiwan and Japan, the listed company may not be the primary financial interest of the controlling shareholder because it is a subsidiary of another listed entity, or the controlling shareholder has various other interests. In these cases, there is a greater risk of the controlling shareholder's interest not being aligned with investors.

Related-party transactions are an issue in Thailand, Indonesia, Korea and China

Figure 84

Companies that do not engage in material related-party transactions



Source: CLSA

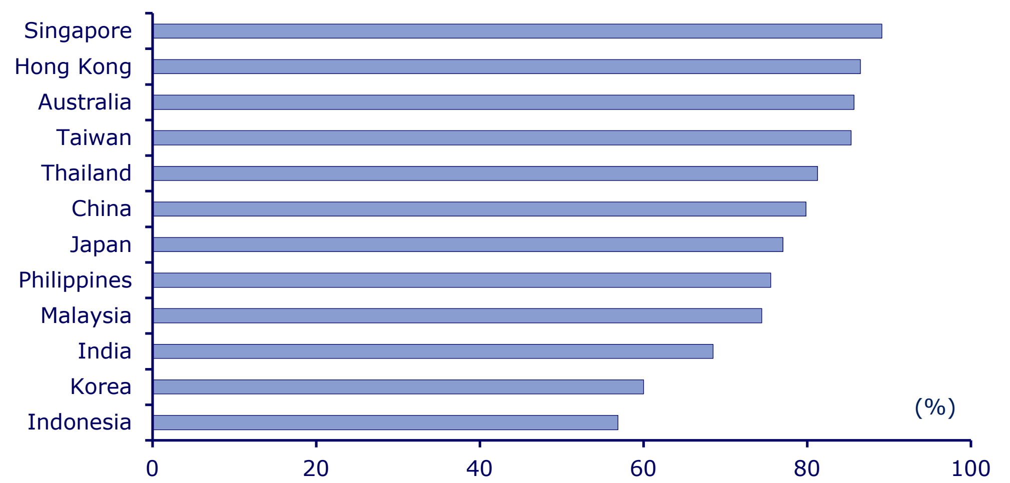
Watch for related-party transactions

Another source of concern is where related-party transactions are common or ongoing in day-to-day operations. This creates the risk that pricing might be set to favour one or the other of the entities and the given company might not be capturing the full value of its operation. Related-party transactions appear to be a bigger issue in Thailand, Korea, Indonesia and China. Singapore does not do very well on this criterion simply because of the dominance of GLCs that would obviously have significant dealings with other GLCs, but this should generally all be above board.

About 30-40% of our coverage in Indonesia, Korea and India have made decisions that disadvantaged investors

Figure 85

Companies without controversy over decisions made at the expense of investors



Source: CLSA

Without voting by poll, shareholders could be disenfranchised

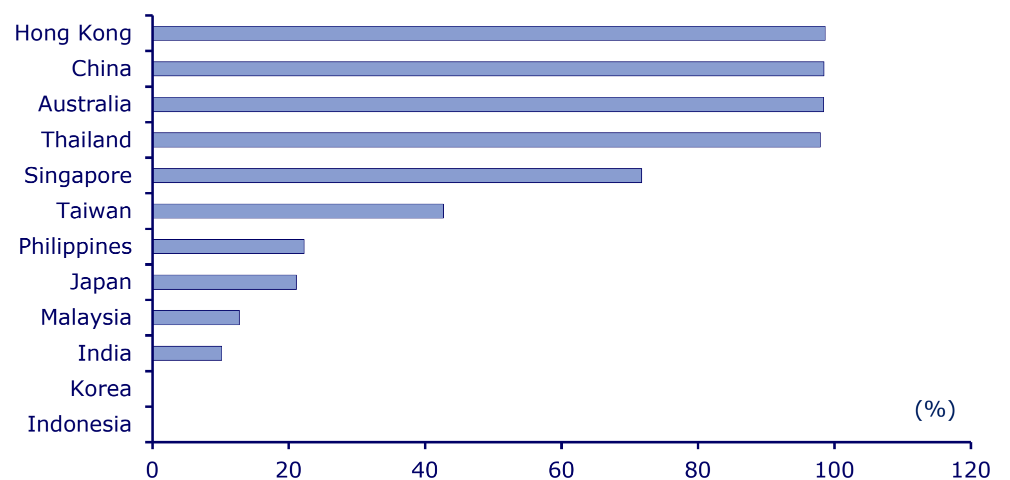
In most of Asia, voting is done by show of hands with a rough-and-ready method of tallying up the proxy votes. One hand up does not give any indication of the percentage of ownership that hand represents, diluting the vote of some larger shareholders. In many markets, custodians who vote on behalf of institutional investors will be allowed to vote either in favour or against as a block for all the investors they represent. If there is a significant minority of investors they represent who might have chosen to vote the other way, their vote is lost. This standard way of voting in a large number of AGMs and EGMs in the region often disenfranchises shareholders.

All companies in HK vote by poll at AGMs as it is mandatory

Polls are still non-existent in Korea and Indonesia

Figure 86

Voting by poll at AGMs and EGMs



Source: CLSA

Growing acceptance for voting by poll

Voting by poll gives all votes cast their proper weight. It involves determining the percentage ownership for all votes cast at the AGM/EGM by those present. Proxy votes by custodians are given based on the percentage of shareholding that are for and against each item. To be properly followed, all items on the agenda should be voted in this manner and the results announced within 24 hours, stating the percentages in favour or against each resolution.

Growing acceptance of voting by poll

Hong Kong set the benchmark for voting by poll in 2009. It has also been standard practice in China, Thailand and Japan (though not in complete form) for many years. It will become mandatory in Singapore from August 2015, although many large, mid- and even small caps have already adopted it voluntarily.

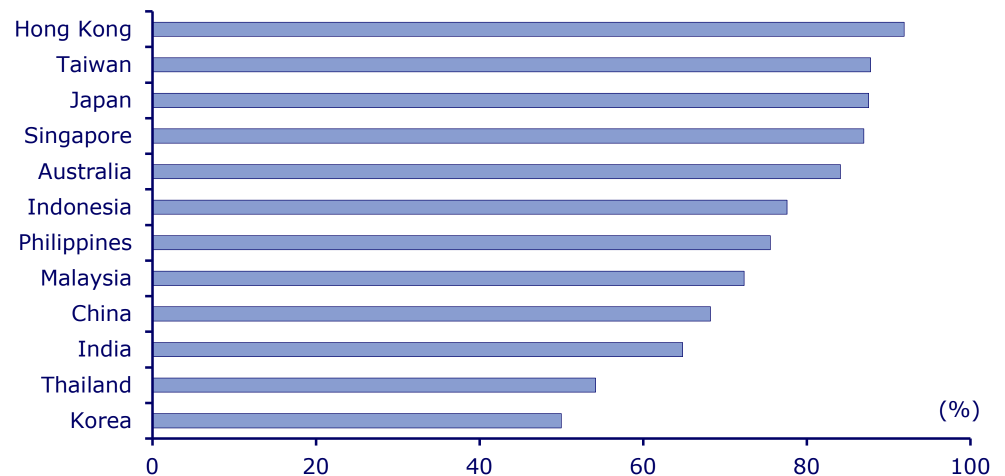
The biggest surprise over the past year has been the increased adoption of polls in Taiwan and India following the development of electronic voting systems (whereby votes are delivered directly to company share registrars through a purpose-built electronic system that simplifies the complex and antiquated voting chains in both markets). However, in India few of the companies that carry out electronic voting declare the result within 24 hours, which is part of our criteria on voting by poll.

Indonesia, Korea, Malaysia and the Philippines remain holdouts. To be fair to Indonesian companies, the law requires them to count votes at their meetings - they just don't get around to publishing the results! And in Malaysia, polls are now mandatory for transactions requiring independent shareholder approval.

Government has major influence on business decisions for around half of Korean companies

Figure 87

Companies able to make decisions independent of government interference



Source: CLSA

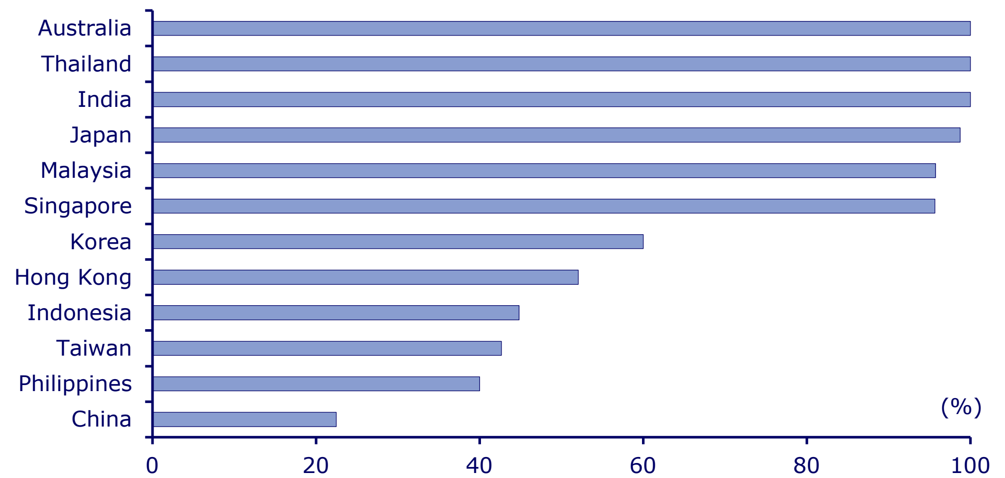
Government can also affect firms' ability to maximise value in Thailand and India

Government interference can impact the ability of companies to maximise shareholder value and is an issue particularly in Korea, Thailand and India, as well as China and Malaysia. Hong Kong comes out best on this score, but even here investors have to keep alert for government interference for about 10% of the companies.

All companies in Australia, Thailand and India publish results within two months of financial year-end

Figure 88

Companies that publish full-year results within two months of financial year-end



Source: CLSA

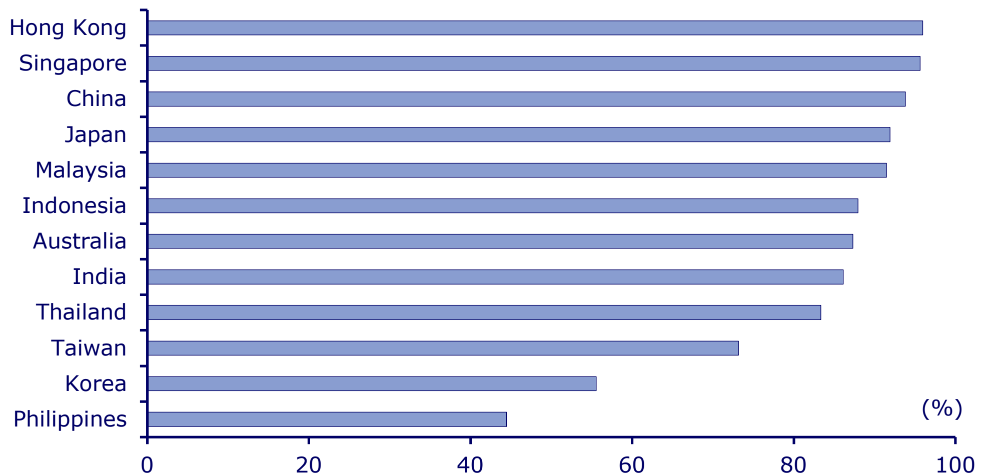
Chinese companies slow in reporting results

In Australia, Thailand, India, Japan, Malaysia and Singapore, most listed companies now publish full-year results within two months of their financial year-end. In 2012, none of the companies in our Indonesia coverage reported full-year numbers within two months: now over 40% meet this criterion. However, companies in China are still tardy - less than a quarter publish their full-year results within two months.

Relatively few Philippine and Korean companies disclose market-sensitive information promptly

Figure 89

Companies that disclose major and market-sensitive information punctually



Source: CLSA

Slow disclosure encourages insider trading

Prompt disclosure of market-sensitive information is important for guiding the market on the latest business developments and discouraging insider trading. Poor disclosure of such information is a particular issue in the Philippines and Korea. Thailand has seen an improvement since 2012: more than 80% of companies now disclose major and market-sensitive information punctually.

Market profiles

Australia 79

China 82

Hong Kong 95

India 109

Indonesia 119

Japan..129

Korea..142

Malaysia 152

Philippines..162

Singapore 172

Taiwan 183

Thailand 193

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Australia - Remuneration still king

Key issues and trends

- Remuneration remains the highest-profile issue as Australia is a developed market.
- "Two strikes" rule has increased shareholder engagement and number of strikes was down in 2013.
- Leighton and Newcrest were the biggest negative CG score movements.
- Sydney Airport, Asciano and Wesfarmers were the positive movers, with a five-year track record not including actions following the Global Financial Crisis (GFC).

Remuneration is the highest-profile CG issue

Adherence to corporate governance principles is assumed to be the norm

Given that Australia is a developed market, corporate governance and corporate social responsibility are perceived to be established practices. The market is highly regulated and business standards (eg, environmental) are predominantly legislated. Problems with corruption and fraud are rare in investment-grade stocks and there is a reasonable level of corporate transparency and shareholder engagement. Adherence to CG principles is assumed to be the norm in Australia.

Since the GFC, executive compensation levels have come under fire in Australia. This is a similar issue seen across a number of developed markets, particularly in the face of dwindling profits. The key concern boils down to an inadequate link between executive compensative and company performance. It is accentuated by a strong Aussie dollar and comparisons offshore. Increasingly, we observe investors focused on the relative ease of management roles in a market famous for duopolies.

"Two strikes" policy has increased shareholder engagement

Potential board spill if over 25% votes "no" to remuneration report at successive AGMs

In June 2011, the previous Australian government passed the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011. This introduced a "two strikes" rule to the Corporations Act, which was put into effect prior to the 2011 annual general meeting (AGM) season. Under this rule, if a remuneration report receives 25% or more "no" votes (of shares present and voting) at two successive AGMs, shareholders will have to vote on a board spill motion at the AGM. The entire board (aside from the managing director) can be voted out if more than 50% of shares present and voting vote against the board.

Significant step-up in shareholder engagement and consultation

We observe many more Australian corporates have consulted key stakeholders and proxy advisors to resolve their remuneration issues. We observed in 2012 that companies that had received a "first strike" had picked up levels of engagement. A variety of measures have been taken to avoid triggering a strike, ranging from overhauling pay packages to simply improving disclosure. Major names like Fairfax, Cochlear and Lend Lease received strikes in 2012 but not in 2013.

The 2013 AGM season (November 2013) saw a reduction in the number of major companies receiving a strike due generally to better disclosure and engagement. However, some are still learning the hard way - the clearest message from shareholders is still being delivered to boards through a "first strike" to their company. There is no question that companies need to

recognise that shareholder engagement standards have irreversibly changed. High-profile companies that received a first strike in 2013 included Aurizon, Super Retail Group, David Jones (being taken over now), Southern Cross Media, NEXTDC and Greencross.

But there are still stock-specific ESG issues

Material positive and negative moves

This is not to say we are not extremely cognisant of stock-specific ESG issues that can impact shareholder value. We highlight the material positive and negative movements in our CG scoring below.

Key negative moves are Leighton and Newcrest

It is worth noting that some scores have been negatively impacted by stricter interpretation on the composition of the audit committee (requiring that all members to have a financial background): Brambles and James Hardie's scores on our rating have been impacted by this. But more important to us are the stocks that have, through their own actions, seen material negative movement in CG scores:

ACS involvement has led to lower scores for Leighton

- **Leighton.** Most of the changes relate to ACS increasing its active control over Leighton after taking over Hochtief, which had previously been a more passive majority shareholder. In May 2013, the independent chairman and two independent directors resigned over concerns about ACS's increased interference. Then in March 2014, the Leighton CEO and CFO were sacked, with the parent CEO being appointed the Leighton CEO and appointing a new CFO also associated with ACS. ACS also launched a partial bid to increase its ownership, ending at 69%. This triggered the chairman's resignation, replaced by the new CEO who became executive chairman. More independent directors resigned and were replaced by parent company executives.

Newcrest had a very public issue over the past couple of years

- **Newcrest.** In addition to Newcrest being a major underperformer for 2012 and 2013, it also had a much-publicised disclosure issue in June 2013. This resulted in a settlement with ASIC in June 2014, admitting contraventions of the continuous disclosure provisions of the Corporations Act. So not only has the company been scored down for this but, perhaps most interestingly, we have also marked the company down around the investment community having good access to senior management - we suspect a matter of once-bitten twice-shy. As a broader observation, other Australian companies appear to be more nervous about communications with the market as a result of this.

Key positive movers are Sydney Airport, Asciano and Wesfarmers

Post-GFC actions are now not in their five-year track records

There is a degree of commonality among these three companies: each had to take action around the time of the GFC to shore up their respective balance sheets. This led to dilutive equity raisings and/or sale of assets to related parties. Our relevant CG scoring takes into account a five-year track record for companies in such matters, so the updated scoring now removes such actions. In addition, both Sydney Airport and Asciano have dramatically simplified their corporate structures: Sydney Airport (formerly MAp) sold offshore airport assets and took 100% ownership of Sydney Airport (from 85%) resulting in increased transparency and Asciano moved to a corporate structure from a stapled security.

Further details or opinions available on request

Figure 90

Australia: Companies in top-two quartiles (alphabetical order)

Company	Code	Company	Code
Adelaide Brighton	ABC AU	Incitec Pivot	IPL AU
ALS	ALQ AU	Metcash	MTS AU
Amcor	AMC AU	Orica	ORI AU
Ansell	ANN AU	Orora	ORA AU
ASX	ASX AU	Ramsay Health Care	RHC AU
BHP Billiton	BHP AU	ResMed	RMD AU
Brambles	BXB AU	Seek	SEK AU
Carsales.com	CRZ AU	Sigma Pharma	SIP AU
Cochlear	COH AU	Sirtex Medical	SRX AU
CSL	CSL AU	Sonic Healthcare	SHL AU
CSR	CSR AU	Tatts	TTS AU
Fletcher Building	FBU AU	Treasury Wine	TWE AU
IAG	IAG AU	Virtus Health	VRT AU
iiNet	IIN AU	Vocus	VOC AU
		WorleyParsons	WOR AU

Source: CLSA

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China - SOE reform leads the way

Key issues and trends

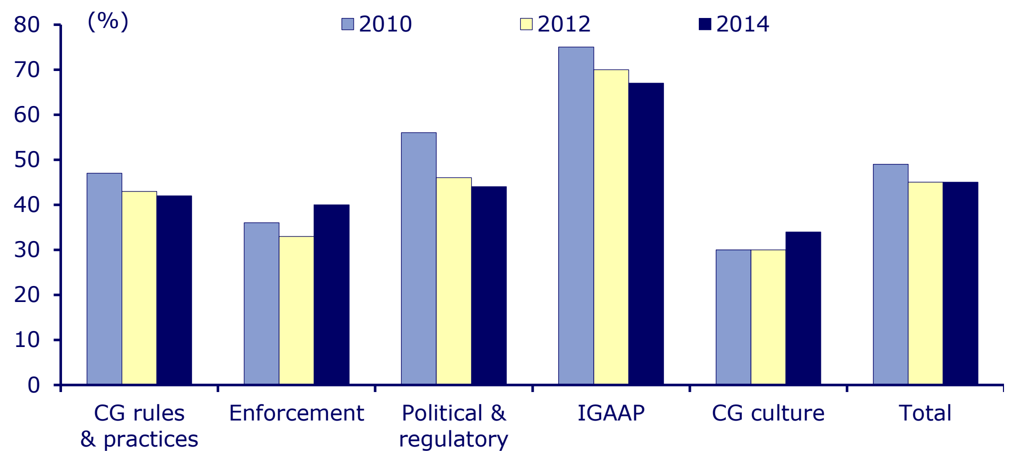
- Enforcement key after the resumption of IPOs in early 2014
- Renewed focus on SOE reform to reduce administrative control in enterprises
- Little correlation seen between stock price and good CG in private firms
- Government determined to raise standards of auditing
- Availability of corporate reports and announcements in English still limited
- Regulatory disclosure has improved, but more English translations needed
- Stockmarket still retail-dominated, regulatory policy often tailored to their interests

Overall score stays the same at 45% for both 2012 and 2014

Scores for enforcement and CG culture increased

Figure 91

China CG macro category scores



Source: ACGA, CLSA

China has seen improvement in regulatory enforcement

After falling a few percentage points in our last *CG Watch* report in 2012, China has steadied the ship of reform and appears on the cusp of moving back into positive territory. The main area of improvement is in regulatory enforcement, with some higher marks as well for certain aspects of the country's CG culture. Ongoing challenges can be seen in the other three categories, but so too can a number of positive signs. China's securities markets remain a work in progress.

CG rules and practices

Falls from 43% in 2012 to 42% in 2014

As the score suggests, not a great deal has changed in corporate governance rules in China over the past two years. No question in this category improved in score, while two declined (on the speed of financial reporting). Fortunately, the addition of three new questions on sustainability reporting halted the slide (see 'Sustainability reporting in China').

China's scores for the speed of financial reporting fell

China's scores for the speed of financial reporting fell following an ACGA review of 2013 audited annual financial statements across the Asia region. Against regional regulatory best practice of 60 days, our analysis of 31 large caps and 10 midcaps listed in Shanghai found almost all of them reporting close to 90 days. The average reporting period for the large firms was just under 89 days - one of the slowest in the region - while for the midcaps, it was actually better. They averaged 82 days.

Annual reports are released right after audited accounts

One positive aspect of the Chinese market, however, is that most of these companies produce their full annual reports just a few days after their audited accounts are released. Although a seemingly sensible thing to do, this is usually not the case in many markets around the region. There is often a significant time lag of a month or more between the publication of audited financials and annual reports.

Dual-listed companies must report before the four-month deadline

It is also worth noting that, while most markets in Asia have moved to a three-month deadline for audited annuals, the rule in China is still four months. Many of those companies in our survey reported much earlier because they have both A and H shares (ie, they are dual-listed in Shanghai and Hong Kong) and must follow the stricter Hong Kong standards of three months.

Financial reporting has improved in China over the past 10 to 20 years

Looking at financial reporting more broadly in China, one can see signs of improvement, say auditors who have worked in the market for the past 10 to 20 years. In particular, firms with A/H shares tend to have more complete disclosure than those with just A shares. A good example is in the accounting for long-term retirement benefits, such as heating subsidies for retirees (a particularly important issue for people in northern China). Dual-listed, state-owned-enterprises (SOEs) will usually engage an actuary to calculate the fair value cost of these liabilities, which can extend far into the future and ensure a proper accrual to both current and non-current liabilities on the balance sheet. Many SOEs with just A shares tend not to do this, according to an auditor we interviewed.

But non-financial reporting remains a challenge

An area of ongoing challenge, however, is non-financial reporting: the disclosure of a detailed MD&A, a report of the directors and corporate governance statement. The relevant regulation from the China Securities Regulatory Commission (CSRC) is titled, *Standards for Contents and Formats of Information Disclosure by Companies Publicly Listed Offering Securities No. 2* - Contents and Formats of Annual Reports. While it requires disclosure of corporate governance systems and developments in annual reports, such standards fall behind regional peers in areas such as board activities, committee reports and so on.

Please consider abstaining

No progress in running of shareholder meetings

In contrast to many other Asian markets, one area in China where we are not seeing much improvement is in the running of shareholder meetings. Although voting by poll is effectively required by the company law's stipulation of "one share, one vote" and the Shanghai Stock Exchange introduced a degree of electronic voting for annual general meetings some time ago, other aspects are a cause for concern. There is anecdotal evidence, for example, of companies trying to influence intermediaries to dissuade their clients from casting "against" votes and inviting them to abstain instead. Minority shareholders, meanwhile, stand a better chance of getting their say on resolutions where controlling shareholders cannot vote, such as certain related-party transactions. Once again, the evidence suggests that dual-listed companies perform best in this area, as they will engage the presence of PRC lawyers and an independent share registrar to count the vote.

Signs of emerging shareholders activism in China

Interestingly, there are signs of emerging shareholder activism in China, with domestic institutional shareholders taking a more active role in company engagement and voting and attending general meetings. Some minority investors have taken it even further: in June 2013, six shareholders of China Resources Power, a subsidiary of the large state enterprise China Resources, mounted legal action in Hong Kong against more than 20 of its current and

former directors, among them group chairman Song Lin (who was subsequently arrested by the Central Commission for Disciplinary Inspection), over the acquisition of mining assets in Shanxi Province (the litigation was later withdrawn over a procedure issue). More recently, a group of minority shareholders launched a class action against China Everbright for trading errors in 2013.

The concept of corporate social responsibility has gained in importance in China

Sustainability reporting in China

Since an amendment to the company law in 2006, the concept of corporate social responsibility (CSR) - the term most commonly used by government agencies - has grown in importance in China. Both the Shanghai and Shenzhen stock exchanges have CSR guidelines for listed companies and require them to report on a range of environmental, social & governance (ESG) issues in their annual reports. The State-owned Assets Supervision and Administration Commission launched its own CSR guidelines for central state-owned enterprises in 2008, while two years later the Ministry of Finance published its Application Guidelines for Enterprise Internal Control, No.4 - Social Responsibilities, which stated that CSR reporting should include issues such as safety production, product quality, environmental protection, resource saving, a high employment rate and protection of employee rights. In 2014, the National Development and Reform Commission, China's top planning agency, announced that it would require all companies that emitted more than 13,000 tonnes of carbon dioxide in 2010 to report their future annual emissions of major greenhouse gases.

ACGA found the quality of sustainability reporting in China is poor

In an ACGA review of the sustainability reporting of 10 large caps and 10 midcaps in China, we found the larger companies had some reporting on these issues, but the quality of this reporting was mostly poor. Three of the large caps did well, had standalone reports (ie, separate from the annual report) and followed the Global Reporting Initiative (GRI) standards. But the others had very weak disclosure, at least in English. We found the same pattern, only intensified, among the midcaps: only two had a sustainability report in English, while five companies did not even have a website. There is little evidence of sustainability being seen as a strategic issue for mainland companies, despite the government's best efforts.

Hard-working bank INEDs

Can INEDs in China truly be independent?

Whether independent non-executive directors (INEDs) are truly independent in China is a persistent question, particularly when most high-level board appointments are still a political matter and such directors are not appointed by choice. The Code of Corporate Governance for Listed Companies has been in place since 2002 and, as we noted in our last survey in 2012, would benefit from a revamp. While there is talk of revising it, it appears that regulators would prefer to focus their energies on enforcement rather than more board reform (a not unreasonable choice in the current climate).

Banking sector has seen the most changes in corporate governance

Nevertheless, serious moves are afoot in the banking sector, where the China Banking Regulatory Commission has produced a detailed set of corporate governance guidelines for commercial banks. These lay down some quite specific roles and responsibilities for INEDs, who are required to spend a minimum of 15 working days physically at the banks each year and board committees. Banks in China typically have committees for audit, risk management, nomination, remuneration, strategy and related-party transaction control.

Enforcement

Rises from 33% in 2012 to 40% in 2014

Enforcement clearly has become *the* issue of late for mainland securities regulators. During a delegation that ACGA led to China in September 2013, a senior regulatory official in Beijing told us that the China Securities Regulatory Commission (CSRC) was hiring hundreds of additional staff to beef up its enforcement capabilities. While this may seem an insufficient expansion when set against the 90-100 million retail investors in the country, it nevertheless shows the direction of their efforts. The Shanghai Stock Exchange has also stepped up its surveillance team over the past few years and, overall, we are seeing significant emphasis on tackling insider trading, market manipulation and other frauds.

CSRC is mindful of the need to protect investors from illegal market activities

With the domestic IPO market restarting after a moratorium lasting from October 2012 to January 2014 and a sudden expansion in IPOs, the CSRC is mindful of the need to protect investors from illegal market activities, in particular insider trading. On 27 June, 2014, the commission for the first time published three-year statistics on its enforcement against insider trading. These showed that the number of cases commenced has risen steadily from 48 in 2011 to 70 in 2012 and 86 in 2013. So far in 2014 it has taken on 25 new cases. Regarding disciplinary action against individuals over insider dealing, the number of cases went from just 19 in 2011 to 66 in 2013.

Enforcement in the mainland is often perceived to be politicised

Although certainly more vigorous today, enforcement in the mainland is also perceived to be politicised and often selective. A controversial case in point was the China Everbright "fat finger" incident from August 2013. The CEO of China Everbright Securities resigned after chaotic trading on the Shanghai Stock Exchange was precipitated by his company on 16 August. Investigation by the CSRC appeared to suggest that China Everbright had "design flaws" in its automated trading system and that its internal risk-controls systems were "obviously inadequate". Given its failure to disseminate information about the trading error before conducting the transactions, China Everbright's errors were described as insider dealing. The CSRC ordered China Everbright to suspend its automated trading business and fined it Rmb523m (US$85.5m). Four of its executives were also fined and barred from the securities industry for life. Class action law suits commenced eventually by parties suffering losses. However, a former senior executive of China Everbright's trading department later took the CSRC to court, challenging that it was only a case of trading error and could not possibly amount to insider dealing.

Political and regulatory environment

Falls from 46% in 2012 to 44% in 2014

Following the high-level announcements coming from the landmark Third Plenum of the Communist Party of China's 18th Party Congress in November 2013, it appears that the pace of reform in state-owned enterprises in China will quicken. In particular, the extension of mixed ownership to more state-owned assets, especially those held by unlisted parent companies, appears to be the next trend. An illustration that the market recently witnessed was the rather swift execution of an asset injection by the parent company of Citic Pacific, a major overseas PRC state enterprise incorporated and listed in Hong Kong, into the latter listed vehicle. The deal was announced in March 2014 and completed the following quarter.

Mixed ownership: Sinopec sets the pace

The overall aspiration of SOE reform is to reduce government interference in listed entities and to change the role of the State-owned Assets Supervision and Administration Commission from one of close supervisor of SOEs to more a manager of capital (ie, a type of investment holding company). One of the first

significant transactions to show Beijing's new approach was Sinopec's February 2014 announcement that it would invite private investors and social funds to participate in ownership of its sales unit, thus giving it a "mixed ownership" structure. This invitation was the first of its kind in China's state-owned oil sector and market analysts consider Sinopec's sales unit to be its best asset.

New board to promote good governance

In the mixed-ownership sales unit, the board will have directors from Sinopec, private and social investors and independent directors and employees, rendering it closer to an international-style board of directors than a typical SOE board. The hope is that such a board will be in a better position to promote good governance of the sales unit and, by extension, Sinopec itself. The unit may also potentially become an IPO candidate in future and could serve eventually as a pilot case of a mainland-listed company with a more effective and diversified board.

Sinopec's plans could provide a model for other SOEs

If Sinopec's plans proceed to completion later this year, it would provide a good model for other SOE reform in oil and other sectors. Indeed, another oil giant, China National Petroleum Corporation (the parent of PetroChina) also pledged in March 2014 to move towards the development of mixed-ownership, while China Telecom pledged the same. On 6 June 2014 Cofco Meat, a leading integrated pork company and a consortium of investors comprising KKR, Baring Private Equity Asia, HOPU and Boyu, announced the formation of a strategic partnership. Ning Gaoning, chairman of Cofco Meat, said that, 'bringing in the four strategic investors is an action by Cofco to diversify our equity ownership and enhance our corporate governance.'

Note: China's score in this category slipped due to a lower score on the quality of regulatory websites relative to other markets in Asia.

IGAAP (accounting and auditing)

Falls from 70% in 2012 to 67% in 2014

China's accounting and auditing regime remains a challenging work in progress. The Ministry of Finance (MOF) and the China Institute of Certified Public Accountants (CICPA) are keenly aware of the need to enhance standards of China CPA firms and CICPA has stepped up efforts on professional training as its focus for 2014.

Uncertainties remain over the direction of regulation

Yet uncertainties and a degree of confusion remain over the direction of regulation. In an episode that highlighted a deepening misunderstanding about mainland accounting regulation, a recent MOF consultation sparked controversy in Hong Kong and upset local auditors. In April 2014, the MOF proposed a requirement that any accounting firm doing field audits on the mainland would need to hire personnel qualified under CICPA to do the audits. MOF viewed this as an attempt to enhance the quality of audits and the integrity of its regulation, while Hong Kong accountants saw it, with some justification, as a threat to their livelihoods.

Big 4 will not be affected by proposed rules on audits in China by outside CPA firms

Interestingly, the Big Four are unlikely to be affected by these proposed changes, since they have been localising for many years by hiring mainland staff with CICPA qualifications and increasing the number of local partners according to mainland regulations. Where the proposed rules will likely be felt however, is at 40 to 50 mid-and-small-sized Hong Kong audit firms, which either have no association with mainland CPA firms or, even if they do, no profit-sharing arrangement with them. Some observers have argued that these smaller firms could see their profits wiped out under the new MOF rules. Some may even be forced to shut down.

MOF perceived to want to protect mainland auditors from potential liabilities

Meanwhile, another MOF proposal relating to mainland companies seeking an overseas listing and their local audit firms not signing up for the audited financials, is perceived as protecting mainland auditors from potential liabilities, while leaving their overseas (and Hong Kong) affiliates to sign-off on the basis of work done on the mainland. But again, this has already been the practice of the Hong Kong units of one or more of the Big Four when signing off on Hong Kong listings of mainland firms. Hence, the real impact of these proposals is largely to formalise the existing practices of the larger audit firms.

The market fears MOF's measures will lead to erosion in investor protection

The market perceived (not necessarily accurately) that the MOF's consultation was a protective measure that would lead to an erosion of investor protection. Investors should not conclude that the quality of audits conducted by mainland-qualified accountants was inferior in all cases. The reality is that, if a company is of sufficient size and sophistication with good internal controls and a compliance mindset, it probably relies already on the Big Four or a comparable auditor. On the other hand, audits carried out by smaller China CPA firms may be of more questionable quality.

Note: China's score in this category slipped due to a lower score on the quality of regulatory reporting relative to other markets in Asia.

CG culture

Rises from 30% in 2012 to 34% in 2014

Our score in this category has risen not because we see any dramatic improvement in the CG culture of China. Indeed, a study on board governance published by Beijing Normal University in 2013 found that more than 88% of listed companies failed a survey devised by the university. Yet what is apparent to us from numerous meetings with regulators, listed issuers and auditors over the past two years is that there are signs that some SOEs are taking governance issues, especially the operations of their board, more seriously. In tangible terms, they are more open to having substantive discussions about governance than in the past and are actively looking again for fresh ideas.

No correlation observed between value and good governance in China's private firms

There is an intriguing and opposite, trend however among private enterprises. While there is a growing number of private enterprises on the mainland demonstrating good value, there is no clear correlation between this and good governance. Even so, there are private firms adopting a refreshing take on governance best practices, such as INEDs or supervisory board members being tasked with coaching the second generation of the founding family and ensuring they stay on track.

We do not expect rapid change in the corporate governance culture of China

It would be unrealistic however, to expect rapid change in the CG culture of China. Central SOEs still enjoy monopolies in their respective sectors, so the incentive to relinquish administrative control or influence is not great. An independent director on the board of an SOE would still be caught in the minefield of dynamics among senior management, the supervisory board and the party committee and would find it hard to navigate and discharge his duties as a director without making mistakes, politically or legally.

The seeds for further reform have been sown

On a positive note, the seeds for further reform in the country have been sown. The practical need to interact with the global investment community and China's quest for legitimacy for its economic leadership, have given the government the credibility to convince SOEs that not improving their CG is simply not an option.

Progress of CG code will affect country score in 2016

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

- No sign of vigorous enforcement to protect retail investors
- No progress on corporate governance in SOEs following reforms and restructuring
- Localisation of the audit industry produces a fall in audit quality
- Appointment of INEDs driven by politics rather than company choice
- No progress on revising the Code of Corporate Governance

What to fix?

Quick fixes

- Better engagement with minority shareholders in voting and attendance at general meetings
- Improving information access in English on the websites of regulators and companies
- Enhancing effectiveness of the boards in SOEs, in particular independent directors
- Reviewing and upgrading the Code of Corporate Governance for listed companies

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Research perspective - Corruption battle

Chinese President Xi Jinping has invested in two initiatives: an economic reform agenda, unveiled at the Third Plenum of the Central Committee in November; and a fight against corruption. Twenty-two months into his administration, his anti-corruption campaign is still going strong, bringing down corrupted officials at both high and low levels. China is clearly progressing towards a better-governed country, but the extreme measures also demonstrate how deeply rooted governance issues are in the country.

Local audits despite global ambitions

Controversy over audit of Chinese companies listed or plan to be listed in overseas markets prevails

The controversy over the audit of Chinese companies that are listed in overseas markets or those planning to list in overseas markets prevails. Under Ministry of Finance rules, international accounting firms would have to team up with a mainland accounting firm to conduct these audits. These rules remove the discretion from the international accounting firms to send international staff to assist with these audits and to verify that these audits were done in compliance with international accounting standards.

Relative stability

SOEs disclosure remains poor and there is significant room for improvement

Among our coverage of 216 China/HK entities we have witnessed a number of corporate governance issues over the last two years. Notably, the corruption investigation of Song Lin, chairman of China Resources, the graft investigation at PetroChina and poor communication issues at Prince Frog. In general though there have been fewer corporate governance issues at SOEs despite SOEs representing the majority of China's market capitalisation. SOEs disclosure however, remains poor and there is significant room for improvement.

The China Resources Group chairman is under investigation

Song Lin was removed from China Resources Group's chairmanship by the central government on 17 April, according to the website of the Organisation Department of Communist Party of China's (CPC) Central Committee. Song is currently being investigated by CPC Central Commission for Discipline Inspection for 'suspected serious violations of discipline'. As Song is the senior officer of one of China's largest SOEs, this is seen by the public as a sign that China's anti-corruption campaign is spilling into SOEs and its management structures.

Share price has since stabilised as the focus of investigation shifted towards the individual

China Resources Group has five HK-listed companies (China Resources Power, China Resources Gas, China Resources Enterprise, China Resources Land and China Resources Cement). The share prices of these companies were negatively impacted at the time when the investigation of Song Lin was reported however, the share prices have stabilised since as the focus of the investigation has shifted towards the individual rather than the SOE.

More efficient capital expenditure is the likely end result of the graft investigation at PetroChina

The recent standout corporate governance issue for the oil & gas sector in the region have been graft and corruption concerns among Chinese SOEs. Last year's investigation of CNPC and PetroChina caused a significant drag on share prices and has since spilled over into concerns about the validity of outsourcing contracts. We believe that the crackdown by government will turn out to be positive for shareholders as capital expenditure will become more efficient. We are clearly seeing evidence of this at PetroChina. The environmental issues that investors might anticipate in the energy sector remain but analysis shows continuing improvement in health and safety issues. We believe the rise in natural-gas production and use is significantly beneficial for air quality across Asia as it replaces more polluting fuels. All the investable stocks in the energy sector are contributing to this improvement in health and safety.

Poor communication by Prince Frog is seen as poor corporate governance

Ultimately, being attacked by a short seller by itself is not necessarily a CG issue, but very poor communication with shareholders and an inability to protect minorities is. Prince Frog handled the attack by Muddy Waters poorly and has, as a result, largely faded of the radar of institutional investors.

Food safety under scrutiny

Food scandals in China remain common and involve even MNCs

Food-safety issues in China remain prevalent. For example, McDonald's and KFC, owned by Yum! Brands, have recently been hit by food-quality and safety scandals. Their food suppliers OSI Group and Shanghai Husi Food have been suspended by regulators due to the supply of questionable meat. McDonald's may depend less on China in terms of total revenue, but revenue growth slipped from 6% YoY in 2012 to just 1% in 2013. Heinz also recently pulled its baby food from shelves in China after discovering lead in its infant cereal. In 2013, Fonterra found a potentially fatal bacteria in one of its products, triggering recalls of infant milk formula and sports drinks in nine countries including China.

Mengniu is investable as a leading consolidator in the industry and after acquiring Yashili

Controls at China Mengniu have seemingly improved. In 2008, Mengniu was involved in the chemical melamine scandal that resulted in at least six infant deaths. At the time, the stock price fell by over 70%. However, Mengniu has improved its governance since and has outperformed the HSCEI by 12% in the past year. Ad hoc, Mengniu is involved in controversy - for example, recently the company was sued by a consumer advocate for mislabelling "modified milk" as "pure milk" in milk packaging. We believe the company is investable as it is one of the key consolidators in the industry. On 18 June, Mengniu Dairy offered HK$12.5bn to buy local infant-formula maker Yashili International. Cofco, a state-backed agricultural and food industry supplier, owns 19% of Mengniu.

The level of trust in the food supply chain in China remains low

Due to the lack of trust in dairy products in China, many mainland Chinese cross over to Hong Kong to buy milk powder to bring back to China to sell for profit or to use for their own babies, causing a limited supply of the baby formula product in Hong Kong. Export restriction on formula milk is in force in Hong Kong to ensure adequate local supply. Milk-powder pricing has been under investigation in China with companies such as Danone and Nestle suspected of possibly violating anti-monopoly laws by setting prices too high.

Price fixing in the auto industry

The multinational auto companies being targeted for price fixing in China

Cars have also been a target of anti-corruption measures in China, especially after an excessive turnout of Audis near Tiananmen Square during the annual gathering of the country's parliament. Subsequently, Mercedes-Benz has been found guilty of manipulating the price of spare parts following an investigation by Chinese authorities. According to Xinhua news reports, investigators from the anti-monopoly bureau of the eastern province of Jiangsu found that the purchasing price of the parts used to make one Mercedes C-Class car would cost the equivalent of buying 12 vehicles. BMW, Audi and Chrysler are also facing sanctions as part of an anti-monopoly crackdown by the authorities while Toyota's Lexus division is under scrutiny and General Motors is responding to requests by regulators for information on its main China JV.

Hefty fines are being levied for price fixing in China

China levied Rmb1.24bn in fines against 12 Japanese autopart makers for alleged price manipulation in the latest effort to wield its power against multinational companies, including Hitachi, NSK, NTN and Sumitomo, for colluding over price of auto components and bearings. Bearings maker NSK said in August that Chinese authorities fined it Rmb174.9m. The company derived ¥167.2bn of revenue from China in the financial year ended in March,

up 83% from the ¥91.4bn it posted a year earlier, thanks to new-model launches and steady growth in auto production. Separately, Japanese bearings manufacturer NTN said Chinese authorities fined it Rmb119.2m. In the shadow of the investigations, the auto companies have been slashing the cost of spare parts, in some cases by up to 40%. In many industries, the monopoly that the foreign multinationals exercise is a perceived monopoly on quality and, as a result, these companies have had pricing power.

Some luxury real estate is being dumped

Restrictions on money flows unlikely to be lifted

Xi Jinping has reiterated that corruption could ruin the Communist Party's control over the country and that was the reason why he launched a massive anti-graft campaign after moving into presidency last year. Beijing is unlikely to lift restrictions on overseas investments as the anti-graft scheme reveals overseas accounts held by corrupt officials. Currently, the law limits foreign-currency transfers by individuals to US$50,000 a year. Regulators are concerned that easing of these rules would trigger an outflow of domestic capital and provide opportunities for corrupt officials to launder their assets overseas.

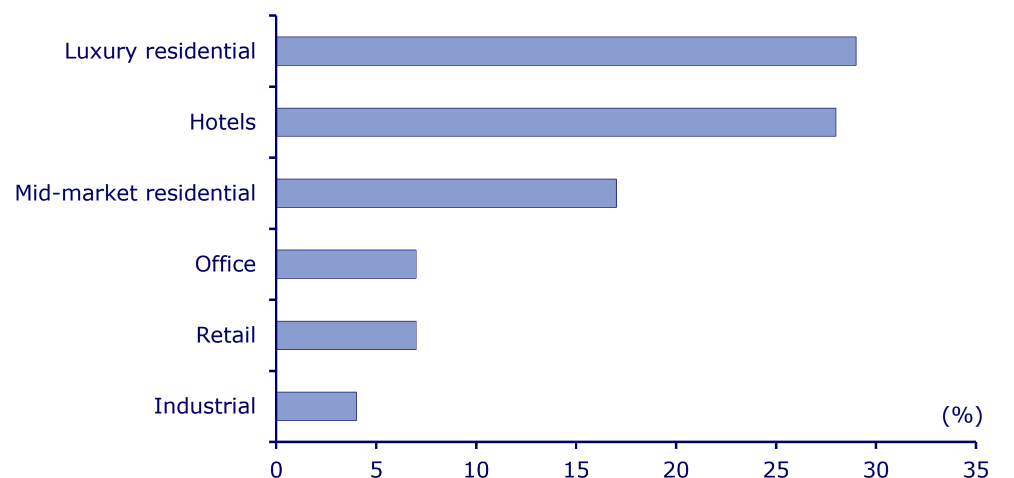
Anecdotal evidence suggests that corrupt officials are offloading luxury homes

Chinese officials have also been rushing to sell their luxury homes amid corruption crackdown. According to a manager at Shanghai Centaline Property Consultants, Chinese officials have wilfully been selling their property at 5-10% discounts to the average prices of comparable homes and party members usually find a buyer within two weeks while most other sellers find buyers following a longer waiting period in anticipation of a higher price. According to official data, housing sales in the first seven months of this year fell 10.5%. Beijing is paving the way for a nationwide system to tax and register property, which would make it much easier to identify modestly paid government officials who buy multiple homes.

The dumping of luxury properties partly reflects Chinese officials' fears of being targeted for corruption

Figure 92

Segments where developers expect to cut investments next year



Source: Urban Land Institute survey of 107 developers, investors in China's real-estate market (WSJ)

Crackdown on media officials

High-ranking media officials have been targeted in the crackdown on corruption

China's anti-corruption crackdown has increasingly targeted China Central Television, the country's state-run media giant. Chinese television networks are believed to accept money in exchange for positive news coverage relating to Chinese officials. China has arrested Huang Haitao, deputy director of CCTV 8; Li Dongsheng, former vice president of the network; Guo Zhenxi, head of

CCTV's financial news network; and Rui Chenggang, economic news anchor. These arrests have been on display for the general public but the inner workings of the state-owned stations remain off-limit.

SOE restructuring

SOE salaries are under scrutiny

Officials in charge of China's state-owned enterprises may face pay cuts up to 50% (especially in finance and banking) and new job responsibilities under a reform plan approved by President Xi Jinping, due to criticism that the high salaries of SOE managers are unwarranted because many SOEs operate as monopolies. Most of these top executives carry a vice-ministerial or ministerial-level ranking that comes with perks and privileges. At the same time, they are paid like top Western business executives and earn exponentially higher than their fellow officials.

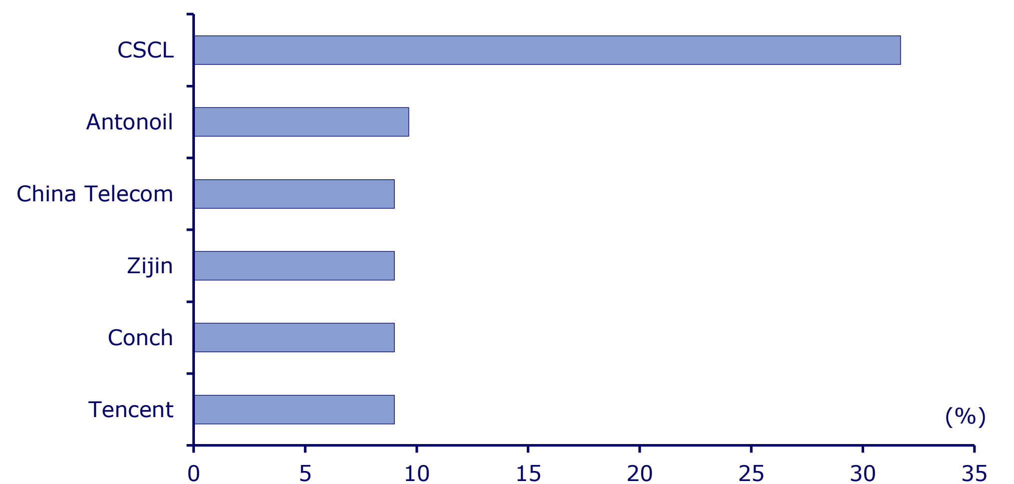
Improvements in CG score

Our CG scoring for companies in 2014 have revealed the following changes over the scoring in 2012.

CSCL and Antonoil are among the companies with the largest positive changes in CG scores

Figure 93

Companies with the largest positive changes in CG scores



Source: CLSA

CSCL is able to make business decisions without government pressure

On the positive side, the cyclical nature of the container-shipping business caused board remuneration at **CSCL** to decrease, while the net loss narrowed from 2009 to 2013. We also believe the firm is able to make business decisions without government pressure, as container shipping is a competitive industry. Offsetting these positive factors, we noticed a decline in the number of independent non-executive directors.

Antonoil has mainly improved in transparency and Clean & Green

Antonoil has delivered better performance mainly in transparency and E&S. On the transparency front, the company's disclosure has improved quite a bit, becoming more informative and timely. Starting late last year, it hosts conference calls following announcements of major new orders. Also, management has given better guidance in terms of revenue/earnings growth, market environment, competition landscape, project progress, etc. On the E&S front, Antonoil has invested heavily to lower its environmental impact and enhance energy efficiency in the process of drilling and fracking, upon the request of its clients.

Improvement in fairness regarding directors' remuneration policy

China Telecom's CG score has increased during the period under review due to improvement in fairness. This is mainly because of the discipline in its directors' remuneration policy. Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals, unlike during previous scoring.

Conch has made two major improvements

Conch has made two major improvements over the past two years. After a change of board earlier this year, all the members of its audit committee have financial expertise. The company has also been delivering earnings growth, while keeping down the remunerations of directors. The company has been sticking to its core business since listing in 1999 and developed from a company with 6m tonnes of sales in 1999 to 228m tonnes in 2013, while profit increased from Rmb118m in 2000 to Rmb9.39bn in 2013. At the same time, net gearing fell from 52% in 2003 to 19% in 2013. It has the lowest cost, strongest balance sheet and good cashflow generation. It had net debt/equity of 19% at the end of 2013, compared with its peers' 69-300%. Conch's operating cashflow generation has been in line with the theoretical calculation of cashflow from its income statement (Ebitda less interest expenses and tax).

The profitability of **Tencent** has gone up a lot and hence directors' remuneration as a percentage of profit has declined substantially.

Declines in CG score

Evergrande lifted 2013 DPS when net gearing rose 75ppts to 165%

The big issue for **Evergrande** is its decision to increase 2013 DPS by 200% when its net gearing rose 75ppts to 165%. Operating cash outflow was just Rmb49.1bn last year, but it will see a further Rmb21.5bn (of which Rmb6.3bn is related to dividend payments) in 2014, based on management guidance. Chairman Hui is the developer's biggest shareholder with a 70% stake.

GAC's share price did not perform well due to Diaoyu Island incidents and a lack of new tech

Guangzhou Automobile Group's (GAC) share price did not perform well during the past two years mainly due to the Diaoyu Island incidents starting from September 2012 and the lack of new technologies and products for its Japanese-branded cars. ROE has been low in the past two years and earnings dropped significantly in 2012. The company has been doing recalls on its models over the years and lagged peers in new-energy vehicles (NEVs).

Changes in audit committee caused the negative change in CG

There were changes in the audit committee of **Weichai Power** over the past two years; the current committee includes an independent director who does not have financial expertise and another independent director whose financial expertise is not clarified. Hence, we penalise the company in the independence section of our questionnaire.

Frequent changes in top management recently suggest that politics influences business

For **China Life**, the decrease in score is mostly due to a change in view on whether the company can make business decisions without political pressure. Frequent changes in the top management recently suggest that the business is increasingly influenced by politics.

Fewer independent non-executive directors

Tingyi's number of independent non-executive directors has continuously declined from five in 2011, four in 2012 to three in 2013.

PetroChina doesn't report results within two months of year-end

The transparency score was lowered for **PetroChina** as the company did not report results within two months of year-end or within 45 days from the end of the interim period.

