CLSA ASIA-PACIFIC MARKETS

CG Watch 2012

Corporate governance in Asia

ACGA
In collaboration with the Asian Corporate Governance Association

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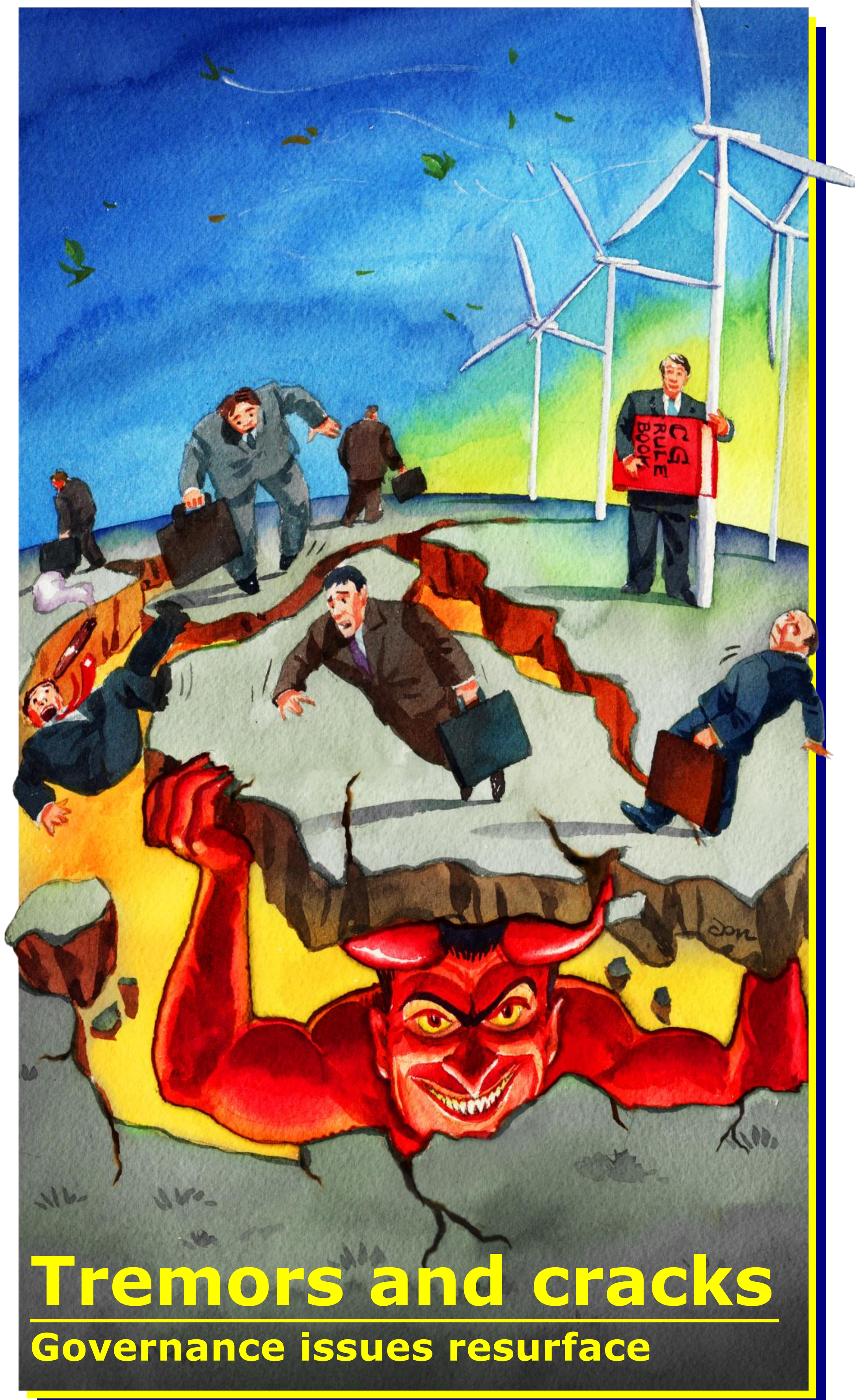
10 September 2012

Asia Pacific
Corp governance

Highest-ranked markets
- **Singapore**
- **Hong Kong**
- **Thailand**
- **Japan**
- **Malaysia**

Top-scoring CG stocks
- **TSMC** (2330 TT)
- **Newcrest** (NCM AU)
- **Brambles** (BXB AU)
- **Tokyo Gas** (9531 JP)
- **BHP Billiton** (BHP AU)
- **Public Bank** (PBKF MK)
- **HSBC** (5 HK)
- **Standard Chartered** (2888 HK)
- **OCBC** (OCBC SP)
- **Mitsubishi Electric** (6503 JP)
- **Singapore Airlines** (SIA SP)
- **Hang Seng Bank** (11 HK)
- **UOB** (UOB SP)
- **Nippon Steel** (5401 JP)
- **AIS** (ADVANC TB)



Tremors and cracks

Governance issues resurface

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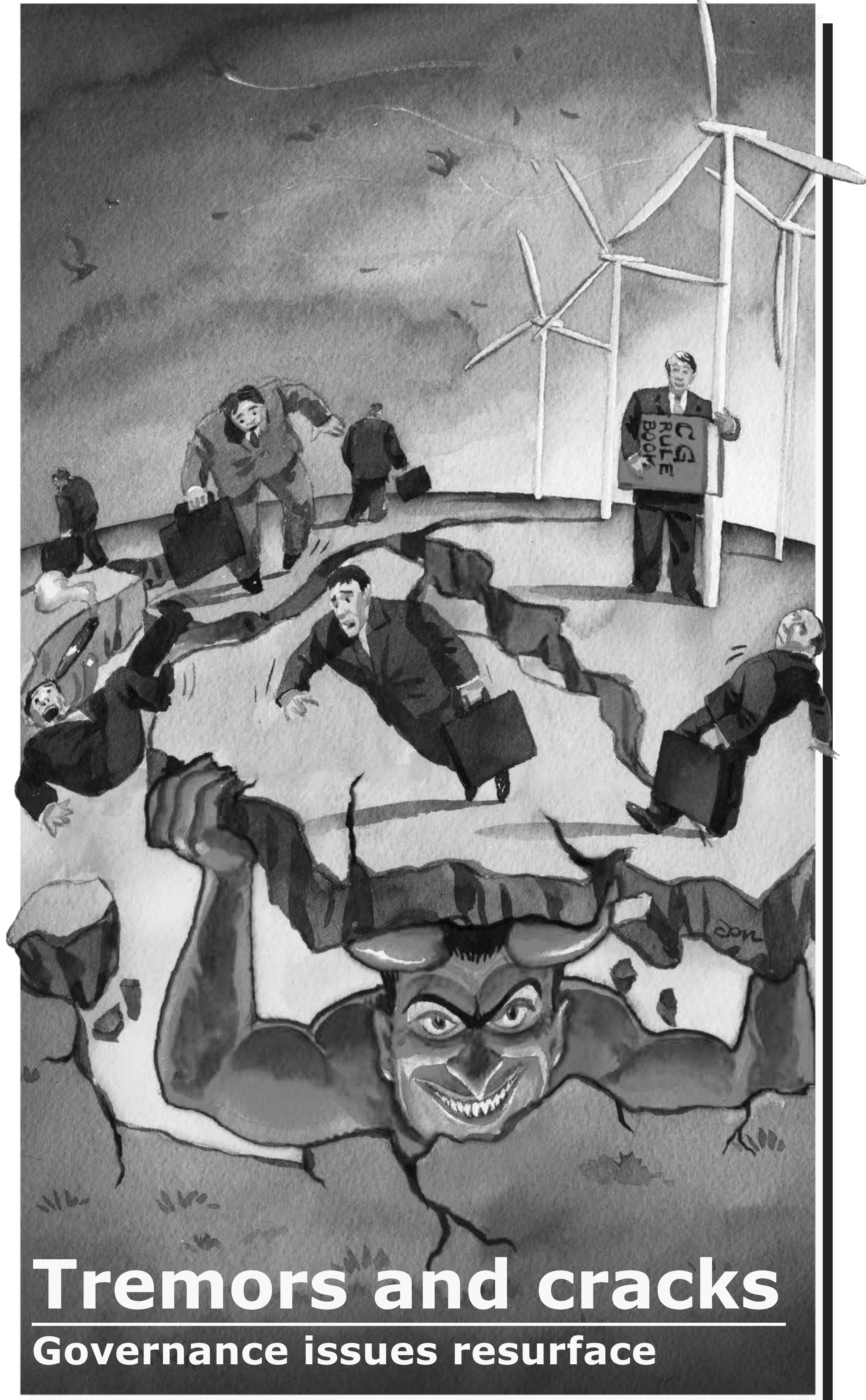