Longfor, Vanke and Belle among the top Chinese companies with high CG scores

Figure 94

China: Companies in top-two CG quartiles

Company	Code	Company	Code
Agile Property	3383 HK	Golden Eagle	3308 HK
Anta Sports	2020 HK	Haitian	1882 HK
Antonoil	3337 HK	Hengan	1044 HK
Baidu	BIDU US	Hidili Industry	1393 HK
Belle Intl	1880 HK	Li Ning	2331 HK
China Life	2628 HK	Lilang	1234 HK
China Taiping	966 HK	Longfor	960 HK
CNBM	3323 HK	Longyuan Power	916 HK
Cogo	81 HK	Mindray	MR US
Coli	688 HK	Parkson Retail Grp	3368 HK
Conch	914 HK	PetroChina	857 HK
Country Garden	2007 HK	Ping An	2318 HK
CR Cement	1313 HK	Shanghai Electric	2727 HK
CR Gas	1193 HK	Shenhua	1088 HK
CR Land	1109 HK	Sinoma	1893 HK
CR Power	836 HK	Sinopec	386 HK
CRE	291 HK	Sun Art	6808 HK
CSCL	2866 HK	Tencent	700 HK
Ctrip	CTRP US	Tingyi	322 HK
Daphne	210 HK	Tsingtao	168 HK
Datang Power	991 HK	Vanke	200002 CH
Dongxiang	3818 HK	Vinda	3331 HK
ENN Energy	2688 HK	Want Want	151 HK
Everbright Intl	257 HK	Weichai Power	2338 HK
Evergreen Intl	238 HK	Zoomlion	1157 HK

Source: CLSA

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Hong Kong - Precarious balance

Key issues and trends

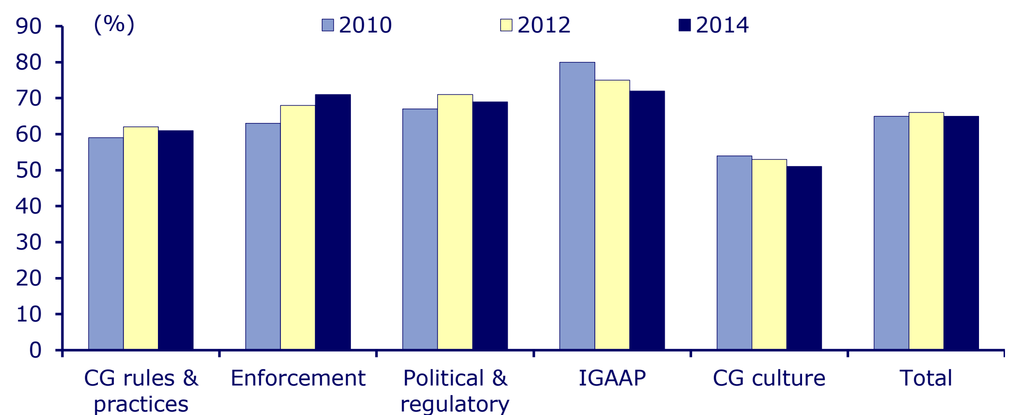
- New CG Code, ESG reporting guidelines and promotion of board diversity.
- New sponsor regime for initial public offerings (IPOs)
- Tough action on enforcement, with innovative use of securities laws
- Introduction of statutory price-sensitive information disclosure regime
- Government and stock exchange too focused on market development at the expense of regulatory quality; new IPOs often of poor quality
- Conflict of interest in stock exchange unresolved, regulatory bodies not immune from political influence
- Political environment is worsening and polarising

Overall score falls from 66% in 2012 to 65% in 2014

Enforcement scores continued rising

Figure 95

Hong Kong CG macro category scores -Current compared to 2010 and 2012



Source: ACGA, CLSA

Bitter fight over whether to include special arrangements for Alibaba to list in HK

The past two years has been a turbulent time for many aspects of Hong Kong society, not least those concerned with corporate governance. The period started promisingly with plans to reform the IPO due diligence process, the imminent arrival of a more robust price-sensitive information disclosure regime and with HKEx getting religion on board diversity. This positive trajectory took a sharp dive with an increasingly bitter fight last year over whether or not Hong Kong should allow the mainland e-commerce giant Alibaba, to list with a "special partnership structure" inimical to shareholder fairness and fell further this year with the release of a set of proposals from a government-appointed advisory body, the Financial Services Development Council, to allow more flexibility in Hong Kong's listing regime (read lower standards of corporate governance).

Does HK need looser listing rules?

We have no issue with a debate on all these issues and welcome the Exchange's new "concept paper" on weighted voting rights, such as dual-class shares and other capital structures. Indeed, it is refreshing that Hong Kong is at last having a proper discussion on its core regulatory values. What is quite depressing, however, is the way in which vested interests put their short-term interests so obviously above what is good for the market as a whole. Looking at the destruction of value that so many IPOs leave in their wake, it is hardly convincing to argue that Hong Kong needs looser listing rules.

CG rules and practices

Falls from 62% in 2012 to 61% in 2014

The quality of financial reporting remains highly varied in Hong Kong, with some firms close to international best practice and producing highly informative reports, mostly among the blue chips, while others continue to mislead or under-disclose. This is reflected in the number of modified audit reports emerging: 153 in 2013 and 133 already as of mid-August 2014. It is also apparent from the decisions of the Financial Reporting Council (the FRC), Hong Kong's quasi-independent audit investigation agency, on complaints made against certain companies for wrongly applying accounting standards. Issues raised in the anonymous decisions range from problems with fair value assessments to improper disclosure of intangible assets, incorrect calculation of financial instruments and inconsistencies in bilingual financial reports.

Quarterly reporting not the norm; annual financial results only need to be announced within three months

Although a few leading companies such as HKEx and HSBC produce quarterly reports, they are the exception and there is no rule to make it a norm. Currently, only companies listed on the GEM Board for smaller companies and PRC companies listed in both Hong Kong and mainland China publish quarterly reports as part of their compliance with Hong Kong Listing Rules and mainland rules. In addition, Hong Kong still lags behind the regional best practice of 60 days for reporting audited annual financial results - the standard in Hong Kong has changed from four to three months starting from year-end 2010.

Many companies not diligent on CG disclosure

Non-financial reporting standards for CG disclosure in Hong Kong shows a similar variety from very good to mediocre. Basic standards are laid down in the Listing Rules and the Corporate Governance Code and further reforms were introduced in 2012 and 2013 requiring listed companies to organise director training and to disclose a board diversity policy. Audit committees were also required to meet the external auditors at least twice a year. Yet as much, non-financial reporting remains formulaic and many listed companies are not diligent in discharging their obligations on CG disclosure; HKEx felt compelled to issue a letter to listed companies in July 2014 reminding them of the importance of "comply or explain".

Slower on reporting, faster on AGMs

Large caps report audited annual results on average in 74 days, but PRC firms are slower and affect the average

As part of our research for *CG Watch*, ACGA undertook a review of Hong Kong-listed companies in mid-2014 and found that the average reporting period among 39 large caps for their 2013 audited financial statements was just under 74 days, while for 10 midcaps it was almost 78 days. The large-cap result, not surprisingly, was heavily influenced by slower reporting among PRC state enterprises and private firms listed in Hong Kong - most reporting in 80 days or more. The home-grown firms reported more quickly, most in under 60 days.

Lag in reporting has shortened slightly from three years back

One overall positive was that this group of large caps did get a little faster at reporting: average number of days decreased from 78 days in 2011 to around 74 days in 2013. They also got quicker at producing annual reports: from 99 days in 2011 to 95 days in 2014.

Good disclosure of information for AGMs

Where Hong Kong stands out, however, is in the disclosure of information for annual general meetings (AGMs). Not only do the 49 companies surveyed set the regional benchmark for sending out AGM notices and final agendas 44 days before meetings, but their notices are almost always accompanied by a detailed circular and the annual report. Some companies even release their annual report well before their AGM notice, thus giving shareholders who wish

to cast a genuinely informed vote plenty of time to make a decision. This contrasts with other Asian markets where the annual report usually comes out much closer to the AGM. (It should be noted, however, that Hong Kong has a much longer deadline for holding AGMs of six months than some other markets: Singapore sets four months, and Korea and Japan both three months. Hence, issuers in Hong Kong have more time to prepare.)

Breakthroughs on shareholder protection

Since January 2013, companies need to disclose price-sensitive information as soon as practicable

In Hong Kong, minority shareholder protection has been improved through enhancing corporate governance and market transparency. In the past two years, the introduction of a price-sensitive information (PSI) disclosure regime has been a major breakthrough in keeping investors more well-informed. From January 2013 onwards, listed companies have been obliged to disclose PSI (defined as "inside information") as soon as reasonably practicable after the company and/or its officers come to have knowledge of it. Disclosure is required to be made through an e-submission system of HKEx and company websites. To facilitate effective compliance, the Securities and Futures Commission (SFC) has issued guidelines to provide assistance for listed companies to comply with the disclosure obligations.

Penalties for companies and officers who do not disclose inside information

Under the regime, the SFC can institute civil proceedings against listed companies and their officers for not disclosing inside information in a timely manner and impose a fine up to HK$8m (US$1.03m). While safe harbours are available under the Securities and Futures Ordinance (SFO) - including disclosure prohibited by Hong Kong law, confidential information concerning incomplete proposals/negotiations, or information that is a trade secret, companies can only resort to any one of them if the information is kept confidential, failing which they will be required to make a disclosure under the regime.

CG Code revisions

Positive impact on board independence from CG code revisions in 2012

The revision of the CG Code in 2012 has brought some positive impact to the independence of the board. The requirement for one-third of the board to comprise independent directors (INEDs) became effective at the end of 2012. The rules were also amended to require issuers to disclose the remuneration of a chief executive who is not a director. A recommended best practice was introduced for the board to conduct a regular evaluation of its performance. Disclosure of senior management remuneration by band is now also required. Yet, a number of proposals, such as mandating a minimum number of hours for director training, were not implemented due to strong opposition from listed issuers. Other matters like requirement of a whistleblowing policy remain recommended best practices. No follow-up actions were made to mandate one woman director for each issuer after the consultation process.

No clear direction for CG reform in HK

On the negative side of the ledger, there is still no clear direction for CG reform in Hong Kong. Much of the reform over the past two years has been piecemeal, with inadequate planning for more coherent and enforceable rules. Opposition from listed issuers is part of the reason, but the Hong Kong Government's reluctance to take a more active and engaging approach in facilitating corporate governance reforms is an undeniable cause that must be fully addressed. CG rules in Hong Kong would continue to make little difference to corporate behaviour unless and until, they are integrated as part of business practice among issuers.

Detailed guidelines on ESG with KPIs

Sustainability reporting in Hong Kong

In August 2012, HKEx released relatively detailed Environmental, Social & Governance (ESG) guidelines designed to be recommended practices only for listed companies. The plan is to raise the obligation to "comply or explain" by 2015 upon further consultation. Listed companies are encouraged to make disclosure on specific key performance indicators (KPIs) for a number of areas, ranging from environmental protection to community involvement. HKEx has gone to great lengths to socialise the business sector to the Guide, holding a series of training sessions, conferences and webcasts since 2011, when it first consulted on ESG reporting.

Large-cap sustainability reporting quite good, midcaps' is weak

In an ACGA review of the sustainability reporting of 10 large caps and 10 midcaps in Hong Kong in mid-2014, we found that nine of the 10 large firms reported on sustainability. Six had standalone reports that were of a relatively high standard, and five followed the Global Reporting Initiative (GRI) framework. Sustainability was seen by these firms as strategic to their long-term business and we found good disclosure on materiality and stakeholder engagement. The other four large caps had relatively weak reporting and focused mainly on philanthropy and the environment.

Reporting among the midcaps was quite weak, with nearly half the companies having none at all. Only two reports were of a decent standard. The remainder had some reporting, but this was often limited to a single paragraph on the environment and another on community engagement.

Enforcement

Rises from 68% in 2012 to 71% in 2014

The SFC has taken an increasingly innovative and formidable approach to sanctioning market misconduct and obtaining protective orders for the investing public over the past two years. Though somewhat draconian in nature, sections 213 and 214 of the Securities and Futures Ordinance (SFO) provide much-needed ammunition for the SFC to freeze assets even before launching civil or criminal proceedings. The SFC's swift enforcement has contributed to a fairer and more orderly regulatory environment that deters market misconduct and gives priority to investor protection, without stifling market development through over-regulation. Another welcome trend is the increasing presence and attendance of institutional shareholders in shareholders meetings, which enriches engagement and communication with management.

SFC has powers to freeze assets even before launching proceedings

SFC sets the benchmark for the region

Indeed, we believe the SFC's robust enforcement sets the benchmark for the region. Feared and respected by its regulatees, the SFC is vigilant in making its moves while mindful of the complex and sometimes conflicting objectives in regulation, especially in a market like Hong Kong where regulatory issues become politicised and difficult to navigate. The Lehman Brothers fiasco is an unforgettable lesson for regulators, where grievances of retail investors became a destabilising factor in the financial system and victims drummed up demonstrations in front of financial institutions on a daily basis.

The SFC's success in the Tiger Asia case in April 2013 has opened up unprecedented possibilities of pre-conviction compensation being made available. The Court of Final Appeal's decision empowered the SFC to act on behalf of the investors and seek compensation orders from the court, without first going through civil or criminal proceedings, under section 213 of the

SFO. In January 2014, the SFC's triumph in obtaining a HK$23.9m (US$3.1m) restoration order from Du Jun, a former Morgan Stanley banker convicted of insider trading, reveals that disgorgement of illegal gains is equally important as sending offenders to prison. In May 2013, the SFC's success in entering into a settlement agreement with a Cheung Kong-related party to unwind the sale of hotel room units at the Apex Horizon protected investors from entering into an unauthorised collective investment scheme. And in September 2014, as *CG Watch 2014* was going to print, the SFC commenced proceedings (after some six years) against CITIC, its former chairman and executive directors, for false or misleading disclosure over massive foreign-exchange losses in September 2008. The SFC is seeking compensation for the 4,500 investors who had purchased CITIC shares at the time and suffered heavy losses.

Investors wound up over CMR winding up

However, the SFC has at times caused grief among investors with certain measures, in particular the winding up of companies. In July 2013, for example, it sought High Court orders to appoint provisional liquidators to wind up China Metal Recycling (CMR), China's biggest scrap metal recycler, following accusations that the company exaggerated its financial position in the prospectus for its IPO in 2009 and its annual report for the same year. The SFC argued it was acting in the interests of investors and that a winding up was the best option; yet some of the minority shareholders of CMR were aggrieved and left in the dark as to what would happen to the company. Since CMR is a Cayman Islands company with assets in mainland China, provisional liquidators may need to pursue separate court actions in the Cayman Islands to secure the winding-up of the company and seize the assets on the Mainland. Shareholders generally rank lower in priority to the provisional liquidators (and the lawyers) as well as secured and unsecured creditors.

HKEx enforcement remains slow

As for enforcement by HKEx, it has limited powers under the Listing Rules to sanction companies beyond a public reprimand or public criticism. Cases still take years to complete and we have seen little improvement in efficiency since our previous reports. The one positive is that Exchange announcements on enforcement decisions are detailed and informative - even if you still need to trawl through the news releases section of its website to find them. A dedicated section of the website to enforcement, with statistical analysis on investigations and outcomes, would be welcome. Some of this information is in its annual report, but could easily be highlighted on the website too.

Political and regulatory environment

Falls from 71% in 2012 to 69% in 2014

In contrast to the broadly positive trend of reform in Enforcement, the Political and Regulatory Environment part of our survey shows some deterioration for Hong Kong. Following rapid economic and political assimilation of the PRC and Hong Kong, the business community and government are juggling the challenges for more business opportunities against long-standing and politically neutral regulatory traditions. There is no clear and coherent policy in place to support corporate governance reforms. Political expediency and an unwillingness to confront vested interest groups creates fragmentation in devising a consistent and coherent regulatory framework. The conflict of interest of HKEx as both a regulator and revenue-generating listed company is unresolved and regulatory bodies are not immune from political influence. The SFC's enforcement activism cannot compensate for a gradual corrosion of the regulatory infrastructure (the checks and balances within the three-tier framework, ie, the government, the SFC and HKEx are no longer functioning as well as they used to) and a level playing field in the market.

Conflict in HKEx being both a regulator and revenue generating listed company

"One share, one vote" under siege

The "one share, one vote" principle is under siege in Hong Kong even after its regulators rejected a multi-billion dollar IPO by Alibaba for a unique shareholding and management structure. The mainland e-commerce company had sought a waiver allowing it to list while giving founders and senior executives control through a right to nominate a majority of the board despite only owning a combined 10% of the shares. The case has spurred calls for market reforms to introduce specialised listing boards.

Risk of regulatory arbitrage

As a key supporter of greater flexibility in capital structures, Charles Li, HKEx Chief Executive, wrote four articles in his "personal" blog on the official HKEx website to advance a discussion on the possible abolition of the "one share, one vote" system in Hong Kong. HKEx is expected to consult on this issue in due course. One possible outcome is that companies with a "centre of gravity" in Greater China and that have dual-class shares may be granted waivers to facilitate a secondary listing in Hong Kong. While the market is keen to have more PRC companies list in Hong Kong, we believe it is conceptually unfair to lower listing requirements for them as it could lead to regulatory arbitrage. Making concessions on this important regulatory principle risks marginalising the Hong Kong Main Board because PRC companies could delist from primary listings and come back as secondary listings.

New Companies Ordinance effective March 2014

Meanwhile, the new Companies Ordinance became effective in March 2014, but has in various ways reduced protection - for example it provides for grounds for dispensation with AGMs for unlisted companies. The Corporate Governance Code review and the introduction of (voluntary) ESG reporting have been considered by some CG activists as "window-dressing" rather than dealing with the root of Hong Kong's CG problems and issues.

Trends to help improve financial regulatory system

While the Hong Kong government and the SFC could do more to enhance the quality of corporate governance, such as enhancing the frequency of reporting and getting serious on statutory backing for all parts of the Listing Rules, other developments include the codification of the PSI disclosure obligations, the new IPO sponsor regime and the setting up of a new Corporate Regulation Team in the SFC which should help to improve the financial regulatory system in Hong Kong over time.

Judicial independence important safeguard

Meanwhile, the media remains generally free and active in reporting CG abuses, although tabloid magazines are usually the ones that go the extra mile in uncovering scandals. While doubts have been cast upon the Hong Kong judiciary (mostly limited to political concerns at the moment), judicial independence remains strong and continues to be the most important safeguard against illegal patronage and inequitable collusion between the business sector and the government.

IGAAP (accounting and auditing)

Falls from 75% in 2012 to 72% in 2014

As we have argued many times, Hong Kong would come first by several points in *CG Watch* if it did nothing more than address the lack of a proper independent audit regulator. Finally, the beast is stirring: the government has issued a consultation paper on turning the Financial Reporting Council (FRC) into a fully-fledged regulator (not just a seriously under-staffed and under-funded investigation agency).

Lack of a proper independent audit regulator

The major challenge for Hong Kong is that the independence, effectiveness and capacity of the audit regulator has yet to meet international standards. The Hong Kong Institute of Certified Public Accountants (HKICPA), the local

accounting body that regulates auditors, does not meet internationally recognised requirements for independence; and does not publish annual reports on audit industry capacity, typically issued by independent regulators in other markets in Asia. The new Companies Ordinance implemented this year has only made limited progress by imposing criminal liability on auditors for knowingly or recklessly causing specified statements to be omitted from the auditor's report. Hong Kong company law does not offer whistle blower protection for auditors, nor does it impose limits on the non-audit work that external auditors can do. There have also been concerns over audit quality at SMEs, but the HKICPA has not set out special provisions in auditing practice for the auditing of these entities. Although practitioners in smaller firms are perceived to have much more problems on professional standards than large firms, SMEs tend to use them because of limited funds and choice.

Inconsistent audit quality

While Hong Kong does not suffer from a lack of qualified staff to meet the needs of doing a fit and proper audit, the absence of an independent auditor regulator leads to inconsistent quality of audit across companies in Hong Kong. Consequently, Hong Kong's audit oversight falls short of minimum requirements of international standards. For instance, Hong Kong's self-regulatory system renders it ineligible to become a member of the International Forum of Independent Audit Regulators, a multilateral organisation for independent audit regulators. Moreover, the European Commission in June 2013 refused to extend Hong Kong's transitional status of EU equivalence and considered it did not have an independent system of public oversight and quality assurance for auditors.

Consultation to give wider powers to FRC

To address these issues, the Financial Services and the Treasury Bureau (FSTB) issued a consultation paper in June 2014. The FSTB proposed that the HKICPA would retain the power to register accountants, provide continuous professional training and set accounting standards. The FRC, which took over investigative powers from the HKICPA following its establishment in 2006, is expected to oversee these HKICPA powers. The proposals also suggest the FRC takes over the powers of receiving applications for recognising overseas auditors, inspection and enforcement or disciplinary proceedings against auditors.

Expect extensive debate

The consultation period ends 19 September 2014. These proposals, however, are expected to be heavily debated in the months to come, before legislative amendments will be introduced and whether Hong Kong is able to develop an independent audit regulatory regime remains to be seen.

CG culture

Falls from 53% in 2012 to 51% in 2014

On the positive side of the ledger, reforms introduced by the SFC and HKEx, including revisions to the CG Code, ESG Reporting, requiring a board diversity policy and the new sponsor regime, are gradually helping to broaden and deepen Hong Kong's corporate governance culture. The upgrade of several "recommended best practices" in the CG Code to "code provisions" (which are subject to "comply or explain") provides for more stringent expectations of companies. Companies in general are more vigilant about information disclosure after the PSI regime became a legal obligation in January 2013.

"Name and shame" for rejected applications

As for the IPO due diligence reforms, sponsors, directors and others who authorise the issue of a prospectus are already currently liable for misstatements in the prospectus. With effect from 1 October 2013, the application proof of the listing application prospectus is required to be posted

on the HKEx website (a grace period until 1 April 2014 has since expired). HKEx has also streamlined the regulatory commenting process and made it clear that it would reject a listing application if it was not "substantially complete". HKEx will also publish the name of the applicant and the sponsor(s) responsible for the rejected listing applications (so called "name and shame") and the application cannot be refiled for eight weeks. Sponsors have to be formally appointed for a minimum period of two months before submitting a listing application. Under the revised Code of Conduct, sponsors are obligated to conduct thorough due diligence and cannot abrogate responsibility by delegating it to third-party professionals.

HK regulators do not have jurisdiction in the PRC

Sadly, however, Hong Kong's overall CG culture has regressed. Investors appear to have reduced confidence in the Hong Kong market as a result of ongoing IPO and other CG problems, notwithstanding the strong enforcement by the SFC. While PRC retail investors are possibly more vocal than their Hong Kong counterparts in shareholder meetings and courtrooms, activism is insufficient or even futile in preventing companies with hidden problems from being listed on the Hong Kong market. Share prices of newly listed companies routinely plunge shortly after their IPOs. The merit-based approach to approving new listings cannot work effectively if Hong Kong regulators have neither the jurisdiction nor power to investigate in the PRC, compounded by the market pressure to cut fees on sponsors and hence reduce efforts in conducting due diligence.

Organisation to represent small shareholders is absent

While ad hoc retail activism occurs in Hong Kong in response to company cases, the city still lacks an organisation representing the interests of small shareholders. Although the free press and independent judiciary remain strong, the upcoming consultation on the reform of "one share, one vote" could result in a serious blow to shareholder protection in a market with significant retail participation yet still dominated by family ownership.

Work-in-progress to bring CG into the corporate culture

Hong Kong is at crossroads in terms of regulation. At times it seems the Hong Kong market is moving away from a genuine commitment to good corporate governance and turning away from good practices that could potentially bring better governance and reduce information asymmetry between controlling majority shareholders, management and minority shareholders. It is a choice between fully embracing higher standards to create a more competitive market and fairer treatment of shareholders, or opting for expediency and flexibility to accept listings that bring more business in the short term but compromise the equitable interests of all shareholders. Overall, the corporate governance culture in Hong Kong has not been fully integrated into the behavioural and decision-making processes of all stakeholders in the market. SFC enforcement may have sufficiently deterred bad practices, but fully bringing corporate governance into the corporate culture continues to be a work in progress.

Downgrade watch list

What to avoid

Factors that could force the score to fall in 2016:

- ❑ Abolition of equality of shareholder protection (ie, "one share, one vote")
- ❑ No vigorous enforcement of the statutory PSI regime
- ❑ No improvement in quality control on new IPO applications
- ❑ Regulatory bodies driven by political influence in enforcement and rule-setting

What to fix

Quick fixes

- Provide more statutory backing to the listing rules
- Develop an independent audit regulatory regime
- Reinforce the "merit-based" approach of IPO approvals
- Upgrade board evaluation and whistle blower policy to code provisions in the CG code

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Research perspective - Not quite fragrant

Independent Commission Against Corruption (ICAC) set up to fight corruption

On 15 February 1974 while Hong Kong was under British rule, Governor Murray MacLehose set up the Independent Commission Against Corruption (ICAC) to fight corruption in the many departments of the Hong Kong Government through law enforcement, education and prevention. The commission continues to wield considerable influence and much of the public remain confident in its work. Yet, in recent years, the body has been vilified after former ICAC chief Timothy Tong Hin-ming was accused in 2012 of misusing public funds during his tenure. ICAC's ultimate responsibility remains to keep the corruption levels as low as possible.

Figure 96

Major ICAC cases

Timeline	Major ICAC cases
1974-1975	Former police chief superintendent Peter Fizroy Godber was charged with bribery and conspiracy after investigators linked to bank accounts worth HK$4.3 million. Extradited from England in 1975, he was convicted and sentenced to four years jail.
1976-1978	ICAC shut down a heroin racket at the Ya Mau Tei fruit market in West Kowloon where police had received kickbacks from drug dealers. Some 87 police officers were arrested on suspicion of taking bribes in the ICAC's single biggest operation.
1976-1979	Former detective sergeant Lui Lok, forced to retire early in 1968 when he could not explain his extensive assets, was later investigated and arrested in 1978. He was eventually convicted, sentenced to two years and fined HK$16 million.
1983-2000	Structural defects at 26 public housing blocks in Kwai Fong built between 1964 and 1973 were traced to construction companies who cut corners after winning multi-million dollar government contracts. Three contractors were convicted.
1986-1987	The ICAC uncovered fraudulent loan practices at the Overseas Trust Bank which clocked HK$700 million in bad debts. The bank's chairman and other senior executives fled Hong Kong but were extradited. All received prison sentences.
1998-2000	The chief property manager of the Government Property Agency was arrested for accepting kickbacks that favoured one company, in exchange for contracts worth more than HK$100 million. He was imprisoned for 30 months.

Source: CLSA, SCMP

Sun Hung Kai executives scandal

Pursuit of the Kwok brothers is the highest profile case the ICAC has undertaken

One of the highest-profile cases that ICAC is pursuing is that of the Kwok brothers, Sun Hung Kai Properties executives Thomas Kwok Ping-kwong and Raymond Kwok Ping-luen, along with former chief secretary Rafael Hui Si-yan. In May 2012, Walter Kwok was arrested by the ICAC in connection with an investigation into an offence (or offences) suspected to have been committed under the Prevention of Bribery Ordinance and was released on bail. Two months later, ICAC charged Thomas and Raymond Kwok along with former chief secretary of Hong Kong Rafael Hui for alleged bribery and misconduct in public office.

Land transactions lack transparency in Hong Kong

The Kwok family was ranked by Forbes as the third richest party in Hong Kong with an estimated net worth of US$15.4bn in 2012. There are many aspects of the way the HK government and the Urban Renewal Authority dispose of land which lacks transparency, which does lend itself to the risk of corruption.

MTRC debacle

CEO Jay Walder departed on 15 August 2014

A fusillade of questions and criticism overtook MTR Corp's shareholders meeting on 8 May. The 380 shareholders that were present expressed concern over the company's major project delays, lack of responsible leadership and miscommunication, or lack thereof, with the government. Change of the guard at MTRC now opens the door to reform that could lead to

higher accountability of the board and senior management, which in turn should lead to higher returns over time. Following an earlier announcement that CEO Jay Walder will not renew his contract at expiry on August 2015, he ultimately departed early on 15 August 2014. The formal announcement stated that no matters in relation to the non-renewal of the contract should be brought to the attention of shareholders. In the general press, there has been extensive speculation that it is related to project delays.

Project officials waited for five months before telling lawmakers of the delay

Figure 97

Timetable for the Guangzhou trains that are running late

Date	Reason
2010	Construction starts on the fully underground, 26-kilometre Hong Kong section of the highspeed railway to Guangzhou.
2013	
March	MTR projects programme team realises work on northern part of West Kowloon terminus and tunnel linking Mai Po and Shenzhen's Huanggang Park is significantly behind schedule. MTR decides rail project is still on track for completion in 2015.
April	Contractors estimate terminus will be finished only in June 2016. MTR urges them to look for solutions to catch up with schedule.
June	MTR realises 2015 target can be met only if it opens terminus in stages, putting only six of 15 tracks into use initially.
July	MTR executive committee agrees with partial opening.
September	Highways Department is briefed on partial opening. It does not indicate agreement, but asks MTR for more information. Plan was never announced to the public.
October	MTR asks contractors for proposal to complete project in 2015 based on partial-opening plan.
November	Government intends to tell Legislative Council of possible delay, but is stopped by MTR chief executive Jay Walder, who calls Transport Minister Professor Anthony Cheung Bing-leung and says deadline is still feasible. At Legco railways sub-committee meeting, Cheung's undersecretary Yau Shing-mu says major works can be finished in 2015, but tests and trials will take another six to nine months. After the meeting, MTR presents schedule towards completion to government, which says it is too brief.
2014	
February	Terminus contractors tell MTR that even with partial-opening plan, terminus will not be ready until June 2016.
March	Black rainstorm causes serious flooding in Yuen Long tunnel and damages tunnel-boring machine.
April	MTR and Cheung announce rail link will not open until 2017. Cheung says he is taken by surprise. Projects director Chew Tai-chong decides to retire early. MTR announces internal investigation.
May	Cheung sets up expert panel to investigate project and government's role. Panel chairman Professor Lee Chack-fan resigns because of conflict of interest.

Source: CLSA, SCMP

Walder left NYC to join MTRC that offered base pay of US$1m and a bonus of US$0.6m in 2013

Walder assumed the position of CEO in January 2012, after exiting an employment contract as chairman and CEO of New York's Metropolitan Transportation Authority prematurely. He left the Big Apple to fill the vacant MTR position that offered base pay of US$1m and a bonus of US$0.6m in 2013.

Potentially more changes ahead

Projects director Chew Tai-chong has revealed that he will retire in early October, for personal reasons and the possibility of other senior-management departures cannot be ruled out. Over the years, the mass-transit-railway company has been relatively efficiently managed, but even so there are now opportunities to improve the skill mix that could lead to an even more positive future outcome for shareholders.

Lengthy project delays

MTRC is working on five projects that are experiencing delays. The scale of the Express Rail Link is notable at HK$68bn. However, investors should note that MTRC is managing this project and the Shatin-to-Central Link on behalf of the government and hence associated balance-sheet risk is relatively low. Other on-balance-sheet projects that are behind schedule include the West Island Line, the South Island line and the Kwun Tong Line extension.

CNPC/PetroChina scandal

Suspension of trading due to an investigation of high level individuals in PetroChina and CNPC

In 2013, PetroChina posted a notice on the HKEx saying that the trading suspension was due to an investigation of Li Hualin, chairman of Kulun. The others under investigation are former CNPC vice president Wang Yongchun and three former executives at PetroChina - vice president Ran Xinquan, chief geologist Wang Daofu and board secretary Li Hualin, who was also a vice president of CNPC and chairman of PetroChina's liquefied natural gas distribution arm Kunlun. Ex-chairman of CNPC Jiang Jiemin was investigated for 'serious discipline violations', shorthand generally used to describe graft.

High level individuals are under scrutiny

Shortly after, the Audit Office announced allegations of black box bidding against PetroChina between November 2006 and July 2013, with assets involving more than 26bn yuan. The Central Commission of Discipline Inspection recently announced that Jiang Jiemin and Wang Yongchun have been expelled from the party while Deputy General Manager Li Hualin, Vice President Ran Xinquan and Chief Geologist and PetroChina's chief accountant Wang Daofu have been put under control.

Princelings become a burden

Hiring of princelings no longer fashionable

A probe of JPMorgan Chase's hiring practices over whether it had hired princelings (family members of influential figures in the Chinese government and elite) to win businesses in Hong Kong has uncovered red flags across Asia. Fang Fang, former CEO of JP Morgan Chase China investment bank was arrested and consequently released on bail. The bank has not been charged with any wrongdoing. Other banks under scrutiny over its Asia hiring practices include Citigroup, Goldman Sachs, Morgan Stanley and UBS.

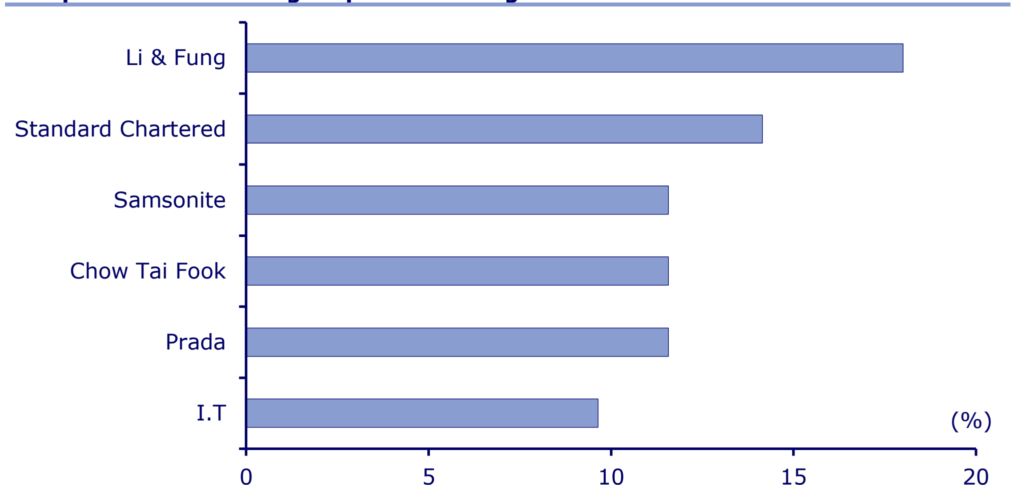
CG scores

We calculated the change in CG scores since 2012 and these are our results:

Li & Fung and Standard Chartered among companies with the largest positive changes in CG scores

Figure 98

Companies with the largest positive changes in CG scores



Source: CLSA

Transparency is enhanced with timelier financial reporting

Li & Fung has shown both real and cyclical improvement in corporate governance, compared to two years ago. Transparency is enhanced with timelier financial reporting. Moreover, we believe that there are less concerns about the company's previous acquisitions as underperforming brands have been written down. The brands business is also spun off as Global Brands Group, leaving the traditional steady sourcing business in Li & Fung. The fairness component of CG is improved as well since the ratio of executive remuneration is now more in line with earnings growth, which should be considered a cyclical improvement.

Increase of independent directors, financially proficient chairman in Audit, and less government pressure

For **Standard Chartered**, firstly the number of independent directors increased. Secondly the Audit committee is now deemed to have a financially proficient Chairman, while the company is now also deemed to be able to make business decisions without government/political pressure.

Samsonite's fairness component of CG is improved

Samsonite showed real improvement in reinvesting its solid cashflow. The company has acquired a number of luggage, casual and electronic device cover brands, which help expand its footprint and build market share. The fairness component of CG is improved since the ratio of executive remuneration is now more in line with earnings growth, which should be considered a cyclical improvement.

Prada has improved transparency with more timely financial reporting

We believe that **Prada** has demonstrated strong discipline and execution in the past two years with top-notch supply chain management and excellent delivery of its retail expansion plan. Concern on its previous acquisitions of brands that did not perform well has rolled off. The company has also improved transparency with more timely financial reporting.

Five out of the 15 directors at Chow Tai Fook are independent non-executive directors

Five out of the 15 directors at **Chow Tai Fook** are independent non-executive, compared to two years ago. Chow Tai Fook has also improved its transparency with more timely financial reporting. The fairness component of CG is improved since the ratio of executive remuneration is now more in line with earnings growth, which should be considered a cyclical improvement.

I.T has increased its number of board members

For part of 2012, **I.T** only had four board members and two were independent non-executive directors. The company now has five board members and three are independent non-executive directors (ie, over 50% are independent non-executive).

Declines in CG score

AIA took a hit on fairness as board remuneration rises amid declining profit

AIA took a hit on "fairness". Board remuneration continued to increase despite a slide down in profit in 2013. As a percentage of profits, it went up from 0.3% to 0.4%.

Untimely fashion of disclosing adequate information

We believe **HPH Trust** is able to make business decisions without government pressure, as container shipping business is competitive, lifting its score. However, we do not think it disclosed adequate information regarding the industrial action that happened in Hong Kong last year in a timely fashion. We also penalised the firm after it conducted material related-party transactions. It also had material management fees paid to trust manager for acquisitions.

Payments made to affiliated companies controlled by the Chairperson's family

For **Emperor Watch** we updated the scores from 2012 since the chairperson Cindy Yeung is involved in daily business management and is an executive director. The firm also paid HK$243m of rental (over 20% of its selling and distribution expenses) to affiliated companies controlled by the Yeung family.

Earnings declined not adjusted proportionally with remuneration

Oriental Watch showed a cyclical decrease as earnings declined massively while remuneration did not get adjusted proportionally. Earnings declined as luxury watch sales slowed down amid a tough business environment and clampdown on corruption in China.

Audit committee was replaced by someone who is not a financial or accounting specialist

In Jan 2014, a member **GCL Poly**'s audit committee (Qian Zhixin) resigned and was replaced by Xue Zhongsu, who has extensive power industry experience but is not a financial or accounting specialist. Unrelated to the scoring, there have also been two resignations in the Connected Transaction Committee over the past two years.

Directors' remuneration increasing faster than net profit

Hongkong Land's decrease was from directors' remuneration increasing faster than net profit (based on five-year Cagr to 2013) and that FY13 results were announced more than two months after year-end.

The top 50 companies based on CG scores in our universe are shown in the table below.

Standard Chartered and HSBC among companies with high CG scores

Figure 99

Hong Kong: Companies in top-two CG quartiles (alphabetical order)

Company	Code	Company	Code
AIA	1299 HK	MGM China	2282 HK
Cathay Pacific	293 HK	Midland	1200 HK
Cheung Kong	1 HK	Mongolian Mining	975 HK
Cheung Kong Infra	1038 HK	MTRC	66 HK
Chow Tai Fook	1929 HK	New World Dev	17 HK
CLP Holdings	2 HK	OOIL	316 HK
CSI Properties	497 HK	Oriental Watch	398 HK
Emperor Watch	887 HK	Power Assets	6 HK
Esprit	330 HK	Prada	1913 HK
First Pacific	142 HK	Rusal	486 HK
Galaxy	27 HK	Samsonite	1910 HK
GCL-Poly	3800 HK	Sands China	1928 HK
Great Eagle	41 HK	SHKP	16 HK
Henderson Land	12 HK	Shun Tak	242 HK
HN Renewables	958 HK	Sino Land	83 HK
Hongkong Land	HKL SP	SJM	880 HK
HPH Trust	HPHT SP	Standard Chartered	2888 HK
HSBC	5 HK	Swire Pacific	19 HK
Hutchison Whampoa	13 HK	Swire Properties	1972 HK
Hysan	14 HK	Techtronic	669 HK
I.T	999 HK	Trinity	891 HK
Kerry Properties	683 HK	VTech	303 HK
Li & Fung	494 HK	Wharf	4 HK
Lifestyle	1212 HK	Wynn Macau	1128 HK
L'Occitane	973 HK		

Source: CLSA

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India - On the path to reform

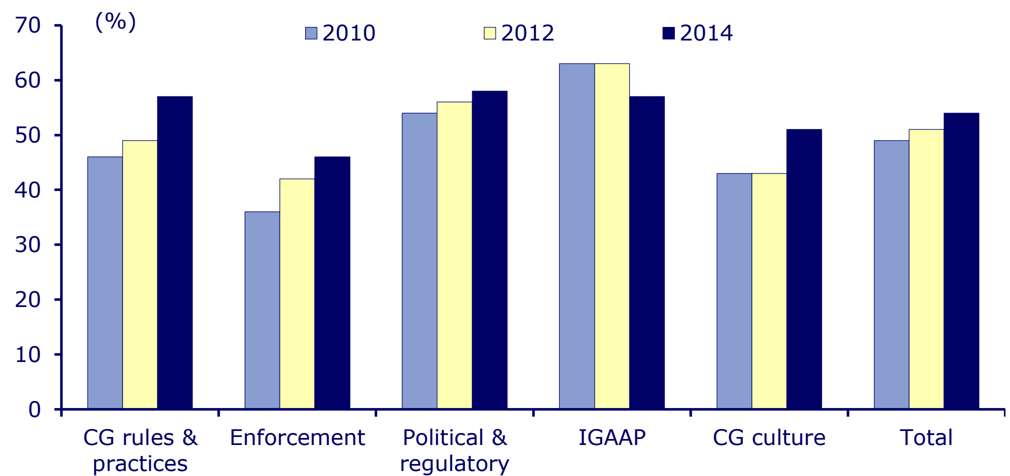
Key issues and trends

- The new Companies Act finally passed in August 2013, after years in the making
- Amendments to Listing Agreements to align with the new Companies Act
- Voting by poll becomes mandatory through default
- Improvement in regulation of related-party transactions, but Ministry of Corporate Affairs dilutes the rules; companies take advantage of loopholes
- IFRS convergence continues to be delayed; no definite timetable
- Institutional investors come alive, spurred on by Indian-proxy advisers

Rises from 51% in 2012 to 54% in 2014

Figure 100

India CG macro category scores



Source: ACGA, CLSA

New Companies Act finally passed in August 2013

After more than a decade of waiting, the corporate world was caught by surprise when the Companies Bill 2013 was finally passed. As a leaner act than its 1956 predecessor, it is dragging the country firmly into the 21st Century, even becoming a leader in the region on gender diversity (by mandating companies of a certain class to have at least one women director on their boards) and, more importantly, addressing fundamental issues such as related-party transactions, whistleblower mechanisms for directors and employees and mandatory audit-firm rotation after two consecutive five-year terms.

SEBI updated Clause 49 on corporate governance in February 2014

The Securities and Exchange Board of India (SEBI), the peak securities regulator, followed suit on 13 February 2014 by approving amendments to Clause 49, the section of the Listing Agreement that deals specifically with corporate governance norms at listed companies. The amendments aligned the provisions of the Listing Agreement with the provisions of the newly enacted Companies Act 2013, while making requirements more stringent for Indian-listed companies including mandatory approval of all material related-party transactions by minority shareholders only through a special resolution; providing e-voting platforms to all shareholders for postal ballots and general meetings; a compulsory whistleblower mechanism; and restricting the total tenure of an independent director to two terms of five years each.

BJP sweeps to victory in May 2014; hopes rise for better governance

In May 2014, the National Democratic Alliance, led by the Bharatiya Janata Party (BJP), won 336 seats out of a possible 543 and swept into power. What was more remarkable was the BJP itself won 272 seats, the first party to have won enough seats to govern without the support of other parties since the 1984 general elections. A major reason for BJP's outright victory is Narendra Modi, a strong leader who led the party on a multi-faceted platform, including economic growth, better governance and anti-corruption and now, the Prime Minister. Both the image of Modi as a strong leader and the outright victory of the BJP promise a stability that is in stark contrast to the state of Indian politics for the past decade. The previous Congress-led United Progressive Alliance Party became increasingly fractious and allies refused to support initiatives and policy reforms that Congress tried to push through.

Implementation of new Companies Act still a concern

While we laud the advent of the Companies Act and the amendments to the Listing Agreement, we continue to have doubts about the enforcement and are concerned about certain loopholes that exist. Institutional Investor Advisory Services (IiAS), a proxy-voting advisor, has published a report on how certain companies have used their unlisted subsidiaries to circumvent the related-party transaction (RPT) regime, while the Ministry of Corporate Affairs (MCA), according to IiAS, has diluted RPT provisions in the Act through a clarification to its rules that regulate the provision.

BJP policies on CG still unclear

It is too early to assess the new government's likely policies on corporate governance. Many are of the opinion that the ease of doing business, creating jobs, improving infrastructure and generating more growth are the primary objectives of the new government. While Modi is staunchly against corruption and pro good governance, it would seem that it is good governance without too much government intervention.

CG rules and practices

Rises from 49% in 2012 to 57% in 2014

India gained strongly in this section due, in large part, to the passing of the new Companies Act in August 2013. The Act introduced a host of CG initiatives that cheered the investor community and seemingly levelled the field, which until then had been firmly dominated by promoters/controlling shareholders. Some key initiatives included:

- A more comprehensive definition of the "independent director" now excludes relatives of the promoter or directors in the company, its holding, subsidiary or associate companies, as well as any person who has been an employee or proprietor or a partner, during the preceding three financial years of a firm of auditors, company secretaries or cost auditors of the company or its holding, subsidiary or associate companies. However, on the negative side, the new Act defines "relatives" to cover fewer relationships than the previous law - eight as opposed to 22 previously - with third generation of relatives (grandparents and grandchildren) no longer included.
- Mandatory spending on corporate social responsibility (CSR): Companies with Rs5 crore or more of profits in the last three years must spend at least 2% of their average net profit on CSR activities. Companies that fail to meet the obligation will have to disclose the reasons in their annual reports or face penalties.

Voting by poll at last arrives in India . . .

Points were also gained for the way in which regulators pushed through voting by poll, albeit in a rather roundabout fashion. In 2012, SEBI initially mandated that companies should provide e-voting facilities for any business

to be transacted by postal ballot, starting with the top 500 listed companies. Then in February 2014, SEBI mandated that all listed companies should provide e-voting facilities to their shareholders 'in respect of all shareholders' resolutions, to be passed at general meetings or through postal ballot'. This was mandatory for all listed companies from April 17, 2014.

. . . through a clever MCA interpretation of the law

Since e-voting closes three days before a general meeting, the question immediately arose as to what should happen in the meeting? Would companies still be able to put resolutions to a vote on a show of hands for the shareholders in attendance? The Ministry of Corporate Affairs (MCA) clarified the matter in June 2014 when it stated that any resolution open to e-voting could not be voted on by a show of hands, leaving companies with no choice but to vote by poll in the meeting itself.

Vote-result disclosure in India is surprisingly detailed

Research by ACGA shows that a number of companies outside the largest firms, such as Suryalata Spinning Mills, Thakkers Developers and Standard Industries, provided e-voting facilities to their shareholders this year and voted by poll in the meeting itself. Another positive is that the standard of disclosure of these results is somewhat superior to other jurisdictions: total votes are not only broken down into for and against, but into different shareholder groups as well (promoter group, public institutional and public other), which provides a handy indicator of how minority shareholders have voted on each issue.

RPT rules still causing grief, despite improvements

Not all is bright and sunny in the Indian regulatory environment. Most egregious, perhaps not surprisingly, has been the issue of related-party transactions (RPTs), a topic we drew attention to in our 2010 White Paper on Corporate Governance in India. At the time, SEBI argued that it could not amend its rules on RPTs until MCA made revisions to the Companies Act. While the new Act defines RPTs more clearly, it requires that they can only be passed by a special resolution on which only minority shareholders can vote and SEBI has accordingly amended its rules stating that only minority shareholders should vote on "material" RPTs, the question remains who defines materiality? According to SEBI, it is the company. We would argue that this creates a clear potential for conflict of interest.

MCA allows flexibility in interpretation of RPT rules

Meanwhile, SEBI's rules do not come into effect until 1 October 2014 and MCA has already diluted the RPT provisions by issuing a circular in July 2014 that a shareholder will be considered a related party with 'reference only to the contract or arrangement for which the said special resolution is being passed'. According to a report by IiAS, companies are already taking a 'more aggressive interpretation' of this, allowing shareholders who are 'likely to benefit but are not "related" in a legal sense, to vote their shares'.

Unlisted subsidiaries seem to be exempt from RPT rules

A typical example, noted IiAS, was the case of two JSW Group entities where the promoters voted their holdings on a resolution seeking approval to pay approximately Rs150 crore (US$1 = Rs60.6; 1 crore = 10m) in aggregate annually as brand royalty to a related company. Had SEBI's rule been in place, this would not have occurred. But companies are pushing through resolutions prior to the amendment taking effect. Even when SEBI's amendment takes effect, companies seem to have found a way around them by using unlisted subsidiaries, an issue that SEBI's rules do not cover, according to IiAS. Cairn India used this method when it extended a loan to a company owned by its parent company, Vedanta Group, in early 2014, but did not inform its investors until an earnings call later in the year, said IiAS. When

investors voiced their displeasure, Cairn clarified that the loan was given by an unlisted subsidiary, which is not covered by the Act and will not be under the new SEBI rules.

India comes to the CSR party quite late

Sustainability reporting in India

The Indian government only started promulgating laws on sustainable business behaviour quite recently, with the 2011 National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business (NVGs) from MCA and the 2012 SEBI Business Responsibility Reports (BRR) within annual reports for the top 100 listed companies. In 2010, the Department of Public Enterprises introduced its guidelines on Corporate Social Responsibility for Central Public Sector Enterprises; and revised them in 2013.

Energy efficiency incentivised

The government has incentivised energy efficiency activities, providing companies with tax benefits through accelerated depreciation schemes. It also introduced the Performance Achieve and Trade (PAT) scheme, which provides a market base mechanism through which large energy-intensive companies, such as fertilisers, pulp and paper, textiles, iron, steel and aluminium plants, can earn and trade energy saving certificates.

Sustainability reporting widespread among top 100 firms

In terms of reporting, according to a 2013 KPMG survey of CSR reporting in India, the Global Reporting Initiative (GRI) was the most widely used reporting framework with 64% of the top 100 reporting companies (using standard reporting frameworks) referring to GRI. However, the NVG-SEE framework is estimated to overtake GRI among the top 100 companies with mandatory requirements on BRR. From our research of large companies in mid-2014, it is a mixed bag. Some rate highly on CSR/ESG disclosure, such as Tata Consultancy and Infosys, while others see it as much more of a box-ticking exercise. Most small-and-midcap companies also view CSR reporting as a tick-box exercise.

Voluntary greenhouse-gas emissions reporting started in 2013

Finally, there is a market initiative called the India GHG initiative, started late in 2013, which is 'a voluntary initiative to standardise measurement and management of GHG emissions in India', but it is unclear what their reporting/disclosure standards are.

Enforcement

Rises from 42% in 2012 to 46% in 2014

Some progress has been apparent in enforcement, but it is less marked than changes in rules and regulations. Corruption and scams continue to be a thorn in India's side. In 2013, the National Spot Exchange, an electronic commodities trading platform, was embroiled in a US$915.1m scam, having given money to its members without receiving any or inadequate stocks. The fraud came to light after the Exchange failed to pay its investors in commodity pair contracts at the end of July 2013. A number of regulators have been involved in the investigation of the case, including the Central Bureau of Investigation, the Forward Markets Commission and SEBI. While charges have been filed against all directors of the Exchange and its promoter company Financial Technologies India, a satisfactory conclusion has yet to come about - an issue made more difficult by the involvement of so many regulators.

SEBI getting tougher on enforcement . . .

Regulators especially SEBI, have been dogged in their pursuit of cases against high-profile names, including Subrata Roy of Sahara and Mukesh Ambani's Reliance Industries. In addition to its increasing powers, SEBI has also been steadily increasing its manpower from 607 employees in various grades in 2010, including 493 officers, to 756 employees in 2014, of which 662 were officers.

. . . but disclosure of enforcement activities remains poor

The disclosure of regulatory enforcement activities remains woeful. SEBI provides a lot of data, but everything from insider trading to market manipulation is lumped together in aggregate. The website of the National Stock Exchange (NSE) is confusing to surf, let alone find meaningful information, despite the fact it was recently overhauled. At this point in time, the Bombay Stock Exchange (BSE) has a far superior website in terms of the ease of finding useful data and general information.

Indian institutional investors finally stirring

What has steadily grown over the past two years is institutional investor activism. While some observers believe institutional investors should be voting more responsibly, it can be argued that they are now voting in larger numbers and voting against resolutions with which they disagree. The most recent incident was a vote against a proposal by Tata Motors for payment of remuneration to three of its directors in excess of permissible limits.

Robust retail activism is lacking

What is lacking, however, is a robust retail-investor base. Retail investors and shareholder associations have, in the past, been reasonably active; but more recently there has been limited activity in this area. As we have stated before in previous *CG Watch* reports, most investor associations in India are city or state-based, hence their influence is limited.

Political and regulatory environment

Increases from 56% in 2012 to 58% in 2014

To its credit, SEBI has sought to address several issues that we have highlighted as problematic over the years, including related-party transactions and voting by poll. The Listing Agreement amendments, which will become effective on 1 October 2014, as discussed earlier, will also include performance evaluation of both independent directors and the board of directors, restricting the number of listed company boards on which independent directors can serve to seven, excluding nominee directors from the definition of an independent director, more stringent definitions of an independent director and mandatory constitution of nomination and remuneration committees, with the chairman of these committees having to be independent.

New Clause 49 rules a sea change

While some of the amendments could have been much stricter and SEBI should have defined “material” with regards to related-party transactions more precisely, we believe that the changes enacted represent a sea of change compared to the status quo of the past few years.

SEBI gets more enforcement powers

Moreover, SEBI has finally been granted more powers as of August 2014, when the Securities Law Amendment Act was passed by Parliament and became effective. The powers, which were partially conferred on SEBI through an ordinance last year and promulgated three times since then, include allowing the regulator to conduct search and seizure operations at a suspect’s premises and setting up a special SEBI court. The new Act also empowers SEBI to take action against all unregulated money-pooling schemes involving Rs100 crore or more.

Lack of clarity on new government’s approach to CG reform

Overall, however, India only gains marginally here as the new government’s approach to corporate governance reform, its stance on fighting corruption and how it will enhance public governance in general, all remain unclear.

Stock-exchange websites should be improved

On a slightly more negative note, points were also deducted because the accessibility of company information on regulatory websites leaves much to be desired. Trying to find something as simple as an annual report on

either of the two exchange websites is like searching through a labyrinth - one experiences many deadends and sometimes never finds a way out! As noted in the earlier section however, the BSE website is more user-friendly than NSE's.

IGAAP (accounting and auditing)

Falls from 63% in 2012 to 57% in 2014

India suffered a drop in score in this section, as did most other markets. While nothing has really changed in accounting and auditing standards or practices over the past two years, the score fell due to questions on the quality and scope of audit oversight by regulators.

New Indian accounting standards still not in effect

Everyone is waiting to see when Indian accounting standards (Ind-AS), the Indian version of International financial reporting standards (IFRS) with significant "carve-outs" to reflect the Indian environment, will be implemented. MCA had notified the public of 35 Ind-AS standards in 2012, but failed to say when they would take effect. There was silence for two years and then, the new Finance Minister in his 2014-15 Budget Speech in February 2014 said the standards would be implemented in 2015-16 - yet another wait-and-see moment.

India still has no independent audit regulator

What continues to plague the country is the lack of an independent audit regulator, since the self-governing Institute of Chartered Accountants of India (ICAI) fails to 'exercise effective and independent disciplinary control' over the profession. We continue to give this question only a marginal point because while the Companies Act talks about establishing a new audit oversight board, the National Financial Reporting Authority, no timeline has been set. As one auditor commented, this might only happen in the distant future because other sections of the Companies Act take precedence and MCA is already facing challenges in the Supreme Court to establishing a National Company Law Tribunal and the Appellate Tribunal.

India also lacks a detailed report on the state of the audit industry

India also scores negatively on a new question about whether the audit regulator publishes a report on its inspection of CPA firms, audit engagements and the state of audit industry capacity, such as one finds in Japan, Singapore, Taiwan and Thailand.

CG culture

Rises from 43% in 2012 to 51% in 2014

CG culture does seem to be changing gradually for the better in India. Substantive developments over the past two years that have pushed the country's score higher in this section include:

- Companies outside of the top 100 offering e-voting facilities to their shareholders for their AGMs this year, a whole year ahead of schedule.
- Maruti Suzuki India backing down on plans for a Gujarat plant in early 2014 in the face of opposition from institutional investors, then agreeing to put it to a vote of its minority shareholders (expected later this year).
- Private companies showing more openness to discussing CG issues with foreign investors - a fact we noted during an investor delegation that ACGA led in India in February 2014.
- The three depositories offer electronic voting platforms and make them open to both retail and institutional investors (domestic and foreign).

Domestic proxy advisors drive greater shareholder involvement in CG

We also view engagement by both domestic and foreign institutional investors in a more positive light this year. While mutual funds have had to form voting policies, vote their shares and disclose all of this due to a 2010 SEBI mandate, domestic proxy advisors have been a driving force in furthering engagement activities with listed companies. They also publish original reports on the state of the market and other topics that are of interest to investors. One such report that analysed the voting patterns of mutual funds, showing a number of mutual funds either abstaining from voting on a majority of resolutions or voting "for" a majority of the resolutions, caught the regulator's eye, leading SEBI to tighten regulations in April 2014, requiring mutual funds to publish their actual voting practices at investee companies every year and giving reasons behind the votes.

State enterprises still reluctant to discuss CG

However, numerous weaknesses remain in India's CG culture, from inactive retail investors to poor reporting on executive compensation to certain state enterprises' public sector undertakings (PSUs) that are reluctant to meet foreign shareholders to discuss CG issues, despite the fact that they are listed entities with a significant foreign shareholder. Finally, India's score saw no change in many of its scores on other questions in this section of the survey, such as board leadership and independence, director training and CG preparation in initial public offerings.

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

What to avoid

- ❑ No progress in addressing loopholes in the RPT regime
- ❑ No progress in establishing the National Financial Reporting Authority
- ❑ Ineffective implementation of the new Companies Act and Clause 49 of the Listing Agreement
- ❑ MCA rules that dilute corporate governance initiatives

Quick fixes

What to fix

- ❑ Release cashflow and balance sheet data with quarterly reports
- ❑ Improve websites of regulators
- ❑ Improve communication at state enterprises (PSUs)
- ❑ Release AGM notices at least 28 days before date of meeting

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Research perspective - Rising activism

Indian companies' CG practices have seen a bit of a shake up over the last couple of years as some traditional Indian companies improve their disclosures and governance practices, while some multinational companies (MNCs) have seen deterioration thanks to the rising interference by parent companies via increasing royalties and M&As. However, since the days of the Satyam blowup (2008/09) and the political scandals of 2010/11, overall CG practices have improved.

Rising shareholder activism is a key positive

Minority shareholders stand to benefit from the new Companies Act implemented in phases. The biggest cultural change has clearly been a rise in shareholder/independent director activism. Cases like Maruti, ACC/Ambuja etc., where the management/owners were seen as passing resolutions detrimental to the interests of minority, have seen coordinated shareholder revolts. While these strategies may not always succeed (ie, Coal India), the companies are being incrementally driven to consider minority opinion while making major decisions.

Key CG changes

Improving disclosures driving positive scores

We scored 106 companies for the 2014 CG exercise. The companies that saw an increase in their CG scores include key players Tata Motors, Tata Steel and Hindalco. All three have a common theme of improvement in their disclosure standards, particularly for foreign acquisitions that companies made in the past. Other companies seeing a bigger increase in scores include pharma companies such as Lupin and Dr Reddy (no equity issuances, rising independent directors) as well as Axis Bank (rising independent directors).

Rising owner involvement - either Indian or foreign - drove negative scores

Stocks which have seen a larger decline in CG scores include the Holcim-owned cement companies of ACC and Ambuja, both involved in major controversies over the issue of the acquisition of stake in ACC by Ambuja and the increase in 'technical fees' charged by its parent despite objections from independent directors. Other larger declines were seen in the score of Infosys (controversy over rising owner involvement) and Cadila Healthcare (management aloofness to the investor community).

Tata Motors, Tata Steel and Hindalco see great improvement

Figure 101

Stocks with larger CG scores change

Company	Code	Comment
Significant improvements		
Tata Motors	TTMT IB	Better disclosures on foreign business Jaguar Land Rover
Hindalco	HNDL IB	Better disclosures in general including foreign business Novellus. Increase in the number of independent directors
Tata Steel	TATA IB	Better disclosures on foreign acquisition Corus. Increase in number of independent directors
Significant declines		
ACC Ambuja Cements	ACC IB ACEM IB	Levy of 'technical fees' by parent Holcim in both ACC and Ambuja despite objections by independent directors. The group restructuring of its India business whereby ACC became a subsidiary of Ambuja was deemed questionable.
Infosys	INFO IB	A fall in the number of independent directors; stronger increase in Board compensation compared to Net Profit over the last three years. Also, executive changes over the last couple of years were found to be objectionable. This is now corrected by the appointment of a new CEO.
Cadila	CDH IB	Management access by investors/analysts and disclosures have deteriorated

Source: CLSA

Institutional shareholders more active

Rising shareholder activism a positive

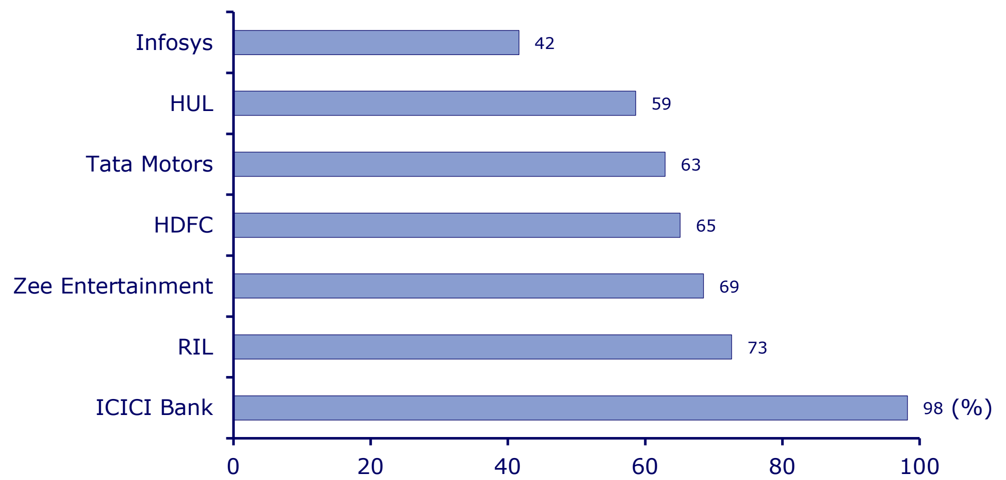
One of the developing changes in India's CG count has been the rise of shareholder activism. Anecdotal evidence suggests that the participation by Institutional shareholders in voting on resolutions put up for shareholder approval has increased. The current (FY14) AGM's have seen a majority of institutional shareholders exercising their voting franchise in several large caps like ICICI Bank, RIL and HDFC and stocks with high institutional ownership like Zee.

Majority of institutional shareholders have started voting

These disclosures were not compulsory in FY13

Figure 102

Institutional shareholders voting in FY14 AGM



Source: CLSA, companies

Few victories were won by institutional shareholders

The impact of rising shareholder activism has been seen over the past couple of years, particularly among issues related to MNCs trying to raise royalties (Holcim group) and conducting M&As deemed unfair to the minority (Grindwell - Gobain). Some of these issues have actually yielded results for the investors with Maruti being forced to modify its plan of getting its parent company to construct a separate manufacturing facility in India. The new plan is more favourable to Maruti.

Voting recommendations by proxy advisors has gained wider acceptance among institutional shareholders

Figure 103

Key stocks seeing shareholder/independent director activism

Issue	Company
M & A	Grindwell Norton - Saint Gobain Sekurit merger was blocked by Grindwell's shareholder as merger ratio was deemed unfavourable
Royalty issue	ACC/Ambuja: Independent directors have opposed levy of a 'technology fee'
Related party	Maruti Suzuki (After shareholders protested parent Suzuki's plans to open a separate manufacturing plant in India, terms of purchase from same were made more favourable to Maruti)
Compensation	Tata Motors' resolution to raise compensation for its key CEO's was blocked by shareholders

Source: CLSA

A few cases of corporate fraud

Few black sheep lingering

There are still a few cases of corporate fraud/CG issues recently. These include the commodity-trading exchange National Spot Exchange Limited (NSEL) scam where the stocks of commodities that were supposed to back up the underlying commodity futures contracts were found to be inadequate despite money being given by NSEL for the same. The recent Bhushan Steel

loan is also a CG issue cropping up recently. Also, issues pertaining to the treatment of related-party transactions with UB Holdings/United Spirits led to substantial delay in publishing its March 2014 results, while the June 2014 quarterly results are still not published. This has caused discomfort to the minority investor community.

Some of the past cases relating to telecom scams (ie, mobile licenses and spectrum were allegedly sold significantly below market prices), coal scams (ie, coal blocks allotted without auction to private parties allegedly causing a loss of government revenue), Competition Commission of India (CCI) enquiries against builders (ie, one-sided contracts with buyers) and cement companies (ie, price-fixing) are also on the radar as they make their way through the court process.

Larger picture shows improvement

Rising investor involvement, acceptance of higher standards by corporates, cleaner balance sheets

Overall though, the tone is one of improvement on the CG front. Disclosure standards for Indian companies have improved, partially attributable to regulatory changes. The company owners themselves have been cleaning up their balance sheet via asset sales and reducing chances of negative surprises. Even government-owned companies may see better CG ahead as Prime Minister Modi is in general a greater believer in PSU-board autonomy (read our 22 April 2014 *Drawing from Gujarat PSUs* note). A more conscious investor base, e-voting charging up retailer participation and a tighter governance framework by the authorities provide a path to better corporate governance in India.

Private sector banks, technology companies dominate the list

Figure 104

India: Companies in top-two CG quartiles (alphabetical order)

Company	Code	Company	Code
Asian Paints	APNT IS	JPL	JAGP IB
Axis Bank	AXSB IB	Larsen & Toubro	LT IB
Bajaj Auto	BJAUT IS	Lupin	LPC IB
Bank of Baroda	BOB IB	Marico	MRCO IB
Bharti Airtel	BHARTI IS	Maruti Suzuki	MSIL IB
BHEL	BHEL IB	Max India	MAX IB
Colgate India	CLGT IB	Motherson Sumi	MSS IS
Dabur	DABUR IS	Oberoi Realty	OBER IN
DB Corp	DBCL IB	ONGC	ONGC IB
Dr Reddy's	DRRD IB	Petronet LNG	PLNG IB
eClerx	ECLX IB	Power Finance	POWF IB
Grasim	GRASIM IB	Power Grid	PWGR IB
GSK Consumer	SKB IS	Rural Electrification	RECL IB
GSK India	GLXO IB	Shree Cement	SRCM IB
HCL Tech	HCLT IB	Sobha	SOBHA IS
HDFC Bank	HDFCB IB	Sun Pharma	SUNP IB
Hindalco	HNDL IB	Tata Consultancy	TCS IB
HPCL	HPCL IB	Tata Motors	TTMT IB
ICICI Bank	ICICIBC IB	Tata Power	TPWR IB
Idea Cellular	IDEA IB	Tata Steel	TATA IB
IDFC	IDFC IB	Thermax	TMX IB
IndusInd Bank	IIB IS	Titan	TTAN IB
Info Edge	INFOE IS	UltraTech	UTCEM IS
Infosys	INFO IB	Wipro	WPRO IB
ITC	ITC IB	Yes Bank	YES IB
J&K Bank	JKBK IB	Zee Entertainment	Z IB

Source: CLSA

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Indonesia - Long journey, single step

Key issues and trends

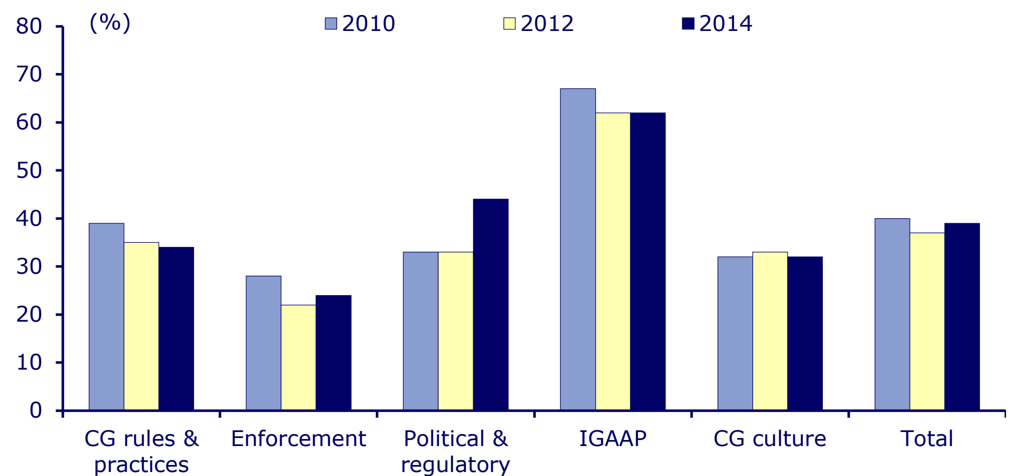
- Launch of OJK, Indonesia's financial super-regulator, a hugely ambitious project
- OJK creation seems to have had a soporific effect on the Indonesia Stock Exchange
- New CG Roadmap a far-reaching manifesto for CG reform
- CG environment still suffers from a culture of compliance, but some large and small caps showing more interest in CG
- Biggest weaknesses remain insider trading, toothless enforcement, inadequate regulation of related-party transactions, and political meddling in the OJK
- Regulatory disclosure improving, but could be much better
- Still early days, but independent audit regulatory system taking shape

Overall score rises from 37% in 2012 to 39% in 2014

Scores for enforcement, political & regulatory increased

Figure 105

Indonesia CG macro category scores



Source: ACGA, CLSA

CG rules and practices

Falls from 35% in 2012 to 34% in 2014

Some progress has been made in tightening up financial and non-financial reporting in Indonesia since our last survey. In August 2012, Bapepam-LK, the Indonesia Capital Market and Financial Institutions Supervisory Agency (predecessor to OJK), introduced new rules on the form and content of annual reports and required greater disclosure on the real beneficial ownership of principal and controlling shareholders. In December 2012, it released an 83-page guide for issuers on financial report disclosure.

Financial reporting standards vary widely among large listed companies

Not surprisingly, financial reporting standards among large listed companies vary widely. Leaders include banks (predictably given tougher regulatory requirements imposed), such as Bank Rakyat Indonesia and Bank Negara Indonesia, but interestingly, also state-owned enterprise (SOE) Perusahaan Gas Negara, as well as Kalbe Pharma.

As with all markets in our survey, there is a marked difference in financial reporting standards between large-cap and smaller-cap listed companies in the country. Our sample analysis of 17 large and midcaps showed more

Surya Toto Indonesia and Wintermar Offshore Marine stand out among small-cap peers

basic compliance-driven reporting among smaller companies, with fewer notes and less detail generally. The incidence of smaller audit firms working for small to midcap companies certainly plays a part in this, but not always. Two smaller companies, Surya Toto Indonesia and Wintermar Offshore Marine, stood out from their peers for detailed and qualitative financial as well as non-financial reporting.

Similar trend observed for non-financial reporting

Non-financial reporting standards among Indonesian corporations follow a similar trend, with a marked difference in disclosure and qualitative reporting between large caps and smaller caps surveyed in our sample. Notable omissions include detailed ownership data of insiders, weak-board remuneration data and extremely limited information on audit and non-audit fees earned by audit firms. Detailed CG statements required by the existing Code have been voluntary and, predictably, many companies choose to ignore much of what they do not like or at best, pay lip service to the requirements by meeting minimum disclosure standards. The OJK's CG Roadmap envisages a change to that regime, with plans to introduce a comply-or-explain regime by 2015.

Environmental and social reporting is "mandatory"

Environmental and social reporting is mandatory, but there is no guidance provided on disclosure levels and a general lack of support from regulators (see 'Sustainability reporting in Indonesia'). The IDX has no such requirements for listed companies and does not even issue its own report.

Speed of reporting

Only a quarter of large firms in our sample reported within 60 days

An ACGA review of financial reporting among 317 large and 110 midcaps in Asia in mid-2014 found that only a quarter of 27 large firms in Indonesia reported their audited annual financial results within 60 days, the regional regulatory best practice. The average time it took for large firms to publish their reports was 75 days (perhaps not surprising since the deadline in Indonesia is currently 90 days). Predictably, midcaps fared worse with just one of the 10 companies we reviewed meeting the 60-day deadline. The average number of days among midcaps was 85 and several were at 90 or more. Interestingly, three exceeded the 90-day deadline by three weeks each.

Majority rule

Minority shareholder protection remains weak

Minority shareholder protection in Indonesia remains weak generally. Disclosure requirements for directors and major shareholders still lag best practice. Directors and commissioners and major shareholders (5% and above) are required to notify OJK within 10 business days of any changes in their holdings. An August 2012 rule change requires companies to disclose the ultimate beneficial owner behind a shareholding up to the individual level. While the rule change is to be welcomed, as several professionals we spoke with in Jakarta indicated, the key issue is how OJK will police compliance with the new rule.

So too are rules relating to price- sensitive information

Rules relating to price-sensitive information (PSI) are also weak. The deadline for disclosure of this information is only two days; the definitions are vague and open to abuse and/or misinterpretation and as we were emphatically informed during our in-country interviews, woefully policed and enforced. As such, according to our sources on the ground, insider trading remains rife in Indonesia.

Related-party transactions impose another challenge

Related-party transactions also remain a problem for Indonesia with weak regulations that afford unscrupulous insiders plenty of loopholes, similarly with disclosure and approval requirements.

Pre-emption regime - the only bright spot for minority investors

The one bright spot in Indonesia for minority investors remains the country's pre-emption regime - the strictest in Asia. OJK rules stipulate strict conditions for placements. Hence, issuers mostly raise capital instead through rights issues and bonds. IDX rules also prohibit non pre-emptive issues from being issued at a discount and impose a one-year lockup on new shares.

Notices of general meetings also fall far below best practice

Notices of general meetings also fall far below best practice, which is 28 days for annual general meetings (AGMs). Indonesian company law mandates a minimum period for a general meeting of 15 days. According to companies we spoke with, regulatory requirements for the pre-approval of AGM agendas and proposed board appointments effectively prevent the notice period being extended. Likewise, the administrative procedures required by regulators discourage companies from releasing detailed meeting agendas to their shareholders ahead of AGMs.

Weak voting disclosure

Fully fledged poll voting is not mandated in Indonesia, although in practice companies generally count votes cast before and during the meetings. Voting disclosure is generally weak.

Minority shareholders have little chance of calling a meeting

While Indonesian law permits minority shareholders holding 10% or more of a company's shares to requisition a general meeting of the company, the process by which this must happen, with a request being put first to the board of directors, next to the board of commissioners and failing action, and then finally to the courts, means that practical chances of minority shareholders actually succeeding in calling a meeting are slim.

Individual remuneration disclosure not mandatory

Companies are required to disclose the total remuneration for the board members (including directors and commissioners), but there is no requirement to disclose individual remuneration.

Unique board rules

Opportunity for manipulation by executive boards and/or controlling shareholders

While Indonesia benefits to a certain extent from its split-board structure, with a board of commissioners (*Komisaris*) supervising an executive management board (*Direksi*), following the Dutch company law model, the definition of independence for the purpose of qualifying as an independent member of the Board of Commissioners is weak. This leaves plenty of scope for manipulation by executive boards and/or controlling shareholders.

Few audit committees in Indonesia genuinely independent

Audit committees are mandatory for the board of commissioners and disclosure standards among companies is good. An unusual, but apparently helpful, feature of the Indonesian audit committee system is the appointment of independent professionals from outside the board of commissioners to the audit committee. This meets a practical need, namely a general shortage in accounting expertise among commissioners. That said, few audit committees in Indonesia could be said to be genuinely independent since the board of commissioners itself is not truly independent: its composition usually reflects the proportional ownership of shareholders.

Persons convicted of a crime banned from serving on boards

Indonesian law bans persons from serving on boards of companies if that person is convicted of a crime, or has been deemed to be at fault as a director or commissioner for causing the bankruptcy of a company or has himself or herself been declared bankrupt. The law only covers those events within five years of a person's appointment and we have yet to come across an instance of a director convicted of fraud in Indonesia being removed from office.

Sustainability reporting in Indonesia

Sustainability reporting at early stage

Sustainability reporting in Indonesia is in an early stage of development, but moving quite quickly. Given the importance of natural resources and commodities sectors, the government has mandated it for SOEs, limited liability companies and natural resources concerns. No guidance is available however, from government or regulators as to the standards or content of company sustainability reports. The Indonesia Stock Exchange (IDX) currently has no requirements for sustainability reporting for listed companies. It plans to implement this on a voluntary basis, most likely in accordance with the GRI reporting guidelines, but no date has been set for implementation.

IDX was the first Exchange in Asia (outside Japan) to release a sustainability index

While IDX has not actively promoted carbon disclosure, it claims that environmental impact assessments are required as part of listing requirements. Only three listed companies reported to the CDP in Indonesia in 2013. However, IDX was the first exchange in Asia (ex Japan) to release a sustainability index, called the SRI-KEHARI Index. It comprises 25 companies chosen for good sustainability performance in six different areas: environment, community, corporate governance, human rights, business behaviour and labour practices/decent work.

Almost all bigger firms report on sustainability

An ACGA review of a sample of 10 large-caps and 10 midcaps found that almost all the bigger firms reported on sustainability and half had relatively sophisticated reporting. Of the midcaps, most (8/10) had reports, but they were unsophisticated and largely philanthropic in nature.

Enforcement

Increase from 22% in 2012 to 24% in 2014

Enforcement in Indonesia remains a key area for improvement. While our score increased this time by two percentage points, the higher scores were limited principally to improvements by OJK in hiring and transparency.

Enforcement is weak and requires considerable investment

All practitioners and companies that we spoke with, and even OJK itself, admits that enforcement is weak and requires considerable investment. Since its inception in 2013, OJK has embarked on an aggressive hiring campaign and plans to recruit about 500 net additional staff per annum for the next five years. While the agency remains under the indirect control of the Ministry of Finance, it will gain a level of financial independence with the introduction of a new capital market levy. It expects to be self-funding by 2017.

Progress in improving disclosure and transparency

OJK has made progress in improving disclosure and transparency, with a much improved website and data on enforcement and regulation that were unavailable under the previous Bapepam-LK regime. That said, the website remains a work in progress and could be further improved with more data available in English, a more logical layout, easier navigation and deeper and better functioning databases.

OJK granted wide power of supervision and investigation

Under the FSA Law of November 2011, the OJK was granted wide powers of supervision and investigation, as well as the ability to impose administrative penalties and undertake civil litigation against companies and directors. It can and does cooperate with the police over criminal investigations but does not have power to prosecute these cases, which remain the purview of Indonesia's cumbersome and corrupt legal system. There has never been a successful prosecution for insider trading and, as far as we know, the regulators have never seriously tried.

Little evidence of enforcement success

Despite OJK's new powers, there is little evidence thus far of major enforcement successes. Much of the regulator's enforcement activity to date appears to be aimed at market oversight, such as monitoring related-party transactions and checking compliance with filing requirements and general meetings. While some of this should be the job of the local stock exchange, the arrival of OJK appears to have shifted enforcement responsibility away from IDX, with a clear view in the exchange that the OJK is the frontline regulator.

Small improvement in market enforcement

Market enforcement has improved a little, with shareholder engagement on the (slight) increase over the last couple of years. Some companies and investors we spoke to report more voting by shareholders at meetings, including institutional investors. That said, few institutional investors hold any realistic expectation that they can overturn resolutions.

Political and regulatory environment

Increase from 33% in 2012 to 44% in 2014

This is the area of greatest improvement for Indonesia in our survey and is largely, but not exclusively, due to the establishment of OJK and its introduction of the CG Roadmap. Compiled with the assistance of the World Bank and launched in February 2014, the roadmap is an ambitious and impressive plan to move CG standards towards international best practices, focusing on the CG framework, protection of shareholders and the roles of stakeholders, boards of commissioners and directors. What is interesting about the document is its candour in laying out Indonesia's strengths and weaknesses in CG. It is an honest paper, not a marketing gimmick.

Level of transparency in Asean CG Scorecard is impressive

We have also been impressed with the level of transparency in Indonesia's response to the Asean Scorecard project, a survey of CG practices among the largest listed firms in six Southeast Asian countries. There was always the danger that the Scorecard would become a box-ticking exercise, with each market looking for ways to boost their scores artificially. This does not appear to have been the case for Indonesia, which has used the competitive nature of the process to improve its CG standards. We also note that regulators in Indonesia have made a concerted effort to reach out to ACGA and the global investor community over the past 18 months.

OJK has to prove its effectiveness in the market

As a quasi-independent and certainly better funded regulator (particularly so once the new levy system is fully implemented in 2017), OJK has a clear opportunity to prove its effectiveness in the market. At this stage, it is too early to tell. A key part of the challenge will be the ability of OJK to operate as independently as possible. With the board of commissioners appointed by the government, the potential for political meddling is clear. The trend however is certainly encouraging.

If the CG Roadmap is successful, there will be more rule introductions

New rule-making by regulators has been less impressive since our last survey, with new Bapepam-LK rules in 2012 and more in the pipeline, relating to the conduct of general meetings, and audit, nomination and remuneration committees. IDX increased the minimum public float from 5% to 7.5% but then promptly granted a two-year holiday, while new IPO candidates must now appoint an internal auditor. Clearly, if the CG Roadmap is successful, there will be more significant rule introductions, both by OJK and IDX, in the years ahead.

IOSCO Multilateral Memorandum of Understanding

Another notable achievement by the regulatory authorities occurred in January 2014, when Indonesia signed the International Organisation of Securities Commissions (IOSCO) Multilateral Memorandum of Understanding, the 100th country to do so.

Corruption issues remain a challenge

Challenges for Indonesia in the political and regulatory arena include tackling serious corruption issues, including its judicial system, with little sign of any progress on this front to date. There has been an attempt to train judges and establish special courts to try securities cases, but this is in its infancy.

Media coverage of CG scandals sometimes subject to business interests

Media continue to report on major graft cases and CG scandals, and do so generally with impartiality. However, we note with some concern the extent to which business interests manipulated the press during the recent general elections.

Indonesia's anti-corruption commission has demonstrated good results

The KPK, Indonesia's anti-corruption commission has survived several political purges and continues to pursue public officials, with some success, so there is some hope for the future, particularly with the promise of a new broom following the election of Joko Widodo as the country's president.

IGAAP (accounting and auditing)

Constant at 62% for 2012 and 2014

Indonesia completed Phase 1 of convergence with IFRS 2009 standards in 2012, but has not adopted certain standards (see below) and is not likely to any time soon. Phase 2 of its convergence process will be completed by 2015, at which stage the country will have converged with IFRS 2014 standards. A couple of problem standards prevent Indonesia from full adoption, principally relating to agriculture and real estate. Indonesia states a commitment to full adoption of IFRS, but has not fixed a deadline.

Indonesia's auditing standards in line with international standards

In contrast, Indonesia's auditing standards are in line with international standards of auditing (ISAs) and one presumes that the auditing of large listed companies is mostly of a high standard, not least because anecdotal evidence supports the view that the bigger and better CPA firms do not assist large caps with account preparation. The same cannot be said of smaller issuers who often do seek help and some even expect their auditor to help prepare the accounts.

Weak disclosure of audit and non-audit fees

Disclosure by companies of audit fees and non-audit fees earned by their auditors remains patchy. While some we surveyed disclosed both amounts, they were in the clear minority, with most making little if any disclosure.

Indonesia is lacking audit professionals

Indonesia's audit profession is in a challenging position. While CPA firms remain understaffed and under-resourced, regulation that mandates partner rotation every three years and firm rotation every six years exacerbates the problem. The situation has become so dire that in order to meet rotation requirements, firms regularly change their name and appoint new (sometimes titular) partners, thus enabling them to qualify as a new audit firm; and all this is done by the book and with full knowledge and consent of the Ministry of Finance. To their credit, regulators have recognised the problem and plan to amend the rules to remove mandatory firm rotation and instead extend audit partner rotation to five years for "public interest entities" (listed and other public companies).

PPAJP licenses public accountants and carries out inspections of both auditors and audit firms

Although improving, the audit oversight and supervisory system in Indonesia remains somewhat fragmented. The main audit regulator, the PPAJP, which stands for The Accountants and Appraisers Supervisory Centre of the Ministry of Finance, licenses public accountants and carries out inspections of both auditors and audit firms. It aims to do about 50 firms a year and each firm about once every seven years - there were 394 CPA firms in Indonesia at the end of 2013. Meanwhile, the Indonesian Institute for Public Accountants (IAPI) carries out quality peer reviews of its members on a voluntary basis. If they find a problem, they will inform the PPAJP, which has ultimate disciplinary oversight - although it has issued some suspensions and reprimands, it has not yet revoked a license. Meanwhile, the OJK has an audit inspection unit that is intended to look at listed company audits and financial reports. PPAJP will coordinate with them as necessary too.

CG culture

Decreases from 33% in 2012 to 32% in 2014

Like other Asian markets, CG in Indonesia remains principally a compliance-driven process with little genuine evidence of CG reform or initiatives that are not mandated or regulated somehow.

Poor CG disclosure

Based on our research and survey, listed companies in Indonesia are generally reporting CG on issues because they have been told to do so. Most of the accounts we reviewed were basic and formulaic when covering CG issues, including descriptions of risk management and internal control systems and policies relating to remuneration and board evaluation, with disclosure based only on answering the specific question rather than providing a more holistic and engaging narrative. There were few standout companies seeking a high level of transparency, but a few did surface: Kalbe Pharma, Perusahaan Gas Negara and Bank Rakyat Indonesia. Even rarer, a few small-to-midcap firms also shone such as Toto Surya Indonesia and Wintermar Offshore Marine.

Indonesian listed companies have fairly solid investor relations practices

In contrast to poor CG disclosure, Indonesian listed companies adopt fairly solid investor relations practices, especially the larger issuers, no doubt in part because of the presence of foreign institutional shareholders on their registers. Websites are generally easy to navigate, well thought out and contain useful filings and supporting data.

Separating the chair from the CEO and window-dressing remains an issue

Separating the chair from the CEO remains an issue in Indonesian firms and there is a good degree of window-dressing with many companies claiming that since they have a president commissioner (equivalent to a chairperson) and a president director (CEO), the roles are split. In practice, since the controlling shareholder of an Indonesian corporation invariably controls both the board of commissioners and directors, there is seldom any real division in the roles.

Full disclosure of AGM voting results would be welcome

Voting by poll is partially practised in Indonesia, with most companies adopting an "open dissenting vote" policy, where dissenting votes are counted and subtracted from the total shares (votes) represented in the meeting. OJK rules require the disclosure of summary results, but few companies make detailed announcements in tabular form showing the full votes For, Against and Abstain on each resolution, as is now common practice in many other Asian markets. One would only know these results, therefore, if you attended the meeting.

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

Progress of CG code will affect country score in 2016

- No effective implementation of the new CG Roadmap, in particular the proposed new CG code
- Limited progress on improving the quality of auditing
- No progress on prosecuting insider traders and market manipulators
- No action against companies who fail to disclose PSI and RPTs properly. as well as beneficial ownership
- No improvement in disclosure of regulatory enforcement activities

Quick fixes

What to fix

- Overhaul regulatory websites are to include full English content and databases that work, including a chronological and searchable list of regulations
- Produce an annual report on independent audit regulation and inspection
- Mandate publication of all AGM voting results
- Mandate disclosure of supporting information for AGM agenda resolutions and director/supervisor names prior to the meeting

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Research perspective - Jokowi factor

- Aggregate CG scores for Indonesian firms showed marginal improvement.
- Jokowi, the next president is all for better corporate governance and will put strong emphasis on this, as he has shown as governor of Jakarta.
- From a low base, CG scores for Adaro Energy and Bukit Asam saw notable increases.
- Mayora's unclear business direction deserves a downgrade.

The aggregate CG scores for listed companies in Indonesia showed small increases over the past two years. More companies indicated improvement compared to those that mentioned deterioration in scoring. The overall lift in companies' CG ratings was due to a combination of the following factors:

- Some companies have become more institutionalised. The bull market in 2012-13 enabled companies to improve liquidity of their stocks through placement or issuance of rights. As companies become more institutionalised, accountability also increases as the companies are "forced" to show clean governance and transparency to its larger shareholders base.

Stricter regulatory supervision

- The commencement of OJK (the financial-services authority) in early 2013 as the new regulatory body (replacing Bapepam) to oversee the equity market has resulted in a higher compliance standard to corporate governance by the listed companies.

"Who's who" is still a concern

Related parties transaction is still a concern especially with large business groups, hence we believe, understanding "who's who" is still an important factor for foreign investors in picking the right stocks to own.

Jokowi is all for better corporate governance

Jokowi to put strong emphasis on CG . . .

Joko "Jokowi" Widodo will be sworn in as the country's seventh president on 20 October 2014. We believe he will put a strong emphasis on CG of his administration and Indonesian firms (listed/non-listed alike).

. . . as he has shown as governor of Jakarta

As a governor of Jakarta, he has enforced the importance of transparency and accountability. For instance, the Jakarta municipality launched an online procurement system for goods and services to reduce corruption and bureaucratic red-tapes. He also took away the bus management rights from the Transport Ministry due to a corruption case involving the import of buses from China. As a President, he will have a stronger mandate to push for better corporate governance.

Much room for SOEs to improve CG

His advisory team stated that Jokowi would like to see more SOEs listed in the market, as he wants to see SOEs better managed and becoming more transparent. He will also ensure SOEs will be led by good technocrats such as in the case of the state railway and port companies. SOEs historically did not score high in corporate governance. This is well reflected in the list of top-two CG quartiles which shows the dominance of private companies.

Notable changes in company CG scores

From low base, CG scores for Adaro and Bukit Asam saw a notable increase

We raised CG scores for Adaro and Bukit Asam by 17ppts and 10ppts. Over the past two years, we witnessed improvements in both companies' corporate governance. Unlike in the past, since 2012, Adaro has stayed focused on its

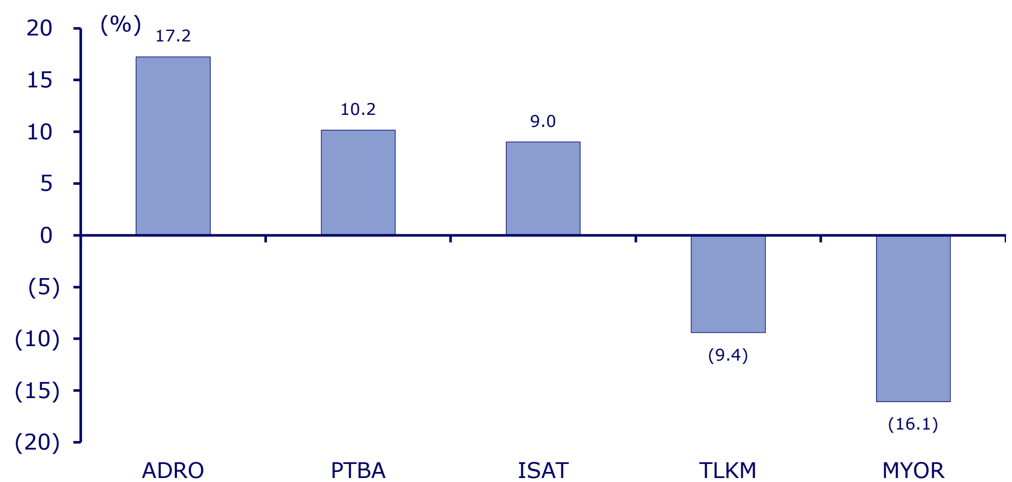
coal-related energy operations. It also announced its financial results within two months of the end and independent commissioners attended all meetings for 2013. Meanwhile for Bukit Asam, results were announced within two months of the end period. Directors are also available to meet analysts and investors. Moreover, the government also passed a regulation on the minimum selling price which discourages transfer pricing. However, despite these improvements, more can still be done. Both companies are still in the bottom half of the Indonesian CG ranking.

We also upgraded Indosat by 9ppts, given the company has become more disciplined in publishing their financial results within two months of the end period. Nonetheless, its score is also in bottom half versus peers.

Not many companies see material change in scores

Figure 106

Companies that see significant changes in CG scores



Source: CLSA

Top-two CG quartiles dominated by private companies

Figure 107

Indonesia: Companies in top-two CG quartiles

Company	Code	Company	Code
Astra Intl	ASII IJ	Unilever Indo	UNVR IJ
XL Axiata	EXCL IJ	Harum Energy	HRUM IJ
Vale Indonesia	INCO IJ	Elnusa	ELSA IJ
Jasa Marga	JSMR IJ	Kalbe Farma	KLBF IJ
Surya Citra Media	SCMA IJ	Astra Agro	AALI IJ
Summarecon	SMRA IJ	BCA	BBCA IJ
Ciputra Dev	CTRA IJ	Wintermar	WINS IJ
Ciputra Surya	CTRS IJ	Ace Hardware	ACES IJ
Pakuwon	PWON IJ	Tower Bersama	TBIG IJ
United Tractors	UNTR IJ	BRI	BBRI IJ
Indocement	INTP IJ	Lonsum	LSIP IJ
Semen Indonesia	SMGR IJ	PTPP	PTPP IJ
BTPN	BTPN IJ	Intiland	DILD IJ
ITM	ITMG IJ	Supra Boga Lestari	RANC IJ

Source: CLSA

Cut Mayora by 16%, and TM by 9.4%

We reduced the scoring for Mayora, because it is unclear if it intends to stick to clearly defined core business with the creation of a pay-TV platform and entry into property. The group launched a coffee product brand outside the listed co (under a family business) which raised concern over the competitive landscape against its existing instant-coffee product (in the listed company). On Telkom, we are concerned about the creation of a pay-TV platform right after it sold its original pay-TV platform TelkomVision.

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Japan - True converts at last?

Key issues and trends

- The government makes a big push for CG reform
- Stewardship Code released (first in Asia); work on first CG code underway
- Japanese companies not fully on board
- Steady enforcement effort, with no new major scandals
- IFRS still only voluntary, with no timetable for full implementation
- More companies appointing outside directors, but are they independent?

Overall ACGA market score rises from 55% in 2012 to 60% in 2014

Government getting serious about CG reform

Over the past year, we have seen something we feared might never come: the Japanese government getting serious about CG reform. As part of Abenomics, Prime Minister Shinzo Abe, who in December 2012 started his second term as Japan's leader following his first in 2006-07, is seeking an overhaul of the way domestic companies are governed. This is an integral part of his drive to rejuvenate the local economy after two lacklustre decades during which China surpassed it as the world's second-largest. In a society that prizes often painfully slow consensus-building, Abe has moved quickly and decisively.

While reform fever has fuelled Japan's rise to third place after Hong Kong and Singapore . . .

In February 2014, Japan became the first Asian country to issue a Stewardship Code for institutional investors. In August, the government set in motion the drafting of a complementary (and the country's first) CG Code of Best Practice for listed companies. This sudden burst of reform fever has helped lift Japan's ranking in this year's survey by one notch to third, still below Hong Kong and Singapore, but with an improved score of 60% compared to 55% in 2012.

. . . Japan is still catching up to leading markets in Asia and elsewhere

Before we get carried away, a bit of context is needed. In many areas of CG, Japan is still playing catch-up to leading markets in Asia and elsewhere. It is more than a decade behind most Asian markets in promulgating a CG code and, despite the bold reform moves, independent directors and audit committees are still not mandatory for all listed companies. Perhaps most significantly, much of Japan's corporate sector seems less convinced of the value of adopting global CG standards than regulators, and looks likely to drag its feet in the name of preserving traditions.

Better CG need not undermine corporate decision-making and strategy

Japanese corporate culture of course has many positive aspects, from a focus on long-term business performance to concerns for employee welfare. However, the emerging consensus among policymakers and the more open-minded elements of the business community in Japan is that a greater regard for shareholders does not have to mean a disregard for other stakeholders, and the inclusion of outside voices in boardrooms would most likely strengthen, not weaken, corporate decision-making and strategy. Nor should better CG undermine the individuality and uniqueness that so many Japanese companies prize. This has not been the result of reform in any other part of the world, and there is no reason to think Japan would be any different.

CG rules and practices

Rises from 45% in 2012 to 48% in 2014

In June 2014, the Japanese parliament passed a host of amendments to the Companies Act, including a provision making the appointment of at least one outside director at all listed companies a "comply or explain" obligation, but not a mandatory one thanks to stiff resistance from the conservative business

Latest CG regulations are aimed at promoting more independent boards and effective board oversight of management

lobby. Four months earlier, the Tokyo Stock Exchange (TSE) changed its listing rules to strongly urge companies to appoint independent directors. The amendments to the Companies Act also contained the introduction of a new type of board structure in Japan called 'company with audit and supervisory committee', a hybrid between the traditional governance structure involving statutory auditors (*kansayaku*) and the "three-committee system" introduced in 2003 (that is, the creation of audit, compensation and nomination committees in the board). Together, these latest CG regulations are intended to promote more independent boards and effective board oversight of management at Japanese companies.

In May 2014, the ruling LDP called for a "comply or explain" CG Code

While that may prove to be the case, by simultaneously opening debate on a proper national CG code, even the Japanese government seems to be hedging its bets. In its *Japan Revitalization Vision* report released in May 2014, the ruling Liberal Democratic Party (LDP) called for a "comply or explain" CG code that would entail at least two independent directors - despite opposition from its traditional allies in the business sector. Three months later, a Council of Experts under the aegis of the Financial Services Agency (FSA) held its first meeting to hammer out the details. This is certainly a step in the right direction that we will monitor closely, but it did not influence scores in this report since discussions on the code have only just started.

Stewardship Code complements the CG code

The other major regulatory initiative was Japan's Stewardship Code. A complement to a CG code, this regulation spells out seven principles that institutional investors should follow to enhance long-term investment returns for their clients and beneficiaries. As of the end of May 2014, these "comply or explain" principles had received 127 domestic and foreign institutions as signatories, including most notably the massive Government Pension Investment Fund (GPIF), which owns ¥130tn (US$1.25tn) in assets.

Reporting of audited annual financial results is slow

Less positively, scores have fallen for the speed with which listed companies report their audited annual financial results relative to other markets. The rule in Japan is three months, and an ACGA review of the 2013-14 financial statements of 28 large caps and 10 midcaps found that all of them had published detailed numbers relatively quickly - within 30-50 days of their financial year-end - but none of the reports had been fully audited. Shareholders must wait the best part of 90 days for auditor signoff, usually in the last week of June (as most issuers have March year-ends). In contrast, large caps in many Asian markets are providing audited annual reports in less than 60 days (the regional regulatory benchmark).

Scores on non-financial reporting declined

Japan has also lost points on non-financial reporting. Not only does the country have one of the most fragmented corporate reporting systems in Asia, but the quality of this reporting leaves much to be desired. Listed companies are required to publish quarterly and annual "securities reports" under the Financial Instruments and Exchange Law; "business reports" for their annual general meeting; and "corporate governance statements" to the Tokyo Stock Exchange (TSE). Some also publish "annual reports", as commonly required in other markets but voluntary in Japan. The net result is that information on corporate governance, such as the report on the board of directors, is spread around different reports, quite limited in scope and usually formulaic. The CG statements on the TSE website are more detailed, but typically in Japanese only. The one area of strength in non-financial reporting is the informative business reviews/management discussion and analyses that the better companies produce.

More reforms promoting sustainable business behaviour

Sustainability reporting in Japan

Since 2001, the Japanese government has promulgated several laws that promote sustainable business behaviour, including the 2004 Law of Promotion of Environmentally Conscious Business Activities, which requires an environmental report every year, and the 2012 Tax Reform Act, which introduced a carbon tax with the aim of helping Japan to cut its greenhouse-gas emissions by 25% by 2020 and 80% by 2050 from 1990 levels.

Government's strong focus on environment lacks broader CSR guidelines

Regulators heavily promote carbon disclosure and, as a result, 233 firms report to the Carbon Disclosure Project (CDP). Meanwhile, the TSE and Standard & Poor's have jointly developed the S&P Topix Carbon Efficient Index, while the Ministry of Economy, Trade and Industry has set up an online search tool, "ecosearch", to help share best practices around environmental and corporate social responsibility (CSR) reporting. Despite this strong focus on environmental matters, the government has produced no voluntary or mandatory requirements around broader CSR reporting, nor does it provide any CSR or sustainability reporting guidance.

Many companies published high-quality reports

Even so, an ACGA review in mid-2014 found that all large-cap Japanese companies reported on sustainability, often to a high quality. Many large caps' reports were sophisticated and strategic in nature, with sustainability strategies going out to 2020 - the best examples of long-term strategic planning in our CG Watch sample. Of the 10 large caps sampled, eight had standalone reports with at least three to four pages dedicated to CG; and nine reported to the CDP and received high marks. All 10 midcap companies surveyed had sustainability reporting: three had standalone reports, and the remainder provided annual reports. At least four of the midcap reports were of quite a high standard and were strategic in nature. The majority of them, however, were centred on the environment only.

Enforcement

Rises from 57% in 2012 to 62% in 2014

Coming off a string of scandals during the previous period of our assessment, Japanese authorities have continued to make a steady effort to improve enforcement. There were no repeats of massive accounting fraud à la Olympus, nor a similar spate of insider-trading cases. This seems to be due in part to the fact that both the Japanese securities regulator and stock exchange have continued to increase their staffing levels in investigation and enforcement. For example, the total number of budgeted personnel at the Securities and Exchange Surveillance Commission, the FSA's market watchdog, went from 697 in 2010 to 714 in 2012 and to 763 in 2014.

New regulatory initiatives to deter insider trading

There were also new enforcement initiatives on deterring insider trading. In July 2013, the Japan Securities Dealers Association (JSDA) revised self-regulation rules applicable to its 500-strong member firms. As many incidents of insider trading in Japan had occurred when information concerning listed companies' upcoming public-share offerings was leaked to clients by sales staff at brokerages who did not themselves trade on advance knowledge of their underwriting colleagues' activities, the JSDA required member firms to:

- Conduct periodic monitoring of management of confidential information;
- Establish internal rules, including the requirement that their staff refrains from conveying information related to public-share offerings to clients;

- Abstain from underwriting when information has leaked before the public announcement of an offering (unless the issuer specifically requests not to abstain); and
- Consult with the issuer about the timing of the launch in case the lead underwriter finds that trading was conducted by people with the knowledge of undisclosed information before the public share offering is made public.

The JSDA can sanction its members involved in insider-trading cases, namely by suspending the qualifications of brokers because it is responsible for registering all securities professionals under Japan's securities law. In April 2014, the FSA followed up by tightening regulations to hold not only users, but also tippers, of insider information guilty; and it raised monetary penalties.

Institutional investors are pushing for independence on many boards of directors

In terms of market-based enforcement by minority shareholders, Japan already has one of the highest levels of voting in Asia. Institutional investors routinely vote against resolutions with which they disagree (such as poison pills), and they have been flexing their muscles over the lack of independence on many boards of directors by voting against either the chairman or other directors. Notable firms in the firing line included Canon and Nippon Steel. Judging by what happened next - the appointment of outside directors to these companies - it would appear the strategy is working. A group of global investors then sought to keep the momentum going by writing to selected blue chips in mid-2014 and asking them to make at least one-third of their boards independent by the 2017 annual general meeting (AGM) season. (Note: Since we already give full points to the relevant questions on this in the enforcement section, we have reflected this extra effort in the CG culture category.)

Stewardship Code can be a significant catalyst for better CG

Things should become even more interesting with the advent of the Stewardship Code. In addition to the more than 120 domestic and foreign signatories, the GPIF's support for the code and its rethink on its strategy for domestic equity investment could be a significant catalyst for better CG over the longer term. The giant pension fund is benchmarking against the new JPX-Nikkei 400 index, which tracks companies with the best returns on equity, CG and accounting standards, in addition to broader Topix and other indexes.