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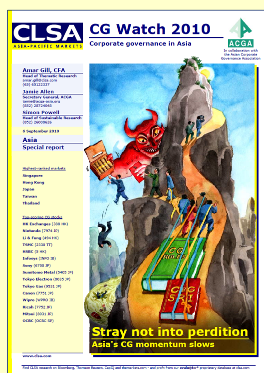

ACGA

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ACGA endorses the methodology used in CLSA's 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.

Tremors and cracks

Cracks reappear

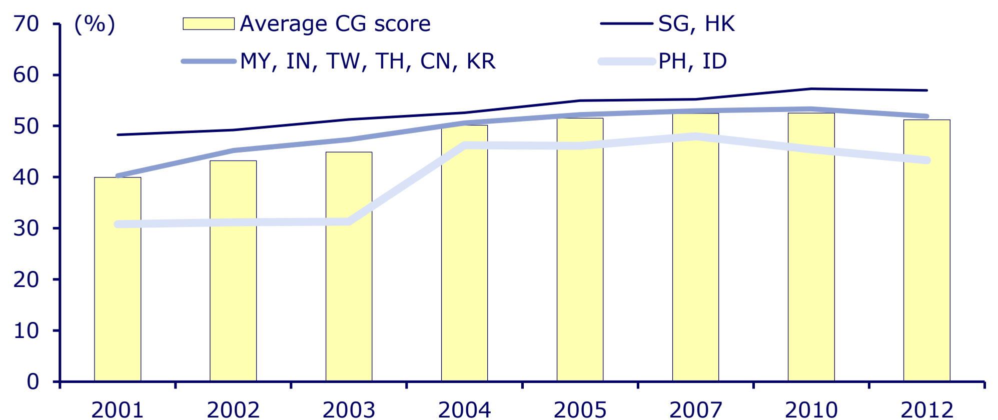
Since issuing our last CG Watch report in 2010, cracks in Asian corporate governance have become more apparent. Indeed, our scoring of companies has seen slippage, after rising for most of the past decade following our introduction of comprehensive CG scoring of Asian corporations in 2001. The issues investors have had to face range from relatively minor corporate transgressions to growing concerns about the reliability of financial statements and, at the extreme, outright fraud. CG, once again, can no longer be taken for granted. Investors will need to swerve, and in most cases get a tighter grip, when dealing with the cracks in governance and the tremors in Asian investing.

Market CG scores - Southern comfort

Asian CG reform is usually non-linear: few countries or markets have been able to sustain improvements every year. Political will rises and falls in inverse proportion to the stock market, and the average investor only becomes enthused following a corporate or financial crisis. A curious feature, however, emerges in this year's market rankings. Most of the markets with improved CG ratings are in Southeast and South Asia, although each motivated by different factors. Most of those with falling CG ratings are in North Asia, including Japan, Taiwan and China, although Korea is an exception with a notch up in its score. Overall, we believe the systemic quality of CG in Asia is gradually getting better, despite the appearance of numerous frauds and other market malfeasance around the region. Indeed, it is precisely such crises and challenges that spur regulators, investors, the media and others to take governance more seriously.

Average CG scores of companies have slipped, bigger decline in markets with lower CG

Average company scores on CG



Source: CLSA Asia-Pacific Markets

Calibrated governance

We streamlined our governance scoring of corporations, narrowing the focus of our main CG questionnaire down from 46 to 30 main issues, covering five core areas: discipline, transparency, independence, responsibility and fairness. We scored 864 companies in this year's survey across the Asia-Pacific markets, including Japanese and Australian firms. Those from Down Under lead in CG scoring, while Singapore and Hong Kong remain among the better markets for corporate standards. CG perceptions are coloured by the worst companies: China, Korea and Indonesia are thus generally seen as where CG is a major issue.

Independence of the board a key issue

Asian corporations fare worst on the independence of boards. The composition of the audit committee is a genuine test that most companies fail. Few have an independent chairman, and not many have a majority of

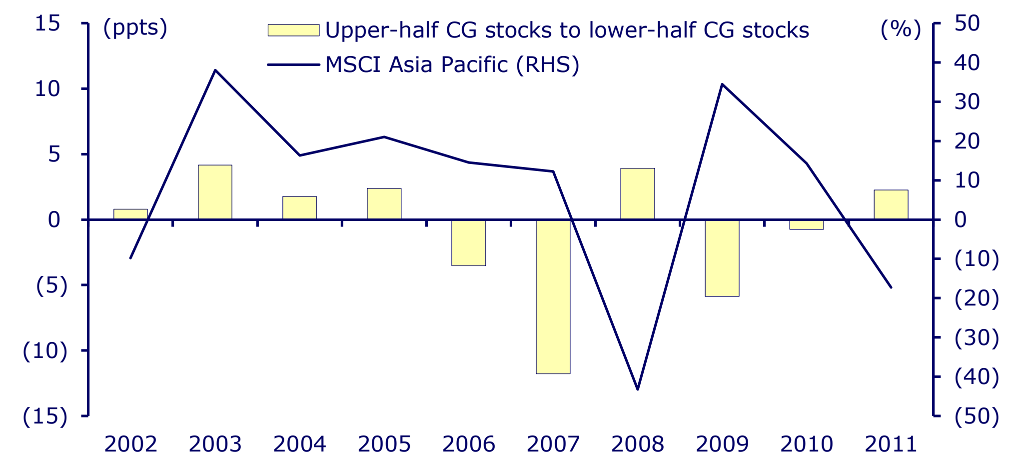
independent directors. Instead, around 40% of firms in Taiwan, Hong Kong, Singapore and the Philippines have three or more family members sitting on the board. The potential for conflict of interest is a major issue. Around half the companies in these markets are deemed not to be the primary financial interest of the controlling shareholder.

Don't get caught in shifting ESG plates

While Asians are fighting for better natural and working environments, laws that have long been on the books are brought down to the reality on the ground. For investors, pitfalls remain as companies are forced to deal with issues that previously would have been swept under the rug. Reporting standards are improving, driven both by stock exchanges tightening disclosure standards, and rising subscription to global environment, social and governance (ESG) reporting standards. Our Clean & Green (C&G) and corporate social responsibility (CSR) scores are down slightly from 2010, but that is on a sample size that has nearly doubled. On ESG, we see more meaningful improvements in Northeast Asia. Our scores provide investors an initial screen to weed out potential mines in Asian stocks.

Upper-half CG stocks have outperformed every year when the markets were down but tend to lag when markets are rising

Performance of upper-half CG stocks to lower-half versus MSCI Asia Pacific



Large caps dominate high CG rankings but see inside for mid caps with comparable CG scores

Top-20 CG large caps in Asia

Company	Code	Country	Sector
TSMC	2330 TT	Taiwan	Technology
Newcrest	NCM AU	Australia	Materials
Brambles	BXB AU	Australia	Transport
Tokyo Gas	9531 JP	Japan	Power
BHP Billiton	BHP AU	Australia	Materials
Public Bank	PBKF MK	Malaysia	Financial services
HSBC	5 HK	Hong Kong	Financial services
Standard Chartered	2888 HK	Hong Kong	Financial services
OCBC	OCBC SP	Singapore	Financial services
Mitsubishi Electric	6503 JP	Japan	Technology
Singapore Airlines	SIA SP	Singapore	Transport
Hang Seng Bank	11 HK	Hong Kong	Financial services
UOB	UOB SP	Singapore	Financial services
Nippon Steel	5401 JP	Japan	Materials
AIS	ADVANC TB	Thailand	Telecoms
Vanke	200002 CH	China	Property
Infosys	INFO IB	India	Technology
Shin-Etsu Chem	4063 JP	Japan	Materials
Keppel Corp	KEP SP	Singapore	Conglomerates
Belle Intl	1880 HK	China	Consumer

Source: CLSA Asia-Pacific Markets

Cracks reappear

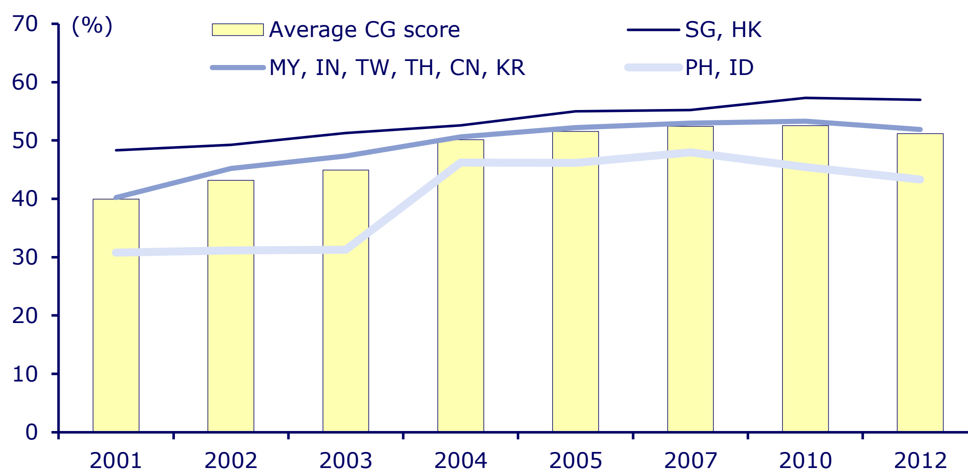
CG issues have reappeared

Since issuing the last CG Watch report in 2010, cracks in Asian CG have become more apparent. Indeed, our scoring of companies has seen slippage, after rising for most of the past decade following our introduction of comprehensive CG scoring of Asian corporations in 2001. The issues investors have had to face range from relatively minor corporate transgressions to growing concerns about the reliability of financial statements and, at the extreme, outright fraud. CG, once again, is no longer an issue investors can take for granted.

On a comparable scoring basis, average CG scores of companies are down, bigger decline in markets with lower CG

Figure 1

Average company scores on CG



Source: CLSA Asia-Pacific Markets

Investor due diligence required

CG rankings often change after the fact. Fraud, for instance, is generally impossible to detect until it is exposed. Yet, an overview of the issues facing investors in Asia provides pointers. Kicking tyres and broad channel checks often reveal valuable clues. A CG checklist and scoring will identify potential issues. Market rankings give investors relative comfort, or concern, when investing in particular bourses. Our biannual survey of governance with the Asian Corporate Governance Association (ACGA), we believe, sets out the issues investors need to be aware of specifically for this region.

CG is analogous to the braking system of a car

Below we provide an overview of CG issues that have arisen in Asia over recent years. We sketch some implications for investors and the potential evolution of the CG environment in these markets. In the following sections, we provide ACGA's updated survey of the markets and our review of Asian corporate practices. High-CG stocks may not necessarily provide outperformance but investing in the region without cognisance of governance issues is analogous to driving on a winding road without checking whether the brakes are in good condition. Investors will need to swerve, and in most cases get a tighter grip, when dealing with the cracks in governance on the bumpy road of Asian investing.

Japan: Olympus lessons

Olympus blowup another case study

The Olympus blowup is instructive, although the main prescriptions are not the most obvious. Investment losses from a decade back needed to be covered up and thus the management made acquisitions essentially of dud companies at inflated prices and then made large provisions that could be attributed to the new businesses. The foreigner who had been appointed CEO,

unaware of the real motivation for these acquisitions, sought to expose those before him who had been responsible. The trouble-making Briton was sacked by the board. Eventually, the chairman and other directors involved had to resign as well when the earlier losses and attempt to cover this up through the acquisitions were revealed.

Earlier Olympus seen as above average for CG - then red flags appeared

Olympus had above-average CG ratings before the shenanigans were revealed. After all, it was one of the few Japanese companies that had a foreign CEO, which was seen as a sign that the most capable person, not the most geriatric, had risen to the top. As often in cases of fraud, an earlier benign perception on governance can belie a murky reality. However, red flags soon appeared in succession. The acquisition of businesses that were not related to its core operations was the first cause for concern. The subsequent change of auditors from FY09 to FY10 was another red flag. Then, the departure of someone from senior management, in this case the CEO, was a signal that something was seriously amiss.

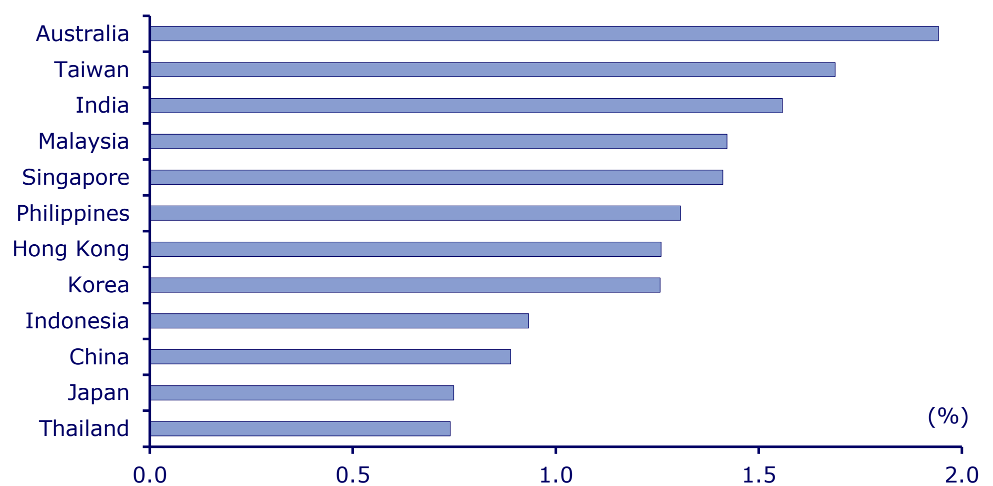
Fraud is not unique to Japan

The whole episode might be taken as representative of poor CG among Japanese corporates. Our Japan strategist Nicholas Smith, however, makes the point (in the Japan section on page 119) that CEOs in Japan do not get massive incentive-based pay; thus the incentive to take on huge risk is not large. Window-dressing and fraud, which were the main issues here, are perennial and ubiquitous. But they are not a feature of Japan any more than developed markets where blowups on a similar scale have also happened.

Directors in Japan get paid about the lowest as a share of net profit of companies in our sample

Figure 2

Director's remuneration as a share of net profit



Source: CLSA Asia-Pacific Markets

No penalty against companies that harass whistleblowers

The main difference, however, is that in the West, whistleblowers are usually protected. Japan has a Whistleblower Protection Act but it does not penalise companies that harass whistleblowers. Japanese auditing also suffers from being underpaid; audit fees are typically one-quarter or less those in the USA. To keep costs down, audit firms in Japan have a brigade of young recruits with less experience; thus auditing standards are probably lower than for other developed markets. Japan is also lagging most markets in not requiring any training of directors, which is shocking when the statutory auditors (ie, audit committee equivalent) are supposed to be the guard dogs of governance.