One sign of genuine CG reform is how well listed companies win over retail investors and attract their money again

What Japan lacks, however, is a base of engaged retail shareholders as in Singapore, or civic groups defending minority shareholder interests as in Korea. One reason for this is the fact that individual investors only account for 18.7% (as of 2013) of the total market cap of listed Japanese companies. The country's famously diligent savers presumably remember all too well the spectacular crash of the domestic stockmarket that followed the bubble years of the late 1980s. One sign of genuine CG reform thus would be how well listed companies win over retail investors and attract their money again.

Political and regulatory environment

Rises from 52% in 2012 to 61% in 2014

Reflecting the sea change in the government's attitude towards CG reform, Japan's score in this category has seen a marked improvement. During its general-election campaign in December 2012, the LDP included an ambitious CG agenda. It called for, among other things, tightening the definition of outside directors, mandatory adoption of multiple independent directors, tougher regulations on insider trading and a more effective whistleblower system. These were unexpectedly strong recommendations, especially given the LDP's historically close relationship with the *Keidanren* (Japan Business Federation) - the most vocal defender of the existing CG system.

Abe translates rhetoric into action surprisingly quickly

The second Abe administration then moved surprisingly fast to translate its CG rhetoric into action. Within six months of coming to power, it kicked off the process to draft the Japanese version of the Stewardship Code, which came into force just eight months later. The LDP also shepherded into law the amendments to the Companies Act proposed by the previous government of the opposition Democratic Party of Japan, thus making the appointment of at least one outside director a "comply or explain" requirement for the first time. And now, in addition to its decision to draft a CG code, the government is working to promote more constructive dialogue between investors and companies through a Ministry of Economy, Trade and Industry (METI) initiative called the Competitiveness and Incentives Structures for Sustainable Growth: Building Favorable Relationship between Companies and Investors.

Stock exchange hopes to motivate companies to pursue voluntary CG reform

Joining the effort from the market side, the Japan Exchange Group (JPX), TSE and Nikkei together have introduced the JPX-Nikkei 400 index in January 2014. It contains 400 companies with high ROE and investor-friendly governance (eg, the appointment of at least two independent outside directors and adoption of IFRS accounting standards). Stock-exchange officials hope the JPX-Nikkei 400's more stringent inclusion criteria will motivate listed firms to pursue voluntary CG reforms that go beyond the requirements of the law.

IGAAP (accounting and auditing)

Rises from 70% in 2012 to 72% in 2014

Partly as a result of Olympus and other accounting scandals over 2011-12, much effort has been focused in recent years on improving accounting and auditing. While Japan continues to hedge its bets over committing to IFRS - perhaps because of the USA's recent decision not to converge - elsewhere, the country has shown more clarity of direction.

New set of auditing rules introduced

In late 2012, Japanese regulators proposed a new set of auditing rules in response to the scandals and the failure of audit firms to spot them. In its draft Standards for Addressing Fraud Risk in an Audit, the FSA spelled out a detailed process external auditors were required to take when they suspected fraud.

More risk-factor analysis for auditors

For starters, as the auditor develops an audit plan, he must consider typical fraud risk factors, including unusual or highly complex transactions, management dominated by one person or a small group, and a strained relationship between management and the current or former auditor. Then, during the audit, the auditor must ask management for explanations of suspicious material statements and perform additional procedures to verify them. If the auditor concludes that the possibility of a fraud exists, the original audit plan must be modified to investigate it. In addition, when a company appoints a new audit firm, the old auditor must follow strict handover procedures to communicate any risks of fraud to the new auditor. The new rules became effective on 31 March 2014.

Japan is taking audit oversight more seriously

Japan is also taking audit oversight more seriously. In our conversations during 2012-14 with the Certified Public Accountants and Auditing Oversight Board (CPAAOB), Japan's independent audit regulator, we concluded that it was upping its game in exerting disciplinary control over the audit profession. Although struggling with limited resources - CPAAOB had just 42 inspectors as of March 2014, up from 29 in 2004 - its leadership was well aware of where the problem areas lay, as well as the constant need to push auditors to

exercise more professional scepticism. For anyone interested in auditing issues in Japan, including a summary of persistent auditing weaknesses, read CPAAOB's annual reports. The latest was published in July 2014 and includes a detailed overview of its inspection work, undertaken in cooperation with the Japan Institute of Certified Public Accountants. The board also publishes a series of case reports on audit-firm inspections.

Japan needs to decide which set of accounting standards it will follow

Meanwhile, on the issue of accounting standards, the current state of play is that Japanese companies have a choice of whether to apply IFRS or JGAAP, and several dozen major firms have chosen the former. Investors who follow these issues believe that such choice 'promotes cherry picking and incomparability in financial reporting across companies', as an analyst from a major US asset manager told ACGA. 'We encourage Japan to decide whether JGAAP or IFRS will be the accounting rules that Japan will consistently enforce, and to cease the current policy of optional GAAP which is not investor friendly.' This seems sensible advice to us.

CG culture

Rises from 53% in 2012 to 55% in 2014

CG culture does seem to be changing for the better in Japan, albeit at a gradual pace. While many listed companies appear somewhat bemused by the whole thing, a couple of major firms have dropped welcome bombshells: in June 2013, for the first time in its history, Toyota Motor voluntarily appointed three outside directors, including a foreigner, to its 16-member board. Then in March 2014, Canon followed suit by appointing its first two outside directors. Until then, both firms had been staunch defenders of the all-insider boards at most Japanese enterprises.

Toyota seems to have changed its mind after massive and embarrassing recalls of defective vehicles in North America in 2009, which damaged its reputation for uncompromising quality. As for Canon, a steady erosion of shareholder support in director elections for its chairman and CEO, Fujio Mitarai, in protest against his vocal opposition to the appointment of outside directors apparently prompted the company's about-face. (The tracking of shareholder voting trends was possible, because Japan has had a strong regime of proxy voting and disclosure for some years.)

Stewardship Code implementation

As for the investor side of the equation, it will be interesting to watch how the signatories to the Stewardship Code implement their obligations, including explaining how they manage conflicts of interest affecting their businesses (a key factor in Japan), how they monitor and engage with companies, and what practical steps they take to enhance governance of their investee companies. It will be equally fascinating to watch how companies respond to these advances and how robustly they defend or seek to explain their governance systems. As Asia's first country to adopt a stewardship code, it would be nice to think that Japan could set some regional best practice benchmarks for other regional markets to follow.

Japan is still behind in director training and board evaluation

One area where Japan remains behind the regional curve, however, is in director training and board evaluation. Several organisations provide training, but it needs to become commonplace and accepted as an inherently good thing for all directors (inside and outside, executive and independent) to do. Meanwhile, many other Asian markets are moving forward on director evaluation and, although still early days, this has the potential to enhance board effectiveness considerably. We hope that Japan takes up this idea too.

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

Progress of CG code to affect score in 2016

- Adoption of a national CG best-practice code that proves to be toothless
- No progress in mandating the adoption of independent directors for all listed companies
- No progress in encouraging the adoption of audit committees in listed firms
- Ineffective implementation of the new Stewardship Code by institutional investors
- No progress in boosting staff resources for key regulators such as the CPAAOB

Quick fixes

What to fix?

- Enhance corporate disclosure of internal-control and risk-management functions
- Enhance corporate explanations of executive and employee remuneration policies
- Release detailed AGM agendas at least 28 days before the meeting
- Improve information access in English on websites of regulators and companies
- Increase director training

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Research perspective - Seeing the light

Financial scandals are extremely rare in Japan, compared to the USA and Europe, and particularly compared to the rest of Asia. The reason that Enrons tend to happen less in Japan is simple: Japanese managers generally have negligible stock options or holdings of their companies' shares, and therefore do not have the financial incentive to rob the till. The most recent figure for CEO pay for S&P500-listed companies was US$12.3m, 354x the average employee's salary, according to labour union AFL-CIO. A study of Japanese executive pay by Shukan Diamond showed that in all of Japan's 3,432 listed companies, there were only 445 executives who were paid more than US$1m. If anything, they seem in need for more incentives rather than less. The trouble is that when things do go wrong, Japanese companies have tended to lack the systems to deal with the problem.

Japanese executives lack the over-incentivisation that tempts malfeasance

CEOs at US S&P500 firms average 354 times the pay of average employees

Figure 108

Average CEO pay at S&P500 companies, 2012

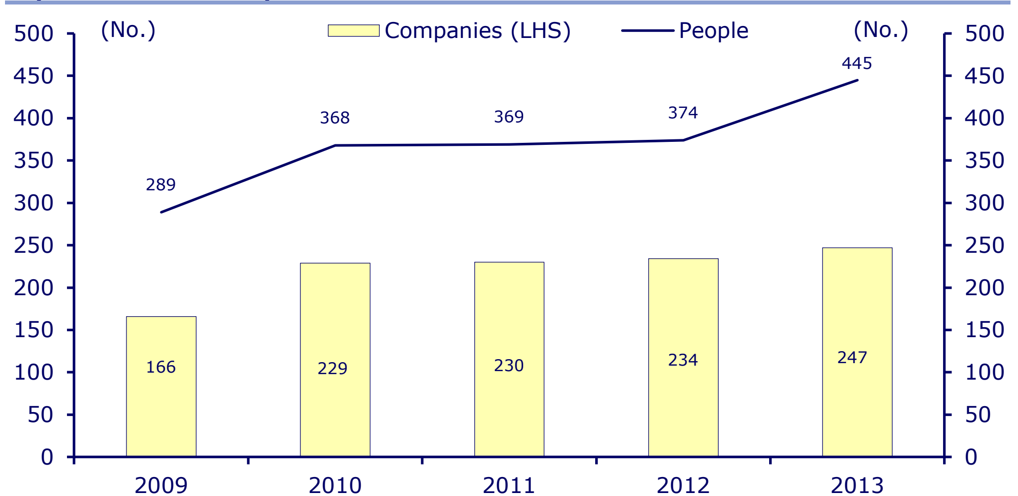
Salary	US$1,109,715
Bonus	US$273,154
Stock awards	US$4,466,452
Option awards	US$2,186,363
Non-equity incentive plan compensation	US$2,259,543
Pension and deferred compensation earnings	US$1,507,640
All other compensation	US$457,023
Total	**US$12,259,894**

Source: AFL-CIO

Few Japanese executives even make over US$1m

Figure 109

Japanese executives paid more than ¥100m



Source: Shukan Diamond, CLSA

The Olympus scandal exposed the lack of failsafe systems

This was tragically exposed by the Olympus scandal of October 2011 (read our 12 December 2011 *Learning from Olympus* note). Faced with sagging profit in the 1980s, Olympus had supported earnings with financial engineering. That went badly wrong when the stockmarket tanked and succeeding generations of managers conspired to hide the losses while they tried to fix the problem. In Japan, the USA and elsewhere, almost invariably, fraud is exposed by whistleblowers, and that was the case with Olympus also. A disaffected employee leaked the story to a then-little-known magazine, *Facta*. Some months later, this was brought to the attention of the British

CEO, who had not known of the story because he spoke no Japanese. When he brought the story to the board, he ended up getting ousted. Enron had won prizes for the quality of its board and Olympus also was ahead of its time in having outside directors at a time when few in Japan had them. As at Enron, it did absolutely no good: the outside directors voted alongside the rotten directors in ousting the CEO. Olympus outside director Professor Yasuo Hayashida protested to the Nikkei, 'I do attend board meetings but I have no idea about their content. I only provide medical advice'. He lacked the skills and the training that would have been required of an outside director in most other countries.

Historically, outside directors were a sign of a struggling company

Until the Olympus scandal, most Japanese companies couldn't see the point of outside directors. As a Toyota official told the Nikkei at the time, 'we will consider outside directors if they can understand our management policy, but no one comes to mind now'. There was then an inverse relationship between the percentage of outside directors and returns on equity or invested capital: heavily loss-making companies like Sony had (and still have) a majority of outside directors; high-return companies like Fanuc had none. Now, however, the companies with large numbers of outside directors are more of a mix: Sony and Olympus have three-year-average ROEs that are large negative numbers; Resona has a high ROE because it torched its equity and, though it is no longer a ward of state, has yet to repay all the government money it received; others, such as Hoya and Fast Retailing, are simply well-run, high-return businesses.

Leaders for outside directors still contain many walking-wounded

Figure 110

Topix 500 top ranking for share of outside directors

Company	Mkt cap (¥bn)	% outside directors	3Y avg ROE (%)
Hoya (7741)	1,485	85.7	13.2
Fast Retailing (9983)	3,620	83.3	19.2
Sony (6758)	2,230	75.0	(7.9)
Showa Shell Sekiyu (5002)	416	75.0	10.5
Calbee (2229)	453	71.4	11.4
Shinsei Bank (8303)	663	66.7	5.4
Miraca (4544)	276	66.7	11.2
Japan Display (6740)	353	66.7	n/a
Hitachi High-Tech (8036)	421	66.7	5.7
Hitachi Chemical (4217)	408	66.7	6.6
Eisai (4523)	1,290	63.6	10.6
Oracle (4716)	538	62.5	34.1
Olympus (7733)	1,314	61.5	(16.1)
Resona (8308)	1,371	60.0	24.2
Shionogi (4507)	828	60.0	11.6

Source: Bloomberg

There are still 64 Topix-500 companies with no outside directors. Many have enviable returns and appear to be extremely well-run.

There are still 64 Topix-500 companies with no outside directors

Figure 111

Topix-500 companies with no outside directors, ranked by market cap

Company	Mkt cap (¥bn)	% outside directors	3Y avg ROE (%)
Sumitomo Realty & Dev (8830)	1,917	0.0	10.1
Unicharm (8113)	1,440	0.0	13.9
Hino Motors (7205)	861	0.0	19.2
Daihatsu Motor (7262)	773	0.0	16.5
JTEKT (6473)	602	0.0	4.8
Kajima (1812)	550	0.0	5.2
AEON Financial Service (8570)	506	0.0	n/a
Don Quijote (7532)	433	0.0	13.6
FamilyMart (8028)	415	0.0	9.3
Otsuka Corp (4768)	413	0.0	13.2

Source: Bloomberg

There is no skill or experience requirement for outside directors

The percentage of outside directors has increased considerably since 2011: the market cap-weighted average is now 24.3% for the Topix-500 companies, against 87.2% for the S&P500. Unfortunately, while most companies have outside directors, there is still no skill requirement. Nicholas Benes is the representative director of The Board Director Training Institute of Japan (BDTI), a non-profit, public-interest organisation certified by the Japanese government with a highly regarded "bootcamp" course for directors (http://bdti.or.jp/english/). He commented to Benthos, 'Japan is one of the very few countries in the world that doesn't have any rules whichever about knowledge or training requirements for board members - or even rules for disclosure about such things. Pakistan, on the other hand, requires all directors to receive training and certification from approved institutions, with rare exceptions - for instance, for those with many years of board experience or foreign training. Japan's position on this is particularly odd because: a) even statutory auditors, whose job to perform "accounting audits" and "legality audits", don't need to know anything about accounting or law; b) the OECD has prioritised director training in Asia; and c) most companies in Japan wish their boards to have a clear majority of insiders, who by definition have almost never sat on a board before, so they have no experience. Yet ISS [Institutional Shareholder Services] advises, and most investors vote, to elect all of these directors, no questions asked.'

Japan has made significant changes in the past two years

Asked for his appraisal of changes over the past two years, he commented 'There have been five major advances. First, because of the long debate that dragged on about outside directors, more and more Japanese companies started to see the light and autonomously started appointing outside directors, and with this has come a greater understanding and acceptance of their role and value. Second, the Company Law was finally passed with a rule requiring (de facto) each listed company to appoint one outside director, supported by a strong "comply or explain" provision. Third, the Stewardship Code was put in place and 127 institutions voluntarily signed on to it; more will come, because the FSA is pressuring institutions to commit to it. Though stewardship practices will take time to develop, one should not underestimate the changing of the tide from "stable, quiet shareholders" that this represents. Fourth and most important, pursuant to the Revised Growth Strategy, the FSA and TSE have set up a Committee of Experts to set the core policies of Japan's first corporate-governance code, which the TSE will reflect in its listing rules so that it can be enforced on a "comply or explain" basis. The code is required to fit with the OECD's principles, be internationally well-received, and must be up and running

in time for next year's AGM season. Last, we have seen a number of more minor but still significant reforms, such as double derivative lawsuits, the selection of the audit firm by *kansayaku* (statutory auditors) and strengthening of internal requirements for subsidiaries .'

The Stewardship Code has the potential to bring epoch-making change

He is by no means despondent: 'I believe that the drafting of a corporate-governance code by Japan has the potential to be an epoch-making change. For the first time, there will commence a meaningful discussion about "best board practice" in Japan. Moreover, the use of "comply or explain" disclosure about governance practices at each firm is what will enable institutions to be better "stewards", thus allowing the Stewardship Code to be much more effective. And the government has sent clear criteria: that the code be "internationally well-received". It is not possible to meet that goal without multiple independent directors, board committees and rules about knowledge/skill levels and training for board members, whether inside or outside. The code will probably raise the bar across the board.'

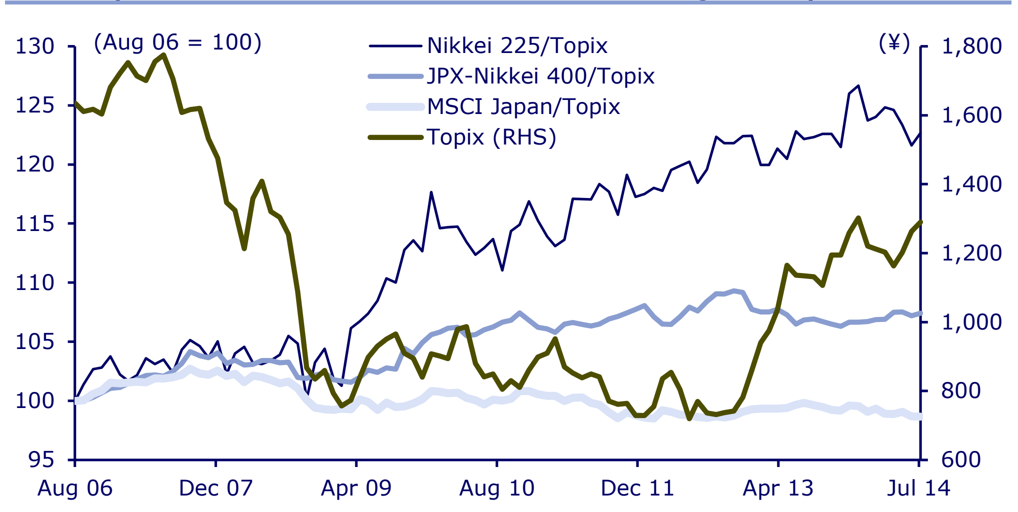
The new Nikkei index is focusing attention on shareholder returns

Benthos has been highly critical of the new Nikkei index (JPX-Nikkei 400), pointing out that it has actually underperformed the old Nikkei 225, and that it doesn't do what it says on the wrapper. It claims to be a high-ROE index, yet it was launched containing loss-making companies such as Sony with what was then a three-year ROE of minus 9.6% (see *GPIF buying & dumb beta*, 30 June 2014). Nevertheless, whatever the shortcomings of the index, it does seem to have focused attention on returns, spurring companies such as Amada to announce share buybacks. Buybacks are running at all-time-high levels and finance magazines such as *Toyo Keizai* are full of stories discussing ROE and ranking companies for their performance. If nothing else, the creation of the index has made the issue the subject of serious debate.

The new Nikkei index has underperformed its old counterpart

Figure 112

Relative performance of JPX-Nikkei 400 and Nikkei 225 against Topix



Source: Bloomberg, TSE, CLSA

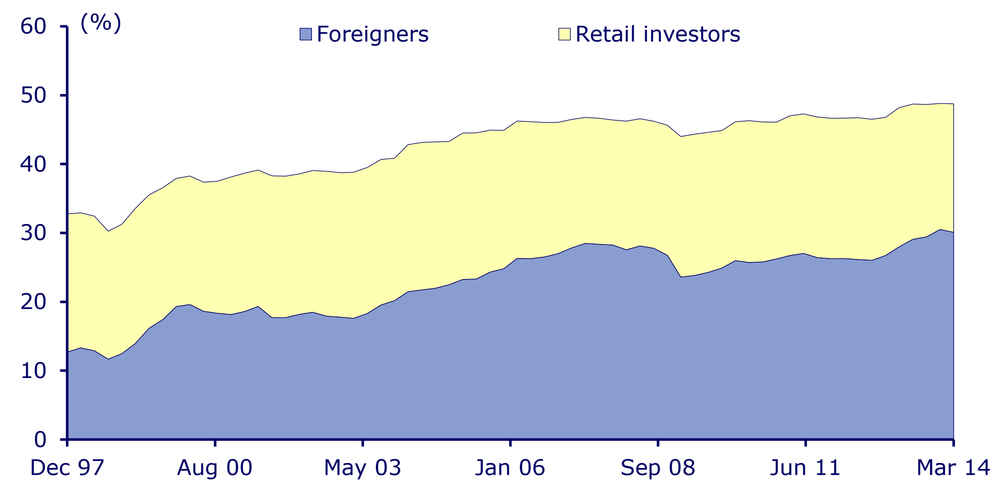
Most companies have their annual general meetings in June. By then, there is good reason to expect significant advances in CG. As explained in 8 March 2012 *Eye on M&A* report, Japanese corporate law has been completely rewritten with the specified aim of creating an active M&A market - for foreigners. Laws, however, are largely worthless if shareholders fail to assert themselves and historically the problem in Japan has been that domestic institutions have often been the subsidiaries of banks, brokers and insurance

companies that told their investment subsidiaries not to rock the boat over CG failures. In the past few years, however, foreigners have risen to become the largest shareholder group, at 30.1% of market value, as well as by far the largest determinant of market direction, at 60-70% of traded value. Together with retail investors, foreign investors now account for half of market cap. The two are natural allies with a common interest in demanding more of corporate managements. If they fail to assert themselves, they increasingly only have themselves to blame.

Foreign plus retail together owns half the Japanese equity market

Figure 113

Foreign and retail investors as a percentage of Japanese equity ownership



Source: Bank of Japan, CLSA

Figure 114

Companies with biggest change in CG score

Company	Code	Change in CG score (ppts)	Reason for change
Sapporo	2501 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Japan Tobacco	2914 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Nitori	9843 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Mizuno	8022 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Kirin	2503 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Fast Retailing	9983 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Asics	7936 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Asahi Group	2502 JP	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals
Hitachi	6501 JP	9.0	Embraced a diversified board and increased the number of independent members. The former heads of 3M, BP, Anglo-American, on the board represent the company's increasing targeting of global top 50 companies as customers for the Hitachi group and best practices of global companies.
Nintendo	7974 JP	(8.4)	Decline in fairness - over the past five years, total directors' remuneration has increased faster than net profit after exceptionals and decline in discipline - that the company has built up cash levels, through retained earnings or cash calls, that have brought down ROE
Inpex	1605 JP	(14.5)	Significant share price movement before public offering
Dentsu	4324 JP	(15.4)	The acquisition of Aegis was partially financed by the company selling treasury shares, which looked unnecessary to us, it would have been better for shareholders had they issued bonds.

Source: CLSA

Consumer, consumer electronics, tech, autos among highest for CG in Japan

Figure 115

Japan: Companies in top-two CG quartiles (alphabetical order)

Company	Code	Company	Code
Advantest	6857 JP	Nikon	7731 JP
Aisin Seiki	7259 JP	Nintendo	7974 JP
Asahi Kasei	3407 JP	Nissan Motor	7201 JP
Bridgestone	5108 JP	Nitori	9843 JP
Canon	7751 JP	NSK	6471 JP
Chiyoda	6366 JP	Obayashi	1802 JP
CyberAgent	4751 JP	Panasonic	6752 JP
Daihatsu	7262 JP	Ricoh	7752 JP
Daiwa House	1925 JP	Sega Sammy	6460 JP
DeNA	2432 JP	Sekisui House	1928 JP
Denso	6902 JP	Sharp	6753 JP
Ebara	6361 JP	Shimizu	1803 JP
Fast Retailing	9983 JP	Shin-Etsu Chem	4063 JP
Fujifilm	4901 JP	Shiseido	4911 JP
Fujitsu	6702 JP	Sony	6758 JP
Gree	3632 JP	Stanley Electric	6923 JP
Hitachi	6501 JP	Sumitomo Bakelite	4203 JP
Hitachi Chemical	4217 JP	Sumitomo Osaka	5232 JP
Honda Motor	7267 JP	Sumitomo Rubber	5110 JP
Hoya	7741 JP	Suntory B&F	2587 JP
Ibiden	4062 JP	Suzuki Motor	7269 JP
Isetan Mitsukoshi	3099 JP	Taiheiyo Cement	5233 JP
Itochu	8001 JP	Taisei	1801 JP
J Front Retailing	3086 JP	Taiyo Yuden	6976 JP
Japan Exchange	8697 JP	Takashimaya	8233 JP
JGC	1963 JP	TDK	6762 JP
Kajima	1812 JP	Teijin	3401 JP
Konami	9766 JP	Tokyo Electron	8035 JP
Konica Minolta	4902 JP	Tokyo Ohka	4186 JP
Kose	4922 JP	Toray	3402 JP
Kuraray	3405 JP	Toshiba	6502 JP
Kyocera	6971 JP	Toyo Engineering	6330 JP
Mandom	4917 JP	Toyo Tire	5105 JP
Marubeni	8002 JP	Toyota Industries	6201 JP
Minebea	6479 JP	Toyota Motor	7203 JP
Mitsubishi Corp	8058 JP	West	1407 JP
Mitsubishi Electric	6503 JP	Yahoo Japan	4689 JP
Mitsui	8031 JP	Yamaha Motor	7272 JP
NGK Spark Plug	5334 JP	Yaskawa Electric	6506 JP
Nidec	6594 JP	Yokohama Rubber	5101 JP

Source: CLSA

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Korea - Triumph of corporate politics

Key issues and trends

- Political momentum for CG reform stalls
- The government's growth priority gives breathing space to *chaebols*
- Very few *chaebols* pursuing voluntary CG reforms
- Tougher enforcement against market manipulators
- Shareholders take action on unaudited accounts being presented at AGMs

Overall score stays the same - 49% in 2012 and 2014

Park's administration has not made CG a high priority

Over the past two years, Korea has remained a market where government looms largest in the corporate governance landscape. This is not to say, however, that Korean regulators have been towering reformist figures. The administration of President Park Geun-hye, who assumed office in February 2013, has not made CG a high priority. Rather, she has been seemingly content to bring to fruition various changes already put in motion by her predecessor, Lee Myung-bak, a former construction company CEO who was widely seen as too friendly to big business. This is ironic, because Park campaigned on a theme of "economic democratisation" - a slogan capitalising on the public's dissatisfaction with the outsized power of the *chaebols* (family-controlled conglomerates) compared to smaller businesses and a widening gap between the country's haves and have-nots.

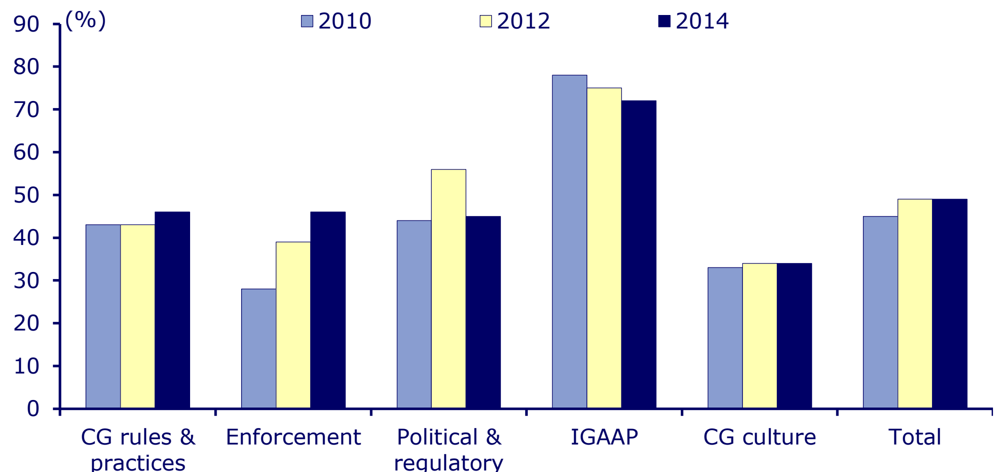
Korea's performance reflects Park's lack of leadership on CG matters

In 2012, we expressed our concern that the burst of reform zeal among Korean politicians might not last beyond the dual parliamentary-presidential elections of that year. Alas, that is what happened. Korea's performance in this survey largely reflects Park's lack of leadership on CG matters. In her early months in power, she failed to translate "economic democratisation" into a comprehensive reform agenda and allowed others to recalibrate her government's policy priority towards growth - the perennial mantra of the business elite. Soon after, this not unexpected pivot begot an all-out, three-year effort at "deregulation", which Park has identified as key to revitalising the Korean economy.

Increase of score in CG rules & practices, Enforcement sections

Figure 116

Korea CG macro category scores



Source: ACGA, CLSA

Park quietly shelved CG-related regulatory changes that *chaebols* oppose

No doubt, Park is sincere in her desire to unleash a new wave of innovation and entrepreneurial energy to maintain Korea's dynamism. But she cannot deliver growth in the short term without the cooperation of big business and, in a necessary compromise and has quietly shelved CG-related regulatory changes that the *chaebols* oppose. These conglomerates are superbly adept at navigating Korea's capricious political currents. The *chaebols* know that Korean presidents today only stay in office for a single five-year term, while no time limits apply to their dominant influence. With listed companies little inclined to pursue voluntary, bottom-up CG changes that could offset the regulatory slowdown, Korea's ranking in this year's survey has failed to improve on the result of 2012, staying unchanged at eighth.

CG rules and practices

Rises from 43% in 2012 to 46% in 2014

Korea has made several important CG rule alterations

Despite our comments above, we recognise that Korea has made several important CG rule changes in the past two years and have raised its score for this category. For starters and in keeping with the global trend, an amendment to the securities law in May 2013 made it mandatory for listed companies to disclose the remuneration of individual board directors and internal auditors. Previously, only the aggregate amount for all of them was required to be disclosed.

Securities law amended to end "shadow voting" system

A month earlier, the securities law was also amended to end the so-called "shadow voting" system from 2015. Designed to address the low turnout of shareholders at AGMs, since 1991 this system had allowed the Korea Securities Depository (KSD) to vote on behalf of absent shareholders when listed companies could not meet the quorum requirement to pass resolutions. However, because the KSD was obliged to cast shadow votes in proportion to the actual votes on a resolution, the controlling shareholder and allies could often count on this practice to tilt the results in their favour, say, in director elections. Critics had argued that the shadow voting system was no longer necessary with KSD's introduction of electronic voting in 2010, which made it easier for listed companies to meet the quorum requirement.

Korea addressed widespread use of cross-shareholdings among *chaebols*

Although not part of our survey assessment, Korea has made some progress as well in addressing the widespread use of cross-shareholdings among the *chaebols*. Thanks to the practice, family-owners of many *chaebols* exert control over their business empires with relatively little direct ownership stakes. In December 2013 however, the National Assembly revised the Fair Trade Law to ban new cross-shareholdings among affiliates of large *chaebols* with assets of 5tn won (US$4.9bn) or more from July 2014. The measure obviously does not affect existing ownership structures which are what many opposition politicians had wanted but we recognise that every such step contributes to "economic democratisation".

***Chaebols* argue CG hurts competitiveness of Korean firms**

The problem is that corporate Korea's pushback has thwarted other, more significant changes. In August 2013, as the National Assembly was starting debate on further tightening the country's CG regime, 19 national business groups, including the powerful *chaebol* association, the Federation of Korean Industries, joined forces to oppose it and argued that the move would erode the global competitiveness of Korean firms. As a result, the legislative process on the issue has ground to a halt. Proposed amendments to the company law from the Ministry of Justice (MOJ) which lie in limbo include:

- Mandating the "executive officer" system to more clearly delineate the duties of management and the board of directors;

- Requiring listed companies with more than 2tn won in assets to cap the voting rights of any major shareholders to 3% of their holdings in the election of audit committee members at the AGM; and
- Mandating cumulative and electronic voting for listed companies of an as-yet undetermined size.

Lack of progress on Best Practice Guidelines for financial firms

Similarly, a proposal from the Financial Services Commission (FSC) for Best Practice Guideline on the governance of financial institutions has not moved since it first floated in June 2013. Since then, habitual government meddling in the governance of major private banking groups has continued.

KRX and Korea Corporate Governance Service are working on "comply-or-explain" document

A somewhat more bright note was the ongoing work to update Korea's Code of Best Practices for Corporate Governance (February 2003) by the Korea Exchange (KRX) and its affiliate, the Korea Corporate Governance Service, as a "comply-or-explain" document. However, the new document is not likely to be released before 2015 and thus we cannot give credit in this year's survey.

Speed of reporting

Korean large caps reported in 67 days on average, while midcaps in 68 days

Also interesting were the results of an ACGA review of financial reporting speeds around Asia and, in particular, whether companies met the regional regulatory best practice of 60 days for audited annual financial statements. Our research found that Korean large caps reported in 67 days on average, while midcaps in 68 days (for their 2013 annual statements). Although slightly worse than the regional standard, a few of bigger firms reported in under 60 days and, overall, Korea's speed fared well against actual regional reporting speeds.

Sustainability reporting in Korea

Korea has focused on CSR since 2006

Korean regulators have made efforts to release corporate social responsibility (CSR) reporting guidelines since 2006: that year, for example, the Ministry of Knowledge Economy published the BEST Sustainable Management guidelines, which is based on Global Reporting Initiative (GRI) standards. Since 2008, the Korean government has also had a keen focus on "green growth" and low-carbon economic growth.

Green Posting System

In 2012, the Financial Services Commission introduced the Green Posting System, which requires around 500 firms to post the amount of their greenhouse-gas emissions and energy used. If they are listed on the Korea Exchange (KRX), they are required to include the information in their annual reports. As a result, 96 companies report to the Carbon Disclosure Project. The KRX, along with its affiliate, the Korea Corporate Governance Service (KCGS), is actively involved in educating the business sector on sustainability reporting. The KRX has also developed three sustainability indices.

Best practice code lacks broader guidelines

Although the KCGS published a best practice code for socially responsible management as well as environmental management in 2010, there are no broader sustainability guidelines for KRX-listed companies and environmental, social and governance (ESG) reporting remains voluntary.

Large caps demonstrated higher-quality reporting compared to midcaps

That said, all large caps that ACGA reviewed had sustainability reporting. Of the 10, eight had very sophisticated standalone sustainability reports, with two-to-four pages dedicated to CG issues. The same number of large-cap companies also had reports that were verified by third parties and were aligned with the GRI. But smaller companies were not as impressive: only two of the 10 midcaps had some sustainability reporting on their websites.

Quick reporting is driven by very tight deadlines for AGMs

Although admirable, it should be noted that the main factor driving such quick reporting is the very tight deadline in Korea for annual general meetings (AGMs) - a mere three months, the same as Japan. Larger firms like to have their AGMs in mid-March or earlier and must release their audited accounts at least one week before. Hence, this immediately limits the time they have to release audited figures. As we also note below in the section on Accounting and Auditing, even this early reporting by regional standards is not early enough for institutional investors wishing to vote by proxy before Korean AGMs.

Enforcement

Rises from 39% in 2012 to 46% in 2014

In contrast to its largely quiet two years for policy reform, the government has kept a tight rein over enforcement and added new capacity to go after lawbreakers. In April 2013, the Park administration unveiled a major initiative to crack down on share-price manipulation and unfair trading by empowering relevant market regulators to carry out investigations more effectively. In response to the criticism that the existing system dealing with the market misconduct was too fragmented and slow to nab increasingly sophisticated perpetrators, the FSC, MOJ, National Tax Service, Financial Supervisory Service and KRX jointly announced a revamp of the market monitoring and investigative processes, as well as stiffer penalties. Specifically, the KRX now operates an automated online monitoring system and has raised the maximum reward for tips to 2bn won from 300m won. Once suspicious activity is discovered, a new special investigative unit at the FSC analyses it for a possible referral for fast-track treatment by the public prosecutor's office, which has also set up a new securities crimes investigative unit. If a person is found guilty of illegal trading and handed a prison sentence, he or she is slapped with a mandatory fine that is at least twice the amount of ill-gotten gains.

Tough rulings against law-breaking tycoons continue

Meanwhile, tough rulings against law-breaking tycoons continued. In September 2013, LIG chairman Koo Cha-won was sentenced to a three-year prison term for allowing a troubled subsidiary, LIG Engineering and Construction, to issue billions of won in commercial paper in 2011 - even though he knew it was on the brink of bankruptcy. However, only five months later, his sentence was suspended on appeal and he was freed. Koo's case, along with the court's suspension of the three-year prison term for Kim Seung-youn, the head of Hanwha Group who was convicted of embezzlement in 2012, raised many eyebrows that perhaps the Korean justice system was becoming soft again on corporate criminals.

SK Group example

The bigger picture was subtler, though. In another appeal-case decision in February 2014 involving Chey Tae-won of SK Group, who is serving a four-year prison term for embezzling company funds for personal use, the Supreme Court upheld the lower courts' ruling against him. A repeat offender, Chey helms a much bigger group than either Koo or Kim. So while the practice of extending leniency to businessmen for their "contribution" to the economy does not seem to have been buried for good, the judiciary seemed determine to make a strong example of Chey. So far, Park too has kept her campaign promise not to pardon *chaebol* chiefs who run afoul of the law. Chey had obtained a presidential pardon in 2008 to erase an earlier conviction for accounting fraud.

Political and regulatory environment

Falls from 56% in 2012 to 45% in 2014

This was Korea's worst-performing category this year, with the score dropping a hefty 11 percentage points. The failure of leadership precipitating this disappointing slide was attributable more to elected politicians than to career regulators. When Park (as the presidential candidate) took up key elements of the opposition party's largely anti-*chaebol* economic platform, there was much scepticism about both her sincerity and ability to deliver them. Not only was her ruling Saenuri Party the traditional political allies of the *chaebols*, they were also the brainchild of her father as state-nurtured agents of Korea's industrialisation.

As president, Park has pursued no bold CG reforms that would turn "economic democratisation" into a tangible reality. Instead, she has opted for piecemeal changes that even her pro-business predecessor Lee Myung-bak might find too restrained. During our visit to Korea in early 2014, a key opposition politician told us that all legislative efforts that began under Lee to beef up the CG components of the Commercial Act had been frozen on her orders. Instead, in March 2014, she elevated "deregulation" to the top of her economic agenda, with the argument that it is the only way to increase investment in innovative industries without raising government spending and realise her goal of keeping the economy growing at a 4% annual rate. To this end, Park has asked her officials to eliminate 20% of the existing regulations by 2016, including 2,200 rules constraining businesses.

Korean government's awareness of CG increases

In the face of such political headwinds, technocrats in the Korean government have their work cut out to ensure that the country's CG regime does not fall too far behind ever-evolving global standards. Judging by our interaction with them, we believe they are in fact better aware of the challenges and are trying harder to meet them than just a few years ago.

Frequent rotating of officials limits their ability to gain expertise on CG matters

Apart from politics, another major problem that consistently undermines the government's effectiveness on CG matters is the Korean civil service's tradition of rotating officials every two years. This may help minimise corruption, as intended, but it can also hamper civil servants from gaining expertise and dilutes the institutional memory of complex regulatory developments. In our interaction with Korean ministries and commissions, the need to constantly meet new appointees who may or may not have technical expertise in financial regulation and corporate governance makes it exceedingly difficult to have productive discussions - and certainly inhibits the development of any long-term rapport that could lead to a better mutual understanding.

IGAAP (accounting and auditing)

Falls from 75% in 2012 to 72% in 2014

This remains Korea's best category, although the score has fallen slightly from two years ago. As in 2012, we have continued to take a more critical look at Asia's accounting and auditing regimes and this explains the fall in score. While we do not fault Korean accounting standards, which are largely in line with global standards (all listed companies adopt IFRS since 2011), Korea lost a few points for the quality of its audit regulatory regime and corporate disclosure. Specifically, the Financial Services Commission/Financial Supervisory Service, does not publish a detailed annual report on its activities as one now finds in many other Asian markets (Japan, Malaysia, Singapore and Thailand). Firms, when disclosing their audit and non-audit fees, do not provide much commentary on what any non-audit services provided by their auditors entail.

The unaudited-accounts issue is unique to Korea

This issue prevents some investors from approving Korean financial statements

There were some other features unique to Korea that required our attention for the first time this year, including the issue of unaudited accounts being presented for shareholder approval at AGMs. This situation arises from the fact that, while the law allows the audited financial statements to be filed as late as seven days prior to the AGM, the notice and agenda of a shareholder meeting must be filed 14 days prior to the meeting. This can result in a company sending out proxy materials containing a voting item on unaudited financial statements. (During the 2013 AGM season, more than 98% of listed firms did not release audited financials with proxy materials, according to Institutional Shareholder Services, the proxy voting adviser.) Such practices are a major departure from globally recognised voting norms and prevent some investors from approving Korean financial statements, as that would not be in line with their own proxy-voting policies.

Two-thirds of the companies reacted constructively on ACGA's effort to highlight the issue

Therefore, prior to the AGM season this year, ACGA wrote to 26 Korean issuers with significant foreign ownership highlighting the issue and urging them to work to find a mutually satisfactory solution. For example, when sending out their AGM notices, we suggested that the issuers provide an auditor's statement which confirms the financial numbers included in the AGM notice are final, as well as the auditor's official opinion on the financial statements. To our pleasant surprise, the responses we received were quite positive, with two-thirds of the companies reacting constructively to our letter. (For more details, see the ACGA website: www.acga-asia.org)

CG culture

Stays the same - 34% in 2012 and 2014

We saw few signs that the general attitude among Korean companies towards pursuing good corporate governance for its own sake, rather than compliance, has spread in the past two years. True, statistics compiled by the MOJ showed that there are dozens of Korean listed companies that separate board chairman and CEO roles and maintain audit committees entirely comprised outside directors - even though neither is legally mandated. At most *chaebols*, however, CG remains an uncomfortable topic best to be avoided in discussion with outsiders. A case in point: listed Korean company participation in ACGA's annual conference in Seoul in 2013 was noticeably lower than in many other Asian markets where we have held the event. For such reasons, the score for this category this year did not budge from 2012.

While Korean mid-level managers understand the importance of CG, top management does not acknowledge it

That said, we have been able to deepen our dialogue with a handful of blue chips beyond the perfunctory IR conversations. These meetings have given us a strong impression that mid-level managers of these companies "get" the importance of good CG. Where frustration sets in, however, is with both their and our, inability to break through to top management. Indeed, in terms of outside CG groups' access to the CEO or board members, Korea is one of the toughest among the 11 Asian markets that we cover.

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

What to watch for

- No clarity from government as to its overarching CG strategy
- No progress in passing shelved CG-related amendments to Commercial Act
- Update of the Code of Best Practices for CG that proves to be toothless
- Undeserved leniency for corporate criminals
- No further improvement in enforcement
- No further progress in the unaudited-accounts issue

Quick fixes

What to fix

- Enhance disclosure of internal-control and risk-management functions
- Enhance explanations of executive/employee remuneration policies
- Spread out AGMs to avoid clustering
- Release detailed AGM agendas at least 28 days before the meeting
- Adopt electronic voting and voting by poll for all resolutions at AGMs
- Improve information access in English on websites of regulators/firms
- Increase director training

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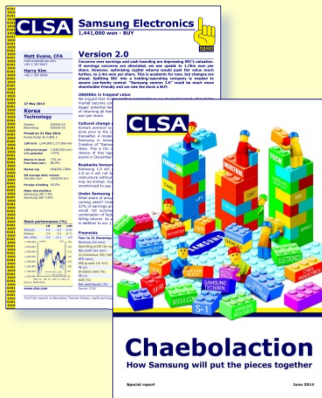
Research perspective - Eye on *chaebols*

The major story on the corporate governance front recent months has been the Samsung's accelerated restructuring. We believe it will eventually lead to a much cleaner structure for the group in which Lee family incentives are much better aligned with those of minority investors (see our reports *Version 2.0* and *Chaebolaction*).



The jury remains out on precisely where the company is headed, but in our view the endgame is that the antiquated *chaebol* structure will finally be confined to the dustbin of history, replaced by a shiny new holding company place. Unfortunately this endgame may still be three-to-five years away. Investors should look to the listing of Samsung SDS and Samsung Everland in the next nine months as the next pieces of the puzzle to potentially provide clues.

A related issue is moves by the government to incentivise higher dividend payments. We believe this is not unrelated to the restructuring and can be considered a carrot encouraging the Lee family to move forward. However, as with the restructuring story patience will be required and the large part of Korea's listed universe which is cyclical may not be able to pay dividends for some time, even if it wants to.

Meanwhile, the salaries of company directors must now be disclosed. This follows a revision in the capital market law last year. This has resolved a frustration that corporate governance activists and investors have had for many years, meaning shareholders will no longer have to suffer the tiresome explanation "this is not in our culture".

Family members dodging the law by technical resignation as directors

While it could potentially backfire and incentivise controlling shareholders to extract extra cash from companies using nefarious means, we are hopeful the long-term impact will be a shift to more dividends. So far, however, the main impact of the regulation has been the mass resignation of Chaebol family members from their boards of directors. This simply means they have dodged the regulations via a loophole. There is now debate over whether these *chaebol* family members should be required to disclose their salaries even though they are not technically directors.

Positive impact with two Chey Tae-won shamed into "donating" his salaries

There has been some positive impact, however. SK Group's chairman Chey Tae-won was paid 30m won by various SK companies despite telecommuting to work at these various companies from a prison cell. The outcry resulted in Chey donating the money to Kaist Entrepreneur Centre and other social foundations. However nothing was returned to the shareholders of the companies the money was taken from. Chey also received 28.6bn won in dividend income mostly from his SK C&C stakes holdings. Shareholders hope that in future the focus will be on the dividends and less on salary. We would have no problem with Chey paying dividends amounting to hundreds of millions of dollars, even while in prison, so long as minorities participate on the same basis.

Hanwha group chairman, Kim Seung-yun, also returned a 20bn won salary out of total 31bn won compensation last year. His dividend income was 7bn won. Meanwhile, Samsung chairman Lee Gun-hee received no salary from Samsung affiliates as technically his is not an employee at any of them. His dividend income from Samsung Electronics and Samsung Life stakes amount to 107bn won per year. We believe the dividends paid by Samsung Electronics will eventually rise dramatically, although only once the restructuring is complete.

Salaries of company directors must now be disclosed following a revision in the capital market law last year

Figure117

Corporate salary disclosure for registered directors, 1Q14

	Name	Company & title	Total compensation (m won)	*Chaebol* family
1	Shin Jong-gyun	Samsung Electrics CEO	9,664	NO
2	Gyung Chul-ho	Ex-HDS chairman	4,992	NO
3	Chung Joon-yang	Ex-Posco chairman	3,996	NO
4	Kim Woo-jin	Ex LIG Insurance VP	3,752	NO
5	**Koo Ja-yul**	**LS Corp chairman**	**3,544**	**YES**
6	Ha Young-bong	Ex-LG International chairman	3,053	NO
7	**Chung Mong-gu**	**HMC group chairman**	**2,840**	**YES**
8	Huh In-chul	Ex-E-mart advisor	2,441	NO
9	Kim Hyun-joong	Ex-Hanwha E&C CEO	2,370	NO
10	Chung Sang-ho	Ex-GS Caltex CEO	2,339	NO
11	Ahn Byung-duk	Ex-KOLON global CEO	2,276	NO
12	Seo Gyung-bae	Amore Pacific chairman	2,035	NO
13	**Choi Shin-won**	**SKC chairman**	**1,975**	**YES**
14	**Kim Dong-yun**	**Bookwang a chairman**	**1,857**	**YES**
15	**Cho Yang-ho**	**HanJin group chairman**	**1,838**	**YES**
16	Chung Dong-wha	Ex-Posco E&C CEO	1,800	NO
17	**Shin Young-ja**	**Hotel Lotte CEO**	**1,792**	**YES**
18	**Koo Bon-moo**	**LG Corp CEO**	**1,759**	**YES**
19	Park Gi-hong	Ex-Posco CEO	1,679	NO
20	Kim Joon-sik	Ex-Posco CEO	1,671	NO
21	Ha Young-gu	Korea Citi Bank	1,658	NO

Source: Local news

Improvements in CG score

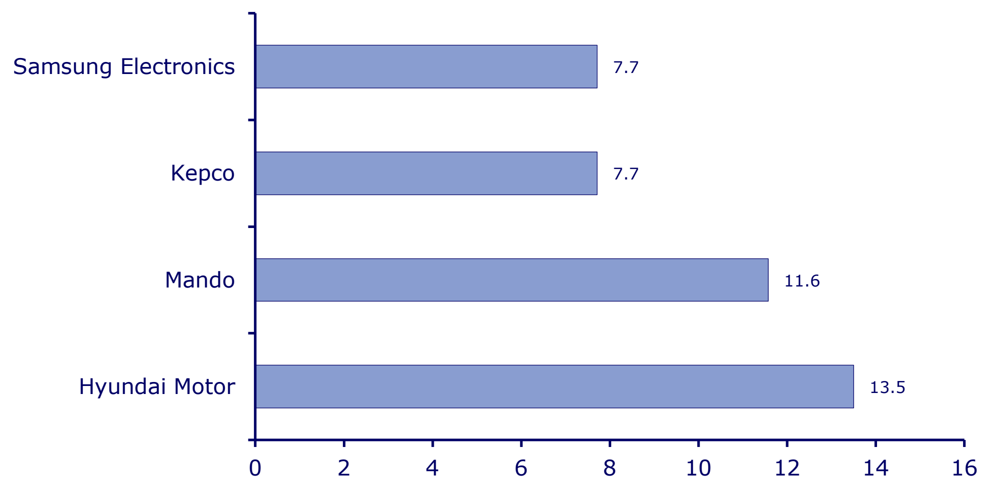
Companies showing material increases in corporate governance scores include Hyundai Motor, Mando, Kepco and Samsung Electronics.

Hyundai Motor had previously been scored negatively on the question of whether the board had disadvantaged minorities in the past five years. With the passage of time this is no longer the case. Kepco has improved its accounting practices. Samsung benefited from an increase in the number of independent directors.

Hyundai Motor and Mando among companies with the largest positive changes in CG scores

Figure 118

Companies with the largest positive changes in CG scores



Source: CLSA

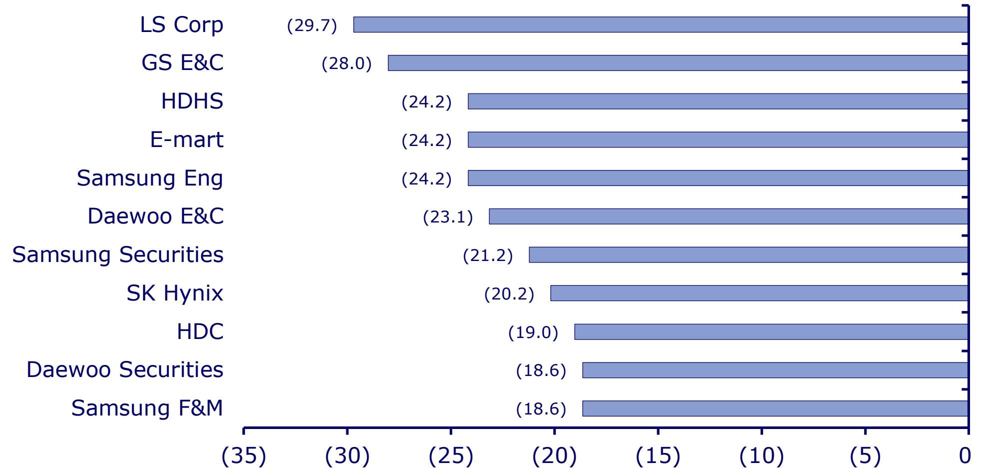
Declines in CG score

The relatively modest increase in corporate governance scores shown above were offset by more significant decreases in scores at the companies shown in the chart below.