Lack of investor assertiveness

Ultimately, Nicholas argues the big problem for Japanese corporate governance is the lack of investor assertiveness. This is a structural problem because of the ownership of asset managers that leads them not to be assertive against companies that the owners of the asset managers - banks, insurance or securities companies - may have a commercial relationship with. Japan needs new laws, not so much on accounting and corporate fraud where existing legislation is ample. Rather, we argue legislation is needed to ensure that funds exercise their votes for the clients, like they are obliged to in the USA and Europe.

Insider trading also an issue in Japan

Insider trading in Japan has also come under a spotlight with rights issues often being preceded by weeks of underperformance for the stocks. Reports of new share issuance often appear in the media even before the company makes an announcement. We find that even the *Irish Times*, across the other side of the world, prints reports of placements in Japan before the company has cared to announce this to its investors. A policy of leaking information from the investment-banking department appears to have become institutionalised in some of the large Japanese securities houses. Insider trading is only illegal if it is acted upon in Japan. Tipping in itself is not illegal and appears rife among brokers and the media. If Japan is to make any real progress against insider trading, it will need to make it an offence, as it is in most markets, to disseminate non-public price-sensitive information.

China: P-chips and SOEs

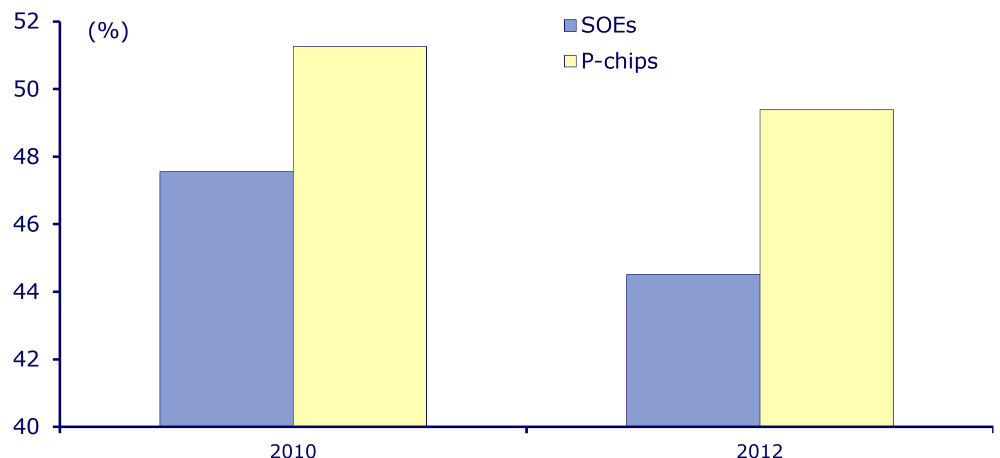
Due diligence required

The mainland has been viewed as a minefield for corporate governance and the past two years have been no exception. Short-sellers have made much of companies with questionable accounts, including Sino-Forest, Longtop and Chaoda. Cases of fraud that eventually were exposed have resulted in a collapse in the value of the companies. In a number of cases, the short-seller reports have not been well-founded (see our review of short-sellers reports in Appendix 8: Beware false profits). Nevertheless, these are a reminder that investing in private companies in China, the so-called P-chips, has to be undertaken with due diligence to match position size. Visiting facilities, watching whether the number of trucks coming in and out on a normal day is consistent with the level of business, examining margins of the company relative to peers, channel checks and information from the competition on the main players in the sector, are par for the course in investing in P-chips.

SOEs on average score worse than P-chips in our CG assessment

Figure 3

CG scores: SOEs versus P-chips



Source: CLSA Asia-Pacific Markets

CG checklist will not signal fraud

Companies that appear too good to be true probably are. Outright fraud is not going to be signalled by whether a mainland company has in place the standards of governance seen as essential in the developed world. In most cases, fraud can be well hidden even in the financial statements and from the auditor. If the reasons for fat profits are not obvious, calling in investigators to do due diligence may be required before making a substantial investment.

Major governance issues with SOEs

Beyond fraud in the smaller companies, investors have to grapple as well with major governance challenges at the state-owned enterprises (SOEs). The large listed banks were the instruments to finance the government's massive infrastructure stimulus in 2009, increasing total loans outstanding by a third within 12 months. Much of the loans went to special purpose vehicles of state governments with poor cashflow and limited servicing ability. Analysts have difficulty quantifying with certainty the extent of NPLs and thus the real book value of these banks. Reported NPL figures of 0.9% sector-wide are inconceivable after such a surge of loans within a very short period. The procedures on recognising and charging for NPLs do not inspire confidence and lead to uncertainty in the valuations of the Chinese banks.

Petrochemical companies made to subsidise end-users

Petrochemical companies in the mainland are made to subsidise fuel users and thus incur losses on their refining process. Meanwhile, power-equipment manufacturers are seen using their cashflow to acquire shares in the public market of their customers, the independent power producers (IPPs). The obvious inference is that the equipment providers are being required to support the share prices and help to recapitalise IPPs, which are suffering from high coal prices and the inability to pass on fuel cost to customers.

Expect gradual reform

These uncertainties have resulted in Chinese equities trading at a discount. Ultimately, a well-functioning capital market with equities valued appropriately is a precondition for equity markets to finance legitimate capital-raising without excessive dilution. It is also necessary for script to be a suitably priced currency for making international acquisitions. The confidence of domestic investors clearly needs to be rebuilt to mobilise the massive domestic savings. We expect ongoing reform on CG practice in China but the pace, as with most reform, is likely to be gradual.

The grubby property sector

Squabbling Kwoks

The squabbling among the brothers that ran Sun Hung Kai Properties (SHKP) lifts the veil on the sector. After the former chairman was booted out by his two younger brothers, he lodged a police report, following which his two brothers and the former Hong Kong chief secretary have been charged with corruption, with court proceedings that are set to commence soon. The opportunity was for the family to take a backseat in running the firm even if they held on to their 43% stake, but pass on the baton of senior management to outside professionals. While two long-serving senior managers were appointed to the board, each of the two arrested Kwoks have appointed their sons, aged 29 and 31, as alternative directors to this US$35bn market-cap company.

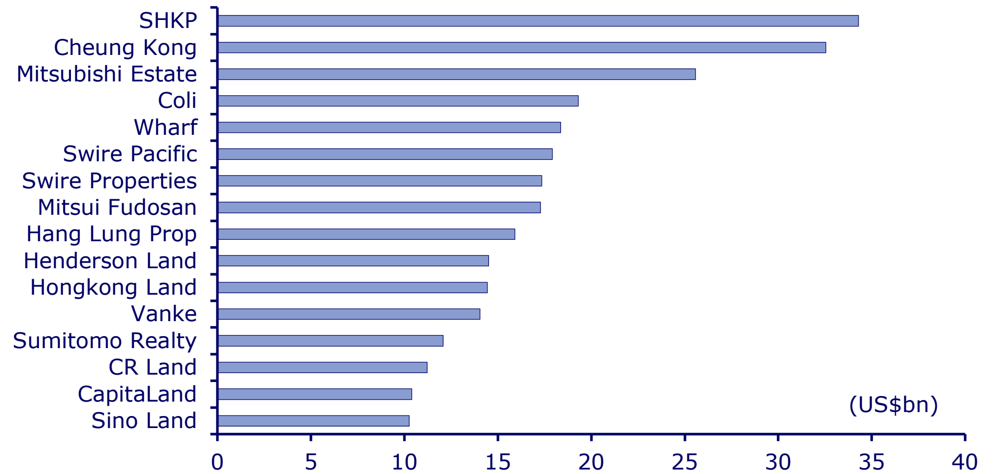
Sector under a cloud

SHKP had widely been seen as conservatively run among the property oligarchs in the territory. The chairman of Chinese Estates, another Hong Kong developer, is also charged with bribing a cabinet secretary in Macau to get a choice development site. Meanwhile, the outgoing chief executive of Hong Kong left under a cloud, smeared with allegations that he had been provided accommodation arrangement in southern China by Hong Kong developers at very favourable terms.

Among Asian property companies, SHKP still has largest market cap

Figure 4

Market cap of largest property developers in Asia Pacific



Source: Bloomberg, CLSA Asia-Pacific Markets

Less tolerance in Singapore

In a sector where single large projects can make a big difference to the profitability of even large firms, the temptation is obviously great to secure favourable landbank through currying favour with officials who can sway decisions. The question is how serious the authorities are to stamp this out. In Singapore, in 1986 the cabinet minister responsible for housing killed himself following allegations that he had accepted bribes from a developer. In his suicide note to the then Prime Minister, Lee Kuan Yew, he said that as an oriental gentleman he had to do the honourable thing. Since then, there has been no sniff of property companies in Singapore bribing officials. Hong Kong, now with a new chief executive who is seen not as beholden to the tycoons, has the opportunity to untangle whatever nexus that has existed between the developers and officials.

Development is a headache for Beijing as well

This could also be an example for the mainland. There developers are widely believed to buy land from shelf companies controlled by government officials. The shelf company makes a tidy profit from getting the land much cheaper from the government after using police and other goons to chase away previous residents who have no legal rights. A large number of demonstrations centre on land acquisition, while elevated prices of developments are a source of widespread dissatisfaction. Unless better and more transparent procedures are put in place, this remains political dynamite on the mainland.

Risks with global banks

Practices of HSBC and StanChart come under scrutiny

In previous years, HSBC and Standard Chartered had been seen as the leading lights on CG in the region. In recent months, however, HSBC has admitted to having lax anti-money laundering oversight in Mexico. StanChart has had to pay a US$340m fine to the New York state financial regulator - and may have to pay more to Federal authorities - apparently as it was facilitating the transfer of funds to Iranian entities through poor documentation. Notably, while StanChart agreed to the figure of US$250bn being the total value of transactions at issue, it settled without explicitly admitting guilt.

Markdown in their CG scores

For investors, the risk of these banks being caught in a regulatory web for practices in the past that may have been made an offence only of late is a real concern. The higher risk to investors of mismanagement in some part of

the banking business of these multinational banks and the lack of transparency on this risk in the financials lead us to mark down their CG scores. They both remain, however, among the highest in our CG rankings across our Asia-Pacific coverage.

India: Paralysis and graft

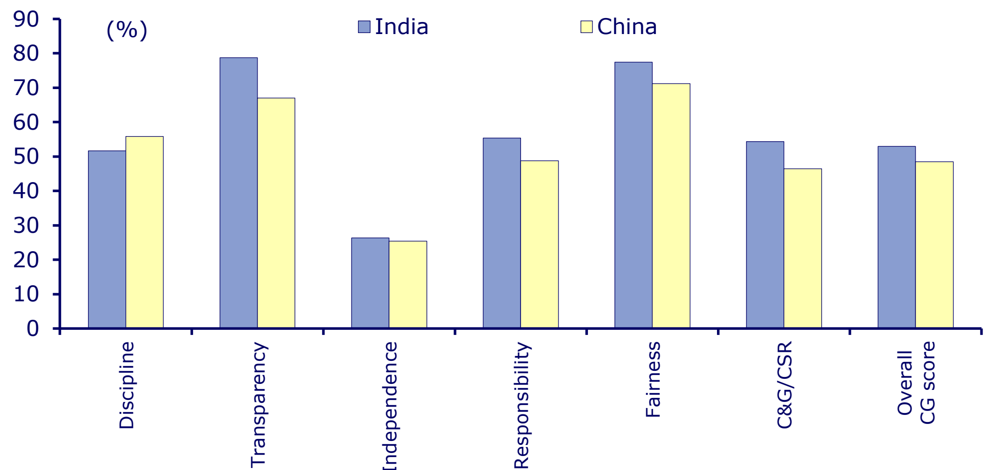
Graft brought to light

Investors have largely turned off the Indian market this year following apparent political paralysis and corporate scandals that brought to light the country's rampant graft. However, the positive is that for the first time, government officials as well as corporate figures have been fingered and are behind bars. Others have been embarrassed and are likely to be much more careful in their business practices going forward.

On average, Indian corporates score better than China's, but not by much

Figure 5

CG scores: India versus China



Source: CLSA Asia-Pacific Markets

Telecoms sector under a cloud

One of the areas where graft has become public has been the issuance of 2G licences in 2008. The telecoms minister at the time has been charged with accepting bribes and is languishing in jail awaiting trial. Foreign telcos including Telenor as well as Malaysia's Axiata find that their licences in India are deemed no longer valid because they or their agents are charged with securing them through illicit means. Hundreds of millions that had been invested in building the infrastructure are now assets that might be lost. All the 2G licences will need to be retendered for, which has put the whole sector under a cloud.

Graft impacting power and steel sectors

Allegations of graft in the mining sector, meanwhile, have held up approvals and operations at iron-ore as well as coal mines across the country. This has impacted both the steel and power industries. IPPs are unable to source the coal supplies they had expected from Coal India. Power capacity is underutilised while India, which has large coal resources, has had to push up coal imports, leading to a larger current-account deficit and contributing to pressure on the rupee, one of the weakest currencies in the region YTD.

Major changes not expected until next general elections

India needs convincing measures to tackle corruption not just for its economic advancement but for investors to have confidence that there are no hidden scandals that might erupt in the companies they invest in. Some reshuffling in the government and recent appointments give faint hope of a change in direction. Not many, however, expect any major changes in the national governance backdrop until the next general elections due in 2014.

Asean: Virtue and vice

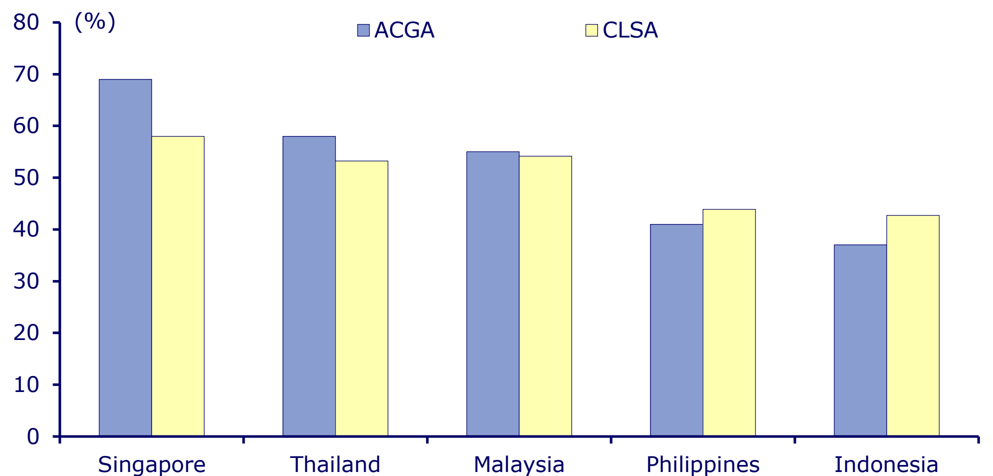
Singapore has the highest CG score of markets we cover ex-Australia

Asean spans markets that in our rankings are the highest as well as those that come at the bottom of CLSA and ACGA's rankings. Singapore has, on average, the highest score for governance among its corporates. As this report goes to print, there is a battle for corporate control for Asia Pacific Breweries (APB), which owns leading beer brands in the region (Tiger, Anchor, Bintang, etc). The conglomerate F&N looks set to dispose its majority stake in APB to Heineken, with which it has had a partnership arrangement that was disturbed when Thai Beverages made a bid for both a stake in FNN and control of APB. The likely outcome is that F&N disposes of its stake in APB at a premium and might disentangle its current structure that puts brewing and softdrinks together with a large property division. That a battle for corporate control in one of the largest conglomerates is leading to realisation of shareholder value with commercial logic prevailing is a rarity in the region.