Increase in CG scores referred to above have been offset by more material declines

Figure 119

Biggest declines in corporate governance scores



Source: CLSA

The average score for companies where we had a CG assessment in 2012 and 2014 is a decline of 6.4ppts. A number of companies have seen the assessment on a transparency decline as well as on intergroup transactions. We have also become stricter in scoring companies for disclosing year-end financial results within two months. Another minor factor contributing to declining scores at several companies is cyclicality, which has a negative impact on the criterion of management compensation relative to earnings, which uses a 2008 base.

LS Corp has seen a decline in its score to poor disclosure and lack of clear reporting in recent years, especially with regards to earnings from subsidiaries. The number of independent directors has also fallen over the past three years.

Accounting and disclosure of construction companies has declined

Construction companies **HDC**, **Samsung Engineering** and **GS E&C** all saw declines as we judge the transparency of their accounting to have declined since our last survey. This follows a period of inflated earnings in 2011-12 and huge provisions in 2013. There have also been controversies at some of these companies with regards to internal transactions which helped major shareholders at the expense of minorities. Sufficient quarterly disclosure has also been lacking from these companies.

E-Mart has become a victim of government interference

E-mart has now started a new joint venture with Shinsegae Department Store in which they are investing in new shopping mall developments, a departure from previous strategies and the company has also become a victim of government interference. There have also been several management changes at rapid pace and investigations into their treatment of their staff.

Samsung Securities was scored down on its lack of poor disclosure and changes in board composition. The cyclical factor noted above also reduced the company's score. Similar factors hurt the score of **Samsung Life**, which also scores negatively from appointing members to the audit committee.

SK Hynix is already making payments to several SK companies

Cyclicality and our stricter scoring has led to decline in average company score over 2012

SK Hynix was bought by SKT since our last survey. As this is a chaebol company it causes several questions to change from positive to negative responses, especially those related to affiliate party transactions. Sadly, SK Hynix is already making payments to several SK companies, including a 4bn won royalty payment for branding. Although this is not a material amount principle counts here, why should Hynix pay a branding royalty when it is not a consumer-facing brand? The explanation is the usual and depressing: "all the SK companies do this".

Figure 120

Korea: Companies in top-two CG quartiles (alphabetical order)

Company	Code	Company	Code
BS Financial	138930 KS	LG Chem	051910 KS
Com2us	078340 KS	LG Corp	003550 KS
Daum	035720 KQ	LG Display	034220 KS
DGB Financial	139130 KS	LG Electronics	066570 KS
Duksan	077360 KS	LG H&H	051900 KS
Gamevil	063080 KS	LG Innotek	011070 KS
GKL	114090 KS	Lotte Chemical	011170 KS
GS Home Shopping	028150 KQ	Mando	060980 KS
Hana Financial	086790 KS	Naver	035420 KS
Hankook Tire	161390 KS	NCsoft	036570 KS
HMFI	001450 KS	NHN Entertainment	181710 KS
Hotel Shilla	008770 KS	Posco	005490 KS
Hyundai Mobis	012330 KS	Samchuly Bicycle	024950 KQ
Hyundai Motor	005380 KS	Samsung Electronics	005930 KS
Hyundai Steel	004020 KS	Samsung SDI	006400 KS
i-Sens	099190 KS	SFA	056190 KQ
KB Financial	105560 KS	Shinhan	055550 KS
Kepco Plant Service	051600 KS	SK Hynix	000660 KS
Kia Motors	000270 KS	SK Innovation	096770 KS
Korea Zinc	010130 KS	S-Oil	010950 KS
Korean Re	003690 KS	WeMade	112040 KS
KT&G	033780 KS	Woori Financial	053000 KS

Source: CLSA

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Malaysia - Still improving

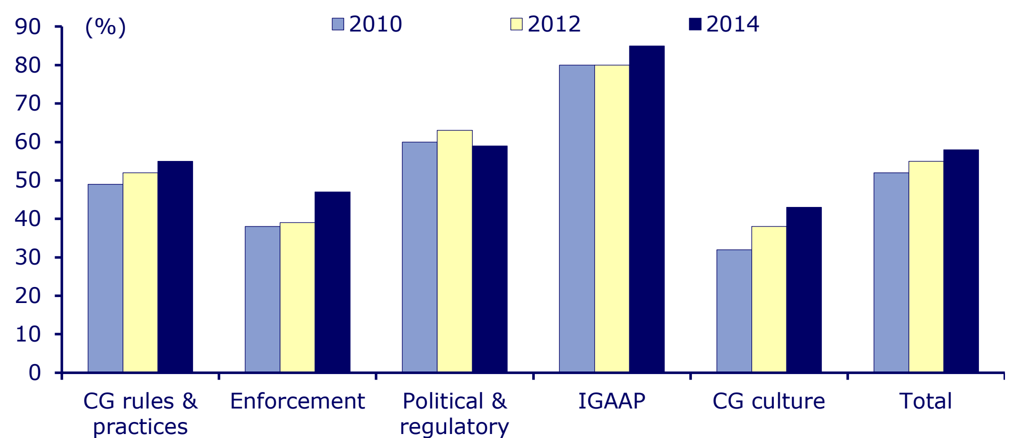
Key issues and trends

- The government continues to implement CG Blueprint 2011
- Reform remains largely top-down, state-led
- Corporate financial reporting considerably better than non-financial
- Launch of the Malaysian "stewardship code" will hopefully galvanise domestic funds
- Audit Oversight Board (AOB) developing into an effective regulator, one of the most focused in the region
- Lack of effective enforcement action against senior officials and politicians remains a concern

Overall score rises from 55% in 2012 to 58% in 2014

Figure 121

Malaysia CG macro category scores



Source: ACGA, CLSA

Malaysia one of the few markets to show consistent improvements in CG score

Malaysia occupies an interesting and rather unique position in our survey. It is the only market that has consistently edged up in score in each of our last four surveys: 49% in 2007, 52% in 2010, 55% in 2012 and 58% this year. Not a bad achievement, given that most markets find it hard to sustain reform for any length of time (three-to-four years being the norm before they lose momentum). Yet Malaysia has done this largely through a mix of government-driven reform (see its CG Blueprint 2011 report), gradually improving enforcement, a state-grandfathered push to require domestic institutional investors to take CG seriously and the creation of one of the region's better independent audit regulators.

Yet the country remains full of contradictions

But the country remains unusual in other ways too. Despite a zeal for reform, the government is reluctant to take bold steps in some of the easier aspects of shareholder rights, namely mandatory voting by poll and publication of vote results. It began promoting corporate social responsibility (CSR) reporting in 2007, well ahead of most other Asian markets, yet certain aspects of basic CG non-financial reporting, such as the MD&A, is still not required of listed companies. Although it has the most numerous and established group of state pension funds in Asia, called government-linked investment companies (GLICs), many of them show little overt interest in pursuing better CG. It seems at times that the whole is less than the sum of the parts.

CG rules and practices

Rises from 52% in 2012 to 55% in 2014

Scores went up slightly in this section as a result of improved financial reporting and because Malaysia performed quite well on our three new CSR/ESG reporting questions. Despite a four-month deadline for producing audited annual accounts, we found that a number of larger issuers were reporting in just under 60 days, the regional best practice benchmark. Of the 25 large caps that we reviewed this year, 14 reported within 60 days and another three in about 61-66 days. Three of 10 midcaps did so as well.

Financial reporting improving

Data from Bursa Malaysia, the stock exchange, suggests that listed companies as a group are indeed getting better at financial reporting. It issues fines for companies that fail to meet reporting deadlines and the number of cases has been falling in recent years. Since 2008, when there were 77 breaches of financial reporting deadlines by 39 companies, the incidence fell to 27 breaches by 14 companies in 2013. This amounts to just 1.5% of all issuers. Bursa also argued that the differences between the Q4 quarterly reports of most companies and their audited annual accounts are small, with only 1.76% of issuers showing deviation in their numbers. Since quarterly reports have to be produced within two months, Bursa believes that Malaysia effectively meets the 60-day benchmark.

Malaysia an early adopter of CSR reporting standards, though most reporting middling to poor

Of our three new questions on CSR/ESG reporting, Malaysia fared quite well on the first, which looked at whether such standards are in line with international norms. Malaysia was an early adopter of sustainability reporting guidelines for listed companies - ostensibly to address its environmental issues and to attract some of the billions of dollars invested in socially responsible investing (SRI) funds globally - and so is somewhat further advanced than most jurisdictions. However, we found the quality of reporting by large companies to be middling, while smaller companies rated poorly.

Scores on most questions stayed the same in this section. One area where they declined was in the quality of non-financial reporting standards, mainly the continuing lack of a requirement for a management, discussion and analysis (MD&A) section in annual reports. While Bursa notes that most of the top 100 companies now provide them and indeed encourages them in its Corporate Disclosure Guide (2012), an imminent rule change does not appear likely.

The country is behind the curve on other non-financial reporting

Another area where Malaysia remains behind the curve on non-financial reporting standards is the disclosure of director and executive remuneration. Appendix 9C (on the contents of annual reports) of the listing requirements only asks companies to provide 'aggregate remuneration of directors with categorisation into appropriate components' (eg, director fees, salaries, bonuses) and separated into executive and non-executive directors, plus the number of directors whose remuneration 'falls in each successive band of RM50,000 distinguishing between executive and non-executive directors'. There is no need for disclosure by individual names, nor of the pay of senior executives who are not directors.

Non-financial reports often tedious to read

Actual non-financial reporting practices in Malaysia can, like most markets, be mind-numbingly formulaic, legalistic and full of management-speak. An example of a bank describing its board evaluation process: 'Performance evaluations are conducted annually and cover the Board, each Director and the Board Committees. The framework used to assess the Directors is based on the expectation that they are performing their duties in a manner which should create and continue to build sustainable value for shareholders and in

accordance with duties and obligations imposed upon them under the law and guidelines issued by the regulatory authorities.' It is doubtful that any shareholder of this company would find such information useful in assessing board performance.

While Malaysia's revised CG Code of March 2012 took quite a tough position on certain best practices - for example, the board must comprise a majority of independent directors where the chairman is not an independent director and the tenure of independent directors should not exceed the nine years - it backed off from promoting universal voting by poll. Instead, it merely said that the 'board is encouraged to put substantive resolutions to vote by poll'.

Sustainability reporting in Malaysia

CSR reporting standards introduced from 2007

The Malaysian government began advocating sustainability reporting standards in 2004, when the then Minister of Finance, Tan Sri Nor Mohamed Yakcop, told a conference that the government 'strongly supports the adoption of voluntary CSR reporting and standards'. Nevertheless, by 2007, the government decided to require all listed companies to include some degree of CSR reporting in their annual reports (and Bursa Malaysia amended its listing rules accordingly). Both Bursa and the government have released sustainability reporting guidelines, while the Exchange actively engages the business community through its Business Sustainability Programme and holds periodic training and seminars. Bursa also has its own sustainability report aligned to the Global Reporting Initiative (GRI). It has no sustainability index, but plans to develop one by the end of this year.

Carbon disclosure promoted from 2013

Carbon disclosure is promoted through the National Corporate GHG Reporting Programme, which began in 2013, while the Malaysian Code for Institutional Investors launched in June 2014, recommends that institutional investors should incorporate corporate governance and sustainability considerations into the investment decision-making process. Mandatory carbon disclosure could come in by the end of 2016.

Regarding the performance of companies on CSR reporting, our review of 10 large caps found that four had standalone reports, while the remainder covered these issues in their annual reports. Only two of the 10, however, had sophisticated reports that attempted to view sustainability strategically (ie, link it to corporate strategy and operations). The others were quite superficial, focusing mostly on philanthropy and community initiatives.

Few corporate sustainability reports of high quality or strategic in outlook

The midcaps were, on balance, markedly weaker. Nine out of 10 had sustainability reports, while only two had standalone reports (yet both were good reports). The other reports, however, were much shorter than those of the large caps and even more centred on community initiatives.

One of the reasons for this gap between standards and practices in Malaysia could be the nature of the standards themselves. The sustainability reporting guidelines developed by the Exchange are comprehensive, but quite general and written in consultant jargon, while the section of the Listing Requirements that "mandates" CSR reporting merely says that annual reports must include the following: 'A description of the corporate social responsibility activities or practices undertaken by the listed issuer and its subsidiaries or if there are none, a statement to that effect.' See Appendix 9C (Part A, paragraph 29) of Bursa's listing rules.

The quality of reporting may well improve in the coming years, since Bursa plans to carry out an assessment of CSR reporting of the top 200 listed firms and engage with the weaker ones.

Enforcement

Rises from 39% in 2012 to 47% in 2014

This is the section of our survey where Malaysia performed best. We did not change our score as to whether the regulators have a reputation for vigorously enforcing their own rules, since there are mixed views on the effectiveness of Bursa and the SC in pursuing and enforcing in cases that matter. Nor did we change our score on whether the SC has effective powers of investigation and sanction, since achieving a successful criminal prosecution requires the participation of other parts of government, notably the judiciary. Court cases can still take years in Malaysia and at lower levels, judges do not all have sufficient knowledge of company and securities law. However, scores did go up for the degree of effort made by regulators, a slightly higher score on enforcement against insider trading and market manipulation and the quality of regulatory disclosure on enforcement activity.

Data from Bursa Malaysia, for example, shows that the exchange issued 37 private or public reprimands against listed companies in 2011, then 40 in both 2012 and 2013. Over the same period, it issued 68, 77 and 39 reprimands against directors. (Note: The number of reprimands does not equate to the number of firms or directors reprimanded, since it many cases they received more than one reprimand.)

Court cases still painfully slow in Malaysia

Regarding penalties for insider trading, market manipulation and other criminal breaches, the government's track record is not stellar. As the SC's announcements show, the progress of prosecution is usually tortuous, cases often do not start for five to 10 years after the offence and successful convictions are typically appealed, again and again. One case from last year with a slightly different twist dated back to March 2003, when charges were laid against an individual for submitting misleading information to the SC in 2000 and 2001. The case was not resolved until April 2009, when the Sessions Court ordered the defendant to pay a fine of RM200,000 for one charge, but acquitted him on two others. In this case, the Prosecution appealed to the High Court, which dismissed the appeal in February 2013. The Prosecution then went to the Court of Appeal and won its case in December 2013. The Court of Appeal sentenced the man to a fine of RM500,000 for each charge or, in default of payment, one-year imprisonment. It seems clear from reading the criminal action announcements that the SC does not like losing in court!

People do go to prison in Malaysia for securities crimes

Despite the small number of people being fined or jailed for a criminal breach of securities law in Malaysia, the fact is that some cases are successfully prosecuted - albeit years after the fact - and some people are being sentenced to prison. As inefficient as the system may be, this is tougher enforcement than one sees in Singapore. Hence, we felt a slightly improved score was warranted compared to our 2012 survey.

Financial regulators good on disclosure of enforcement activity

In terms of the disclosure of enforcement activity, the SC and Bursa are also among the better reporters in the region. Both of their websites are well-designed and provide easy and logical access to enforcement information (Singapore take note!). The SC site has an obvious section on enforcement that is sensibly organised into sections called "Actions", "Updates on ongoing cases", "The reporter" (a newsletter), "Enforcement related press releases" and so on. The Actions page, for example, is further divided into AOB sanctions (Audit Oversight Board), criminal prosecutions, civil actions and settlements, cases compounded and administrative actions. It could not be clearer.

More detailed statistics on enforcement trends would be welcome

What would be helpful, however, are some comprehensive statistics showing enforcement trends in different types of cases over time (five or more years), with a breakdown into complaints, referrals, investigations, prosecutions, settlements, convictions and acquittals and an explanation of what all the numbers mean. This would help independent observers assess the true level of progress being made by regulators in a particular market. At present, the SC publishes no aggregate enforcement statistics, while Bursa only gives figures for the previous year. One odd feature of the Bursa website is that the "Enforcement news" page does not contain news, but generic summaries of cases and it does not link to the "Media releases" page which contains the detailed enforcement announcements.

As for "private enforcement" by minority shareholders, retail or institutional, scores have stayed largely the same as in 2012. The Minority Shareholder Watchdog Group (MSWG), a retail shareholder group funded largely by government, continues to participate actively in general meetings and seeks to hold companies accountable. It was also instrumental in coordinating and writing the new Malaysian Code for Institutional Investors.

The Malaysian Code for Institutional Investors should facilitate more market enforcement

We do not see any significant change yet in the level of institutional investor participation in voting or engagement, by either domestic or foreign funds, although there are high hopes that the Malaysian Code for Institutional Investors will encourage more active stewardship in the coming years. Given the large number of state-managed pension funds in Malaysia and the interest already shown in CG by the Employees Provident Fund (EPF) and KWAP, the civil service fund, one would hope that a more vibrant domestic institutional culture could be developed in Malaysia. Meanwhile, based on anecdotal information received from a select group of funds, we have given a slightly higher score for whether institutions are voting against resolutions at AGMs and EGMs.

Political and regulatory environment

Falls from 63% in 2012 to 59% in 2014

Since publishing its CG Blueprint in 2011, Malaysia has been fairly consistent in its approach to corporate governance policy and the Blueprint has led to a series of reforms. In January 2012, listing rule amendments came into effect covering such things as multiple proxies, immediate announcement of poll results if a poll has been taken and stricter rules on the disposal of major assets, including a requirement for shareholder approval. In March of the same year, the revised Code of Corporate Governance was published. And then in November 2012 came further amendments to the listing rules to align with the revised CG Code, including mandatory polls for related-party transactions (RPTs) that require shareholder approval, limiting the number of directorships to five, mandating nomination committees and enhancing disclosure of director training.

New rules on faster publication of annual reports

More recently, in December 2013, the timeframe for the issuance of annual reports was reduced from the current six months to five months (from the end of 2014) and to four months (from the end of 2015). As a result of this, the authorities decided not to make any changes to the deadlines for quarterly and annual audited financial statements (two and four months). This was preceded by a consultation in May 2013.

January 2014 brought another consultation, this time a review of listing requirements in various areas. The most relevant to corporate governance involves RPTs, where Bursa believes the rules may be too strict: some 2009

amendments may have been too stringent and caught immaterial RPTs. It proposes raising the monetary limits in the rules from RM250,000 to RM500,000 for mainboard firms, but not changing existing percentage ratios. The amended rules are expected by the end of 2014 or soon thereafter.

Disclosure of laws and regulations on regulatory websites is well organised

In terms of policy consistency and rule-making, Malaysia continues to do fairly well in our survey. We have not changed any scores from 2012. We also continue to rate the SC and Bursa well for the clarity of their websites on rules and regulations. While this may seem too ordinary an issue to worry about, the ability to access laws, regulations, rules and codes quickly and then find what you need in a well-laid-out contents page within each document is not something that every financial regulator in Asia offers. Indeed, the ones who do it really well are in a minority. Meanwhile, the Bursa website is one of the few in the region offering company announcements going back more than 10 years.

Malaysia scores less well for fighting corruption

Where Malaysia loses points in this section is on questions relating to its anti-corruption efforts and public governance. We moved one question from the enforcement section to the political and regulatory category - on whether or not an effective independent commission against corruption existed - and added a new question on whether the government was improving standards of public governance. Malaysia's challenges here are reflected in the country's ranking in Transparency International's corruption perceptions index. It has stayed roughly the same since 2010 and is currently ranked 53rd out of 177 countries. Our research broadly supports this, as we have not met any independent observers in the country who believe things are improving significantly.

Another factor we took into account was the work of the Malaysian Anti-Corruption Commission (MACC) and specifically its arrest statistics. While the MACC has been arresting people quite actively in recent years, the number of cases has dropped sharply since 2011. Although this could be interpreted positively or negatively, the commission's record of arresting top management within the "government-servant" category is low and almost all those arrested are middle-management and support staff. It seems unlikely that corruption is only a problem of the lower levels.

IGAAP (accounting and auditing)

Rises from 80% in 2012 to 85% in 2014

An improved score for the effectiveness of the Audit Oversight Board (AOB), the independent audit regulatory body under the Securities Commission and full marks for two new questions, were the main reasons for the positive outcome in this section.

Audit Oversight Board is making good progress

The AOB is one of the better organised and more transparent audit regulators in Asia and has made progress since its formation in 2010. It has wide powers to carry out inspections of firms, can sanction firms as well as individuals and has a clear strategy governing what it is doing. On enforcement, it decided that in its early years that most of its sanctions should be "remedial" in nature. In this sense, it has taken a similar approach to its close counterparts in Singapore (ACRA) and in Thailand (the SEC). But over the past 18 months it has started getting tougher: it issued public reprimands against six auditors in 2013, another two in February 2014 and then issued its first sanction against a CPA firm in May 2014, prohibiting it from accepting any "public interest entity" (ie, a listed or public company) as a client for 12 months and fined the firm RM30,000.

AOB is encouraging consolidation among small CPA firms

One interesting feature of the AOB's work is its efforts to encourage consolidation among small CPA firms, the part of the industry considered at highest risk from an audit quality perspective. The AOB is encouraging firms to have more partners, since you need more capacity to do big audits and more resources brings other benefits, such as bigger clients. Data from the AOB shows that the number of CPA firms with sole proprietors decreased from 13 in 2011 to just three this year, while the number with two to four partners decreased from 48 to 35 over the same period. Meanwhile, the number with more than 10 partners has increased from six to eight. Malaysia now has 52 firms undertaking listed and public company audits, a number that the AOB would not want to see fall below 40. The Board is also trying to encourage the better small firms to share their insights with other small firms.

The two new questions on which Malaysia also scored well were: Does the audit regulator publish a detailed annual report on audit industry capacity and its inspection/enforcement activities? Also, does the country have an active programme for CPA education? Both received a firm Yes.

CG culture

Rises from 38% in 2012 to 43% in 2014

Although not a great deal has changed in Malaysia's CG culture over the past two years, the higher score in this section is the result of incremental improvements in the quality of corporate communication to shareholders, good disclosure of director remuneration among some companies (though not most), some voluntary voting by poll and recognition of the efforts made to launch the Malaysian Code for Institutional Investors.

CG culture improvements still largely driven by regulators

Interestingly, the main driver of better CG culture in Malaysia right now appears to be Bursa Malaysia, not necessarily the corporate sector itself. Bursa is, for example, organising numerous seminars and training courses for companies. In the area of voting by poll, Bursa has taken on the job of talking to service providers to develop a system that is efficient and cost effective. It does not want to make polls mandatory until the infrastructure has been put in place. While this attitude is admirable, it is the opposite of the approach taken in more *laissez faire* Hong Kong - where authorities expect the private sector to create their own solutions - and there is always a risk that a government-driven response may not be the right one.

Slightly alarmingly, when we asked companies why they did not already vote by poll, they all quoted from the 2012 CG Code and said 'they only felt it is important to put substantive resolutions to a poll'. When we asked if this meant that they did not consider the election of their directors to be substantive, only half saw the irony! Indeed, one said it did not consider any of its AGM resolutions to be substantive.

Bursa trying to encourage smaller issuers to do MD&As

On the issue of MD&As, Bursa explained that it is trying to encourage them with its Corporate Disclosure Guide. But to make MD&As mandatory would require building a culture, especially among smaller companies that find the process difficult. Resources is one issue, while having the right person to write these reports is another. Not all stock exchanges are quite so forgiving!

Finally, one area where Malaysia does excel is in the training and development of directors. For example, Bank Negara, the central bank, has long had a strong director training programme and established Iclif, a non-profit organisation that provides leadership development and corporate governance training to financial institutions and companies in Malaysia and elsewhere.

Downgrade watchlist

What to avoid

Factors that could force the country's score to fall in 2016:

- No improvement in non-financial reporting
- A continuation of voting by a show of hands at general meetings
- No progress in making MD&As mandatory
- Poor implementation of the Malaysian Code for Institutional Investors

Quick fixes

What to fix

- Provide more detail on regulatory enforcement cases, including a statistical analysis of enforcement trends
- Make voting by poll mandatory
- Encourage companies to disclose more detail in AGM agendas
- Encourage companies to provide commentary on services covered by non-audit fees

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Research perspective - The GLC question

- Governance issues among privately owned companies have been fairly benign, with attention shifting to government-linked companies (GLCs) where minorities are at risk of playing second fiddle to strategic agendas.
- Top three companies with the highest CG scores are BAT Malaysia, Astro and Axiata, with Public Bank remaining the leader among big-cap financials.
- The Genting group of companies as well as GLCs like RHB Capital and Sime Darby where discipline and independence appear weak, continue to score poorly.

CG landscape has been relatively benign, putting investors in a forgiving mood re transgressions

Among big caps in Malaysia, the CG landscape has been relatively benign since our last update in 2012. This calm, coupled with the push factor of ample domestic liquidity, has contributed to a markedly forgiving mood among investors. For example, the Berjaya Group, controlled by tycoon Tan Sri Vincent Tan and with a long history of CG-unfriendly inter-companies lending and asset shuffling, has seen strong demand for its recent listings such as Berjaya Auto and 7-Eleven Malaysia. Airport operator MAHB has seen its share price perform strongly despite a weakly justified doubling in cost of construction of its newest terminal, while healthcare player KPJ has been able to overcome self-inflicted legal and operational liabilities as investors focus on the sector's structural growth attraction.

CG controversy is shifting from entrepreneur-run entities to the now-sprawling GLC space

Privately-controlled companies have by-and-large seen a neutral-to-improving CG trends, but the track record for GLCs, which have come to control 30-100% of capitalisation in the individual sectors, has been much more chequered of late. While big-cap GLCs like Axiata and CIMB are in the top quartile of our CG scoring, both have been pursuing regionalisation agendas which appear to have had a supportive influence on their CG parameters. The bulk of GLCs fall short, especially in areas of discipline and independence. The poster child for GLC CG deficiency is cash-rich plantation company Felda which has seen its board go on an unchallenged broad shopping spree at premium prices and of questionable benefit to shareholders. There is little surprise Felda is at the bottom of our CG rankings and has a share price that is touching new record lows.

GLCs in general face less pressure to conform to CG best practices given state support (including GLICs)

By virtue of their state-sponsorship (including support by GLICs or government-linked investment companies such as EPF and PNB), GLCs are less obliged to market discipline and prone to being vehicles to satisfy political or social priorities - an example is national carrier MAS where vested interests and political meddling has delayed urgent restructuring. However, minorities are being given an exit via a fairly priced privatisation offer by majority shareholder and sovereign wealth fund Khazanah (ie, GLC CG outcomes need not always be negative for minorities).

Developments in the GLC space will be the key influence on Malaysia's CG perception . . .

CG perception of the Malaysian corporate landscape going forward will, by virtue of their size and propensity to engage in restructuring/M&A, continue to be influenced by GLC-related developments. Two current exercises with CG implications are:

. . . with minority rights pending, state-led bank sector mega-merger . . .

- the treatment of minorities in the recently proposed CIMB-RHB Cap-MBSB merger exercise to create Malaysia's biggest banking group; all entities are GLCs controlled by various state funds and investors will be watching how much influence/fair treatment minorities will be accorded (dependent on regulator-sanctioned voting rights of the controlling state funds); and

. . . and the handling of 1MDB's upcoming IPO setting the broad CG tone

- 1MDB, a strategic development company wholly owned by the Ministry of Finance, has been the subject of many critical media articles which have highlighted, among other issues, poor operating and financial transparency including opaque offshore dealings and sudden replacement of external auditor linked to late submission of accounts. How 1MDB's upcoming IPO is handled will be a strong indicator as to how powerful GLCs view CG imperatives and what we can expect of GLC's CG.

Companies that top the list/have seen most improvement

BAT, Astro and Axiata top our CG list . . .

The top three companies with the highest CG scores in Malaysia are BAT (Malaysia), Astro and Axiata. BAT reflects the generally strong governance of listed MNC-controlled companies (peers include Nestle and Lafarge) where scores for discipline (focus on core operations and maximising ROE), transparency and fairness reflect global best practise. Astro scores highly on independence, the related confidence minority rights will be safeguarded underpinning high foreign ownership (20%-plus). Axiata scores well across all CG question buckets - like fellow high-scoring GLCs CIMB and IHH, Axiata's regional ambitions and need to satisfy multiple regulators and stakeholders have served as a push factor to embrace CG best practices.

Among the big-cap banks, Public Bank tops the sector with a particularly high score for responsibility given its financial importance to founder and immensely wealthy chairman Tan Sri Teh. Midcap AMMB also scores highly, with major shareholder ANZ having pushed through steadily improving CG standards since its 2007 entry.

Corporates at the bottom of the list/seen deterioration

. . . while GLC weighting in the bottom quartile (eg, Felda, KPJ, Sime, RHB Cap) is heavy

GLC representation in the bottom quartile is heavy - besides aforementioned Felda and KPJ, Sime Darby continues to struggle to lift its CG ranking in the face of negative history (ex-CEO charged with CBT in 2010, poorly explained acquisitions) but we see green shoots as the current CEO has taken initial steps to streamline sprawling operations (eg, sales of healthcare and power divisions). GLC bank RHB Capital scores poorest among the banks, scoring particularly weakly on discipline (no clear strategy and weak returns) and independence (pension fund EPF's stifling hand).

We show in the table below the companies that rank in the upper half of our CG rankings for Malaysia coverage.

IJM and Tenaga are our High-Conviction BUYs in Malaysia

Figure 122

Malaysia: Companies in top-two CG quartiles (alphabetical order)

Company	Code	Company	Code
AirAsia	AIRA MK	IHH	IHH MK
AirAsia X	AAX MK	IJM Corp	IJM MK
AMMB	AMM MK	KL Kepong	KLK MK
Astro	ASTRO MK	Mah Sing	MSGB MK
Axiata	AXIATA MK	MMHE	MMHE MK
BAT Malaysia	BAT MK	Public Bank	PBK MK
Bumi Armada	BAB MK	Tenaga	TENAGA MK
Bursa Malaysia	BURSA MK	Top Glove	TOPG MK
CIMB	CIMB MK	UEM Sunrise	UEMS MK
Dialog	DLG MK	UMW	UMW MK
Hartalega	HART MK	UMW Oil & Gas	UMWOG MK
Hong Leong Bank	HLBK MK		

Source: CLSA

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Philippines - Reluctant reformer

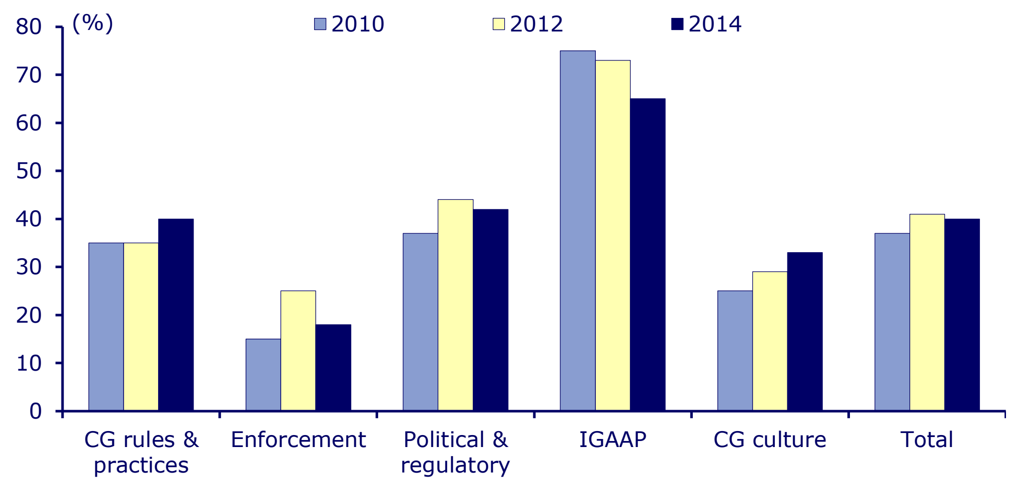
Key issues and trends

- Impetus for CG reform has moved little since our last survey
- Filipino companies show little enthusiasm for genuine CG reform
- SEC has improved under the current Chair
- The Philippines would have ranked last in our survey if not for the SEC's requirement for a CG Report from listed companies
- Other big CG problems are weak enforcement, insider trading and lack of a clear CG strategy

Overall score falls from 41% in 2012 to 40% in 2014

Figure 123

Philippines CG macro category scores



Source: ACGA, CLSA

CG rules and practices

Rises from 35% in 2012 to 40% in 2014

The Philippines does better in this part of our survey for one main reason: a new initiative from the Securities and Exchange Commission (SEC), launched in 2013, requiring all publicly listed companies (PLCs) to produce an Annual Corporate Governance Report (ACGR). The purpose of the ACGR is to 'consolidate all of the governance policies and procedures of each PLC into one report for easy reference', as the Philippine chapter of the Asean CG Scorecard 2013-14 stated.

The SEC is forcing higher CG disclosure standards from companies

Apparently stung by the Philippines' poor scores relative to its peers in the first Asean CG Scorecard of 2012-13, the SEC sought to force higher disclosure and transparency standards by mandating a report that closely tracked the questions in the Scorecard. Companies were given until June 2013 to complete their reports, which were then analysed by the Institute of Corporate Directors and various partner organisations. The result: the average score of 94 large Philippine companies increased from just under 49 points in 2012 to 58 points in 2013. Although very much a compliance-driven approach to raising standards, with many boilerplate ACGRs being produced, some of them are informative and helpful and the SEC is to be applauded for taking the initiative.

Like other markets, small cap reporting compares poorly to large caps

Like most Asian markets, there is also a clear difference in the Philippines in terms of the quality of financial reporting between larger and smaller firms. Most small caps only meet minimum disclosure requirements, with a few

exceptions such as Union Bank and Security Bank demonstrating much higher standards - in part due, no doubt, to the tough line the central bank takes on bank governance.

Speed of reporting

Few large caps beat the 60-day best practice benchmark for audited annual accounts

The variation in reporting quality is reflected in reporting speeds, a mark of how well organised a company is in terms of its accounting systems. An ACGA review of 27 large caps and 10 midcaps found that only a small number met or beat the regional regulatory best practice of 60 days. Notable reporters were Globe Telecom, which produced its audited results in just 41 days, Metrobank in 56 days and PLDT in 63 days.

Non-financial reporting also varies widely

Variation in quality can also be seen in non-financial reporting among companies, namely their MD&A, director reports and other CG disclosures. MD&A statements in our research sample varied enormously, mirroring the differences in the ACGR. Despite the best efforts of the SEC, it is hard to escape the feeling that the overwhelming majority of companies, large and small, see this type of reporting as just a compliance exercise as well. Those taking a more serious approach include, once again, Globe Telecom, Meralco, PLDT, Union Bank, Security Bank and Manila Water.

Protecting the little guy (or not)

Disclosure of substantial ownership stakes slow by regional standards

Minority shareholder protection needs strengthening in the Philippines. SEC rules require disclosure of the ultimate beneficial owner of shares, but only within 10 business days, which is far behind regional best practice of three working days in Hong Kong. It is also unclear whether regulators are able to monitor compliance with this rule effectively. Similarly, director dealings and changes in shareholding by holders of 10% or more are only required to be disclosed within 10 business days, although The Philippine Stock Exchange (PSE) requires directors to disclose dealings within five business days. Why not for major shareholders too?

PSI rules tough, but enforcement is weak

SEC rules on disclosure of price-sensitive information (PSI) are more stringent: SRC Rule 17.1 requires disclosure of PSI to the stock exchange within 10 minutes of the event and prior to any media release and then within five business days to the SEC. While the law to regulate PSI is in place, based on our research and interviews conducted in the country, monitoring and enforcement of this rule is lacking.

RPTs rules also do not meet regional standards . . .

Regulations governing related-party transactions (RPTs) in the Philippines do not meet international best practice. While disclosure requirements are reasonable (companies generally disclose full details of RPTs in their annual reports) and have improved under the ACGR initiative, there are no SEC or PSE rules that require companies to notify shareholders in advance of major RPTs, nor to obtain the prior approval of minority shareholders. This is also an area highlighted as especially weak by the Asean CG Scorecard.

. . . and ditto for insider trading rules

We have again not awarded any score for the Philippines' rules against insider trading. While the Securities Regulation Code and the SEC's Corporate Governance Code prohibit insider trading, the rules do not provide any credible deterrent against the practice and we have seen no meaningful evidence of enforcement against the practice. The PSE's laudable, but ultimately ill-fated, attempt to improve surveillance and enforcement of insider trading by spinning off the Capital Markets Integrity Corp (CMIC) proved short-lived. In 2013, the PSE replaced senior management and all but one of the Board of CMIC according to our sources, because the CMIC proved

too effective and embarrassed practitioners close to the PSE board. Our sources in the country confirm that insider dealing remains a serious problem in the Philippines.

No mandatory voting by poll

There is currently no requirement in the Philippines for voting at general meetings to take place by means of a poll and very few companies are voting in this way (Manila Water and PLDT are notable exceptions). With a pickup across the region in the adoption of polls - the latest markets being India and Taiwan to start in force - the Philippines is falling further behind.

The limits of board independence

No term limits for independent directors

Board composition is another area that requires attention. While there are rules defining independence, they are not sufficiently robust: we have found nominally independent directors (INEDs) sitting on boards for more than 20 years. Moreover, the large number of relatives of controlling shareholders on boards surely makes it difficult for INEDs to operate independently. That said, as can be seen from the ACGR reports, a small minority of companies are introducing term limits for INEDs.

Poor disclosure of executive remuneration

Disclosure of board remuneration has improved slightly with the ACGR system and SEC requirements, but still falls short of international standards. In accordance with SEC requirements, companies disclose total compensation for the top five named executives/directors and cite the balance paid to the rest, unidentified. The reason given for non-disclosure of individual remuneration is usually security. We suspect the real reason is more a case of wanting to avoid potential embarrassment internally. Interestingly, we also found two companies whose directors appear to work free of charge!

Audit committee members often not genuinely independent

The ACGR requires more disclosure than previously on audit and other board committees, their mandates, responsibilities and structures. While some companies seem to be taking this seriously, it remains difficult to accept the *genuine independence* of most audit committee chairmen. A good example is Manila Water: although one of the best companies in our sample, the chairman of its audit committee, an INED, has sat on the audit committee for nine years and is a director at Bank of the Philippine Islands and Ayala Land, which are also Ayala Group companies. The other three members of the committee have connections to Ayala too.

Executive directors sometimes sit on audit committees

Meanwhile, the presence of executive and closely connected non-executive directors on audit committees raises further doubts about their independence. According to its website, SM Prime has an audit committee with two independent directors, one of whom has sat as an INED of the company for 20 years, the other sits as an INED on the boards of two SM Group-related companies. The committee also comprises one executive director, two non-executives who are senior executives of other SM companies and one non-executive who spent his career at the firm’s external auditor (though not on the auditing side). There is no doubt all these people bring considerable expertise to their role, but any impartial observer would be justified in wondering how independent their decisions will be.

Pre-emption rights easily eliminated

Pre-emption rights remain a problem in the Philippines. While this right is enshrined in company law, Section 39 of the Corporation Code permits companies to deny it if it secures a two-thirds vote of shareholders. Many companies have done so. Lest we forget, this is the country that gave us the Alphaland scandal.

Early disclosure of detailed AGM agendas a bright spot

On a more positive note, Filipino corporations are generally good at providing detailed notices of annual general meetings (AGM) with ample notice ahead of the meeting. The definitive information statement is generally comprehensive and is sent to shareholders by most companies at least 21 days ahead of the AGM, as required by the SEC. There is, however, conflict with this SEC requirement in the Securities Regulatory Code that stipulates the minimum necessary notice is 15 days. Some companies exploit this anomaly and it is time to close the loophole definitively. A May 2014 SEC circular now mandates disclosure of minutes of shareholder meetings to be posted to the company's website within five days of the meeting, which is certainly a welcome improvement.

Regulators need a comprehensive CG strategy

Overall, not a great deal has changed in Filipino CG since our last survey. While the ACGR is to be welcomed, it seems a pity that the catalyst for its introduction came as much from an external stimulus as from an internal initiative. Until Filipino corporations start to embrace CG as more than just a compliance programme and regulators devise a comprehensive and consistent CG strategy, it is hard to see meaningful progress being made.

General reporting on CSR required

Sustainability reporting in the Philippines

The 2011 CSR Act mandates general reporting on CSR activities and the PSE reports on its own CSR activities in its annual report and website. The PSE does not however, have any listing requirements around CSR reporting, nor does it promote sustainability reporting standards, carbon disclosure or assurance of sustainability information.

No specific sustainability reporting guidelines

Companies are not incentivised to disclose quality information. There are currently no existing sustainability reporting guidelines that are specific to national sustainability reporting other than the CSR Act that requires a general disclosure of CSR-related activities by all large tax-paying corporations. There is also little provided by the authorities to socialise the business sector on CSR reporting through training courses and seminars.

Sustainability reporting mostly on philanthropy

In an ACGA review of company reporting in mid-2014, we found that nine out of 10 large-cap companies reported on sustainability, with all reporting taking place via the annual report or website. But most of these companies only reported on philanthropic activities and were not sophisticated in their disclosure. Reports are relatively short and only one company used the Global Reporting Initiative (GRI) framework. No large-cap companies had standalone sustainability reports.

Enforcement

Falls from 25% in 2012 to 18% in 2014

The Philippines recorded the region's lowest score for enforcement for good reason. No one we talked to in the country believes that securities regulators have a reputation for *vigorously and consistently* enforcing their own CG rules and regulations. The exception in the wider financial sector is of course the central bank, Bangko Sentral Ng Pilipinas (BSP), but the focus of our survey is largely on the capital markets. The SEC has improved under new leadership, but remains under-resourced and overwhelmed. Like many for profit exchanges in the region, the PSE seems more intent on promoting listings than enforcement.

SEC needs more funding

Funding for the SEC has increased since our last survey, but not by sufficient sums to make a meaningful difference to surveillance and enforcement activities. The SEC's FY 2014 budget is approximately US$12.5m, less than

5% of the budget of the entire Department of Finance. Considerably more investment is needed, particularly in the area of enforcement. Powers of enforcement granted to the SEC are in theory adequate, but what is the use of such powers if they are rarely enforced due to lack of funding? We have not learned of a conviction for insider trading or market manipulation in the Philippines and we do not believe regulators have actually tried to prosecute such a case.

PSE did a good job enforcing its minimum public float rule

The PSE deserves mention for its efforts to impose and enforce an increase in the minimum public float to 10% in 2013, against strong opposition from certain business interests. It has pursued the delisting of Alphaland for flagrant CG misdemeanours. Yet the emasculation of the CMIC, referred to earlier, due to pressure from the PSE board and local securities firms was depressing.

Regulatory websites woeful

Information on enforcement activity is not well organised on the SEC website, which appears in dire need of a redesign: it incorporates a confusing list of opinions, orders and decisions issued by a variety of departments, most nothing to do with the listed securities market and many woefully out of date. The latest available annual report on the website is for FY12. The PSE site, when it works (we continually found it down during our research), also needs an overhaul. While better than the SEC site, navigation is complicated, there is no discrete section on enforcement and the section on listing rules and disclosure obligations is poorly indexed and confusing. The PSE's new announcements site EDGE, while an improvement on its predecessor, is also confusing to navigate and only contains two years of filings.

Signs of life in shareholder activism

More positively, there are early signs of life in shareholder enforcement in the Philippines. We found evidence from disclosures in the ACGRs that minority investors are actively attending some annual meetings, while a few companies provide detailed disclosure of question and answer sessions held at their meetings. We also understand that SharePHIL, an independent minority shareholder group, is beginning to engage companies at AGMs.

Shareholders use the legal system only rarely

Minority shareholders rarely, if ever, sue companies in the Philippines. There have been two notable incidences of high-profile legal cases in the past 12 months of shareholders suing boards and/or controlling shareholders of Alphaland and Alliance Select International. But these are really disputes between substantial shareholders, rather than independent minority shareholders going against board proposals.

Political and regulatory environment

Falls from 44% in 2012 to 42% in 2014

The score slipped here for a number of reasons. The government lacks a consistent policy on CG reform, despite promises to the contrary after our last survey in 2012. There is no obvious CG champion in government. The SEC deserves recognition for its ACGR initiative, but that hardly constitutes a strategy. The PSE appears even less active, while the SEC and PSE do not seem fully connected on regulatory issues. And the CG Code has not been revised since 2009.

BSP is a good regulator

On a more positive note, the BSP is by all accounts an effective regulator, but CG does not just apply to banks. Government-linked companies (GLCs), known as government-owned and controlled corporations (GOCCs), in the Philippines, have undergone a comprehensive rationalisation programme, but none of these initiatives forms part of a comprehensive and consistent strategy for CG reform.

SEC not very independent

The SEC remains under the purview of the Department of Finance and is certainly influenced politically, hence is far from independent. A comprehensive overhaul of securities laws and regulations is well overdue.

PSE enthusiasm for CG reform muted

The PSE revised its minimum public ownership (MPO) rules in 2013 and, more impressively, managed to enforce them. It plans to increase the MPO level to 20%, but there is no fixed timetable for implementation. Not much else has changed. Apart from its annual CG Bell Awards, we see little enthusiasm for CG reform from the PSE.

Philippines still not signed up to IOSCO MMOU

The Philippines still has not signed the International Organisation of Securities Commissions (IOSCO) Multilateral Memorandum of Understanding: it is listed in Appendix B of the document, which means it has committed to seeking the legal authority to enable it to become a full signatory. Even Indonesia has become a full signatory. The Philippines is now the only market in our survey that is not a signatory.

PSE's EDGE company filing system an improvement, but deeper archive would be nice

As noted, the SEC and PSE websites need an overhaul, especially the SEC's. Navigation is difficult, data hard to find, notices and updates often out of date and links frequently do not work. The PSE site is better and its EDGE disclosure system is certainly better than its predecessor. But the corporate filings database does not go back far enough and the organisation of material is sometimes confusing.

Judiciary slowly being cleaned up

Media sometimes under pressure to kill stories

Our scores for the Philippines' legal system improved slightly in this survey, perhaps generously, but we felt higher scores were appropriate since disadvantaged shareholders have been able to access the courts and the judiciary is being slowly cleaned up after President Aquino took on the Supreme Court over former Chief Justice Corona in mid-2012 and won. In contrast, we have adjusted slightly downwards our scores for media freedom and impartiality. Over the past couple of years, we have encountered cases of journalists and editors being paid by companies to spike embarrassing or damaging stories.

Still no ICAC

The Philippines still lacks an independent commission against corruption and there is no sign of one on the way. The government has made some progress in reforming the public sector and earned points on our new question on public governance for its work reforming GOCCs. This resulted in the closure of a number of zombie GLCs and improved reporting lines and CG standards in some others.

IGAAP (accounting and auditing)

Falls from 73% in 2012 to 65% in 2014

Scores in this section fell markedly because of two new questions added to the survey and ongoing weaknesses in oversight of the audit industry.

Accounting standards and practices among large caps are fairly good

Accounting and auditing standards are of a high standard on paper - local standards have largely converged with IFRS, with some exceptions for agriculture and real estate - and accounting practices among large caps are of a fairly high standard. Smaller cap accounts are also generally good, though contain less detail in general. However, small-cap companies employing small audit firms is where audit quality will be most at risk. We continue to hear about instances of some small caps employing auditors to prepare accounts (a story replicated around the region).

Companies must disclose audit and non-audit fees

Audit fees and non-audit fees are generally disclosed over two years (and sometimes proposed for the forthcoming year) thanks to the SEC's ACGR, which requires this disclosure. The SEC's revised Code of Corporate

Governance (2009) mandates audit committees to "evaluate and determine" non-audit work by the auditor, while regulations mandate five-year audit partner rotation.

Lack of an independent audit regulator a concern

Yet the Philippines still has no independent audit regulator. Regulators tried and failed to introduce one in 2011 after the proposal was defeated by small audit firms. We found no evidence that oversight of audit firms, governed by the Revised Accountancy Law 2003 and the 2004 Board of Accountancy rules and regulations, has improved. For example, the Accountant's Information section of the SEC website has no update on its Findings on Financial Statements beyond 2011.

CG culture

Rises from 29% in 2012 to 33% in 2014

Scores rose marginally for CG culture principally as a result of higher scores for improved investor relations and the emergence of an independent minority shareholder body, SharePHIL. The scores are perhaps generous because not much else has changed.

Annual CG reports driving improved disclosure

While disclosure standards among listed companies have certainly improved since our last survey in 2012, once again this is mainly due to the ACGR and is more compliance than culturally driven. Sources in the Philippines told us that many firms were complaining about the additional cost and time involved. However, we are seeing a little more substance in information covering such things as internal control and risk-management systems and remuneration.

Genuine separation in chairman and CEO roles unrealistic

Few Filipino corporations *genuinely* split the chairman and CEO roles. Usually when the roles are separated (as required by the CG Code), the two positions are held by family members or closely connected individuals. Still, to expect anything else at this stage is unrealistic.

New shareholder group, SharePhil, bodes well

While institutional shareholders are not actively engaging with Filipino corporations to any meaningful degree, we are encouraged to note the establishment of SharePHIL. We understand that SharePHIL has plans for active engagement with local companies and will watch its progress with interest. We would also note the solid work being done by the Institute of Corporate Directors in promoting better CG, not only in terms of training, but also in advocacy with local companies.

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

What to avoid

- Any concerted push back from companies on the ACGR system
- No meaningful progress on improving market surveillance and enforcement
- No improvement in disclosure of regulatory enforcement activities
- No progress in establishing an independent audit regulator

Quick fixes

What to fix

- Overhaul the SEC website and improve the PSE site
- Continue great start with ACGR by increasing substantive disclosure
- Tighten disclosure of director dealings
- Improve rules on INEDs and board committee composition
- Improve voting practices at annual general meetings

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Research perspective - Refining CG

We have CG scores for all 41 companies in our coverage. Note that in 2012, we only had 33 companies in our coverage. Additions to our coverage are Del Monte Pacific, D&L Industries, GT Capital, Robinsons Retail, LT Group, Emperador and Lafarge Republic. Average CG score in 2014 hit 39.5 from the 2012 average of 37.9.

A mixed bag of new and old faces

The top quartile consists of 10 companies and these include, in alphabetical order, Aboitiz Power, Ayala Land, Bank of the Philippine Islands, D&L Industries and Del Monte. Note that Aboitiz Power, Ayala Land and Bank of the Philippine Islands were able to maintain their top quartile position in 2014. On the other hand, Del Monte Pacific and D&L Industries were not part of the 2012 survey.

From bad to good

Companies that had CG issues in the past but were able to get into the top-two quartiles are Vista Land, Robinsons Land, Universal Robina Corporation and ABS-CBN. Recently listed LT Group also landed in second quartile. Vista Land defaulted on some obligations some time back but since it re-IPO in 2007, the group has adhered to sound CG practice. Robinsons Land and Universal Robina Corporation are part of the Gokongwei group of companies. In the 1990s, the group was accused of inter-company financial transactions and poor disclosure standards. In recent years, we have seen dramatic improvement in disclosure standards and transparency. Also, the group has scrapped inter-company financial transactions for years now.

Cleaning up their act

ABS-CBN had issues with capital allocation in the late 1990s to early 2000s as it went from a net-cash position to a highly indebted company as it constructed brand new corporate headquarters. There was even a time when cashflows had to be ringfenced in favour of its creditors. Nonetheless, ABS-CBN has cleaned up its act. Its finances are much better nowadays with net-debt-to-equity ratio at 35.5%. There is also better capital allocation wherein an internal rate of return (IRR) of 15% is used as a benchmark in capital expenditure and capital allocation decisions. LT Group is controlled by Lucio Tan who in the past was accused of ill-gotten wealth and tax evasion. To be fair to Lucio Tan, he has proven to be not guilty of both accusations.