CG ranges from highest in Asia to the lowest

Figure 6

Asean CG scores by market (ACGA) and average of corporations (CLSA)



Source: ACGA, CLSA Asia-Pacific Markets

But S-chips are an embarrassment

However, Singapore's embarrassment is the so-called S-chips, mainland companies that have listed in its market. CG standards are shoddy, a number of firms have flouted the listing rules and directors have absconded to China when the exchange pursues them. The case for Chinese companies listing in Singapore has never been clear and investors in these stocks certainly need to weigh seriously the risks. This segment of the market, however, is likely to diminish in significance over time.

Sime Darby takes a hit again

Across the causeway, the largest of Malaysian conglomerates once again disappointed the market. In the Asian crisis, Sime Darby nearly blew up for its poorly managed foray into banking and stockbroking. Over the recent crisis, its balance sheet is much stronger and loses less significant but it took a hit again, this time for cost overruns at Bakun as well as the Middle East power projects, a business where it has little expertise.

Unfavourable optics in Sime's E&O takeover

An independent director at Sime Darby has recently been charged with insider trading. More embarrassing for the governance perception for the market was Sime's acquisition of a controlling stake in the property company, E&O. This had been preceded by the chairman of E&O buying shares in the company, before Sime Darby announced it was taking over control at a 60% premium. On the basis that the acquisition of the stake was a private transaction

between Sime and the previous significant shareholders (which did not include the chairman), and that the matter had not been discussed by the board of E&O, no charges of insider trading was brought to bear. But unfortunately for the optics of the matter, the E&O chairman was the husband of the then chairperson of the Securities Commission (SC). She has since stepped down when her contract was not renewed earlier this year.

Successful enforcement required to improve perceptions

The now retired SC chairman had been brought to the commission fairly recently in 2006 from outside the agency. The current chairman has been promoted from within and has been a regulator for over 20 years (neither does he have the disadvantage of having a spouse who is a corporate figure). CG issues are nevertheless likely to continue to crop up but the efforts of the SC to take to task directors for insider trading is a positive. The country, though, needs a period without governance accidents at its larger companies and successful enforcement against transgressors to improve the perception of investors on the market.

Little impact from new government in Thailand

Thailand has a new government in place now for slightly more than a year. This has not had much of an impact on the governance outlook for corporates. Related-party transactions remain an issue with certain groups, cropping up again with CP Foods. But as companies get larger we notice improvement in transparency. The stock exchange continues to push for high standards, for instance on voting by poll, which is not mandatory but most companies have been persuaded to adopt this for extraordinary and annual general meetings, a practice that is still relatively uncommon in the region.

Regulatory issues in Indonesia

Indonesian firms have had to deal with regulatory uncertainty with regard to ownership limits on the banks and export restrictions on the mining sector. These impact their ability to maximise shareholder value, which is one of the issues in our CG scoring. Indonesian companies are also the slowest to release full-year results; given the 90-day deadline for releasing full-year numbers, none report within two months which is becoming the norm elsewhere.

Shadow play in the London market

Over in the London market, a shadow play for control of a FTSE constituent that had recently been created to take an interest in an Indonesian mining asset was illuminating. It reveals firstly there is still risk of change in shareholding structure for groups where major shareholders are highly geared. Yet, influential groups will often be able to retain effective control. Other shareholders and investors should expect to go along with the intentions of the effective controlling shareholder.

No real CG change yet in the Philippines

In the Philippines, President Aquino has been in power since 2010 and sets a positive backdrop for clean governance nationally. At the corporate level, however, there is little evidence of much change as yet. Companies continue to issue new equity when the purposes are unclear, eg, Ayala Corp, or sometimes surprising the market with the size, eg, Banco de Oro. Inter-group transaction of assets within the First Philippine Holdings listed companies raised questions over pricing.

Taiwan: Pushing up payouts

Barring challengers from voting contentious issues

The market for corporate control does not work well in Taiwan. A notorious case was a contested election for directors for a listed company, China Petrochemical Development Corp (CPDC). Existing parties dominated the board with only 10% of the vote compared to their challenger's 30%-plus but managed to retain control. ACGA has described how the day before the

annual general meeting (AGM), the company changed the agenda to move to the board election to the first item of the meeting; while at the AGM, CPDC security guards delayed the entry of representatives of the challenging group, thus preventing them from voting on the key item.

CHT to the rescue?

Taiwan's legislature has passed a resolution which has the effect of preventing Chunghwa Telecom (CHT) from paying out surplus cash. The legislature seems to want CHT to invest in rights issues of underperforming state companies. The first of these was China Airlines; there could be others to come.

Incentives to raise the cash dividend

Stock dividends that gradually but systematically dilute existing shareholders are still common. Head of Taiwan research Peter Sutton attributes this to management's indifference to shareholders and the desire to keep as much cash within the company. However, a recent change in the law allows companies to guarantee a minimum dividend, and to pay out from reserves in a cyclically bad year for earnings. We expect this to encourage more companies to pay a higher cash dividend, especially with a tax charged on surplus cash kept as retained earnings. Taiwan has the highest payout in the region and the highest PE, and Peter sees these two factors as related.

Progress through legislation in Korea?

Change in Korea's social contract

In Korea, head of research Shaun Cochran argues a real shift is occurring in the social contract between the elites and the ordinary Korean. Legislation was passed last year requiring that transactions related to directors and family members must secure the endorsement of two-thirds of the board of directors. The law also now mandates that directors not usurp any business opportunity for themselves, at the expense of the company. If transactions are subsequently deemed to be unfair, the directors directly involved as well as directors who approved the transaction will have to indemnify the company's losses. Legislation is also being proposed to tax private companies that expropriate gains through related-party transactions with listed firms.

Anti-*chaebol* sentiment is real

A major caveat is that these laws only have any real teeth if litigants can successfully pursue legal action, which is yet to be seen. Shaun, however, argues that the anti-*chaebol* sentiment is real and a power shift is occurring between the government and the family-controlled conglomerates. The risk partnership of the seventies and eighties that enabled government control of the domestic financial and product markets no longer holds. In parallel, the ability of *chaebols* to expropriate value has been undermined. These developments are a positive for investors. For now though, there is little impact on our CG ratings. Dubious transactions including a telco, SK Tel, buying into a Dram company, Hynix, continue to happen. Over time, other measures including streamlining of corporate structures will be required for any change in the persistent CG discount on the Korean market.

Decline in corporate rankings

Across Asia Pacific, corporate scores for CG have declined 1.1ppt on like-for-like questions

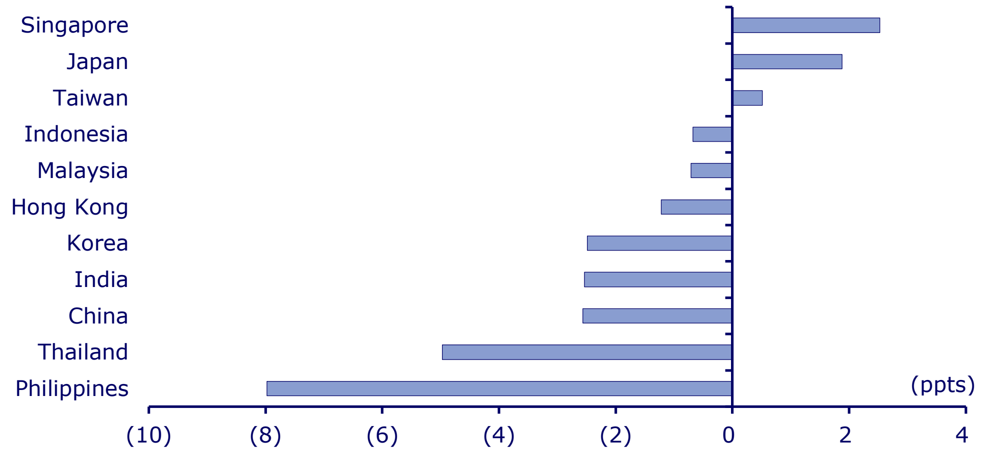
Across the markets, the average CG score of corporates declined by 1.1ppt on a like-for-like basis stripping out the impact of some changes in our scoring (see Section 3 for details) based on 464 companies that were scored in 2010 and again this year. The biggest reductions in scores were in the Philippines and Thailand, partly for reasons discussed above but also due to more rigorous scoring. Most other markets saw average CG scores down by 1-2.5ppts. Singaporean corporates on average saw a 2.5ppt improvement with greater transparency from some of the Reits on their estimated cost of capital compared to 2010 when there was uncertainty on some of these macro factors.