CG stars

Figure 124

Philippines: Companies in top-two CG quartiles (alphabetical order)

Top quartile	Code	Second quartile	Code
Aboitiz Pwer	AP PM	ABS-CBN	ABSP PM
Ayala Land	ALI PM	Ayala Corporation	AC PM
Bank of the Philippine Islands	BPI PM	GT Capital	GTCAP PM
D&L Industries	DNL PM	Filinvest Land	FLI PM
Del Monte	DMPL PM	LT Group	LTG PM
GMA	GMAP PM	PLDT	TEL PM
Globe	GLO PM	Pepsi Philippines	PIP PM
Robinsons Land	RLC PM	Robinsons Retail	RRHI PM
Universal Robina Corporation	URC PM	SM Investments	SM PM
Vista Land	VLL PM	Security Bank	SECB PM

Source: CLSA

Biggest jump in CG scores

Figure 125

Companies with significant changes in CG scores (2012-14)

	Chg in CG score (ppts)	2012 quartile ranking
Increase		
Universal Robina	14.1	3
Energy Development	8.4	4
Ayala Land	8	1
Globe Telecom	7.1	1
Jolllibee	7.1	4
Decrease		
Megawide	(23.1)	2
SM Prime	(18.1)	3
Meralco	(9)	2
Phoenix	(9)	4
Philippine National Bank	(9)	2

Source: CLSA

Biggest improvements

Top five companies in terms of increase in CG scores are Universal Robina, Energy Development Corp, Ayala Land, Globe Telecom and Jollibee.

Sold investment portfolio

Universal Robina up 14.1 points. In 1Q13, Universal Robina sold their investment portfolio (23% of equity) which in the past caused huge swings to the bottom line. With the sale, the firm has eliminated controversies/questions over whether share trading by board members, or placements by the company, have been fair, fully transparent and well-intentioned.

More transparent with problematic 130MW BacMan

Energy Development up 8.4 points. The key reason for the increase is better transparency. Specifically, the company has been more vocal and transparent with the problematic 130MW BacMan geothermal power plant. They disclosed what they intend to do with it (permanent fix), the expected timeline and consequent downtime for such. Energy Development Corporation has also been transparent with the rehabilitation of the Unified Leyte, their largest power complex, following the damage from Typhoon Haiyan.

Immediate reporting of shares trading by officers

Ayala Land up 8 points. Note that the company does not have any non-voting common shares and replaced their non-voting preferences and voting preferences. The company has immediately disclosed share trading by its officers and no controversies have arisen surrounding these. Worth noting as well is that the company's annual report is an integrated annual and sustainability report - the report is prepared in accordance with the Global Reporting Initiative's (GRI) G4 framework comprehensive guidelines and complies with the Asia-Pacific Real Estate Association Best Practices Handbook.

Board remuneration has declined

Globe Telecom up 7.1 points. Board remuneration was well below 1% of 2013 net income after tax for Globe Telecom. Compared to the prior year, Board remuneration declined. Another change has been the profile of all members of the audit committee, including independent directors. These individuals all have financial expertise.

Better transparency

Jollibee Foods up 7.1 points. Jollibee has improved significantly in transparency, especially in terms of disclosing major market sensitive information punctually. In addition to this, management has improved its transparency by giving more details on operations, allowing investors to get a glimpse of how revenue growth and same-store-sales growth has improved or

deteriorated for countries outside the Philippines. On fairness, Jollibee's total remuneration of the Board as a percentage of net profit after exceptionals has not increased at a pace faster than net earnings.

Biggest declines

Top five companies in terms of decrease in CG scores are Megawide, SM Prime, Meralco, Phoenix and Philippine National Bank.

Venturing outside core business

Megawide. The firm has not stuck to defined core businesses, venturing into stakes in the projects and became a PPP proponent rather than just sticking to being a construction company. They have also announced a venture into power generation. Megawide no longer provides estimates of its cost of equity and WACC, as well as its ROA/ROE targets. It raised money but kept the cash for a long time on its balance sheet, lowering its ROE. The firm has flip-flopped about whether to consolidate the Mactan-Cebu International Airport project or not - the main point being that if it consolidates, its revenue will be bigger. This suggests that the firm may be very concerned about their share price and how investors perceive them, perhaps to a fault. The company also overguided on its 2013 earnings and then suddenly pulled the chair from under investors when company management quoted a different figure in its annual shareholders' meeting. Access to senior management has been spotty especially after this incident. The company has also had some inter-company transactions surrounding land owned by the majority shareholders; the mode of payment used was Megawide shares, resulting in some dilution.

Diluting story as a key consumption play

SM Prime. The firm transformed from a pure mall operator into an integrated property developer when it merged with SM Development, a transaction that was not very well-received by investors. The deal diluted the story of SM Prime as a key consumption play in the Philippines. This resulted in ownership dilution of about 37.5% and a decrease of ROE from 16% to 12%. Also, inventories jumped from virtually nothing to P3bn. Receivables increased by 450% from P5.88bn to P32.33bn. The company declined to provide its cost of equity and WACC estimates. The company has also declined to provide explicit ROA and ROE targets. The company did not publish its full-year results within two months of the end of the most recent financial year. It was somewhat remiss in announcing its merger - local newspapers came out with the news before the company issued any press release about it and SM Prime only confirmed the merger rumours after the articles on the newspapers were published.

Board remuneration has increased significantly

Meralco. Board remuneration has exceeded earnings over the past five years - 2013 remuneration rose 4x over 2010 level while net income only grew 2x. The number of independent members reduced by one head, from three in 2012 to two in 2013.

Parking some shares at its parent

Phoenix Petroleum. CG score fell by nine points. Phoenix Petroleum's overall fairness score deteriorated when they decided to "park" some shares at their parent after they expanded their authorised capital base. Management decided to do this in order to comply with the SEC mandate that at least 25% of authorised shares should be issued. While the parent did not financially benefit from holding these shares and had already cleared it via an equity placement in mid-2013, the move still put minority shareholders at a disadvantage.

Board compensation has increased significantly

Philippine National Bank. Lower score on fairness given board remuneration in 2013 rose faster than the percentage increase in net income in the past two years.

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Singapore - International or local?

Key issues and trends

- The government and regulators are somewhat ambivalent in their approach to CG reform
- In contrast to Singapore's image as an international financial centre that aspires to be "world class", CG reform is often dictated by local imperatives
- Conflicts of interest more apparent in the dual regulatory and business role of SGX
- Little improvement in, or disclosure of, regulatory-enforcement activities
- Should the securities regulator remain part of the central bank?
- Singapore is still a regional leader in audit regulation, but ACRA powers need strengthening

Overall score falls from 69% in 2012 to over 64% in 2014

Singapore was clearly ahead of Hong Kong in 2012

Singapore topped our CG Watch scoring in 2012, narrowly beating Hong Kong because we concluded that it had had a more successful period of reform in the two years prior to publication. Major strengths included a more consistent focus on CG reform, a far superior audit regulatory system, faster and more frequent financial reporting and a revised Code of Corporate Governance that addressed longstanding problems such as the definition of "independent director". Singapore at the time was on a regulatory roll in other ways too, with major amendments planned for its companies act and the expected arrival of mandatory voting by poll. It also gained points for efforts made by listed companies to vote by poll voluntarily and by retail shareholders to participate actively in annual general meetings (AGMs).

We no longer see any substantial difference between the two markets

This time, Singapore and Hong Kong come equal first, with lower points for both markets but a larger drop for Singapore. On a rounding basis, Hong Kong scores 65% and so may appear to be slightly better than Singapore's 64%. On a two-decimal-place basis, however, the gap is not significant and we have therefore ranked the markets equally. While both markets have their strengths and weaknesses - and indeed reached the same score by quite different routes - we no longer believe either market deserves to be an outright winner.

Singapore's decline in score is due to a combination of factors. Among other things, we believe the government has shown less consistency in its approach to CG policy than previously, at times even appearing somewhat ambivalent. The reform process has often been slower than we expected, while some new regulatory proposals seem rather tentative. In the area of shareholder rights, Singapore perpetuates some outdated rules: a prime example being the 14-day deadline for releasing AGM agendas.

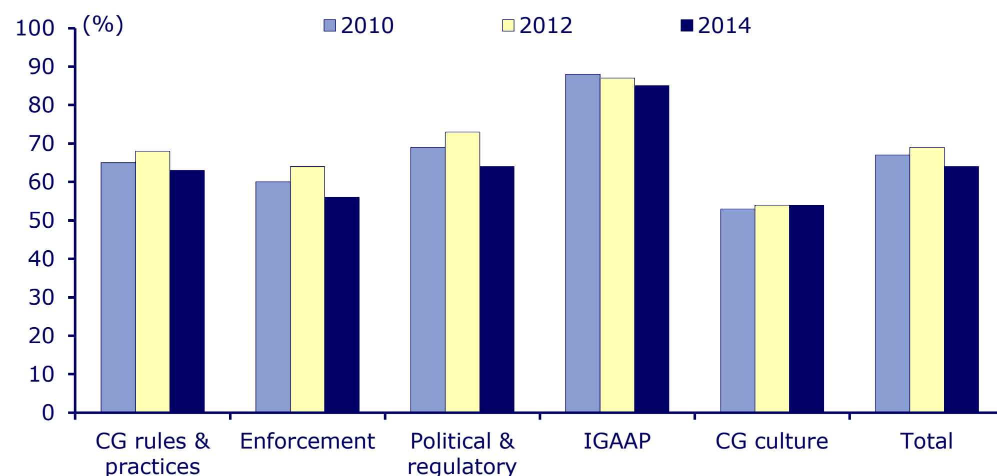
Local imperatives drive CG reform as much as international aspirations

An underlying dynamic of corporate governance reform in Singapore is the need to placate the complaints and fears of a large pool of small listed companies. While the city presents itself as an international financial centre with world-class standards, there is no doubt that business attitudes are often more local than global. This even affects some large firms: when voting by poll was first raised a few years ago, the reaction of some executives was horror at the thought that director-election results would be disclosed. The bigger firms have mostly moved on, but not so many of the smaller ones.

Scores fall in four of five sections

Figure 126

Singapore CG macro category scores



Source: ACGA, CLSA

CG rules and practices

Falls from 68% in 2012 to 63% in 2014

Singapore's score fell in this section for a combination of reasons:

- **Speed of financial reporting.** While Singapore has a number of large firms that report their audited annual accounts quickly - in less than the regional best practice of 60 days - the performance of smaller issuers is less impressive. We were probably too generous in our assessment of SMEs on this question in our last report.
    - An ACGA review of 28 large caps found that 18 companies (or 65%) reported in less than 60 days, while a selective review of 10 midcaps found only three of them did so. Given that the midcaps selected were among the bigger and better in Singapore, it is reasonable to conclude that a larger sample would produce an even lower outcome.
- **Non-financial reporting.** While Singapore's standards for non-financial reporting on basic CG issues are quite extensive (eg, MD&As, reports of directors, CG statements), we pared the score back slightly to bring it in line with Hong Kong (whose standards in this area are certainly not worse) and due to weaknesses in the rules on disclosure of director/executive remuneration and AGM voting results.

Singapore somewhat behind the curve on CSR reporting standards

- **CSR/ESG reporting standards and practices.** Singapore scored lower than some other markets on three new questions in our survey on sustainability reporting. Although the Singapore Exchange (SGX) issued voluntary guidelines on sustainability reporting in 2011, these are still not subject to "comply or explain". While large-cap companies in our sample survey of 10 firms all undertook some degree of sustainability reporting; only four of them were of high standard. The other six were mainly concerned with the philanthropy or community and environmental initiatives, with no attempt to link sustainability initiatives to corporate governance or business strategy. In fact, five of the six had reports of less than 10 pages. Reporting among midcaps was generally even less substantive. (See 'Sustainability reporting in Singapore' for more.)
- **Disclosure of material information**: The general consensus among investors, managers and analysts we interviewed was that disclosure of price-sensitive information in Singapore, even among large caps, is

weaker than Hong Kong. This view is held despite the efforts of SGX to increase the number of queries to companies about continuous disclosure from 333 in FY12 to 405 in FY13.

It was not all bad news. We gave a slightly higher score on whether or not voting by poll was mandatory under the listing rules. While it is still voluntary - and only becomes a rule in August 2015 - the fact is that the number of listed companies doing it is growing. This applies to small and medium-sized firms as well as large ones. It is a reasonable assumption that these firms have decided to implement the listing rule change early, hence adjusting the score upward is fair.

Singapore issued voluntary guidelines on CSR reporting in 2011

Sustainability reporting in Singapore

SGX first issued voluntary guidelines on sustainability reporting in 2011 and expects to move them up to "comply or explain" in future, although a date has not been set. The Monetary Authority of Singapore's Code of Corporate Governance was revised in 2012 to broaden the responsibility of company boards to include sustainability and ethical standards. Energy usage and carbon disclosure is promoted and large companies are required to manage and report on energy usage under the Energy Conservation Act of 2012. In 2013, SGX published an investor guide on sustainability to accompany its existing *Investor Guide to Reading the Annual Report*. SGX has been publishing sustainability reports since 2009.

Sustainability reporting remains voluntary, however. There is little evidence yet of the regulator socialising its policies through training or seminars. There are currently no incentives in place to encourage quality reporting through, for example, awards or sustainability indices - although SGX says it is considering both. (Note: ACCA and some other organisations run sustainability awards).

Four of 10 large caps had a high standard of sustainability reporting

All large cap companies in our review of 10 firms undertook some degree of sustainability reporting. Half of the companies had standalone reports and the other half included a section in their annual reports. Four of the large caps had a high standard of reporting. The other six were mainly concerned with philanthropy or community/environmental initiatives, with no link to CG or business strategies. In fact, five of the six have reports of less than 10 pages and three are only one page! Meanwhile, only four large caps followed the Global Reporting Initiative (GRI), three sought sustainability assurance and two responded to the Carbon Disclosure Project questionnaire.

Six of 10 midcaps in our review reported on sustainability. Four of the six published reports are of good standard although they were very short (only one was more than 10 pages). Only one midcap used the GRI and none sought external assurance. Overall, the mid cap reports were considerably less substantive than those of large caps.

Enforcement

Falls from 64% in 2012 to 56% in 2014

Singapore's score fell in this section because, firstly, it has a more fragmented system of securities enforcement than Hong Kong. In Hong Kong, this work is largely divided between two agencies, the Securities and Futures Commission (SFC) and the of Hong Kong Exchanges (HKEx), with the Commercial Crime Bureau of the Hong Kong Police undertaking a small number of serious and complex commercial fraud investigations. In Singapore, the equivalent work

done by the SFC and HKEx in Hong Kong is split between three bodies: the Monetary Authority of Singapore (MAS), the Commercial Affairs Department (CAD) of the Singapore Police Force and the Singapore Exchange (SGX). This is because, as a securities regulator, MAS is constrained to only having civil-sanctioning powers and, therefore, limited powers of investigation. It cannot launch criminal prosecutions, which it must pass to the CAD.

Action against insider trading is not as tough as in Hong Kong

Secondly, action on serious securities crimes, such as insider trading and market manipulation, is noticeably more low-profile in Singapore than in Hong Kong. Whereas in Hong Kong in recent years, the SFC's enforcement action has resulted in prison sentences as well as hefty fines and other punishments, in Singapore offenders tend to get off with a fine or a fine and some other sanction, such as disqualification as a director. MAS settles most cases of insider trading without going to court.

Consider the following clear-cut case of insider trading from December 2012 that resulted in only fines: Two executives of commodities company, Wilmar International, Goh Ing Sing and Keu Haw Gee, were fined for trading in relation to Wilmar's purchase of a 20% stake in Kencana in 2010. The two bought Kencana shares just ahead of the announcement of the deal on August 10, 2010. Goh and Keu admitted contravening the Securities and Futures Act and paid civil penalties of S$110,000 and S$50,000, to avoid court action. A third employee, Ang Kok Min, was fined in April 2013.

SGX enforcement less vigorous than in 2012

We also gave a lower score for the enforcement performance of SGX. In our last survey, we upgraded SGX for its more vigorous enforcement efforts over 2010-11, including ordering "special audits" of S-chips (mainland Chinese firms listed in Singapore) and reprimanding multiple directors from single companies as well as the companies themselves. However, SGX announcements indicate a sharp decline in regulatory action against listed companies from early 2012 following the China Sky debacle (an S-chip that initially refused to appoint a special auditor). The "Past disciplinary actions" page under the "Regulation" on the SGX website shows that there were only two disciplinary cases in 2013 (only one of which was against a listed company) and one case in 2014.

SGX enforcement data lacks clarity

Other data provided by SGX paint a slightly different picture. The "Statistics" page of its website (also under "Regulation") gives figures for such things as private warnings and public regulatory action - 28 in FY12 and 22 in FY13. Yet these numbers are the total of all cases against listed companies, intermediaries and their representatives. There is no explanation of what the numbers mean, how they break down and no link to the "Past disciplinary actions" page. The statistics also show that SGX issued no fines in 2012 and only one in 2013. Meanwhile, much of its effort went on referring cases of insider trading and market manipulation to MAS. However these referrals also fell noticeably in 2013 compared to 2012. Finally, enforcement data is only provided for two years.

To be fair, SGX is trying to beef up its enforcement powers. In February 2014, following the manipulation of the shares of small caps Asiasons, Blumont and Liongold in October 2013, it introduced a new tool, the "trade with caution" notice that highlights issuers with abnormal share price movements which are not satisfactorily explained. Moreover, as part of an effort to 'reinforce the SGX listings and enforcement framework', SGX will establish three "independent" committees, namely the Listings Advisory

SGX is expanding its enforcement toolbox

Committee, Listings Disciplinary Committee and Listings Appeals Committee comprising members from the private sector. 'They will introduce a wider range of sanctions for breaches of listing rules. These will further strengthen SGX's listings process, improve transparency of its disciplinary process and enhance its ability to enforce the listing rules,' stated an SGX press release. This new structure will be put in place from early 2015 onwards. (While this will no doubt be an improvement on the current system, it is worth noting that SGX has chosen not to adopt the Hong Kong strategy of giving its Listing Committee real decision-making power.)

Meanwhile, MAS is not a particularly active communicator about its enforcement work either. The MAS website has an "Enforcement" page that is quite accessible, but the description of each case is quite short and there are no aggregate enforcement statistics. The MAS annual report for 2012/2013 has just one paragraph on securities enforcement:

> 'Between April 2012 and March 2013, MAS published a total of 56 formal regulatory and enforcement actions against companies and individuals for market conduct breaches. These actions included reprimands, composition of fines, and imposition of civil penalties and issuance of prohibition orders. Over this period, MAS also took other regulatory and administrative actions in another 210 cases.'

Its latest annual report (2013/14) has four paragraphs, but the first three are merely highlights of selected cases. The fourth paragraph is identical to the one above except for new statistics: 'between April 2013 and March 2014, MAS published a total of 43 formal regulatory and enforcement actions against companies and individuals for market conduct breaches . . . MAS took other regulatory and administrative actions in another 159 cases'. There is no comparison with its performance the year before or explanation as to what the fall in numbers means.

Political and regulatory environment

Falls from 73% in 2012 to 64% in 2014

Singapore continues to move forward with a major rewrite of the Companies Act, a process that has been ongoing for several years. In October 2012, the Ministry of Finance (MOF) announced comprehensive changes to the Act, then followed this in May 2013 with the first of two public consultations on the draft Companies (Amendment) Bill 2013. The draft Bill aims to 'reduce regulatory burden and compliance costs, provide greater flexibility for companies and improve corporate governance', according to a press release from the Accounting and Corporate Regulatory Authority (ACRA), which is coordinating the Bill with the MOF. The overarching objective of this review is 'to build on an efficient and transparent corporate regulatory framework that supports Singapore's growth as a global hub for businesses and investors' (ACRA website).

Positive governance-related proposals - both defensive and proactive - in the draft Bill cover such things as:

- Maintaining the current rule on automatic disqualification of directors for fraud and dishonesty, rather than creating a 'disqualification order regime where an application has to be made to Court specifically to disqualify a director';
- Reducing the threshold for calling for a poll from 10% to 5% of total voting rights;

- Introducing "multiple proxies" to empower custodian bank nominee companies and other persons providing custodial services to appoint more than two proxies (the current rule) to shareholder meetings (see below for more analysis);
- Maintaining the rule that the cost of convening a requisitioned extraordinary general meeting is to be borne by the company (some said the proposed = cost should be shifted to requisitioning shareholders).

Some aspects of the new Companies Bill are disappointing

The Companies Act was enacted in 1967 and last reviewed in 1999. Hence, the latest review is a significant development. In some areas, however, the draft bill is disappointing and is unlikely to advance corporate governance. For example, the government stepped away from codifying directors duties (as is the case in the UK) and plans to remove the existing "one share, one vote" restriction on public companies, thus permitting them to issue non-voting shares as well as shares with multiple votes - a reform that may lead to dual-class shares listing on the SGX one day. The new law will also exempt small private companies - those with annual revenue and/or total gross assets of not more than S$10m, or not more than 50 employees - from statutory audits. Apart from the fact that these thresholds are quite high, we believe the annual audit is critical for driving accounting discipline in small limited liability companies. Eliminating it is unlikely to help these companies develop sound corporate governance.

Singapore's overall approach to CG reform shows signs of inconsistency

Despite the positive aspects of the draft companies bill, Singapore lost (or failed to gain) points overall in this part of our survey for the following reasons: the bill has yet to be passed and we do not give points for work not yet complete; we believe the government has a less clear and consistent CG policy compared with two years ago; we see some structural problems in the financial regulatory system; SGX earned fewer points for its listing rule reform efforts; and the SGX website is not as comprehensive as it could be in providing corporate reports and announcements.

Growth versus quality

Just as Hong Kong is struggling with finding a balance between "market competitiveness" and sound CG regulation, so too is Singapore. The debate may be more muted, with battle lines less sharply drawn, yet entrenched interests clearly influence policy just as they do in Hong Kong.

CG reform in Singapore is often surprisingly slow

One indicator is the often slow pace of reform in Singapore. While Hong Kong mandated voting by poll in 2009, Singapore did not consult on it until mid-2011. The rule change was not announced for another two years, July 2013, while implementation will be delayed until after August 2015 (ie, after most issuers have had their AGMs for the year, meaning a 2016 effective date for those with December year-ends). Given that the counting of votes at shareholder meetings is one of the simplest actions a company can do to enhance its governance practices, the opposition to this reform in Singapore from smaller issuers does not say much for their commitment to CG or their organisational competence.

Another reform ACGA has been following closely is the amendment to the Companies Act allowing "multiple proxies". In practice, this means that minority shareholders whose shares are held indirectly (ie, through nominee companies of custodian banks) attend AGMs and extraordinary general meetings (EGMs) and enjoy the full rights of a shareholder. By default, Singapore's old company law allows each registered shareholder to appoint

only two proxies each, meaning that a custodian bank with domestic and foreign institutional investors as clients can send no more than two proxies to any company meeting. This therefore limits the ability of fund managers to attend shareholder meetings.

Obstacles to fund managers attending AGMs will soon be removed

While we very much welcome the multiple-proxy amendment, it is not unfair to say that it has been slow in coming. ACGA and a group of sub-custodian banks raised this problem in a detailed paper in October 2007, after which it was put on the agenda of a steering committee reviewing the Companies Act (which fortuitously began its work the same month). The committee submitted its final report to the MOF in April 2011, following which the MOF announced its conclusions, as noted, in October 2012. By the standards of company law reform, this is not especially slow. But the fact is that other jurisdictions in Asia have acted more quickly on similar issues: Malaysia solved the same problem in early 2012 by amending its listing rules.

SGX faces a conflict of interest in its dual role

The conflict between business and regulation is perhaps most marked in Singapore in the dual role of SGX as a for-profit company and a frontline enforcer of the listing requirements. A look at SGX's active news releases on business progress, its annual report largely devoted to business issues and a website that carries advertisements, suggest an organisation more interested in growth than regulation. We are not suggesting that SGX is undertaking no regulatory reform - over the past two years it has mandated voting by poll, announced changes to its regulatory structure, and started using its "trade with caution" warning system. Yet these positives have to be put in context: a slowish pace of reform and considerably less effort invested in enforcement. If SGX's role as a frontline regulator was as effective as possible, why does MAS not publish its annual review of the Exchange's performance (as happens in Hong Kong with the SFC review on HKEx)?

Perhaps time to reconsider the role of MAS

A more unusual aspect of Singapore's political and regulatory environment is the fact that one institution, MAS, encompasses the duties of a central bank, financial services regulator (banking, insurance, asset management) and securities commission. We have some doubts as to whether such a structure is the most effective long-term solution for Singapore's growing international financial centre.

As noted earlier, MAS' powers of enforcement are more limited than other securities commissions around the region. Secondly, one often feels that securities regulation is a lower order priority for the Authority, as its low-profile approach to enforcement suggests. Most importantly, a separate securities commission would have to have a larger budget, more senior level staff, and, if combined with the relevant division from the CAD, would have considerable clout to address fraud and malfeasance in the capital markets. Such a structure would do more to enhance investor confidence in Singapore than the status quo.

IGAAP (accounting and auditing)

Falls from 87% in 2012 to 85% in 2014

As the score suggests, not a great deal has changed in our assessment of accounting and auditing in Singapore since 2012. Accounting practices among the larger firms are clearly superior to smaller issuers, while the same contrast is seen in the quality of auditing. An annual review undertaken by ACRA indicates ongoing weaknesses in firm-level quality-control systems and audit engagements.

CPA firms improving quality controls, but with varying degrees of commitment

ACRA's 2013 Practice Monitoring Programme (PMP) report highlights 'commendable improvements' made by CPA firms in enhancing their quality control systems, yet also notes that each firm is moving at its own pace and with varying levels of commitment. As for its inspections of audit engagements, ACRA found particular deficiencies in cashflow forecasts and audits of inventories in 2013. Meanwhile, key findings from its 2014 PMP report highlight problems with revenue recognition, accounting estimates and fair value measurement and group audits.

Interestingly, the concentrated structure of the audit industry in Singapore implies that these problems should be easier to resolve than in most other Asian markets. The city has a mere 18 CPA firms undertaking listed-company audits - compared to around 50 in Hong Kong - while the dominance of the Big Four is high: they did 62% of listed-company audits equalling 76% of market cap as of December 2013 (a drop in market cap terms from end-2012, but still high).

ACRA one of the best audit regulators in Asia . . .

We continue to believe that ACRA is one of the best independent audit regulators in Asia. It is certainly one of the oldest: it was formed as a statutory body in April 2004 and has jurisdiction over both the Companies and Accountants Acts in Singapore. Its PMP programme is now in its eighth year, it is enhancing its Financial Reporting Surveillance Programme by reinforcing the responsibilities of preparers and directors in the preparation of accounts and it is seeking to improve its risk-based inspection programme of auditors.

In the area of company-law reform, ACRA has shepherded through an amendment that we believe could be significant for governance and auditing integrity: any auditor of a "public-interest" company wishing to resign must seek the prior consent of ACRA. Time and again, auditors, like independent directors, resign from companies with problems. While understandable from a business point of view, this leaves shareholders at more risk and does not seem entirely fair.

. . . but it needs more power

However, our score for this section has dipped slightly because in one area - enforcement - ACRA now compares less well to its nearest competitors, Malaysia and Thailand. Although the Authority can discipline individual auditors through its Public Accountants Oversight Committee - and it does strike off or suspend auditors for non-compliance with standards from time to time - it lacks the power to sanction CPA firms. An amendment to the Accountants Act will give ACRA these powers, but the passage of the new legislation, originally expected this year, has been delayed to the last quarter of 2015 or thereabouts.

CG culture

Stays the same - 54% in 2012 and 2014

Most of the questions in this section of our survey earned exactly the same score as in 2012. Singapore continues to be characterised by either a culture of compliance among listed companies with regards to CG rules or, not surprisingly, a refusal to comply to some, but without detailed explanations as to their reasons. A survey of 25 mainboard-listed companies and 25 second-board Catalist companies released on 29 April 2014 by Singapore's *Business Times* (BT) identified several areas in which many companies had chosen not to comply with provisions of the revised CG Code of 2012 and which came into effect for annual reports from this year.

While almost all companies surveyed by BT complied with the one-third independent director requirement, few companies chose to provide limits on the number of other directorships their board appointments could hold. Only 12 of 50 companies surveyed set and disclosed such a limit, while 30 companies chose not to set limits at all, explaining that blanket limits were not as effective in their view as undertaking individual assessments. A number of companies provided insufficient explanation as to why they considered their independent directors still independent after having served for more than nine years.

Singapore firms are reticent about disclosing director and CEO pay

Many companies are reticent about disclosing pay. A survey of 100 listed companies released in March 2014, undertaken jointly by the Singapore Institute of Directors (SID) and Singapore Exchange, found that 68% of respondents had no intention of complying with the new CG Code requirements to disclose individual board and CEO remuneration. The most popular reasons cited were confidentiality (81%) and poaching fears (50%).

The BT survey, cited above, also found weak disclosure on executive remuneration. While the Code stipulates that companies should identify individual remuneration on a named basis within the nearest S$1,000, just 64% of mainboard-listed companies and only 24% of Catalist companies surveyed chose to comply.

The one undiluted bright spot on the Singapore corporate CG horizon is voluntary voting by poll. While a majority of large caps have been doing it for a few years, it is now catching on among other issuers. We found that four of 10 midcaps we reviewed voted by poll in 2014, while seven of 20 randomly selected small caps did so as well.

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

What to avoid

- ❑ Any delay in the passage of the revised Companies Act
- ❑ Any further delay in the passage of amendments to the Accountants Act
- ❑ No improvement in regulatory enforcement and disclosure
- ❑ No attempt to ensure high-quality disclosure from companies choosing not to comply with the provisions of the Code of Corporate Governance
- ❑ No improvement in the level of engagement in CG by domestic institutional investors

Quick fixes

What to fix

- ❑ MAS releases the findings of its supervision of SGX
- ❑ SGX fixes its website pages on company reports/announcements
- ❑ SGX archives company reports/announcements for 10 years (HKEx and Bursa Malaysia archive for 14-15 years!)
- ❑ Extends the deadline for release of final AGM agenda to at least 21 days

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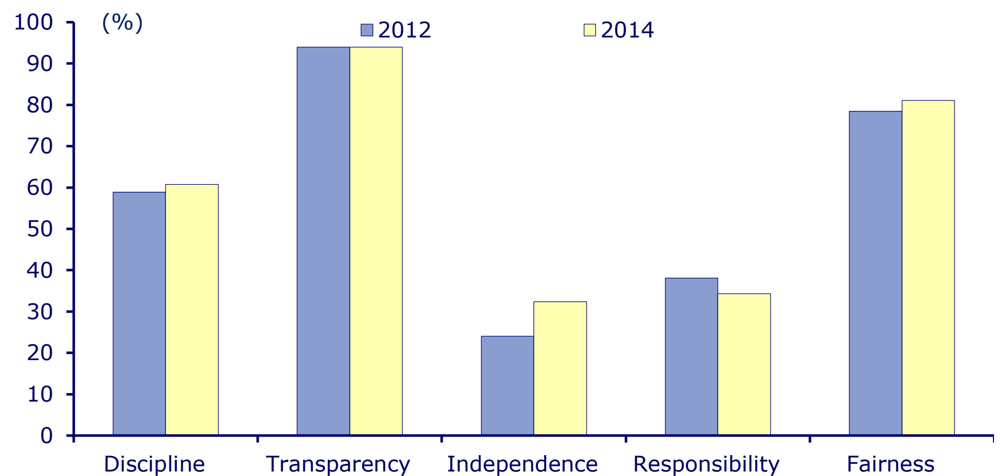
Research perspective - Stable performance

Singapore companies under our coverage have seen a slight increase to their CG scores of 1.6ppts on average since our last survey in 2012. Inclusive of the new environmental & social (E&S) category for this year's scoring, the average score of Singapore companies at 59.9% is in the top three of our Asia-Pacific markets inclusive of Australia. Hong Kong firms under our coverage did slightly better in E&S and also in the responsibility category. The 2.5pt difference in the average CG scores for the two financial city-states do not reflect a material difference. The average CG score of companies in the two financial cities at approximately 60%, reflecting much better CG than typically found in the rest of Asia, where the average CG score is 51% for companies under our coverage in the rest of the region.

Singapore's CG scores have seen slight improvement

Figure 127

Changes in Singapore's aggregate CG scores



Note: Based on only stocks in *CG Watch 2012*. Source: CLSA

More disclosure of ROA and ROE targets; less family involvement

Where companies did seem to improve was on the appointment of more independent directors which was apparent in a number of companies. We saw more disclosure of ROA and ROE targets and family involvement in board composition also reduced.

Companies like Sembcorp Marine which appointed more independent directors saw a big improvement. We also note the banks too saw improvement, but much of this was due to their compliance with Basel 3 regulations which has forced the banks to increase their estimated cost of equity. CREIT also saw some improvement on the back of increased deal diligence and the elimination of non-accretive deals. They also increased the number of independent directors.

Overall companies not getting a better score in independence

While we saw some selected examples of companies appointing more independent directors, overall we did not see companies getting a better score on our independence category. We also saw Singapore corporates generally decline in terms of growing cash piles which reduced ROE targets. Disclosure of time sensitive information emerges as an issue for some firms.

While accounting standards in general are higher in Singapore, enforcement of stock market rules and regulations remains an issue. Over the last six months, Singapore has seen a number of stocks perform very well ahead of the release of price sensitive information. The stock exchange and the MAS

continue to explore ways to handle these issues, but have introduced "trade with caution" warnings to flag abnormal share-price movements and protect shareholders. The SGX has also introduced three new independent committees, which will include private-sector members, to better screen new listings and handle disciplinary actions.

Need more disclosure on management and board-member remuneration

While we applaud the progress in these areas, we continue to be underwhelmed by some of the disclosure required, particularly as it pertains to the disclosure of management and board-member remuneration, which we view as a significant issue as essentially the owners of a company (the shareholders) do not know what management is getting paid.

The other area where we remain disappointed is on various CSR and ESG measures. While the SGX has issued guidelines, companies are not required to disclose their sustainability measures or explain why they have not complied. In addition, we also find that many CSR reports are quite limited and simply highlight philanthropic and community initiatives instead of embracing the true spirit behind CSR and ESG reporting.

Slight increase in overall company CG score

Figure 128

Singapore: Companies in top-two CG quartiles (alphabetical order)

Company	Code	Company	Code
Ascendas	AREIT SP	NOL	NOL SP
Ascott RT	ART SP	OCBC	OCBC SP
CapitaLand	CAPL SP	Raffles Medical	RFMD SP
Ezion	EZI SP	Sembcorp Ind	SCI SP
FCL	FCL SP	Sembcorp Marine	SMM SP
FCT	FCT SP	SGX	SGX SP
First Resources	FR SP	SIA	SIA SP
Keppel Corp	KEP SP	SingTel	ST SP
KrisEnergy	KRIS SP	StarHub	STH SP
M1	M1 SP	UOB	UOB SP
Mapletree Log	MLT SP	Vard	VARD SP
Noble Group	NOBL SP		

Source: CLSA

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Taiwan - Bold steps

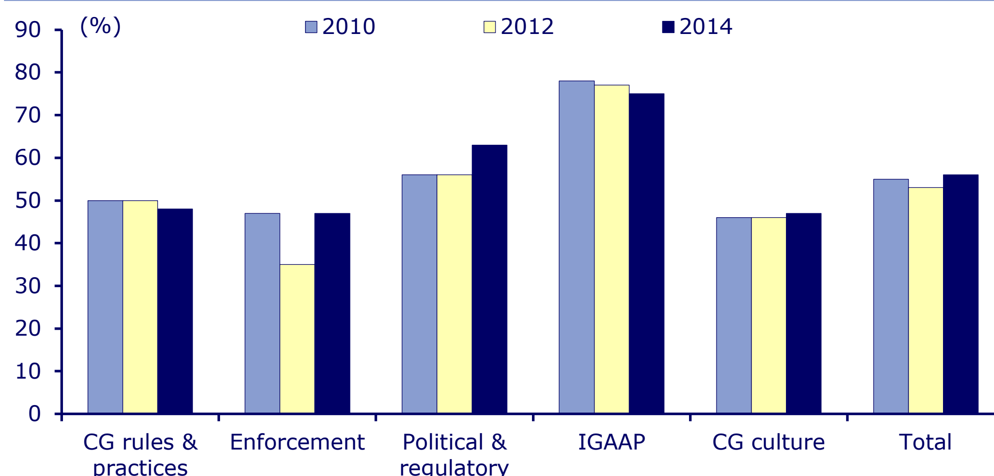
Key issues and trends

- Government recommits to reform with new five-year CG Roadmap
- Independent directors become mandatory for all listed companies
- Mandatory audit committees phased in
- Disclosure on regulatory enforcement improves, but still weak
- TWSE launches new Corporate Governance Center
- Electronic voting and voting by poll take off in a big way
- Good governance is an alien concept to many listed companies

Overall score rises from 53% in 2012 to 56% in 2014

Figure 129

Taiwan CG macro category scores



Source: ACGA, CLSA

CG policy moves from piecemeal to bold

After more than a decade of gradualist and piecemeal reform, Taiwan has taken some bold steps over the past year to enhance its corporate governance regime. It launched a major policy initiative, the CG Roadmap 2013, bitten the bullet on mandating independent directors and audit committees and has heavily promoted its electronic voting system StockVote, leading to an explosion in the number of companies voting by poll. It also plans to sort out its cumbersome director-nomination system, has made some improvements to the way annual general meetings are organised and is trying to improve the disclosure of its enforcement activities.

Taiwan has responded strongly to criticisms of its CG regime

All in all, it has been a highly productive couple of years for Taiwan. Probably more than any other Asian market, it has responded actively and specifically to the many issues we highlighted in our *CG Watch 2012*, which led to downgrades in both score and ranking. As a result, its overall score has risen three percentage points in this biennial survey to 56%, a good outcome given the systemic nature of our survey, meaning it is hard for any market to shift up or down more than a few points in any two-year period.

Tough competition from other markets means Taiwan's ranking does not change

However, Taiwan's ranking remains unchanged at sixth place for two basic reasons: ongoing areas of weakness in its CG system and tough competition from other middle-ranking markets. The unfortunate reality is that the markets Taiwan is competing against and which it could potentially bypass in ranking, have also been working hard to improve or maintain their standing.

The scores of two of them, Japan and Malaysia have risen, while the third, Thailand, has stayed steady at 58%. The challenge for Taiwan over the next two years is to maintain the momentum of its recent reform efforts and deepen the implementation of good CG practices.

CG rules and practices

Falls from 50% in 2012 to 48% in 2014

It may seem odd that Taiwan's score has not risen in this category given the numerous changes it has made in corporate governance regulations. The explanation is simply that while scores have indeed gone up in certain areas, they have fallen in others. Furthermore, we introduced three new questions in this survey on policies and practices regarding sustainability reporting, with Taiwan underperforming in two of them. Another factor was that a large part of the recognition we have given Taiwan for its regulatory and policy efforts is reflected in the Political and Regulatory Environment section of this survey.

The principal changes Taiwan has made to its CG rules include the following:

Taiwan has taken a phased approach to introducing independent directors - but they are finally mandatory

- **Independent directors.** These are now mandatory for all listed companies. While other Asian markets (except Japan) brought in independent directors in one go more than 10 years ago, Taiwan took a gradualist approach; first mandating them for newly listed companies, then large companies with a paid-in capital of NT$50bn or more and public financial institutions from 2006, then all companies with a paid-in capital of NT$10bn or more from 2011. For such companies, the rule was a minimum of two independent directors and no less than one-fifth of board seats. Around 62% of Taiwan's 1,464 listed companies (as of September 2013) adopted independent directors as a result. On December 31, 2013, the Financial Supervisory Commission (FSC), the peak financial regulator in Taiwan, issued a rule stating that all listed companies were required to have independent directors from 2015.

Audit committees will be further phased in over 2015-17

- **Audit committees.** These were previously voluntary in Taiwan for most listed firms (although the regulator had the power to direct certain companies to adopt them). Most companies could in effect choose between having an audit committee and continuing with their traditional "supervisors". Not surprisingly, most chose the latter. Then in February 2013, the regulator required all companies mandated to adopt independent directors in 2006 (ie, financial institutions and larger listed firms) to set up audit committees as well. This led to around 13% of listed companies forming audit committees. The rule now is that firms with paid-in capital of NT$10bn or more must establish audit committees from 2015, while those with NT$2bn to less than NT$10bn have to do so from 2017. Given that the supervisor system is not seen as a particularly effective governance model, the requirement for audit committees should enhance CG in Taiwan over time. Of course, much will depend on the quality of independent directors chosen and whether companies and their controlling shareholders allow audit committees to function properly.

AGM shenanigans will be harder with a new rule on shareholder services

- **Shareholder services.** As a result of problems in the management of annual general meetings (AGMs) in recent years, most notably surrounding the China Petrochemical Development Corporation (CPDC) meeting in June 2012, the regulator now has the power to force issuers to appoint a third-party agent to handle shareholder registration at general meetings. The problems at the CPDC meeting started the day before

when management changed the order of the agenda to bring forward a vote on new directors and then made it difficult the next morning for shareholders to get into the venue.

As a result, the FSC issued several amendments to the Regulations Governing Public Companies' Administration of Shareholder Services in April 2013, stating that listed companies which wished to handle shareholder services in-house must have a resolution passed by their shareholders and apply for approval from the Taiwan Depository and Clearing Corporation (TDCC). Another important change stated that any shareholder who has held 3% or more of outstanding shares for one year or longer may apply to TDCC to have a third-party shareholder services agent appointed on his behalf if there is concern that in-house handling of shareholder services may harm shareholder rights.

Rapid expansion in electronic voting as large firms mandated to use it

- **Electronic voting**. Taiwan was one of the first markets in Asia to develop an electronic voting (e-voting) system, which in theory allows shareholder votes to be transmitted to listed companies more efficiently and minimises bottlenecks in the voting chain. However, the takeup was painfully slow until the regulator began mandating its adoption in 2012, leading to 82 large firms taking it up in that year and 114 the following year. The net was again widened in 2014 to cover more than 200 companies in total.

Taiwan is fixing its opaque director nomination system

An important reform in the pipeline relates to what is called the director nomination system. The financial regulator has proposed an amendment to the company law that would require companies mandated to have electronic voting to also adopt a transparent and fixed system for director nomination. While this may seem a fairly dull reform, it is in fact critical to making director elections more transparent and ensuring e-voting works properly. Currently, shareholders complain that they do not always get full information on the names of directors nominated for election at AGMs, while e-voting cannot work properly if there is not a clear and final agenda, including director nominees, fixed well before the meeting. This problem tends not to affect the top 200 listed firms, but smaller and mid-sized issuers.

Taiwan CG now more in line with developed Asia

Despite these many positives, it is important to note that most of them - with the exception of e-voting - essentially bring Taiwan into line with other Asian markets.

Taiwan's score suffers on CSR reporting quality, speed of financial reporting

Taiwan's score, meanwhile, suffered on a number of counts. Three new questions on sustainability reporting saw Taiwan's rate well on one (relating to the existence of CSR/ESG reporting requirements for listed companies) and poorly on the other two (relating to the quality of such reporting among large and small/midcaps). Points were also lost for the speed of financial reporting, with most of the large and midcaps we reviewed not meeting the 60-day regional best practice for audited annual financial statements. The fastest reporters in our sample included TSMC, Taiwan Mobile and Far EasTone - all rate well against regional benchmarks. Smaller issuers are slower on average than the larger ones.

Some antiquated rules still exist

A further factor holding down Taiwan's score is the regulatory system's high degree of resilience to change in certain areas. In contrast to virtually every other market that requires prompt disclosure of substantial ownership stakes once they reach 5%, in Taiwan the rule is still 10% within 10 days.

TWSE began promoting CSR reporting in 2008

Sustainability reporting in Taiwan

In 2008, the Taiwan Stock Exchange (TWSE) required all listed companies to include CSR reporting in the corporate governance statements of their annual reports and prospectuses. In 2010, TWSE and Gretai Securities Market (GTSM), a board for smaller high-growth companies, jointly released the Corporate Social Responsibility Best Practice Principles and made them applicable to TWSE/GTSM-listed companies on a "comply or explain" basis. TWSE has engaged the CSR community in the development of its guidelines and has hosted several educational forums. Its CSR code is being updated to recommend third-party assurance.

New CSR code of best practice due soon

TWSE does not currently promote carbon disclosure, but will be releasing an updated set of CSR Best Practice Principles this year, which will advise listed companies to disclose direct and indirect greenhouse gas emissions.

Large cap reporting on sustainability not impressive

An ACGA review of large-cap corporations found that nine out of 10 reported on sustainability, but only two of the reports were strategic in nature. The quality of English in these reports was often difficult to understand and much of the disclosure read like box-ticking. Some reporting was confined to a table with headings taken from the regulator's reporting requirements, with another column stating how they were fulfilling those requirements. Much reporting was largely philanthropic. Only one large cap followed the Global Reporting Initiative (GRI) framework and only one sought external assurance.

Midcaps even worse

A review of 10 midcaps found only five had sustainability reporting in English and most of it was tokenistic and philanthropic in nature. Reports were only one to two pages in length. One of the midcap reports was surprisingly good and strategic in nature - a diamond in the rough.

Enforcement

Rises from 35% in 2012 to 47% in 2014

This category shows the biggest improvement in Taiwan's score in our survey, the result of a combination of factors: the efforts of regulators to address disclosure problems we highlighted in 2012 (when we found various holes in regulatory enforcement data), some more effort being made on enforcement by regulators and more engaged "private enforcement" by minority shareholders. The score is now back to where it was in 2010, not especially high compared to other markets but moving in the right direction.

Administrative penalties on the rise

Statistics provided to ACGA by the Securities and Futures Bureau (SFB), one of four bureaus under the FSC, show that administrative penalties stayed steady over 2011 and 2012 at 148 and 146, then increased slightly to 154 in 2013. Most of the breaches were in "shareholding filings", followed by "financial report related" and thirdly, "other CG related".

Coordination between government agencies growing

Since the SFB does not have the jurisdiction to prosecute criminal cases on its own, it must pass cases covering such things as insider trading, market manipulation and fraud to the Investigation Bureau of the Ministry of Justice (MOJ). The SFB says that it is making greater effort on enforcement through more rigorous auditing of evidence, assistance and guidance from prosecutors and the MOJ and more help from whistleblowers. Coordination between the relevant government departments on investigations is improving, according to the SFB, while the establishment of the agency against corruption in July 2011 has helped root out problems too.

New MOJ section to handle corporate fraud prevention

In other enforcement news, in July 2014, the Investigation Bureau established a new section to deal with corporate fraud prevention and corruption, an issue the government recognises that causes significant social and economic damage. According to the MOJ, the main focus of the bureau has been on share price manipulation, insider trading, hollowing out of company assets and staff accepting kickbacks or undue commissions. Since September 2006, the bureau has solved 670 enterprise corruption or bribery cases amounting to about NT$286bn, according to MOJ data. Some of these cases were referred to the bureau by the SFB.

TWSE staff numbers on monitoring and surveillance increase

The Taiwan Stock Exchange (TWSE) has also been enhancing its efforts in enforcement and corporate governance. In addition to setting up a new corporate governance department in March 2014, with staff relocating from the listing department as well as some new recruits, the TWSE has increased its overall staff numbers in monitoring, surveillance and corporate governance by 18% since 2012. The majority (70%) of these staff have expertise in accounting and law and half of them are accountants or lawyers. New recruits account for 25 out of 27 additional staff.

TWSE issues fines for violations of material information disclosure regulations

In terms of actions taken on enforcing its listing rules, the TWSE has, among other things, forced restatements of accounts as part of its ongoing reviews of financial reports, issued 70 monetary sanctions amounting to more than NT$7m for violations of material information disclosure over the past two years and labelled firms as "attention securities" if there are abnormal changes in stock prices or trading volumes. Indeed, each month the TWSE typically issues multiple announcements on abnormal stock price movements and several fines (albeit quite small amounts in most cases) for disclosure breaches.

More English language material on the TWSE website would help

As for quality of information disclosure, the Chinese-language websites of the financial regulators are quite informative in disclosing information on enforcement actions, especially the TWSE which provides about five years' data on penalties for violating material information disclosure and more than 10 years of archives on attention securities. However, much less information is available in English. While full translation of all actions may not be necessary at this stage, an analysis and detailed summary of key enforcement trends in English would be helpful.

Minority shareholders gradually becoming more active . . .

Meanwhile, evidence suggests that private action to stimulate better governance is gradually rising in Taiwan. New data from polls taken at AGMs shows that voting against is quite widespread, while anecdotal information from foreign institutional investors indicates a strong and deepening interest in voting there. A few of them are even attending annual meetings, most notably the Hon Hai AGM in June 2014 prior to which a group of foreign funds wrote an open letter to chairman Terry Gou.

. . . but not domestic pension funds

The extent to which domestic institutions are voting against is harder to judge. Few of them have made any name for themselves as corporate governance advocates and state pension funds are especially quiet. One explanation for the unusually high number of abstentions seen at AGMs in Taiwan - 10% to 17% of total votes is not uncommon - is that domestic pension funds attend but do not vote, according to some custodian banks we interviewed. Why attend in that case? Because the rules in Taiwan say that any shareholder with more than 300,000 shares must be represented at the meeting as a measure to ensure quorum requirements are met.

Political and regulatory environment

Rises from 56% in 2012 to 63% in 2014

The launch of the CG Roadmap 2013 last December could prove a turning point in the Taiwan government's approach to corporate governance. For the first time in about a decade - at least since the formation of the Corporate Governance Reform Task Force in January 2003 - Taiwan has an ambitious and overarching state policy that sets out goals and timelines for reform. The document starts well by candidly admitting what is wrong with CG in Taiwan - a weak culture of governance among companies, conflicts of interest at the board level, inadequate involvement of domestic institutional investors (they 'rarely exercise voting rights and extend their influence'), regulatory enforcement that could be much more effective and transparent and a box-ticking approach among listed companies to financial and non-financial reporting.

Five-year CG Roadmap could be a turning point for Taiwan CG

The roadmap goes on to outline a vision and five-year strategy for addressing these issues that includes ideas for shaping a better culture, promoting shareholder activism, increasing board capabilities, disclosing material information and strengthening regulation. Some of the more specific plans - in addition to the new rules on independent directors and audit committees - include a new Corporate Governance Center (already set up) under the TWSE, a stock exchange-led CG evaluation system and expanding electronic voting. In a more general sense, the regulator wants also to improve non-financial information disclosure, integrate disclosure of transaction irregularities and law-breaking information and strengthen protection of shareholders' rights.

Little overt resistance to reforms

While one hears grumbles about the Roadmap and the increased costs it will impose on smaller and medium listed companies, it is significant that there has been no broad resistance from the business community such as occurred in the mid-2000s when Taiwan first tried to mandate independent directors. It would appear that the government now has the political will to drive through these reforms. Our concern now is whether this effort is sustainable.

One other area where financial regulators have made improvements is in the English-language disclosure of basic laws, regulations and other rules. In 2012, we noted how difficult it was to search legislation of any length, since there was usually no detailed contents page or index, nor any internal html links from the contents page to different sections of the law. To find a specific rule, especially something obscure, one needed to trawl through an entire document to find what you were looking for - an extremely tedious process. Today it is much easier, as major laws have detailed contents pages with html links. The online version of the Securities and Exchange Act, for example, now offers a list of all 183 articles and links to each of them.

IGAAP (accounting and auditing)

Falls from 77% in 2012 to 75% in 2014

Taiwan lost points in this section because the transparency and quality of its independent audit regulatory system is not up to par with other markets. While the FSC takes responsibility for audit regulation, little information is available on how it carries out inspections of CPA firms and their audit engagements. The regulator produces no separate annual report on its activities - unlike Japan, Malaysia, Singapore and Thailand - and the 2012/13 annual report (English version) of the FSC contains only a short statement on the subject: 'The FSC inspected audit quality at six small-and-medium-sized audit firms and also checked the quality of services provided by 38 small- and-medium-sized audit firms to assist companies with IFRS adoption, so as to spur audit firms to make more efforts to improve audit quality.'

Taiwan accounting standards in line with IFRS

However, Taiwan recovers points on accounting standards: As of 1 January, 2013, IFRS became mandatory for listed companies and financial institutions supervised by the FSC. All other public companies must follow them from 2015. One issue still under discussion is whether unlisted firms should be required to follow IFRS for small and medium enterprises.