Japanese corporates had an average 1.9ppt increase in CG score; when a scandal like Olympus breaks into the open, other companies have a strong incentive to make clear they are not in the same league.

Singapore and Japan see improvement but lowered scores in Philippines and Thailand

Figure 7

Change in corporate scores (comparable questions)



Source: CLSA Asia-Pacific Markets

Above the cracks

On average, higher CG scores for larger caps

Against the backdrop of cracks reappearing in the corporate governance landscape, our updated scoring identifies companies that appear to have a higher commitment to CG. In most cases, larger caps would have a higher CG score, partly as they have greater resources. Controlling shareholders are more likely to exert greater control in smaller companies where they would generally prefer less scrutiny and checks upon their decisions. The 100 largest by market cap in our Asia universe have an average CG score of 55.2% (compared to the overall company average of 52.6%). The top 40 on our CG ratings of large caps in the region are shown in Figure 8 with scores of approximately 70% and above.

Australian companies now at the top but other companies like TSMC, HSBC, StanChart, OCBC, Hang Seng Bank, have among highest scores

TSMC, long known for its CG commitment, emerges at the top of our rankings this year. A number of the Australian companies that we have included for the first time in CG Watch unsurprisingly are among the highest scoring including Newcrest, Brambles and BHP Billiton. The large banks have high ratings given that internal controls, checks and balances are key for their businesses. HSBC and StanChart's scores have been marked down slightly but they remain close to the top. One of the best-run Southeast Asian financial groups, Public Bank, had big losses on its securities division in the Asian crisis; thereafter it has improved controls and its CG significantly. OCBC, Hang Seng Bank, UOB and Shinhan are also among the highest in our regional CG rankings.

Unique shareholding of Vanke helps explain its high CG

Singaporean Airlines, Keppel Corp and Advance of Thailand are among the highest scoring companies from Southeast Asia. Vanke, the largest property developer in China, has the highest score among the large caps from the mainland. It has a rare shareholding structure for a Chinese company: there is no major shareholder. The company is run by management who are accountable to their broad shareholder base. For the past decade and more, they have been transparent, professionally run and not had any CG issues come to light. China's consumer-discretionary names also score well, including Belle, the largest shoe distributor in the mainland, as well as Sun Art, which has Auchan, the French retailer, as one of its major shareholders.

TSMC takes top spot as highest CG scorer in the region, followed by Australian companies Newcrest and Brambles

Figure 8

Top-40 CG ranking of large caps in Asia Pacific (>US$10bn market cap)

Company	Code	Country	Sector
TSMC	2330 TT	Taiwan	Technology
Newcrest	NCM AU	Australia	Materials
Brambles	BXB AU	Australia	Transport
Tokyo Gas	9531 JP	Japan	Power
BHP Billiton	BHP AU	Australia	Materials
Public Bank	PBKF MK	Malaysia	Financial services
HSBC	5 HK	Hong Kong	Financial services
Standard Chartered	2888 HK	Hong Kong	Financial services
OCBC	OCBC SP	Singapore	Financial services
Mitsubishi Electric	6503 JP	Japan	Technology
Singapore Airlines	SIA SP	Singapore	Transport
Hang Seng Bank	11 HK	Hong Kong	Financial services
UOB	UOB SP	Singapore	Financial services
Nippon Steel	5401 JP	Japan	Materials
AIS	ADVANC TB	Thailand	Telecoms
Vanke	200002 CH	China	Property
Infosys	INFO IB	India	Technology
Shin-Etsu Chem	4063 JP	Japan	Materials
Keppel Corp	KEP SP	Singapore	Conglomerates
Belle Intl	1880 HK	China	Consumer
Sun Art	6808 HK	China	Consumer
Swire Pacific	19 HK	Hong Kong	Property
Shinhan	055550 KS	Korea	Financial services
Canon	7751 JP	Japan	Technology
Mitsubishi Corp	8058 JP	Japan	Conglomerates
Mitsui	8031 JP	Japan	Conglomerates
Astra International	ASII IJ	Indonesia	Conglomerates
HUL	HUVR IB	India	Consumer
Want Want	151 HK	China	Consumer
Toshiba	6502 JP	Japan	Technology
NHN	035420 KS	Korea	Technology
SingTel	ST SP	Singapore	Telecoms
Nintendo	7974 JP	Japan	Technology
CLP	2 HK	Hong Kong	Power
Wipro	WPRO IB	India	Technology
Tingyi	322 HK	China	Consumer
Fortescue	FMG AU	Australia	Materials
Nikon	7731 JP	Japan	Technology
Marubeni	8002 JP	Japan	Materials
Panasonic	6752 JP	Japan	Technology

Source: CLSA Asia-Pacific Markets

ADR listing can help CG scores

From Japan, among the top scoring on CG are Tokyo Gas, Mitsubishi Electric, Nippon Steel, Shin-Etsu Chemical as well as Canon, which has an American depositary receipt (ADR) listing and thus has to follow the listing requirements of the USA. Most of the other high-CG Japanese companies are long-established entities, many of which in critical areas like defence and hence are under continuous scrutiny. Other high-scoring companies that have retained their top-quartile ranking among large caps include Singapore Airlines, Infosys, Keppel Corp, Swire Pacific, Astra, SingTel and CLP.

Australian companies Iluka, Orica, ASX and CSR at the top

Japan's Tokyo Electron, Osaka Gas, Ricoh and Kuraray also among the higher scoring mid-/small caps

Other high-scoring companies in Asia include Daum, China Steel Chem, Ezion, Yes Bank and Bursa

Figure 9

Top-50 CG ranking of mid/small caps in Asia Pacific (<US$10bn market cap)

Company	Code	Country	Sector
Iluka	ILU AU	Australia	Materials
Orica	ORI AU	Australia	Materials
ASX	ASX AU	Australia	Financial services
CSR	CSR AU	Australia	Materials
Tokyo Electron	8035 JP	Japan	Technology
Transurban	TCL AU	Australia	Infrastructure
Daum	035720 KQ	Korea	Internet
Osaka Gas	9532 JP	Japan	Power
China Steel Chem	1723 TT	Taiwan	Petro/chems
Titan Industries	TTAN IB	India	Consumer
Ricoh	7752 JP	Japan	Technology
Amcor	AMC AU	Australia	Materials
Novatek	3034 TT	Taiwan	Technology
Ezion	EZI SP	Singapore	Transport
Kuraray	3405 JP	Japan	Materials
Ushio	6925 JP	Japan	Technology
Sembcorp Industries	SCI SP	Singapore	Conglomerates
Yes Bank	YES IB	India	Financial services
Bursa Malaysia	BURSA MK	Malaysia	Financial services
Boral	BLD AU	Australia	Materials
Sumitomo Metal Ind	5405 JP	Japan	Materials
Asahi Kasei	3407 JP	Japan	Petro/chems
AAC	2018 HK	China	Technology
Digital China	861 HK	China	Technology
James Hardie	JHX AU	Australia	Materials
J-Power	9513 JP	Japan	Power
Tatts	TTS AU	Australia	Hotels & leisure
Delta	2308 TT	Taiwan	Technology
OOIL	316 HK	Hong Kong	Transport
TXC	3042 TT	Taiwan	Technology
Shiseido	4911 JP	Japan	Consumer
VTech	303 HK	Hong Kong	Technology
Advantest	6857 JP	Japan	Technology
Ebara	6361 JP	Japan	Capital goods
TDK	6762 JP	Japan	Technology
Kansai Electric	9503 JP	Japan	Power
Paladin Energy	PDN AU	Australia	Materials
Vinda Intl	3331 HK	China	Consumer
Sims MM	SGM AU	Australia	Materials
Hysan	14 HK	Hong Kong	Property
Anta Sports	2020 HK	China	Consumer
Taiyo Yuden	6976 JP	Japan	Technology
DGB Financial	139130 KS	Korea	Financial services
Lend Lease	LLC AU	Australia	Property
L'Occitane	973 HK	Hong Kong	Consumer
TSRC	2103 TT	Taiwan	Materials
Monadelphous	MND AU	Australia	Capital goods
Incitec Pivot	IPL AU	Australia	Materials
BAT Malaysia	ROTH MK	Malaysia	Consumer
Far EasTone	4904 TT	Taiwan	Telecoms