Fewer small CPA firms doing listed company audits in Taiwan than other markets

Higher points were also given for the quality of auditing in both larger firms and midcaps. Since the Big 4 account for more than 90% of all listed-company audits in Taiwan, the market does not appear to suffer quite as much as other Asian jurisdictions from the small and inexperienced CPA-firm problem. Nevertheless, with little independent analysis forthcoming from the audit regulator, this conclusion may be generous.

CG culture

Rises from 46% in 2012 to 47% in 2014

As the score implies, we do not see any drastic change in the depth and breadth of CG culture in Taiwan. It is still early days, however, in the government's new CG Roadmap and the TWSE's new corporate governance evaluation system; these measures will take time to have an effect.

E-voting causing an explosion in polls

Interesting changes are afoot, as noted, in the spread of e-voting in Taiwan. Following a few years in which the numbers of firms voting by poll edged up incrementally, the mandatory adoption of StockVote by around 200 large issuers appears to have produced genuine polls among most if not all of them. Not only are the proxy votes cast before AGMs counted by the system, but companies are counting votes in meetings of shareholders who attend (by paper "ballot"). This always used to be the case for director and supervisor elections, but has now spread to other resolutions.

Without mandatory e-voting, polls would be more limited

Without wanting to detract too much from this positive result, it is understood that only around 16 of the current 208 firms using StockVote signed up voluntarily. Therefore, without mandatory e-voting, the extent of voting by poll would be much reduced.

TWSE trying to drive improvements in CG culture

Meanwhile, TWSE has brought in several measures to encourage the deepening of CG culture in Taiwan. In March 2013, it announced that, as part of an ongoing enhancement of its Corporate Governance Best Practice Principles, it would incorporate the concept of gender equality into the Principles. While the new guidelines would not be mandatory or enforced, TWSE hopes to encourage listed companies to take the matter of gender equality into consideration when appointing directors in order to bring Taiwan in line with the international trend towards greater numbers of women in senior positions.

TWSE running workshops for directors and firms

TWSE is also seeking to socialise better governance through workshops for independent directors and seminars on its new CG evaluation system and is planning a new index based on the evaluation system. Its new CG Center meets quarterly to review the work of its CG department and keeps up-to-date on international trends.

Government still drives cultural change

Paradoxically, Taiwan is a market where the government effectively has to drive improvement in CG culture among companies. The marker of real change will come when companies pick up the baton for themselves.

Downgrade watchlist

Factors that could force the country's score to fall in 2016:

What to avoid

- Any sign that the current reform momentum is losing steam
- Lack of progress on regulatory enforcement, including disclosure of enforcement actions
- No improvement in the quality of audit regulation
- No progress in voluntary CG reform by companies

Quick fixes

What to fix

- Encourage listed firms to provide more material in English
- Make the director-nomination system mandatory
- Encourage earlier AGMs
- Change the rule on disclosure of substantial ownership

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Research perspective - Rising enforcement

Our previous CG Watch 2012 discussed concerns on Taiwan's poor record on insider-trading and market-manipulation detection as key reasons for the deterioration of corporate government in Taiwan. The Taiwan regulator stepped up investigations and cleanups of unusual and insider trading in late 2012 and the SFC has started to introduce new rules and laws in the hope of improving the protection of minority shareholders and reducing corporate fraud. The shift to International Financial Reporting Standards (IFRS) for all public-listed companies in 2013 is a signal that the authorities wish to bring Taiwan's stock market closer in line with international accounting norms.

Enforcement of increased representation of independent board members

Following an order by the Financial Supervisory Commission (FSC) in March 2011, the listed financial and non-financial institutions with paid-in capital of more than NT$10bn, effective from 2012, are required to install no less than two independent board members or no less than one fifth of total board seats, with an aim to constrain controlling shareholders from tunnelling corporate resources at a cost to non-controlling shareholders, especially in a market like Taiwan where a high portion of listed companies are family-controlled. This change in regulation is to fix the legacy issue of weak independent directors' oversight on related-party transactions as the traditional corporate monitoring system is under a dual-board system. With law enforcement to increase the representation of independent board members, the interest of minority shareholders will be better protected.

E-voting to offer convenience for activist shareholders

The government also amended the Corporate Law in January 2012 to enforce the implementation of shareholder activism through the introduction of e-voting for all shareholders to exercise their voting rights at shareholder meetings. The first phase was implemented in 2012 for 83 large companies which fit the criteria. The regulator has further expanded the scope and 216 listed companies will be required to introduce e-voting processes in 2014. Currently e-voting is compulsory for listed companies whose capital is above NT$5bn and whose shareholders number more than 10,000 to provide e-voting in shareholders meetings.

Companies that top the list/have seen most improvement

Semicon companies in top quartile

The top two companies with the highest CG scores in Taiwan are TSMC and Novatek, and both are semiconductor manufacturers. As the largest Taiwan market index stock and the world's largest foundry, TSMC has always set a higher standard in discipline than other listed companies, not only to satisfy the demand of international and institutional shareholders but also to encourage customer loyalty by maintaining a transparent and fair representation of its operations and financial position. Semiconductor companies have a large pool of global talents who have experience working in international leading tech companies and they are usually keen to comply or follow international standards in setting up the business structure.

TSMC, impressively, has over half of board members represented by independent board members to ensure the sound protection of major and small shareholders. Currently, TSMC has five independent board members out of a total of eight directors. Other semiconductor companies in Taiwan like Novatek have maintained very high dividend payout ratio, at more than 70% since 2007. Novatek also has a solid track record in providing fair guidance, which shows solid control and discipline over its operating environment and business development.

PCSC showed most improvement in CG with setup of new audit committee

President Chain Store Corp (PCSC) is the company we believe has seen the most improvement in independence as it has taken steps to improve an independent audit committee in June 2012. The three committee members have qualified professional backgrounds and hold PhD degrees in business, law and financial/accounting. The company also complies with the new rule in Taiwan to report under IFRS. Given that PCSC conducts some business within arm-length relationships as some of its subsidiaries offer it services and goods, IFRS helps it report more authentic operating data for the group after eliminating inter-party transactions.

Corporates at the bottom of the list/seen deterioration

Financial sectors not yet fully adopting international accounting rules

The bottom stocks in our Taiwan CG ranking table continue to be dominated by the financial sector. Life insurance companies, in particular, used to sell policies 15-20 years ago with higher guaranteed rates of return over 7%, but their investment returns have declined in the last decade due to yield compression in the global financial markets. In Taiwan, policy liabilities are valued at book, which is effectively the same as an NPV using the policy rate at the time they were issued. International accounting standards require the use of market rates of interest to value policy liabilities, but Taiwan has not moved to conform with international standards yet. Taiwan introduced IFRS in 2013 but has specifically excluded insurance policy liabilities from this standard. In addition, if the FSC decides to adopt IFRS-2013 version starting from 2015, there will be significant impact on the financial sector as one of the new rules will require companies to fully recognise pension liabilities immediately, then deferral in pension recognition over the coming few years.

Lack of transparency at UMC

United Microelectronics Corp (UMC) appeared to have the most deterioration in their CG score from 2012 to 2014. The main concerns on UMC are the lack of an ROE target and restructuring of its diversified business investment and structure. Despite Taiwan moving to IFRS in 2013, which requires consolidation of accounts of all subsidiaries, there is a lack of detail in disclosure and fairness for various subsidiaries and businesses under the group. This sees UMC score low in transparency and fairness.

TSMC and Novatek are the top two in Taiwan CG score

Figure 130

Taiwan: Companies in top-two CG quartiles

Company	Code	Company	Code
TSMC	2330 TT	Taiwan Mobile	3045 TT
Novatek	3034 TT	WPG	3702 TT
Delta	2308 TT	Advantech	2395 TT
PCSC	2912 TT	Taiwan Cement	1101 TT
Vanguard	5347 TT	Tripod	3044 TT
Kinsus	3189 TT	Unimicron	3037 TT
Powertech	6239 TT	Chipbond	6147 TT
Far EasTone	4904 TT	Wowprime	2727 TT
AUO	2409 TT	Uni-President	1216 TT
Huaku Dev	2548 TT	Cathay FHC	2882 TT
SPIL	2325 TT	E.Sun FHC	2884 TT

Source: CAST

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Thailand - Not sinking

Key issues and trends

- Unexpectedly, Thailand does not fall in score; but its ranking drops one place
- Overall score holds up due to improvements in regulatory enforcement
- Passage of legislation was delayed by government paralysis, driving down the score for Political and Regulatory Environment
- Progress continues to be made in the regulation of auditors
- Anecdotal information suggests corruption is getting worse

Overall score stays the same at 58% in 2012 and 2014

Thailand loses points for delays in passing legislation

Our expectation this year was that the parliamentary dysfunction in Thailand from late 2013 to May 2014, followed by the coup, would cause a sizeable dent in the country's score in *CG Watch 2014*. To a degree, this happened. The paralysis in government did impede the passage of important legislative amendments that would have modernised company and securities law in important areas. For this and other reasons, Thailand's score for Political and Regulatory Environment has indeed fallen several percentage points. Yet, like the cavalry riding to the rescue, improvements in Enforcement have counterbalanced the fall and, with the scores in the other three sections remaining flat, Thailand stays exactly where it was in our 2012 survey. It is now equal fourth with Malaysia, one place behind a resurgent Japan.

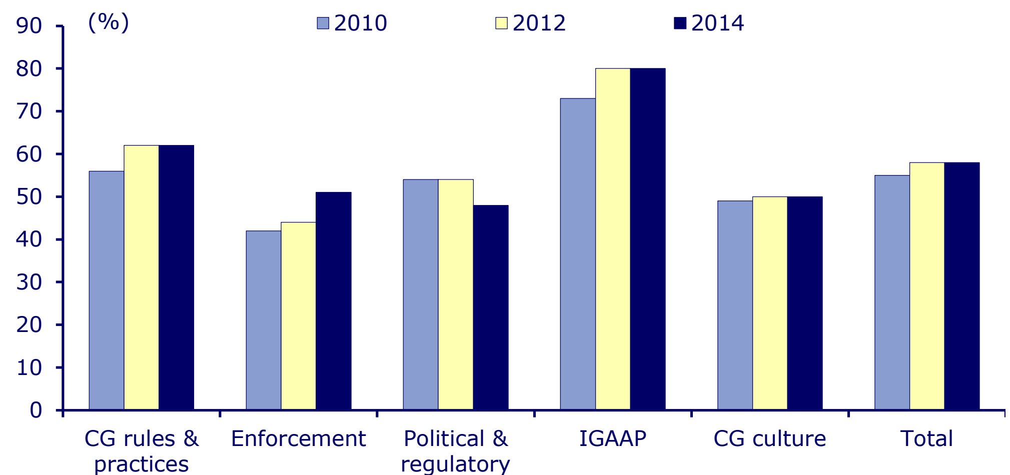
Financial regulators have a clear focus on reform

What this outcome suggests is that even if the executive branch of government and parliament are not functioning, other parts of government continue on, business as usual (almost). Two years ago we did not see any strong or overarching strategy on corporate governance from the then prime minister Yingluck Shinawatra or her cabinet, yet there was a clear focus among financial regulators about how to proceed on CG reform. Supporting organisations in business and the professions were playing a greater, not lesser role, in promoting good corporate governance. From our perspective as an outside observer, none of this has changed. If not for the parliamentary problems and the shockwaves that sent through the system, Thailand's score would likely have gone up in this survey.

Enforcement rises, political & regulatory falls, other sections flat

Figure 131

Thailand CG macro category scores



Source: ACGA,CLSA

CG rules and practices

Stays the same at 62% in 2012 and 2014

The strengths we noted in our last CG Watch survey continue in Thailand. Listed companies continue to report their audited annual accounts quickly - and faster than most other markets in the region. Companies also release their annual general meeting (AGM) agendas early, usually four or more weeks before their meetings. And as has been the case for many years, voting by poll is extensive. The Thai Investors Association (TIA) continues to play its role assessing the quality of almost 500 AGMs every year - still a unique exercise and a significant logistical challenge.

On the speed of reporting, an updated ACGA review of 30 large caps in mid-2014 found that the average reporting period for their 2013 audited annuals was just over 51 days and all of them reported in under 60 days, which is the regional regulatory benchmark. An analysis of nine midcaps found the average reporting period to be around 55 days and all beat the 60-day mark too.

Non-financial reporting continues to be less convincing than financial

The main weaknesses we noted last time have not changed either. In contrast to financial reporting, non-financial reporting practices are typically much less convincing. While companies are usually good at describing their operations and outlook in their business reviews or MD&A, the sections devoted to corporate governance are full of the usual standardised boilerplate and focus more on process (the terms of reference of a board committee, for example) than substance (what that committee has actually discussed during the year).

MD&A and business review sections good, CG reporting is boilerplate

One company we looked at had a 35-page "Management and corporate governance" section in its Form 56-1, the annual registration statement to the SEC. Although quite detailed and with a long comparison of the company's practices to the revised CG Code 2012, it still suffered from the boilerplate. Areas where the company could have reported in some substance, such as its board evaluation and director training, were fairly superficial. On the other hand, its MD&A and Business Review were quite impressive. Another company also had a good MD&A, an interesting section on risk, a weak report of directors and a strikingly self-serving description of its board evaluation - it rated itself excellent on just about everything.

Regulators focusing on improving non-financial reporting

To their credit, the SEC and the Stock Exchange of Thailand (SET) have put greater focus on enhancing non-financial reporting. One avenue is through the revised Principles of Good Corporate Governance, Thailand's corporate governance code of best practice, published in November 2012. Considerably more detailed and specific than the old code from 2006, the Principles state that companies should, among other things, include an MD&A in every quarterly report and provide a summary of the firm's governance, risk management and corporate social responsibility (CSR) policies, as well as any steps taken to implement them. They should also publish data on board and committee meetings, director attendance, director training and undertake board evaluations. The new Principles took effect for the Form 56-1 annual statements and annual reports from calendar 2013 onwards.

Almost a year later in October 2013, the SEC aggregated and amended rules and procedures on the disclosure of financial and non-financial information in Form 56-1 statements (TorChor 44/2556). Key additions included among other things:

- In the section on management and corporate governance practices, new subsections have been added to include disclosure of policies and practices on CSR and anti-corruption.

- Profiles and qualifications of the company secretary and head of internal audit, as well as the opinion of the audit committee on the suitability of the head of internal audit and whether the committee has any authority to appoint and dismiss him/her.
- Companies operating as a group company should disclose their CG policies and practices of subsidiaries and affiliated companies.
- An enhanced management discussion and analysis (MD&A) section. Companies are now required to include a 'more analytical discussion to avoid any boilerplate reporting'.
- The risk management section should include a discussion on how the identified risks could affect shareholders.

Reporting quality gap between large caps and smaller firms as wide as ever

One of Thailand's challenges, like any market, will be to encourage smaller listed companies to see the value of transparency to their market standing, shareholder composition and valuation and to report effectively. Each time we do *CG Watch*, we find a marked quality gap between the reports of large-cap companies compared to smaller caps. If anything, the gap seems wider this year because of our more detailed analysis of financial reporting speeds, disclosure on executive remuneration and sustainability reporting (see 'Sustainability reporting in Thailand').

Thailand came to the CSR reporting game early

Sustainability reporting in Thailand

In 2007, the Stock Exchange of Thailand (SET) established the Corporate Social Responsibility Institute (CSRI) to encourage the business sector to move towards sustainable growth. In June 2012, SET published two CSR guidelines (only in Thai). In December 2013, the SEC approved a Sustainability Development Roadmap. As of 1 January 2014, the SEC requires companies to disclose CSR information in their Form 56-1 annual statements and their annual reports.

There is a high-level of regulatory engagement with companies through the CSRI. SET has released several publications, newsletters and held many training sessions and forums dedicated to helping companies report on sustainability issues. SET also holds annual CSR awards and publishes annual sustainability reports. The Exchange does not promote carbon disclosure, nor does it have a sustainability index, but is planning to introduce both.

Quality of large-cap CSR reports varies widely

All large-cap companies in ACGA's recent review reported on sustainability and eight out of 10 had standalone reports that reported on all three pillars of sustainability-E, S and G. Six of them followed the Global Reporting Initiative (GRI) and three sought sustainability assurance. Only three of the eight standalone reports were strategic and innovative in nature. The others tended to be general and vague, with lofty statements about saving the world but little tangible evidence of what they were doing.

While eight out of 10 midcap companies had sustainability reporting, the reporting was weak and focused mainly on philanthropy. Only one midcap report referenced the GRI, while no companies sought third-party assurance. For some midcaps, part of their reporting was only in Thai.

While it may take time for small companies to improve the quality of their overall reporting, one area of immediate focus could perhaps be the disclosure of price-sensitive information (PSI). While the relevant regulations are sound and the larger companies seem to follow them, a perusal of the

Small firms could focus on improving PSI disclosure

"Investor alert news" page on the SET website highlights several cases where the exchange has had to seek clarification from (mostly smaller) companies on material information. The usual pattern is that the companies talk to the press about a transaction before making any announcement to the Exchange, as they should. Since not disclosing PSI is one of the quickest ways to undermine the confidence of your shareholders, this should be a matter of priority for issuers.

Another area where Thailand's performance was mixed in this survey was on three new questions regarding the quality of sustainability reporting standards and practices. As we show in 'Sustainability reporting in Thailand', Thailand has been promoting CSR reporting for many years and therefore rated well on standards and the degree of involvement of regulators. Actual reporting quality by companies was less impressive, with large caps again doing better than smaller ones, though not necessarily rating well overall.

Enforcement

Rises from 44% in 2012 to 51% in 2014

Despite an overall rise, the scores of the first few questions in this section either stayed the same or saw a slight fall. We see no change, for example, in how the market views the vigour and consistency of regulatory enforcement. Nor has there been any change (yet) in the powers of the SEC.

Scores have improved on several questions:

- Are regulators seen to treat all individuals and companies equally?
- Has the regulator been investing more effort in tackling insider trading, market manipulation and other serious crimes?
- Has the regulator been successful in prosecuting insider trading, market manipulation and other serious crimes?
- Do regulators disclose detailed and credible data on their enforcement track record?

Market enforcement remains rather weak

Scores on other questions did not change, most notably on whether shareholders were more active in enforcing their rights and engaging with companies ("private enforcement"). While there is reasonably extensive institutional investor voting in Thailand, led by pension funds such as the Government Pension Fund and the Social Security Office and by rules requiring asset managers to vote, the degree of active engagement is somewhat limited relative to other markets. This may well change however, with the publication in March 2014 of a joint statement from major domestic pension funds and financial sector business associations on a new set of proxy voting guidelines (see CG culture for more details).

By the numbers

SEC makes an effort to report five-year enforcement statistics

Unlike most of its counterparts in Asia, the SEC makes a conscious effort to report its enforcement statistics in clear tables covering the past five years (2010-14). Its latest statistics highlight the following:

- **Criminal settlements** increased from 96 cases in 2010 to 121 in 2011, fell to 56 in 2012, then started climbing again: 79 in 2013 and 68 for the first seven months of this year.
- Within criminal settlements, the largest subcategory related to breaching financial statement regulations, followed by market manipulation, non-compliance with business conduct rules and then insider trading.

- Over the past five years, the SEC has settled more criminal investigations relating to market manipulation (51 cases) than insider trading (24 cases).

Criminal complaints broadly on the rise

- **Criminal complaints** fell from 65 cases in 2010 to 39 in 2011, then rose again to 82 cases in 2012, 118 in 2013 and now stands at 57 for the first seven months of this year.
- Within criminal complaints, the largest subcategory is again financial statements, followed by market manipulation and unlicensed derivatives businesses about equal, then corporate fraud. There have been relatively few criminal complaints on insider trading.
- Over the past five years, the SEC has filed 10 times as many criminal complaints against market manipulation (51 cases) than insider trading (five cases).

One thing these numbers indicate is that it is clearly easier for the SEC to settle cases on insider trading than pursue them through the courts by filing a criminal complaint. The SEC does not get a lot of help from other parts of the justice system, which is known to be integrity-challenged and extremely slow. This is why there was a need to create the settlement system as an alternative.

SEC provides more transparent enforcement data than most of its counterparts in Asia

The numbers also indicate that the SEC is a broad and fairly active enforcement agency, with fingers in many pies. It is always difficult to draw hard conclusions about enforcement effectiveness from simple numbers. Are the cases of equal merit? Are there more (or less) cases in any one year due to the time-lag effect and factors outside the control of the regulator? Nevertheless, in aggregate, the statistics paint a helpful picture of what the SEC is focused on and where it is making progress. This is some of the most transparent data of its kind in the region.

Meanwhile, at the exchange

SET enforcement disclosure could be better

SET enforcement statistics are not quite so revealing - nor are they as easy to access through its website. Yet the SET does make a plausible case that it is trying to strengthen its supervision of material information disclosure and has made more announcements to warn investors about problems with financial statements, M&A and related-party transactions (RPTs) and share placements 'if the issue affects the company's shareholders significantly'. In addition to issuing warnings to shareholders, it will require companies to disclose more information.

Like other exchanges, the SET refers cases to the SEC for investigation. It referred 28 cases of insider trading to the SEC in the two-and-a-half years from January 2012 to May 2014 and 10 cases of market manipulation.

The Exchange has also altered its supervision strategy to take account of the fact that price manipulations 'have shifted to day trading', hence it has introduced preventive-action concepts of "trading alert" (in January 2012) and an adjusted "cash balance" rule. It issued 64 trading alerts in 2013 compared to 38 in 2012 and 194 cash balance actions in 2013 compared to 98 in 2012. It also issued 116 announcements relating to trading rumours in 2013 versus 96 the year before.

Political and regulatory environment

Falls from 54% in 2012 to 48% in 2014

Despite the conflict between political parties and the paralysed parliament for many months, our rating of Thailand's overall strategy on corporate governance has not changed from 2012. This is primarily due to the consistency shown by

the SEC and SET. Nor do we see any change in the way the central bank governs banks effectively, or whether the securities commission is formally and practically autonomous of government (only marginally).

Scores went up in three areas

On three questions scores have gone up slightly. The first relates to the coherence of the country's financial regulatory structure: we see generally better collaboration between the SEC and SET on corporate governance than one finds between their counterparts in most other Asian markets. The second assesses whether regulators have informative websites, with all key laws and regulations easily accessible. Thailand gained here not because the websites are perfect, but because it deserved to be a notch higher relative to other markets, many of which have less user-friendly regulatory websites. The third is on the existence of an independent anti-corruption commission - we recognise that efforts are being made by the National Anti-Corruption Commission (NACC), albeit of limited impact but better than nothing (hence a zero score here seems unfair).

Overall, however, scores have come down because of the challenges the SEC has faced in shepherding legislative amendments through government, whether the stock exchange has a deep archive of company announcements and reports and because of lingering concerns we have regarding the state of corruption in the country.

Amendments to the SEA and PCA ready to go

On the issue of legislative amendments, the SEC has had a series of proposals ready to go on the Securities and Exchange Act (SEA) for some time, while it has also joined with the SET and proposed changes to the Public Companies Act (PCA) to the Ministry of Commerce. The SEA amendments include provisions on strengthening investor protection, improving the organisation of the SEC itself and more effective enforcement. The proposed PCA amendments include strengthening the rights of shareholders in connection with major transactions, supporting electronic-proxy voting and more flexible pricing in share issuances, among other things. The Ministry of Commerce organised some hearing sessions on the PCA amendment, at which the SEC's proposed changes were included and discussed.

SEC needs civil sanctioning powers

Another urgent change needed in Thailand concerns the enforcement powers of the SEC. While the Commission can investigate criminal breaches and impose administrative sanctions, it still lacks civil sanctioning power. As the SEC website notes: 'For criminal sanction, the SEC's duty is in the preliminary stage of criminal justice administration where it exercises statutory power to gather evidence and investigate the matter suspected to be in contravention of laws under the SEC's supervision. The SEC, nonetheless, has no power to initiate criminal proceedings against the wrongdoers in its own name but has to refer the case of violation of non-compoundable offences with sufficient evidence to the competent inquiry officer for further investigation.'

Draft legislation to give the SEC these powers approved by the current military government

Further: 'To increase efficiency of the SEC's enforcement action and to be in line with capital market regulators in the international arena, the SEC has proposed amendments to the Securities and Exchange Act of 1992 to include civil sanctions.' Civil sanctions would give the SEC more flexibility in pursuing wrongdoers, would allow it to sue for compensation on behalf of investors and would lower the burden of proof. The current status of this long-overdue reform is that draft legislation has been approved by the National Council of

Peace and Order (in the capacity of the Cabinet) and sent to the Council of State for consideration. After that, the draft will be sent to the Cabinet and the National Legislative Assembly.

Meanwhile, we marked down the SET website because it only carries company reports and announcements for the past two years. The benchmark in our question used to be five years, but we have increased it to 10 years for two reasons: the Hong Kong stock exchange now archives for 14 years and we wrote the question more than five years ago.

Corruption still a huge problem in Thailand

On the issue of corruption, we are concerned about the trend of developments in Thailand. In 2011, Thailand was rated 80th out of 183 countries in Transparency International's Corruption Perceptions Index. It slipped to 88th out of 174 countries in 2012 and the following year fell further to 102nd out of 177 countries. This aligns with what we are hearing anecdotally: two years ago kickback percentages were around 30%, now people say they have reached 40-50%. This is a deeply depressing and surely unsustainable. The NACC needs considerably more support from the government leadership and a bigger budget. A more central location might help too, at least symbolically. With a head office more than an hour's drive from downtown Bangkok, one wonders what message that sends.

IGAAP (accounting and auditing)

Stays the same at 80% in 2012 and 2014

Little has changed in our assessment of accounting and auditing in Thailand. The Federation of Accounting Professions (FAP) sets accounting standards, which are intended to converge with IFRS and are currently largely in line. FAP continues to work on translating additional IFRS. The Federation also sets auditing standards and has translated the International Standards on Auditing (ISAs), which are issued by the International Auditing and Assurance Standards Board (IAASB), with "no modifications". It has an auditing committee that has the responsibility to manage the convergence process with IAASB pronouncements, as well as produce publications and provide training courses and seminars for auditors.

In terms of the quality of account preparation and auditing in Thailand among listed companies, we continue to see a gap, as expected, between large caps and smaller issuers. One presumes the quality of the audits carried out for large caps is high since the Big Four accounting firms audit 54% of all listed companies, representing 75% of market cap. However, concerns have been raised about some large caps, specifically state enterprises that are audited by the Office of the Auditor General and issuers that are audited by small CPA firms.

SEC report highlights auditing challenges and weaknesses

A good introduction to the challenges facing the auditing profession - and audit quality in general - is the SEC's report titled, *Independent Audit Inspection Activities Report 2013*. Published in April 2014 in the SEC's capacity as the country's independent audit regulator, the report records some improvements, but also ongoing weaknesses with certain aspects of firm-level quality controls, depth of expertise, experience in the profession, and engagement performance.

This latest report covers the second cycle of the SEC's inspection work and includes aggregate information on quality controls in eight audit firms as well as deficiencies in audit engagements signed by 28 individual auditors. Common problems found in the audit engagements related to such things as 'revenue,

substantive analytical procedures, tests of controls, audits related to fraud risks, audits of accounting estimates, group audits, audits of inventories, reviews of audit work, audit evidence, audits of related-party transactions, using the work of a management's expert, audits of going concern assumption and professional scepticism'.

SEC can sanction both firms and individual CPAs

As an audit regulator, the SEC has extensive powers and can sanction both individuals and firms. To date, it has only taken action against individual auditors because it concluded that the wrongdoing found so far was not directly related to audit-firm quality control systems. It has, however, issued warning letters to the leaders of some audit firms to advise them to more closely monitor the performance of auditors who have breached their duties. Moreover, this year, the SEC has deregistered two auditors for serious non-compliance with auditing standards and issued four warning letters to six auditors for various deficiencies.

CG culture

Stays the same at 50% in 2012 and 2014

As the score indicates, we do not see any significant change in the overall quality of CG culture in Thailand. Anecdotally, the revised CG Principles 2012 have led to some improved reporting among the larger companies as well as board evaluations being undertaken. But it is hard to assess the quality of these evaluations, since descriptions of them in annual reports tend be quite general. On a personal level, we are finding that larger Thai companies are generally more receptive to discussing CG issues than in the past and open to the idea of meeting with foreign institutional investors. We also feel that the level of interest in CG developments outside Thailand is gradually on the rise.

One area where Thailand does somewhat better than other markets is in the disclosure of remuneration. Most companies provide detailed remuneration of individual directors, while that of "key management" outside the board is disclosed without names. Relatively few markets in Asia provide remuneration disclosure on a named basis.

Domestic institutional investors collaborate on new proxy voting guidelines

Meanwhile, not long after the launch of Asia's first Stewardship Code for institutional investors in Japan in late February 2014, a group of leading domestic institutions in Thailand, including the Social Security Office, the Government Pension Fund, the Association of Investment Management Companies, the Association of Thai Securities Companies, the Thai Life Assurance Association and the Thai General Insurance Association announced in late March a collaborative set of proxy voting guidelines. These guidelines, which have received SEC support, aim to promote better CG and CSR and to support the private sector anti-corruption drive. The guidelines also put an onus on investors to monitor companies, discuss with management, vote shares and so on. It is possible that these guidelines might form the basis for a more fully fledged "stewardship code" in future.

Downgrade watchlist

What to avoid

Factors that could force the country's score to fall in 2016:

- No progress in passing the SEC's proposed amendments to company and securities laws
- No passage of the amendment granting the SEC civil-sanctioning powers
- No tangible success in containing corruption
- No improvement in NACC budget

Quick fixes

What to fix

- Improve the organisation and accessibility of regulatory documents on the SEC and SET websites
- SET to archive company announcements and reports for at least five years
- Encourage less boilerplate non-financial reporting from all listed companies
- Encourage improved PSI reporting from smaller listed companies
- Provide more commentary on regulatory enforcement statistics

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Research perspective - Steady as they go

The corporate governance landscape among Thai companies has been stable over the past two years. Interestingly, transparency has improved, but was offset by fairness relating to the increasingly competitive environment and taking aggressive growth strategies posing undue risks to minority shareholders. While Thai companies do score well on transparency in financial disclosure, there is room for improvement in the area of discipline, independence and responsibility.

Improving transparency offsetting fairness

Overall CG has been stable with improving transparency offset by declining fairness

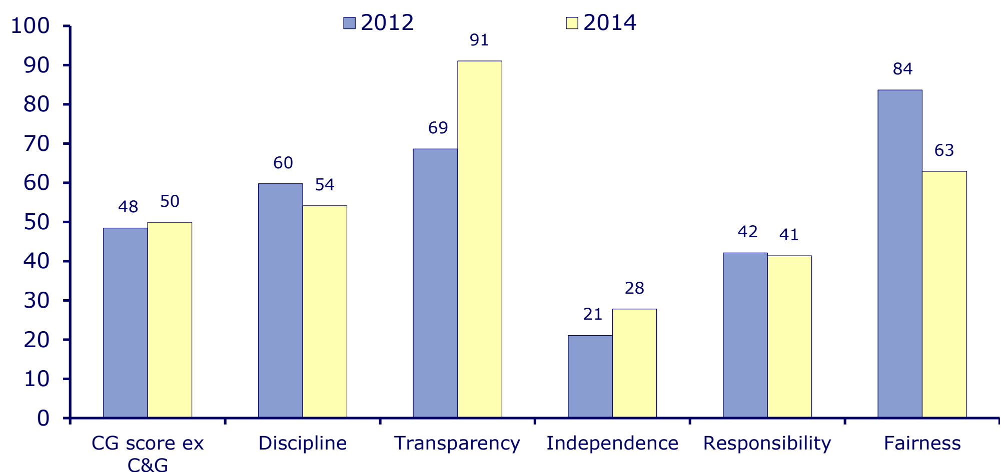
The corporate governance of 29 Thai listed companies in CLSA coverage has been stable over the past two years. However, there was improvement in transparency offsetting fairness. Transparency improvement was seen in PTT group and property developers that provided more financial and business-segment performance disclosure as well as early assessment to any major events potentially affecting their business and financial performance. Thai banks did better on disclosing timely market-sensitive information. In addition, the management of Thai chain store operators have been more open to investor/analyst access.

Fairness, however, was on decline mainly due to their management remuneration growing quicker than their underlying business performance and, partly, that their business policies potentially posed a downside risk to their minority shareholders.

Thailand CG is stronger on transparency, but weaker on fairness

Figure 132

Thailand CG score



Source: CLSA

Dynamics at company level

Top five performers scored well on transparency improvement

The top five performers over the past two years are Hemaraj, LPN, Siam Commercial Bank, Krung Thai Bank and IRPC. All of them have shown improvement in transparency, ie, providing more disclosure especially on major and market sensitive information in a timely manner.

On the other hand, CP All, Tisco, Land & Houses and CP Foods have diluted its fairness and discipline as they expanded aggressively posing undue business and investment risks to, calling capital from, and, in some cases, diluting minority shareholders' interest. AIS faced regulatory headwind hurting its ability to make appropriate business decisions and thus, weak on discipline.

SCC, LPN, Banpu and AIS were old-time medallists

Medallists and subpars

Bangkok Dusit joins the four old-time medallists on CG front, Siam Cement, LPN, Banpu and AIS to be top five CG scorers. However, there is room for improvement on independence and discipline.

plenty of room for Siam Global, Bangkok Life, Land & Houses, Ratchaburi and CP Foods to catch up on CG

On the other hand, there is plenty of room for Siam Global, Bangkok Life, Land & Houses, Ratchaburi Electricity and CP Foods to catch up on CG. They are mainly in the area of discipline, independence and fairness.

Figure 133

Thailand: Companies in top-two CG quartiles (alphabetical order)

Company	Code	Company	Code
AIS	ADVANC TB	LPN	LPN TB
Asia Aviation	AAV TB	Major Cineplex	MAJOR TB
Asian Property	AP TB	Nok Air	NOK TB
Bangkok Bank	BBL TB	PTT Global Chemical	PTTGC TB
Bangkok Dusit	BGH TB	Robinson Department Store	ROBINS TB
Banpu	BANPU TB	Siam Commercial Bank	SCB TB
BEC World	BEC TB	Siam Cement	SCC TB
Central Plaza	CENTEL TB	Stecon	STEC TB
Central Patana	CPN TB	Thai Oil	TOP TB
Electricity Generating	EGCO TB	Thaicom	THCOM TB
Glow Energy	GLOW TB	Tisco	TISCO TB
HomePro	HMPRO TB	TMB Bank	TMB TB

Source: CLSA

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Appendix 1: About ACGA

The Asian Corporate Governance Association (ACGA) is a non-profit membership association dedicated to promoting substantive improvements in corporate governance in Asia through independent research, advocacy and education. ACGA engages in a constructive dialogue with regulators, institutional investors and listed companies on key corporate governance issues and works towards making improvements.

For more details on ACGA's activities and a database of information on corporate governance in Asia, see our website: www.acga-asia.org

Membership network

ACGA is funded by a membership base of more than 100 highly regarded organisations based in Asia and other parts of the world, including:

- Several of the world's largest asset owners and managers. ACGA investor members manage more than US$15tn globally and hold significant stakes in Asian companies.
- Highly regarded listed companies, professional firms, and financial and insurance intermediaries based in Asia.
- Two major multilateral banks.
- Leading educational bodies.

For a full list of ACGA's members, see the "Members" page on www.acga-asia.org.

Founding sponsor

CLSA is one of the original founding corporate sponsors of ACGA and continues to support the association's work.

NBIM
Norges Bank Investment Management

ACGA foundation sponsor

ACGA is honoured that, starting in 2012, Norges Bank Investment Management (NBIM) of Norway became the first foundation sponsor of the association. NBIM has been a valued member of ACGA for many years and this agreement marks a considerable enhancement of its support for corporate governance improvement in the Asia region.

Appendix 2: ACGA market-ranking survey

Evaluation of Asian markets on corporate-governance norms

A	CG rules & practices The following questions are targeted at main-board listed companies	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Do financial reporting standards compare favourably against international standards? (eg, frequency and timeliness of reporting; existence of robust continuous disclosure rules; detailed explanation of P&L, balance sheet, cashflow; and so on)	L	L	L	L	L	L	L	L	L	L	L
2	Do financial reporting practices among large listed companies* compare favourably against international best practices? Both in terms of their periodic reports and ad hoc announcements. ([1]Main market index)	S	L	L	S	L	L	L	L	L	L	L
3	Do financial reporting practices among small- and medium-sized listed companies compare favourably against international best practices?	M	S	S	M	S	S	S	S	S	S	S
4	Do non-financial reporting standards for CG disclosure compare favourably to international standards? (ie, the MD&A, Report of Directors, corporate governance statements)	S	L	L	S	S	M	S	S	L	L	L
5	Do non-financial reporting practices among large listed companies for CG disclosure compare favourably to international best practices?	S	L	L	S	S	S	S	S	L	S	S
6	Do non-financial reporting practices among small- and medium-sized listed companies for CG disclosure compare favourably to international best practices?	M	S	M	M	S	M	M	M	S	M	M
7	Do non-financial reporting standards for CSR/ESG disclosure compare favourably to international standards? (ie, a CSR section in the annual report, a separate GRI or sustainability report, disclosure of CO_2 emissions)	M	M	L	M	S	S	L	M	M	S	L
8	Do non-financial reporting practices among large listed companies for CSR/ESG disclosure compare favourably to international best practices?	S	S	L	S	Y	Y	S	M	S	M	S
9	Do non-financial reporting practices among small- and medium-sized listed companies for CSR/ESG disclosure compare favourably to international best practices?	M	M	M	M	M	N	M	M	M	N	N
10	Do large listed companies report their audited annual financial results within two months or 60 days? (Note: Not to be confused with the "annual report", which usually comes out later.)	N	M	Y	M	N	M	S	S	L	M	Y
11	Do small- and medium-sized listed companies report their audited annual results within two months or 60 days?	N	N	Y	N	N	M	M	N	M	N	Y
12	Is quarterly reporting mandatory, is it consolidated and does it provide adequate and credible P&L, cash flow and balance sheet data?	Y	M	S	Y	Y	Y	Y	Y.	Y	Y	Y
13	Do securities laws require disclosure of ownership stakes of 5% and above (ie, when an investor becomes a substantial shareholder)?	Y	Y	Y	S	Y	Y	Y	Y	Y	N	L
14	Do securities laws require disclosure of share transactions by directors and controlling shareholders within 3 working days?	S	Y	Y	N	N	L	Y	N	Y	M	Y
15	Does the regulatory regime ensure adequate and prompt disclosure of price-sensitive material events and transactions? (ie, sufficient information to allow informed minority investors to assess the risk to themselves of these transactions)	S	L	M	M	Y	M	S	M	S	S	S
16	Does the regulatory regime require--and enforce--adequate and timely disclosure of related-party transactions (continuing, small, and large transactions)?	S	L	M	N	L	S	S	M	L	S	S
17	Do securities laws provide a credible deterrent against insider trading and market manipulation?	M	L	N	N	M	S	M	N	S	M	M
18	Is voting by poll mandatory for all resolutions at general meetings?	S	Y	L	M	L	N	N	N	S	L	L
19	Is there an up-to-date national code (or codes) of best practice based on evolving international CG standards?	M	L	L	M	S	S	L	M	L	L	L
20	Is there a clear and robust definition of "independent director" in the code or listing rules? (ie, one stating independent directors should be independent of both management and the controlling shareholder; that does not make it easy for former employees and former/current professional advisers to become independent directors; and which produces genuinely independent directors)	S	S	S	M	S	S	L	M	S	S	S
21	Must companies disclose the exact remuneration of individual directors and senior executives (top 5) by name (or do they)?	S	Y	L	M	M	L	S	M	L	S	S
22	Are audit committees (or an equivalent) mandatory and implemented?	Y	Y	Y	Y	M	Y	Y	Y	Y	Y	Y
23	Are audit committees (or an equivalent) chaired by a genuinely independent director and given sufficient powers in practice (by the company) to examine financial reports and announcements, internal controls and the independence of external auditors? Are they operating independently?	M	S	M	M	M	M	M	N	S	M	S
24	Can minority shareholders easily nominate independent directors and are these candidates likely to be elected?	N	N	M	N	N	N	N	M	M	M	N
25	Is there a statutory or regulatory requirement that directors convicted of fraud or other serious corporate crimes must resign their positions on boards and in management?	L	L	N	M	L	N	L	Y	Y	Y	Y
26	Are pre-emption rights for minority shareholders - their right to buy any new shares issued by the company on a pro-rata basis - firmly protected? (ie, enshrined in the company law and requiring a supermajority - 75% - to disapply them; and with any new shares only issued under fairly strict caps on percentage of issued capital and price discounts)	N	M	N	Y	N	N	S	N	S	M	M
27	Do companies release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?	N	Y	L	N	S	S	S	L	S	L	L

[1] Main index. Continued on the next page

Evaluation of Asian markets on corporate-governance norms (continued)

B	**Enforcement** **Enforcement covers both "public enforcement" by regulatory authorities of CG rules and regulations and "private enforcement" by investors of their rights as shareholders**	**CH**	**HK**	**IN**	**ID**	**JP**	**KR**	**MY**	**PH**	**SG**	**TW**	**TH**
1	Do financial regulators in your country have a reputation for vigorously and consistently enforcing their own CG rules and regulations?	M	L	S	N	S	L	M	N	L	S	S
2	Have their efforts improved tangibly in recent years?	S	Y	Y	S	Y	S	S	M	S	L	L
3	Are securities regulators seen to treat all companies and individuals equally ?	M	L	S	M	L	M	S	N	L	L	S
4	Are the regulatory authorities sufficiently resourced—in terms of funding and skilled staff - to do their job properly?	S	L	S	S	L	S	S	S	L	S	L
5	Does the main statutory regulator (ie, the securities commission) have effective powers of investigation and sanction?	S	Y	S	M	L	L	S	M	L	L	S
6	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years? (eg, against cases of market misconduct such as insider trading, share-price manipulation, self-dealing)	L	Y	S	S	L	S	S	M	S	S	L
7	Has the securities regulator and/or government had a successful track record prosecuting cases of insider trading and market manipulation in recent years?	S	Y	M	N	S	S	M	N	S	S	S
8	Does the stock exchange have effective powers to sanction breaches of its listing rules?	M	M	M	N	S	M	S	M	M	M	M
9	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years?	S	S	M	N	L	S	S	N	M	S	M
10	Do the regulators (ie, the securities commission and the stock exchange) disclose detailed and credible data on their enforcement track records?	L	Y	S	M	L	M	Y	N	S	M	L
11	Do institutional investors (domestic and foreign) exercise their voting rights?	S	Y	L	S	Y	L	S	M	Y	S	L
12	Are institutional investors actively voting against resolutions with which they disagree?	S	Y	L	M	Y	S	S	N	L	L	S
13	Do institutional investors (domestic and foreign) often attend annual general meetings?	M	M	M	M	M	M	M	M	M	S	S
14	Do minority shareholders (institutional or retail) often nominate independent directors?	N	N	M	N	N	N	N	N	M	N	N
15	Do retail shareholders see the annual general meeting as an opportunity to engage with companies and ask substantive questions?	M	S	M	S	S	S	Y	S	Y	S	Y
16	Are minority shareholder activists willing to launch lawsuits against companies and/or their directors?	M	M	M	N	M	Y	N	M	N	N	N
17	Are minority shareholders adequately protected during takeovers, privatisations, and voluntary delistings?	M	Y	S	M	S	N	L	M	L	S	S
C	**Political & regulatory environment** **This addresses the level of political will within a country to improve corporate governance as well as the nature of the regulatory and legal environment**	**CH**	**HK**	**IN**	**ID**	**JP**	**KR**	**MY**	**PH**	**SG**	**TW**	**TH**
1	Does the government have a clear, consistent and credible policy in support of corporate governance reform?	M	M	S	S	S	M	L	M	S	L	S
2	Does the central bank or equivalent financial authority exercise effective regulatory powers over the governance of banks?	L	Y	Y	Y	S	M	Y	Y	Y	S	Y
3	Is there a coherent and effective structure to the regulatory system governing the securities market? (ie, one without clear conflicts of interest involving either the securities commission or the stock exchange; without fragmentation and disagreement between different financial and economic regulatory authorities; and where there is a clearly definable securities commission or bureau taking the lead on enforcement)	S	S	M	S	S	S	S	M	S	S	L
4	Is the statutory regulator (ie, the securities commission) formally and practically autonomous of government (ie, not part of the ministry of finance; nor has the minister of finance or another senior official as chairman; not unduly influenced by government; and not dependent on the government for its annual budget)?	N	M	S	M	M	N	M	M	N	N	M
5	Has the government and/or the statutory regulator been actively reviewing and modernising company and securities laws in recent years (ie, to improve corporate governance and bring local rules and regulations up to international standards)?	S	L	Y	S	Y	S	L	M	L	Y	M
6	Has the stock exchange been actively reviewing and modernising its listing rules in recent years (ie, with a view to improving corporate governance)?	S	M	S	M	L	M	Y	M	S	Y	M
7	Has the securities commission signed the IOSCO Multilateral Memorandum of Understanding?	Y	Y	Y	Y	Y	Y	Y	M	Y	Y	Y
8	Do the regulators (ie, securities commission and stock exchange) have informative websites, with English translations of all key laws, rules and regulations easily accessible?	S	Y	L	S	L	L	Y	S	Y	L	L
9	Does the stock exchange provide an efficient, extensive and historical online database of issuer announcements, notices, circulars and reports (ie, archived for at least 10 years and in English)?	Y	Y	L	M	S	S	Y	S	S	L	M
10	Does the legal system allow minority shareholders effective access to courts to settle disputes? (ie, in terms of the cost of going to court and the range of legal remedies available)	M	N	N	M	M	S	N	M	N	L	N
11	Is the judiciary independent and clean (in relation to company and securities cases)?	N	Y	S	N	Y	S	M	S	S	L	M
12	Is the judiciary sufficiently skilled in handling securities cases?	M	Y	M	N	M	S	M	M	Y	S	S
13	Is the media free to report on corporate governance abuses among listed companies?	S	Y	Y	L	L	L	S	L	L	L	L
14	Is the media sufficiently skilled at reporting on corporate governance?	S	L	L	S	S	S	L	L	L	M	L
15	Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	M	L	M	S	L	M	M	M	Y	S	M
16	Is the government making progress in improving standards of public governance?	M	S	M	M	S	M	M	S	S	M	M

Continued on the next page

Evaluation of Asian markets on corporate-governance norms (continued)

D	**IGAAP (or "accounting & auditing")** **This section addresses the nature of accounting and auditing rules and practices, as well as the regulation of the accounting profession.**	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Does the government or the accounting standards board have a firm commitment to adopting international (IFRS) accounting standards (and is this being implemented consistently)? ("Adopting" means full implementation of IFRS; less than full implementation is called "convergence")	Y	Y	S	L	L	Y	Y	Y	Y	Y	Y
2	Are local accounting rules fully in line with international standards?	L	Y	S	L	L	Y	Y	L	Y	Y	L
3	Are accounting policies and practices among large companies* in line with international standards and best practices? (*Main index firms) (eg, are accounting policies being followed properly?; do the firms have adequate accounting and financial reporting systems and trained staff?)	L	Y	L	L	Y	L	L	Y	Y	Y	L
4	Are accounting policies and practices among small- and medium-sized companies in line with international standards and best practices?	S	S	M	S	S	S	S	S	S	S	S
5	Do the rules require detailed segment reporting?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
6	Is disclosure of audit and non-audit fees paid to the external auditor required, with accompanying commentary sufficient to make clear what the non-audit work is?	S	L	Y	M	S	S	S	S	S	S	S
7	Does the government or the accounting regulator have a policy of following international standards on auditing (ie, the standards promulgated by the International Federation of Accountants in New York); and is it being implemented consistently?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
8	Are local auditing rules fully in line with international standards?	L	Y	L	Y	Y	Y	Y	Y	Y	Y	Y
9	Are auditing practices among large companies* in line with international best practices? (¹Main index firms) (eg, the auditor does not need to assist in any way with account preparation; audit quality standards are high; audit partners spend sufficient time supervising audits)	L	Y	L	L	L	L	Y	L	Y	Y	L
10	Are auditing practices among small- and medium-sized companies in line with international best practices?	M	S	M	M	S	M	S	S	S	L	S
11	Has the government or accounting regulator enacted and enforced effective rules on the independence of external auditors? (eg, by introducing limits on the non-audit work that external auditors can do; requirements for audit-partner rotation; whistleblower protection for auditors; and so on)	S	M	S	M	S	L	L	S	Y	L	S
12	Has the government established an independent audit oversight board with clear, effective and independent powers of registration, inspection, investigation, and sanction?	S	M	M	S	S	L	Y	N	L	S	Y
13	Does the audit regulator exercise effective and independent disciplinary control over the audit profession (including disclosure of its enforcement work on a timely basis)?	M	M	N	S	S	S	L	M	S	M	L
14	Does the audit regulator publish a report or survey on audit industry capacity (ie, the level of skills and experience in the CPA profession) and on its own inspection work?	S	M	N	N	Y	S	Y	N	Y	N	Y
15	Does the audit regulator and/or the local accounting industry body have an active programme for CPA education?	Y	Y	Y	Y	S	S	Y	Y	Y	Y	Y

Continued on the next page

Evaluation of Asian markets on corporate-governance norms (continued)

E	CG culture **This section looks at the extent to which corporate governance has penetrated company and market behaviour and decision-making.**	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Does the average listed company believe that corporate governance will provide tangible benefits? (eg, lower cost of capital, improved share price, better risk management). Look at evidence from individual companies as well as policies/activities of key business associations.	M	N	M	N	N	N	N	N	N	N	N
2	Are large listed companies[1] genuinely trying to follow the spirit, not merely the letter, of corporate governance rules? (ie, in practical terms this would mean doing more than the rules require). Look also at whether the chairman or CEO is known for taking a leadership position on CG.	S	S	S	M	S	N	S	M	S	S	S
3	Is there an up and coming group of small- and/or mid-cap stocks that is gaining a reputation for being well-governed and also going 'beyond compliance'? (Ditto re chairman and CEO)	M	M	M	M	S	N	M	M	M	N	S
4	Are large listed companies actively seeking to improve their communication and dialogue with shareholders? (eg, through open discussion, more regular briefings and detailed disclosure, and transparent shareholder meetings). Is this disclosure meaningful and honest?	L	L	L	L	L	L	L	L	L	L	L
5	Are small- and medium-sized listed companies actively seeking to improve their communication and dialogue with shareholders? (Ditto)	S	S	M	S	L	M	M	S	S	S	S
6	Do company boards generally have separate chairmen and CEOs, with the Chairman being independent of the CEO? And is this separation meaningful?	N	M	M	M	M	N	M	N	M	N	M
7	Do listed companies provide adequate disclosure of their internal-control and risk-management functions in their annual reports? Key issues to look at: A clearly articulated "risk appetite"? A strategy in line with this risk appetite? Risk committees within the board and senior management? Constant communication by the CEO about the company's risk appetite?	M	S	S	S	S	M	S	S	S	S	S
8	Do listed companies provide a detailed explanation of their executive and employee remuneration policies?	M	M	M	M	N	N	M	M	S	M	S
9	Is there a trend towards listed companies voluntarily voting by poll at their AGMs and making the results public afterwards?	L	Y	Y	M	L	N	M	N	Y	Y	Y
10	Has the stock exchange or another organisation developed an open electronic voting platform ("straight through processing") for investors?	S	N	L	N	Y	L	N	N	M	Y	N
11	Do "reputation intermediaries" (ie, investment banks, accountants, lawyers) or stock exchanges promote high standards of corporate governance in clients about to undergo an IPO?	N	M	N	N	N	N	N	N	N	N	N
12	Are institutional investors (domestic and foreign) actively engaged in promoting better corporate governance practices?	M	S	S	N	S	M	S	N	M	M	S
13	Have institutional investors set up any corporate governance "focus funds"?	N	N	N	N	M	N	M	N	N	N	N
14	Are retail investors or non-profit organisations engaged in promoting better corporate governance practices?	N	L	S	M	S	Y	Y	S	Y	Y	L
15	Have retail investors or members of the public formed their own independent (ie, self-funded) shareholder or corporate governance organisations?	N	M	L	M	Y	Y	M	M	L	L	M
16	Is there an institute of directors (or equivalent) actively engaged in director training?	M	Y	M	Y	Y	M	Y	Y	Y	S	Y
17	Are other professional associations - company secretaries, financial analysts and so on - promoting corporate governance training and awareness raising?	L	Y	Y	M	L	M	Y	L	Y	M	L
18	Are professional associations and academic organisations carrying out original research on local CG practices?	Y	Y	Y	S	L	Y	S	S	Y	Y	L
19	Does the media actively and impartially report on CG reforms and developments?	M	Y	Y	L	L	L	L	L	L	L	Y

[1] Main index. CH = China; HK = Hong Kong; IN = India; ID = Indonesia; JP = Japan; KR = Korea; MY = Malaysia; PH = Philippines; SG = Singapore; TW = Taiwan; TH = Thailand. Y = Yes (+ 1 point); L = Largely (+ 0.75 point); S = Somewhat (+ 0.5 point); M = Marginally (+ 0.25 point); N = No (0 point); X = Zero/no data available. Source: ACGA

Appendix 3: CLSA CG questionnaire

Questions in bold carry negative scoring . . .

Discipline (18% weight)

1. **Does management stick to clearly defined core businesses?**
2. A) What is management's estimate of its cost of equity?

   B) What is management's estimate of its weighted average cost of capital?

   C) Is management's estimate of its cost of capital and of cost of equity within 10% of our estimate based on its capital structure? (Answer "No" if either estimate is less than 0.9x or greater than 1.1x of CLSA's estimate.)
3. **Over the past five years, is it true that the company has not issued equity, or warrants/options for new equity, for acquisitions and/or financing new projects where there was controversy over whether the acquisition/project was financially sound, or whether the issue of equity was necessary if gearing was not high by industry standards, or whether equity financing was the best way of financing a project, or where the purpose for raising equity capital was not clear? Is it also true that the company has not issued options/equity to management/directors as compensation at a rate equivalent to more than a 5% increase in share capital over three years, and that there is no reason to be concerned on these grounds about the issue of equity/warrants for new equity in the foreseeable future?**
4. Over the past five years, is it true that the company has not built up cash levels, through retained earnings or cash calls, that have brought down ROE?
5. Is it true that the company does not have a history over the past five years of restructurings, mergers, demergers or spinoffs that reflect either mismanagement, abandonment of earlier strategies, booking exceptional gains when operating profits are weak, or an intention to hide losses?
6. **Is the company able to make business decisions (eg, pricing/areas of operations/investments) within regulatory/legal constraints but without government/political pressure that restricts its ability to maximise shareholder value?**
7. Has management disclosed three- or five-year ROA or ROE targets? If so, please state in (7b).

. . . including three of seven questions in the discipline section

Transparency (18% weight)

Two of seven questions in the transparency section have negative scoring

8. Does the company publish its full-year results within two months of the end of the financial year? [Previously cutoff was three months, but best practice is now seen as two months.]
9. Does the company publish/announce semi-annual and quarterly results within 45 days of the end of the half-year?
10. Has the public announcement of results been no longer than two working days after the board meeting? Is it true that there has not been any case in the past five years when the share price moved noticeably just before the release of results and in a direction that anticipated the results?
11. **Are the reports clear and informative?** ("No" if consolidated accounts are not presented; or if over the past five years there has been occasion when the results announced lacked disclosure subsequently revealed as relevant; if key footnotes to the accounts are unintelligible; if negative factors were downplayed when presenting the company's results that were important in assessing the business value; or if there is inadequate information on the revenue/profit split for different businesses, or regions/countries or product

Three of seven questions under independence with negative scoring

lines; or inadequate disclosure and/or inadequate provisions for contingent liabilities, NPLs or likely future losses; or inadequate details of group/related company transactions and their rationale.)

12. **Are the accounts free of controversial interpretations of IFRS or of dubious accounting policies?** (If the company has changed accounting policies, or adopted a controversial accounting practice which has boosted stated earnings, or if pro-forma or unaudited result statements are notably different from actual audited accounts, answer "No".)
13. Does the company consistently disclose major and market-sensitive information punctually? Is it true that the company has not in the past five years failed to disclose information that investors deemed relevant in a timely fashion? (Answer "No" if there is any instance over the past five years of share price movement ahead of and anticipating an announcement.)
14. Do analysts and investors have good access to senior management? Good access implies accessibility soon after results are announced and timely meetings where analysts are given all relevant information and are not misled.

Independence (18% weight)

15. Is the Chairman an independent, non-executive director (and seen to be so)?
16. **Does the company have an audit committee? Is it chaired by a perceived genuine independent director and are more than half the members of the audit committee independent directors? Do all members of the audit committee, including independent directors, have financial expertise?** (If any of this uncertain and company does not provide any clarification, answer "No".)
17. Are the external auditors of the company in other respects seen to be completely unrelated to the company? Does the company provide a breakdown of audit and non-audit fees paid to auditors, and if so are the non-audit fees not more than one-third of the audit fees? Does the company disclose that the audit partner, or auditing firm, is rotated every five years? (No if any of the above is scored negatively.)
18. Do independent, non-executive directors account for more than 50% of the board?
19. A) What was the number of independent directors at the end of two years ago (2011)?

    B) And at the end of the last year (2013)?

    C) Has the company increased the number of independent directors over the past three years? (Plans to increase independent directors will count as a negative answer). If the company has reduced the number of independent directors, answer "-1"; if number of independent directors is the same insert "0".
20. Does the company vote by poll at AGMs and EGMs for all resolutions and release detailed results the next day (where all votes including through proxies are given their appropriate weight based on the percentage of shareholding, as opposed to by show of hands)?
21. A) Does the board composition reflect an attempt to bring diverse talents and backgrounds into the board? (Answer "No" if independent directors are mainly retired executives or retired government officials, or if the board is all male.)

    B) Are family members (including in-laws) no more than two individuals on the board?

Two of five questions under responsibility have negative scoring

Responsibility (18% weight)

22. Is it disclosed that independent directors attended at least ¾ of board meetings over the last fiscal year?

23. Is it true that there are no persons with criminal conviction that reflect negatively on integrity (ie, excluding traffic offences, overtly political convictions etc.) sitting on the board or having a senior executive position in the company?

24. **Is it true that the company does not engage in material related-party transactions?** (Eg, sourcing key materials from a related party, or using a related party that is not part of the listed group as a distribution channel, or placing funds in deposit or for investments in a related party that is not part of the listed group, or where the annual report discussion of related-party transactions runs over two short paragraphs, or where the listed company has invested in businesses where the controlling shareholder has interests in the past three years, answer "No". Note that a related party that is not part of the listed group would include a unit under the parent which may be separately listed.)

25. Is it true that the controlling shareholder (whether an individual or company) is not known or widely believed to be highly geared?

26. **Is the controlling shareholder's primary financial interest the listed company?** (Ie, not a government-controlled entity or a listed company where the ultimate shareholder has various other business interests. Answer "No" if the company is a subsidiary of a separately listed parent.)

Three of four questions in the fairness section carry negative scoring

Fairness (18% weight)

27. **Is it true that there has been no controversy or questions raised over whether the board and senior management have made decisions in the past five years that benefit them or the controlling shareholders, at the expense of investors?** (Any questionable inter-company transactions, management fees paid from the listed group to a parent company, or to a private company controlled by the major shareholders on the basis of revenues or profits would mean "No".)

28. Is it true that the company has not issued non-voting common shares? (Any classes of ordinary shares that disenfranchise their holders would mean a "No" answer.)

29. **Is it true that there have been no controversies/questions over whether share trading by board members, or placements by the company, have been fair, fully transparent and well-intentioned?** (Are announcements made to the exchange within three working days, and do the major shareholders reveal all transactions including those under nominee names? Any case where it is believed that parties related to major shareholder were involved in transactions not disclosed to the exchange, or allegations of insider trading, would mean "No".)

30. A) What is total remuneration of the board as a percentage of net profit after exceptionals?

    B) Over the past five years, is it true that total directors' remuneration has not increased faster than net profit after exceptionals? (Answer "No" if directors' remuneration has increased faster than profits or if company does not make any declaration to clarify.)

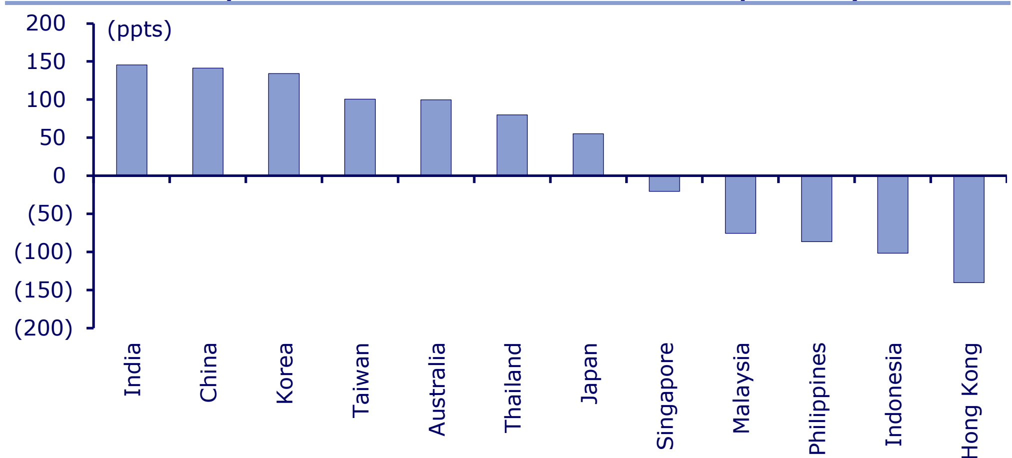
Appendix 4: Better-CG stock performance

Top-half CG stocks outperformed in seven of the 12 Asia Pac markets in past five years

If we take the most recent five-year cycle of market performance from 2009 to 2013, the top half of CG stocks outperformed in 2011 when the Asia-Pacific region was down, but underperformed in two of the past four years when the region was up. However, better-CG stocks have done generally better within markets. They outperformed lower-CG stocks in seven of the 12 markets we cover over the last five years. Above-average CG stocks in the respective markets outperformed the bottom-half CG stocks by over 100ppts in India, China and Korea, and by approximately 100ppts in Taiwan and Australia in this period. However the better-CG stocks underperformed in Singapore, Malaysia, Philippines, Indonesia and Hong Kong.

Strongest outperformance of better-CG stocks in India, China, Korea

Performance of top-half versus bottom-half CG stocks in the past five years



Source: CLSA

Better-CG stocks tend to do best where good CG is relatively scarce

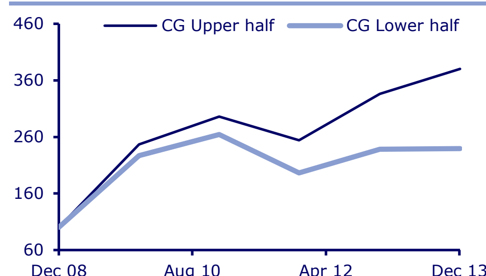
A striking point is that better-CG stocks tend to outperform more in markets where good CG is scarcer. They outperformed in three of the five markets in the bottom half of our CG rankings - Korea, China and India. Only Indonesia and Philippines were the exception among bottom-half CG markets where the better-CG stocks did not outperform. Where standards of CG are generally higher and thus CG is less of an issue, better-CG stocks do not outperform - eg, Hong Kong, Singapore and Malaysia. Taiwan and Thailand are the only exceptions among the top half of our CG rankings where better-CG stocks outperformed in the past five years.

Better-CG stocks in India, China and Korea outperform by 12-14ppts

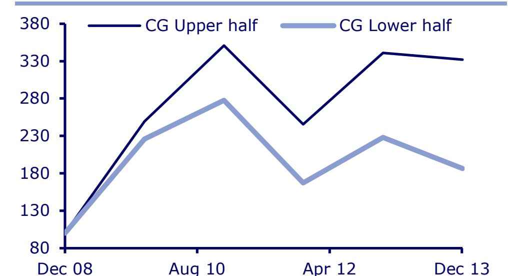
The above-average CG stocks have done particularly well in India, China and Korea, outperforming bottom-half CG stocks by 13.8ppts, 11.8ppts and 11.9ppts per year.

Top-half CG stocks outperformed in China and India

China: Performance of CG stocks



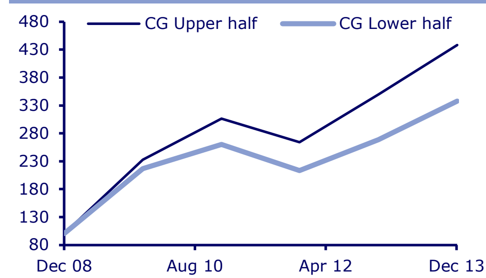
India: Performance of CG stocks



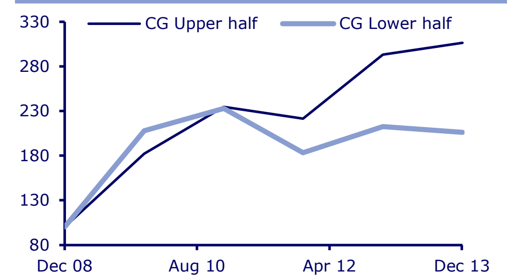
Source: CLSA

Also outperformed in Taiwan, Australia

Taiwan: Performance of CG stocks

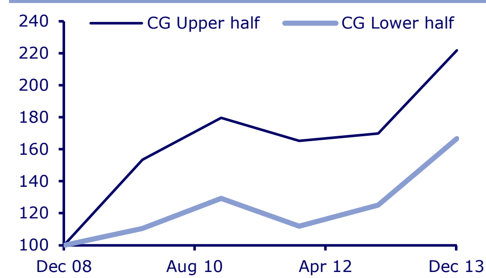


Aus: Performance of CG stocks

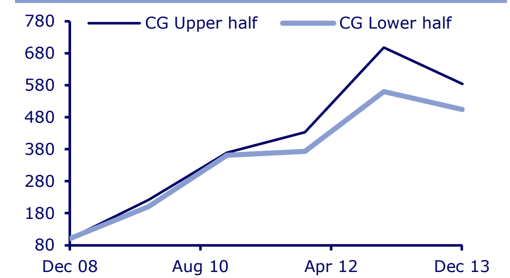


Better-CG stocks outperformed in Japan, less so in Thailand

Japan: Performance of CG stocks

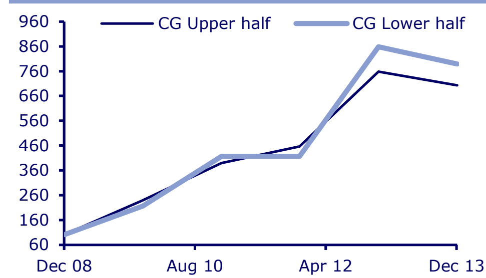


Thailand: Performance of CG stocks

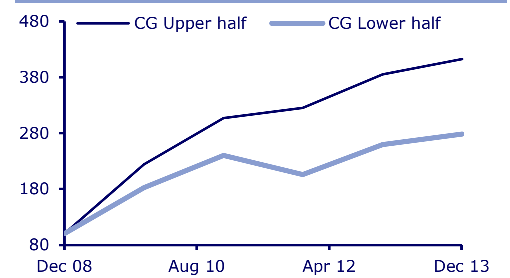


Better-CG stocks outperformed in Korea but underperformed slightly in the Philippines

Phils: Performance of CG stocks

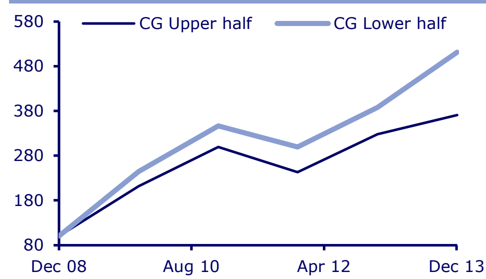


Korea: Performance of CG stocks

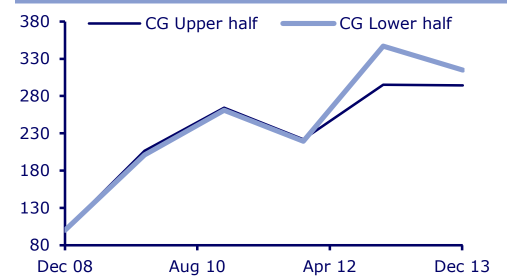


Better-CG stocks underperformed in HK and Singapore, where CG is less of an issue

HK: Performance of CG stocks

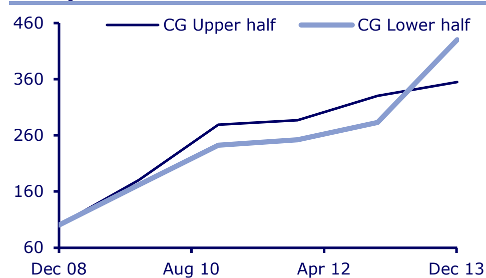


Singapore: Performance of CG stocks

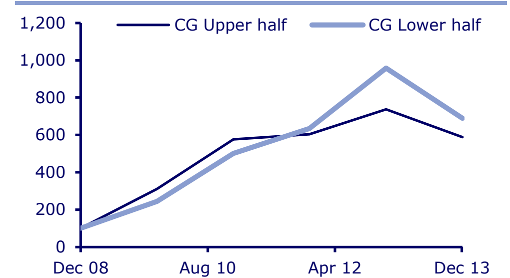


Bottom-half CG stocks outperformed in Malaysia and Indonesia

Malaysia: Performance of CG stocks



Indo: Performance of CG stocks



Source: CLSA

Appendix 5: Changes in CG scores

Gainers

Company	Code	Change (ppts)	Reason
PCSC	2912 TT	25.5	Strengthened the audit committee
Li & Fung	494 HK	18.0	More timely financial reporting, less concern on acquisitions, improvement in earnings relative to directors remuneration
Adaro	ADRO IJ	17.2	Faster disclosure of results, independent directors attended all board meetings, focused on core business
Tata Motors	TTMT IB	14.8	Better disclosure on JLR
URC	URC PM	14.1	Sold investment portfolio, improved transparency
Standard Chartered	2888 HK	14.1	Increased number of INEDs, strengthened the audit committee
Hemaraj	HEMRAJ TB	13.9	Improved on disclosure and transparency
Hyundai Motor	005380 KS	13.5	More than five years since questionable CG issues were raised
CSCL	2866 HK	13.5	Earnings rebounded faster than remuneration of the board
Hindalco	HNDL IB	13.2	Done away with capitalisation of interest on acquisition debt
LPN	LPN TB	12.2	Improved on disclosure and transparency
SCB	SCB TB	11.6	Between 2011 and 2013, added a corporate governance section to its annual report and created a sustainability report
Mando	060980 KS	11.6	Improved on transparency - accounts are free of controversial interpretations of IFRS or of dubious accounting policies; greater ability of management to maximise shareholder value
Samsonite	1910 HK	11.6	Increased number of INEDs and improvement in earnings relative to directors' remuneration
Prada	1913 HK	11.6	More timely financial reporting
Chow Tai Fook	1929 HK	11.6	More timely disclosures, increased number of INEDs
Cambridge Ind	CREIT SP	11.1	Increased INEDs; did a non-accretive transaction but that is now more than five years back
Keppel Land	KPLD SP	10.9	Access to management has improved, increased no of INEDs
DBS	DBS SP	10.9	Increased INEDs
Bukit Asam	PTBA IJ	10.2	Speedier announcement of results, better accessibility to management
Sembcorp Marine	SMM SP	9.6	Appointed more independent directors, independent chairman
Idea Cellular	IDEA IB	9.6	Improvement in discipline - over the past five years the company has not engaged in dilutive issuances and restructurings, mergers, demergers or spinoffs that reflect either mismanagement, abandonment of earlier strategies, booking exceptional gains when operating profits are weak, or an intention to hide losses
I.T	999 HK	9.6	Increased the number and percentage of board members who are independent non-executive directors
Antonoil	3337 HK	9.6	Disclosure becomes more informative and timely
Krung Thai Bank	KTB TB	9.0	Improvement in transparency, ie, providing more disclosure especially on major and market sensitive information in a timely manner
Nitori	9843 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Mizuno	8022 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Kirin	2503 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Fast Retailing	9983 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Asics	7936 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Asahi Group	2502 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Sapporo	2501 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Japan Tobacco	2914 JP	9.0	Over the past five years, directors’ remuneration not increased faster than net profit (change from previously)
Hitachi	6501 JP	9.0	Embraced a diversified board and increased the number of independent members. The former heads of 3M, BP, Anglo-American, on the board represent the company’s increasing targeting of global top 50 companies as customers for the Hitachi group and best practices of global companies.
Indosat	ISAT IJ	9.0	The company has become more disciplined in publishing their financial results within two months of the end of the period
Rural Electrification	RECL IB	9.0	Improvement in fairness - over the past five years no history of board and senior management's decisions that benefit them or the controlling shareholders, at the expense of investors
Zijin	2899 HK	9.0	Directors’ remuneration increased slower than net profit growth in the past five years (unlike previously), while all the current members on its audit committee have accounting or banking backgrounds; access to management and transparency improved
Tencent	700 HK	9.0	Directors’ remuneration as a percentage of profit declined substantially

Continue on the next page

Gainers (continued)

Company	Code	Change (ppts)	Reason
Conch	914 HK	9.0	After a change of board earlier 2014, all the members of the audit committee have financial expertise. Remunerations of directors now growing less than earnings
China Telecom	728 HK	9.0	Over the past five years, total directors' remuneration has not increased faster than net profit after exceptionals, unlike during the previous scoring.
Catcher Tech	2474 TT	8.4	Management began to disclose COE and WACC estimates, improved disclosure
CCT	CCT SP	8.4	Increased the number of independent directors over the past three years
EDC	EDC PM	8.4	The company has been more vocal and transparent with the problematic BacMan geothermal power plant
BCA	BBCA IJ	8.4	Improving transparency in reporting and disclosure of financial targets
Genting Bhd	GENT MK	8.1	Improvement in independence - no more than two members on the board, and responsibility - independent directors attended at least three-fourths of board meetings over the last fiscal year
Ayala Land	ALI PM	8.0	Company replaced their non-voting prefs and voting prefs, improved on disclosing market-sensitive information
IRPC	IRPC TB	7.7	Improvement in transparency, ie, providing more disclosure especially on major and market sensitive information in a timely manner
Samsung Electronics	005930 KS	7.7	Increase in the number of independent directors
Kepco	015760 KS	7.7	Improved on its accounting practices
Suzuki Motor	7269 JP	7.7	Company has not engaged in dilutive issuances in recent years, adopted voting by poll at AGMs and EGM
Japan Exchange	8697 JP	7.7	More information has been disclosed, access to management has improved
BTPN	BTPN IJ	7.7	Improving transparency in reporting and financial targets
Tata Steel	TATA IB	7.7	Better disclosure on foreign acquisition Corus; increase in number of independent directors
Robinson	ROBINS TB	7.5	Improved access to management, improved audit committee structure
Thai Oil	TOP TB	7.1	Improvement in transparency - all reports are clear and informative
OCBC	OCBC SP	7.1	Management began to disclose ROA/ROE estimates; independent, non-executive directors now account for more than 50% of the board
Jollibee	JFC PM	7.1	Company has improved on transparency over the years, more timely with the release of market sensitive information as well as results
Globe Telecom	GLO PM	7.1	Board remuneration not rising faster than earnings (unlike previously)
Panasonic	6752 JP	7.1	Increased the number of independent directors; directors remuneration has not increased faster than net profit; the controversial 2008 Sanyo merger now more than five years back
Fujitsu	6702 JP	7.1	Management has begun to disclose ROA/ROE targets and total director remuneration not increased faster than net profit (unlike previously)
Harum Energy	HRUM IJ	7.1	Management has greater ability to maximise shareholders value, transparency has improved including more timely reporting of results
Lippo Karawaci	LPKR IJ	7.1	Management seen now as sticking to clearly defined core businesses
Ciputra Dev	CTRA IJ	7.1	Management seen now as sticking to clearly defined core businesses
Lupin	LPC IB	7.1	Management seen now as sticking to clearly defined core businesses
Axis Bank	AXSB IB	7.1	Improvement in independence - the company has increased the number of independent directors over the past three years
Techtronic	669 HK	7.1	Increase in number of independent non-executive directors
HSBC	5 HK	7.1	Improvement in transparency - public announcement of results no longer more than two working days after the board meeting; number of independent directors hasn't changed but declined previously for 2012 scoring
Agile Property	3383 HK	7.1	Improvement in discipline - over the past five years the company has not engaged in dilutive issuance

Source: CLSA

Losers

Company	Code	Change (ppts)	Reason
Nintendo	7974 JP	(8.4)	Over the past five years, total directors' remuneration increased faster than net profit the company has built up cash levels that have brought down ROE
Yes Bank	YES IB	(8.4)	Controversy that some of management's decisions were negative for investors
CP All	CPALL TB	(8.9)	Material related-party transactions and controversy over some of management decisions
Tisco	TISCO TB	(9.0)	Has diluted its fairness and discipline as they expanded aggressively posing undue business and investment risks to, calling capital from, and, in some cases, diluting minority shareholders' interest
PNB	PNB PM	(9.0)	Lower score on fairness given board remuneration in 2013 was faster than the percentage increase in net income in the past two years
Meralco	MER PM	(9.0)	Board remuneration has exceeded earnings over the past five years; number of independent members declined
Phoenix Petro	PNX PM	(9.0)	Management decided to "park" some shares at their parent after they expanded their authorized capital base
SapuraKencana	SAKP MK	(9.0)	Over the past five years total directors' remuneration has increased faster than net profit after exceptionals
S1	012750 KS	(9.0)	Had a large acquisition from Samsung group; lowered the numbers of independent directors from 3 to 2
Bumi Serpong	BSDE IJ	(9.0)	Injected assets from related parties financed through non pre-emptive rights issue
SBI	SBIN IB	(9.0)	Directors' remuneration increased faster than net profit after exceptionals
Samsung C&T	000830 KS	(9.3)	Issues arose from merger between Everland and Samsung C&T
Telkom	TLKM IJ	(9.4)	Concerns over its creation of pay-TV platform right after it sold its original pay-tv platform, TelkomVision
Bursa Malaysia	BURSA MK	(9.6)	Decline in number of independent directors
Lotte Shopping	023530 KS	(9.6)	Now greater government direction on their supermarket and discount store business, and there have been intergroup transactions
Titan	TTAN IB	(9.6)	Central bank took several measures to limit gold imports, which have impacted jewellery players, ie, business perceived now to be more subject to government's dictates
CP Foods	CPF TB	(10.3)	Expanded aggressively posing undue business and investment risks to, calling capital from, in some cases, diluting minority shareholders' interest
LIG Insurance	002550 KS	(10.3)	Cost of capital estimate varies from our calculation
Cadila Healthcare	CDH IB	(10.3)	Poorer access to management and reduced transparency
LG Display	034220 KS	(10.8)	Directors attend less than 75% of board meetings
Sembcorp Ind	SCI SP	(11.6)	Number of independent directors decreased, total directors' remuneration has increased faster than net profit after exceptionals
TM	T MK	(11.6)	Related-party transactions
LG Electronics	066570 KS	(11.6)	Decline in fairness - Over the past five years, total directors' remuneration has increased faster than net profit after exceptionals
Cipla	CIPLA IB	(11.6)	Directors' remuneration held up faster relative to earnings
Oriental Watch	398 HK	(11.6)	Directors' remuneration held up relative to earnings decline
Emperor Watch	887 HK	(11.6)	Chairperson not an independent director. The company paid HK$243m of rental (over 20% of its selling and distribution expenses) to affiliated companies.
Leighton	LEI AU	(12.2)	ACS' interference lead to resignation of an independent chairman and independent directors
KPJ	KPJ MK	(12.2)	Directors' remuneration held up relative to earnings decline
Samsung Life	032830 KS	(12.2)	New audit committee member who does not have financial expertise
HPH Trust	HPHT SP	(12.6)	Hasn't provided timely and adequate information regarding the industrial action that happened in Hong Kong last year. Conducted material related-party transactions, and material management fees paid to trust manager for acquisitions.
Tong Yang Life	082640 KS	(12.9)	One new member of audit committee without financial expertise, cost of capital different from our estimate
GAC	2238 HK	(12.9)	GAC didn't perform well in the past two years mainly due to the Diaoyu Island event staring from September 2012 and the lack of new technologies and products for the Japanese branded cars. ROE has been low in the past two years and earnings dropped significantly in 2012. The company has been having recalls on its products over the years and lagged behind peers in the New Energy Vehicle (NEV) segment.
Evergrande	3333 HK	(12.9)	Issued dilutive equity and also had accounting issues

Continue on the next page

Losers (continued)

Company	Code	Change (ppts)	Reason
AIA	1299 HK	(13.1)	Board remuneration continued to increase despite a slide down in profit in 2013
KB Financial	105560 KS	(14.1)	KBFG saw declines due to board-of-director composition and the recent scandal in their IT system change
Hanwha Life	088350 KS	(14.1)	Cost of capital estimate different from our calculation, directors fees rose faster than earnings
Inpex	1605 JP	(14.5)	Significant share-price movement before public offering
Infosys	INFO IB	(14.8)	Number of independent directors reduced; faster rise in directors remuneration relative to earnings
Top Glove	TOPG MK	(15.2)	Related party transaction involving a Co controlled by the chairman
Dentsu	4324 JP	(15.4)	The acquisition of Aegis was partially financed by the company selling treasury shares, which looked unnecessary to us as could have been financed through bonds
RHB Capital	RHBC MK	(16.1)	Decline in independent directors and remuneration of directors rose faster than net earnings
Mayora Indah	MYOR IJ	(16.1)	Private company of controlling shareholder launched competing product
Kiwoom	039490 KS	(16.7)	Directors fees rose faster than earnings
Daelim	000210 KS	(16.7)	Transparency in accounting dropped significantly due to inflated earnings in 2011-12, unexpected provisions in 2013 (biggest in past 10 years); questionable transactions that appear to benefit only major shareholders; poorer disclosure
Hindustan Unilever	HUVR IB	(17.7)	Increase in royalty rates to parent
SM Prime	SMPH PM	(18.1)	No estimates of COE and WACC, as well as its ROA/ROE targets; significant decline in transparency with major developments reported by local newspapers before the company issued any announcement
UMC	2303 TT	(18.6)	Lack of an ROE target and restructuring of its diversified business investment and structure
Samsung F&M	000810 KS	(18.6)	New audit committee member without financial expertise, issued non-voting shares, directors fees rising higher than earnings
Daewoo Securities	006800 KS	(18.6)	Issued non-voting shares and directors fees increased faster than earnings
HDC	012630 KS	(19.0)	Decline in transparency
Land & Houses	LH TB	(19.7)	Diversification into the USA raised concerns by investors
SK Hynix	000660 KS	(20.2)	Affiliate-party transactions, SK Hynix is making payments to several SK companies, including a 4bn won royalty payment for branding
Samsung Securities	016360 KS	(21.2)	Directors remuneration rose faster than earnings
Megawide	MWIDE PM	(23.1)	No estimates of COE and WACC, as well as its ROA/ROE targets. It raised money but kept the cash for a long time on its balance sheet, lowering its ROE. The company overguided on its 2013 earnings and then suddenly quoted a different figure in its annual shareholders' meeting. Access to senior management has been spotty; some inter-company transactions; mode of payment for land from affiliates using shares resulting in some dilution.
Daewoo E&C	047040 KS	(23.1)	Being investigated for overseas and domestic accounting practice and unexpected provisions; also significantly revised down preliminary results numbers
Samsung Eng	028050 KS	(24.2)	Decline in transparency
E-mart	139480 KS	(24.2)	Questions relating to business strategy, government interference, management changes at a rapid pace and investigations into treatment of their staff
HDHS	057050 KS	(24.2)	Invested into a fashion company which appears to be more beneficial to their parent, Hyundai Department Store; the company continues to be involved in potential additional non-core acquisitions
Nestlé India	NEST IB	(26.1)	Increase in royalty rates to parent. Independent directors no longer a majority of the board
GS E&C	006360 KS	(28.0)	Decline in transparency
LS Corp	006260 KS	(29.7)	Poor and disclosure and lack of clear reporting in recent years, especially with regards to earnings from subsidiaries. Decline in independent directors.
Ambuja Cements	ACEM IB	(31.9)	Holcim raised technical fees by 1% of revenues; group restructuring raised issues
ACC	ACC IB	(33.2)	Holcim raised technical fees by 1% of revenues; group restructuring raised issues

Source: CLSA

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Appendix 6: E&S rationale for autos

For the full explanation of the rationale behind our questions, broken out by sector, please see *How big are yours?* This section provides the summary for the automotive sector. In the appendices, we include the question lists for each of the 11 sectors.

The auto sector is highly exposed to sustainability megatrends

In short, the auto sector is highly exposed to sustainability megatrends. Resource constraints and carbon abatement are already major considerations in R&D spending and in some cases revenue. On the societal side, income thresholds, urbanisation and wealth generation are primary demand drivers for the industry. Sector-specific issues include vehicle safety and industrial relations.

Key sector issues

Megatrend/sustainability	Sector relevance
Resource constraints	Petrol and diesel prices and availability are key to auto demand. Oil security (or lack of it) can drive substitution to gas or coal via electric vehicles or through LPG. In this context, electric vehicles, particularly in China and India, are more a solution to fuel availability than climate change, as electricity generation via coal is more carbon intensive than most oil-fuelled cars. The industry is exposed to metal prices/availability and longer-term issues remain, but prices have eased in the past year. Rare-earth availability may be a complicating factor for electric-vehicle batteries, as China is the leading producer and has restricted exports of some rare earths.
Carbon abatement	The sector is strongly linked to emissions. This is primarily through the use of fossil fuels to power vehicles (conventional, hybrid or electric). Though a significant manufacturer, in-house emissions for the auto sector are less significant than those from vehicle use. Even in the absence of regulation, consumer demand is a strong driver of innovation in this space.
Climate change (adaptation)	The auto sector does not have specific exposure, though it requires water, as do other manufacturers. The disruption to auto supply from the 2011 Thai floods highlights risks of concentrated supply chains to the industry.
Environmental pollution	Beijing's Airpocalypse, as well as those in Shanghai and other major cities, may result in more stringent standards. In Paris recently, only vehicles with odd/even number plates were allowed to drive on alternate days.
Population columns	Older drivers may be less inclined to buy larger, higher-status or higher-profit cars. Much older drivers may not be able to drive as much, due to sight deterioration. This could be a perfect niche for autonomous or self-driving cars. As auto-work is considered a higher-status blue-collar job, staff availability should not be a problem as the workforce ages. However, there may be a risk of productivity declines for older workers.
Income distribution	Middle-class growth and urbanisation is a key driver for new auto markets. Where economic growth accrues to a small number of individuals, this may reduce volume growth.
Sector ESG	
Customer safety	Customer safety is not as significant a factor in purchasing decisions in developing Asia as in EU/NA. However, this will change with development and is already an issue for exporting companies and for companies targeting higher-income segments.
Labour relations	Strikes can disrupt production in this industry. Maruti Suzuki is a key example of what can go wrong.

Source: ARE, CLSA

We boil down the 20-plus questions per sector to the three most essential

Appendix 7: Three key E&S questions

In all, we present a bit over 20 questions that investors should be looking at to better gauge companies in each individual sector. We recognise limitations: there is limited face time with management teams and a lot to talk about; and official reporting on a lot of these issues is still somewhat rudimentary (albeit improving), especially in emerging markets. In the table below, we highlight the three to four key environmental/social questions that are most essential to assessing companies.

Key questions

Sector	Key questions
Autos	❑ What is the company's strategy regarding fuel efficiency and alternative transport?
	❑ Has it established a good relationship with the workforce?
	❑ What is its track record on product safety?
Capital goods	❑ Does the company serve end markets that face risks or opportunities due to resource constraints?
	❑ Does it provide solutions for environmental problems, or does it serve end markets at risk from regulation?
	❑ How is it managing its safety record?
Conglomerates	❑ How proactive is management's approach to sustainability/ESG?
	❑ To what extent are the company's underlying operating assets at risk from sustainability/ESG issues?
	❑ To what extent does sustainability/ESG provide opportunities for the company's underlying operating assets?
Consumer	❑ How well is the company positioned to take advantage of the growing Asian middle-class consumer?
	❑ Is it taking steps to mitigate any social issues created by consumption of its products?
	❑ How is it handling water issues across its value chain, from factory discharges to water access in raw-material supply?
	❑ How does it ensure that its suppliers are not cutting corners in a way that could affect its reputation?
Financials	❑ To what extent is the institution systemically important and how does it prudently manage its risks?
	❑ How is the company positioned to meet the evolving needs of consumers in its target geographies, specifically for ageing consumers or where there is an emerging middle class?
	❑ How does the institution manage sustainability/ESG-related risk in its credit processes and what is its track record?
Information & communication technologies (ICT)	❑ To what extent is the company investing in products and services that deliver resource efficiencies either directly or through smart grids/machine-machine networking?
	❑ To what extent is it investing in reducing its in-house energy use and managing water quality?
	❑ What is its track record on worker safety and how does it ensure supply-chain standards?
	❑ How is it managing the protection of customer data?
Materials	❑ How is the company ensuring it has sufficient access to raw materials, particularly access to water?
	❑ How is it handling its relations with communities in its operating areas?
	❑ What regulation is expected for pollution in the normal course of business and relating to violations? What steps is the company taking to manage pollution and how effective have these moves been?
Petro/chems	❑ Is the company maintaining its reserve-replacement ratio at more than one without dramatic increases in expenditure?
	❑ Does it have uncontested access to its production areas?
	❑ What is its track record on Occupational Health and Safety (OHS)/pollution?
Power	❑ What is the company doing to mitigate environmental emissions and what are the implications for returns?
	❑ How is it positioning itself in light of declining renewables cost curves?
	❑ To what extent is the company at risk of regulation on price increases that reduce returns in order to provide an affordable supply?
Property	❑ How do the company's buildings compare in terms of energy use per square metre to other facilities with a similar use?
	❑ Are its landbank and developments aligned with potential demand in those areas?
	❑ How does it ensure that contractors are minimising site-level environmental, health and safety violations?
Transport	❑ How is the company managing energy- and carbon-related risks?
	❑ How well is the company positioned to benefit from changes in income distribution?
	❑ What is its safety track record and what steps is the company taking to address passenger safety?

Source: ARE, CLSA

Companies mentioned

ACC (ACC IB - Rs1,510.8 - BUY)[1]
Adelaide Brighton (ABC AU - A$3.32 - Underperform)[1]
Agile Property (3383 HK - HK$6.05 - BUY)[1]
AirAsia (AIRA MK - RM2.57 - Outperform)[1]
Airtac (1590 TT - NT$270.0 - Outperform)[2]
Ajinomoto (2802 JP - ¥1,754 - Outperform)[1]
ALS (ALQ AU - A$6.92 - UNDERPERFORM)[1]
Amcor (AMC AU - A$11.09 - BUY)[1]
AMMB (AMM MK - RM6.74 - Underperform)[1]
AMP (AMP AU - A$5.56 - BUY)[1]
Ansell (ANN AU - A$19.49 - Outperform)[1]
Apple (AAPL US - US$101.63 - BUY)[3]
Asia Aviation (AAV TB - Bt4.7 - Outperform)[1]
Asian Property (AP TB - Bt7.3 - Outperform)[1]
Asustek (2357 TT - NT$305.0 - Outperform)[1]
ASX (ASX AU - A$36.20 - Underperform)[1]
AUO (2409 TT - NT$13.6 - Outperform)[1]
Ayala Corp (AC PM - P711.50 - Outperform)[1]
Bangkok Dusit (BGH TB - Bt18.7 - Outperform)[1]
BEA (23 HK - HK$32.75 - Underperform)[1]
BEC World (BEC TB - Bt45.0 - Underperform)[1]
Bharat Petroleum (BPCL IB - Rs681.9 - BUY)[1]
BHP Billiton (BHP AU - A$35.74 - Outperform)[1]
BlueScope (BSL AU - A$5.67 - BUY)[1]
Brambles (BXB AU - A$9.58 - BUY)[1]
Bridgestone (5108 JP - ¥3,624 - BUY)[1]
BYD (1211 HK - HK$53.40 - SELL)[1]
Canon (7751 JP - ¥3,528 - BUY)[1]
Carsales.com (CRZ AU - A$10.18 - Underperform)[1]
CCCC (1800 HK - HK$5.60 - BUY)[1]
China Merchants (144 HK - HK$25.10 - BUY)[1]
ChipMOS (8150 TT - NT$37.5 - BUY)[2]
Ciputra Dev (CTRA IJ - Rp1,120 - Underperform)[1]
Ciputra Surya (CTRS IJ - Rp2,185 - Outperform)[1]
Cochlear (COH AU - A$67.43 - SELL)[1]
Conch (914 HK - HK$27.85 - BUY)[1]
CP All (CPALL TB - Bt45.5 - BUY)[1]
CP Foods (CPF TB - Bt31.0 - BUY)[1]
CSL (CSL AU - A$72.60 - BUY)[1]
CSR (CSR AU - A$3.54 - Underperform)[1]
D&L (DNL PM - P12.90 - Outperform)[1]
Daihatsu (7262 JP - ¥1,826 - BUY)[1]
Daum (035720 KQ - 149,200 won - Under review)[1]
Del Monte Pacific (DMPL PM - P17.92 - BUY)[1]
Delta (2308 TT - NT$197.0 - Outperform)[2]
Denso (6902 JP - ¥4,752 - BUY)[1]
DGB Financial (139130 KS - 17,050 won - Outperform)[1]
Dongbu Insurance (005830 KS - 59,600 won - Outperform)[1]
eClerx (ECLX IB - Rs1,393.4 - Outperform)[1]
Emperador (EMP PM - P11.00 - BUY)[1]
Ezion (EZI SP - S$1.83 - BUY)[1]
Filinvest Land (FLI PM - P1.53 - BUY)[1]
Fletcher Building (FBU AU - A$8.10 - BUY)[1]
Foxconn Tech (N-R)
Fujifilm (4901 JP - ¥3,266 - BUY)[1]
Fujitsu (6702 JP - ¥695 - BUY)[1]
Future Bright (703 HK - HK$3.42 - BUY)[1]
Giant Mfg (9921 TT - NT$240.0 - BUY)[2]
Haier (N-R)
Hang Seng Bank (11 HK - HK$130.60 - SELL)[1]
HCL Tech (HCLT IB - Rs1,608.1 - BUY)[1]
Hitachi (6501 JP - ¥820 - BUY)[1]
HMFI (001450 KS - 30,650 won - Underperform)[1]
HMI (3658 TT - NT$1,295.0 - BUY)[2]
HN Renewables (958 HK - HK$2.75 - Outperform)[1]
Honda Motor (7267 JP - ¥3,650 - BUY)[1]
HSBC (5 HK - HK$82.50 - Underperform)[1]
HTC (2498 TT - NT$127.0 - SELL)[2]
Huadian Fuxin (816 HK - HK$4.40 - Outperform)[1]
Huaku Dev (2548 TT - NT$66.6 - Underperform)[2]
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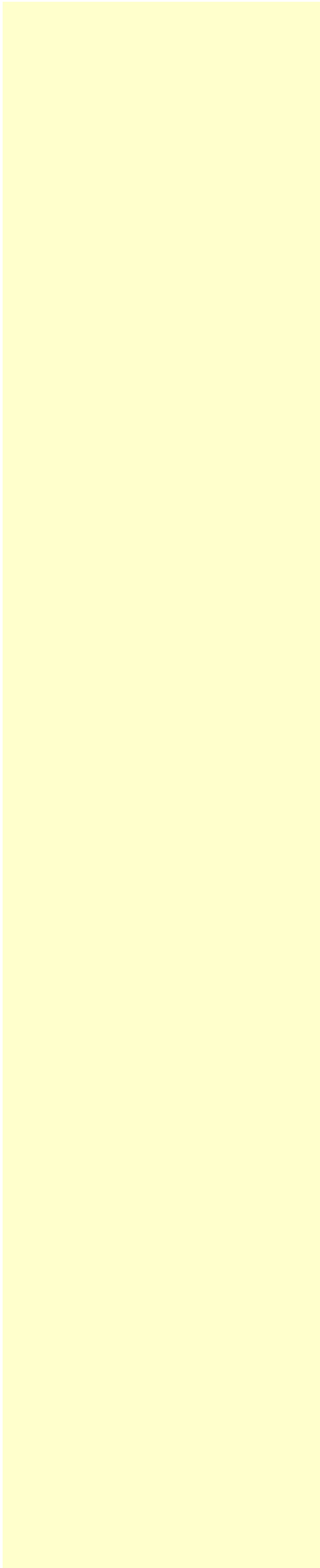
Huishan Dairy (6863 HK - HK$1.74 - BUY)[1]
Hyundai E&C (000720 KS - 62,400 won - BUY)[1]
Hyundai Mobis (012330 KS - 277,000 won - BUY)[1]
Hyundai Motor (005380 KS - 218,500 won - Outperform)[1]
IAG (IAG AU - A$6.14 - BUY)[1]
Idea Cellular (IDEA IB - Rs169.1 - Underperform)[1]
IHI (7013 JP - ¥509 - Outperform)[1]
iiNet (IIN AU - A$7.80 - Outperform)[1]
IJM Land (IJMLD MK - RM3.20 - BUY)[1]
Incitec Pivot (IPL AU - A$2.87 - BUY)[1]
Indocement (INTP IJ - Rp24,000 - BUY)[1]
Isetan Mitsukoshi (3099 JP - ¥1,281 - BUY)[1]
ITM (ITMG IJ - Rp26,025 - Outperform)[1]
J Front Retailing (3086 JP - ¥1,337 - BUY)[1]
Japan Exchange (8697 JP - ¥2,623 - SELL)[1]
Jasa Marga (JSMR IJ - Rp6,350 - BUY)[1]
Kao (4452 JP - ¥4,346 - BUY)[1]
Keppel Land (KPLD SP - S$3.43 - BUY)[1]
King Yuan (2449 TT - NT$26.1 - BUY)[2]
Komatsu (6301 JP - ¥2,488 - BUY)[1]
Konica Minolta (4902 JP - ¥1,226 - BUY)[1]
Korean Re (003690 KS - 11,450 won - Outperform)[1]
Kose (4922 JP - ¥4,500 - BUY)[1]
KrisEnergy (KRIS SP - S$0.79 - BUY)[1]
KT&G (033780 KS - 91,200 won - Outperform)[1]

Companies mentioned (Continued)

Larsen & Toubro (LT IB - Rs1,560.4 - BUY)[1]
Lenovo (992 HK - HK$11.94 - Outperform)[1]
LG Corp (003550 KS - 72,000 won - Outperform)[1]
Lilang (1234 HK - HK$5.29 - SELL)[1]
Lion (4912 JP - ¥590 - BUY)[1]
Lite-On Tech (2301 TT - NT$47.6 - BUY)[2]
Longfor (960 HK - HK$9.62 - BUY)[1]
Lonking (3339 HK - HK$1.43 - SELL)[1]
Lotte Chemical (011170 KS - 169,000 won - Outperform)[1]
LPN (LPN TB - BT20.9 - BUY)[1]
M1 (N-R)
MapletreeLog (MLT SP - S$1.16 - Underperform)[1]
Marubeni (8002 JP - ¥786 - BUY)[1]
Metcash (MTS AU - A$2.74 - Outperform)[1]
Minth (425 HK - HK$15.72 - BUY)[1]
Mitsubishi Corp (8058 JP - ¥2,255 - Outperform)[1]
Mitsui (8031 JP - ¥1,759 - Underperform)[1]
Motherson Sumi (MSS IS - Rs439.1 - BUY)[1]
Nikon (7731 JP - ¥1,574 - BUY)[1]
Nissan Motor (7201 JP - ¥1,054 - BUY)[1]
Novatek (3034 TT - NT$149.0 - BUY)[2]
OCBC (OCBC SP - S$9.67 - Underperform)[1]
ONGC (ONGC IB - Rs421.3 - BUY)[1]
Orica (ORI AU - A$19.57 - Outperform)[1]
Orora (ORA AU - A$1.67 - Underperform)[1]
Panasonic (6752 JP - ¥1,319 - BUY)[1]
Pax Global (327 HK - HK$8.31 - Outperform)[1]
Petronet LNG (PLNG IB - Rs197.8 - Underperform)[1]
Power Grid (PWGR IB - Rs136.8 - BUY)[1]
Powertech (6239 TT - NT$54.0 - Underperform)[2]
Ramsay Health Care (RHC AU - A$49.10 - BUY)[1]
ResMed (RMD AU - A$5.77 - BUY)[1]
Ricoh (7752 JP - ¥1,209 - BUY)[1]
Samsung Electronics (005930 KS - 1,206,000 won - BUY)[1]
Samsung F&M (000810 KS - 276,500 won - Outperform)[1]
Samsung Life (032830 KS - 108,000 won - Outperform)[1]
Seek (SEK AU - A$16.87 - Outperform)[1]
Sembcorp Marine (SMM SP - S$3.83 - SELL)[1]
SGX (SGX SP - S$7.23 - Underperform)[1]
Shanshui Cement (691 HK - HK$3.00 - Underperform)[1]
Sharp (6753 JP - ¥331 - BUY)[1]
Shiseido (4911 JP - ¥1,886 - BUY)[1]
Shree Cement (SRCM IB - Rs8,654.3 - BUY)[1]
Siam Cement (SCC TB - Bt452.0 - BUY)[1]
Sigma Pharma (SIP AU - A$0.79 - Underperform)[1]
Sinoma (1893 HK - HK$1.94 - BUY)[1]
Sinopec (386 HK - HK$7.25 - Underperform)[1]
Sirtex Medical (SRX AU - A$21.90 - BUY)[1]
SK Innovation (096770 KS - 90,700 won - BUY)[1]
Sobha (SOBHA IS - Rs429.9 - BUY)[1]
Sonic Healthcare (SHL AU - A$16.86 - Underperform)[1]
Sony (6758 JP - ¥2,163 - BUY)[1]
SPIL (2325 TT - NT$41.5 - BUY)[2]
Standard Chartered (2888 HK - HK$155.70 - BUY)[1]
Sumitomo Rubber (5110 JP - ¥1,561 - Underperform)[1]
Swire Pacific (19 HK - HK$103.60 - Underperform)[1]
Tata Motors (TTMT IB - Rs512.3 - BUY)[1]
Tata Steel (TATA IB - Rs507.6 - Outperform)[1]
Tatts (TTS AU - A$3.16 - Underperform)[1]
TCL Corp (N-R)
Techtronic (669 HK - HK$22.50 - BUY)[1]
Teijin (3401 JP - ¥259 - Underperform)[1]
Thaicom (THCOM TB - Bt39.0 - SELL)[1]
Tokyo Electron (8035 JP - ¥7,154 - BUY)[1]
Toshiba (6502 JP - ¥491 - BUY)[1]
Toyota Motor (7203 JP - ¥6,305 - BUY)[1]
Treasury Wine (TWE AU - A$4.84 - BUY)[1]
TSMC (2330 TT - NT$122.5 - BUY)[2]
UltraTech (UTCEM IS - Rs2,589.2 - BUY)[1]
Unicharm (8113 JP - ¥6,970 - BUY)[1]
UOB (UOB SP - S$22.80 - Outperform)[1]
Virtus Health (VRT AU - A$8.02 - Outperform)[1]
Vocus (VOC AU - A$5.39 - BUY)[1]
VTech (303 HK - HK$90.95 - Outperform)[1]
Weifu High-Tech (200581 CH - HK$27.25 - BUY)[1]
Wesfarmers (WES AU - A$43.02 - BUY)[1]
WorleyParsons (WOR AU - A$16.19 - Underperform)[1]
Xiaomi (N-R)
Xinyi Solar (968 HK - HK$2.61 - BUY)[1]
Yokohama Rubber (5101 JP - ¥939 - BUY)[1]
ZTE (763 HK - HK$17.86 - SELL)[1]

[1] Covered by CLSA; [2] Covered by CAST; [3] Covered by CLSA Americas



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