Source: CLSA Asia-Pacific Markets

Mid to smaller caps management also seek to signal high CG

A number of mid- to smaller caps also appear to have a strong commitment to CG. In some cases, however, these are companies that have listed fairly recently and seek to signal high CG commitment. Without a long track record, their actual commitment may not really have been tested. Yet, of the stocks below US$10bn market cap, Figure 9 presents 50 companies that are among the highest in our CG scoring regionally with scores of approximately 70% and above, thus scoring similar to the high-CG large caps. (There is a longer list of mid caps in this score range, as three-quarters of the companies in our survey are below US$10bn market cap.) Again, at the top are Australian firms including Iluka, Orica, ASX and CSR. Among the Japanese companies with high CG scores are Tokyo Electron, Osaka Gas, Ricoh, Kuraray and Ushio, while Daum, China Steel Chem, Titan Industries, Novatek, Ezion, Sembcorp Industries, Yes Bank and Bursa Malaysia are among the highest scoring mid to smaller caps in our coverage.

CG and market valuations

Dividend yield for upper-half CG markets almost 50% higher compared to lower half

Figure 10 has the 10 Asia ex-Japan markets we have scored with the corporates sorted by the average CG score, together with the key valuations. The upper-half markets for CG are trading at an average PE of 14x, 11% higher than the average PE of the lower-half markets. The dividend yield for the upper-half CG markets, at 3.4% is almost 50% higher than the yield for the lower-half markets at 2.4%. The higher CG markets have a higher payout ratio thus offer a higher dividend yield despite trading at a higher PE (ie, at a lower earnings yield). Net gearing at 23% for the better-CG markets is almost one-fifth lower than the 30% gearing for the lower-CG ones. By these market averages, higher CG tends to be associated with higher valuations. Nevertheless, markets with higher CG provide a better dividend yield with lower financial risk given lower gearing of the corporates.

Upper-half CG markets trade at a higher PE but offer investors a higher yield with corporates having lower gearing

Figure 10

Asia ex-Japan market valuations and average CG of corporates

2012	PE (x)	ROE (%)	Div yield (%)	Net gearing (%)	CG score (%)
Singapore	13.6	11.0	3.4	29.2	58.0
Hong Kong	12.1	9.5	3.7	18.7	55.9
Taiwan	18.2	9.8	3.3	8.2	54.3
Malaysia	14.1	15.4	3.4	15.3	54.2
Thailand	12.1	17.2	3.4	45.9	53.2
Avg upper-half CG mkts	**14.0**	**12.6**	**3.4**	**23.4**	**55.1**
India	11.7	16.1	2.1	46.7	52.9
China	10.0	16.0	3.0	24.9	48.5
Korea	9.5	13.6	1.3	24.8	48.2
Philippines	17.2	14.2	2.6	29.5	43.9
Indonesia	14.6	21.9	2.8	23.2	42.7
Avg lower-half CG mkts	**12.6**	**16.3**	**2.4**	**29.8**	**47.3**

Note: Valuations as of 31 Aug 2012. Source: CLSA Asia-Pacific Markets

CG and stock performance

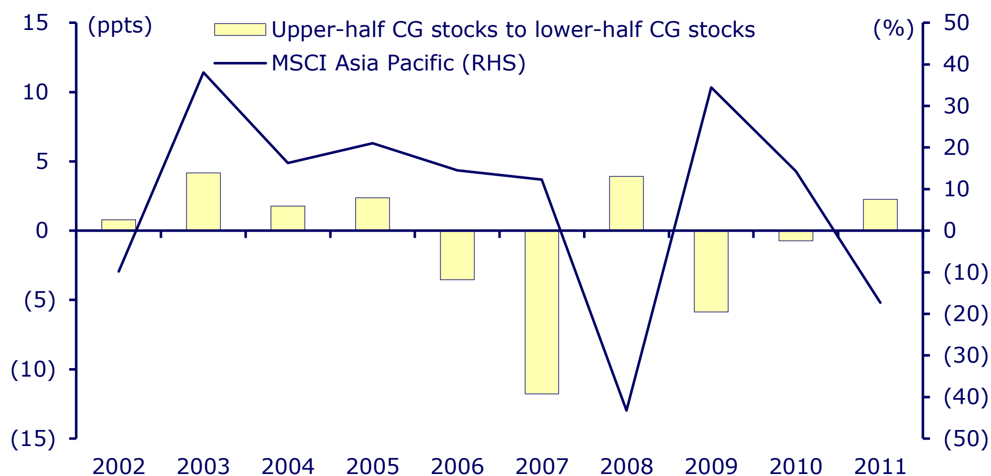
Risk appetite key to determining performance of high/low-CG stocks

The evidence that good CG stocks tend to outperform is mixed. We find that when markets are strong high-CG names tend to underperform. Low-CG stocks do better when risk appetite is high or rising and investors are willing to take more risk for returns. However, when markets are declining, low-CG stocks can be expected to underperform and higher-CG names do better. As risk appetite declines, investors shift towards quality.

Upper-half CG stocks have outperformed every year that the markets were down

Figure 11

Performance of upper-half CG stocks relative to lower half and MSCI Asia Pacific



Source: Bloomberg, CLSA Asia-Pacific Markets

Upper-half CG stocks outperform when markets are declining but not necessarily over time

Figure 11 shows the performance of the upper-half CG stocks relative to the lower-half ones by our current ranking across Asia Pacific (including Australia and Japan) over the past 10 years. It is striking that every year when the MSCI Asia Pacific index declined, ie, 2002, 2008 and 2011, higher-CG stocks outperformed the lower-CG ones. When markets in the region were rising, the upper-half CG stocks tended to underperform, eg, in 2006 and 2010 and very significantly 2007 and 2009. Upper-half CG stocks outperformed somewhat against lower-half CG names when markets were rising over 2002-04, but in general underperformed in years when markets were rising. Thus, over the past 10 years, on average the lower-half CG stocks outperformed the upper half marginally (by 0.7%). That is, there is no indication that better-CG stocks will outperform over time, except that when markets are declining they can be expected to do better, providing relative safety when risk appetite is diminishing.

Companies with a good reputation for CG might already have this reflected in their valuations

Corporate governance is largely about checks and balance; it can thus be seen as like the braking system of a car. While essential for handling a track safely, the fastest cars around a track are not necessarily those with the best braking system - although they should be! Similarly, a company might have taken huge risks, irrespective of CG, and happened to have been lucky that things turned out in their favour; their stock will likely be a strong performer. Over time, companies with the reputation of being great companies are likely to see this incorporated in their valuations. Hence, high-CG stocks will not likely be big outperformers; rather it will be those where the business fundamentals have improved significantly, even if the CG has been stagnant or poor, that would see the strongest stock moves.

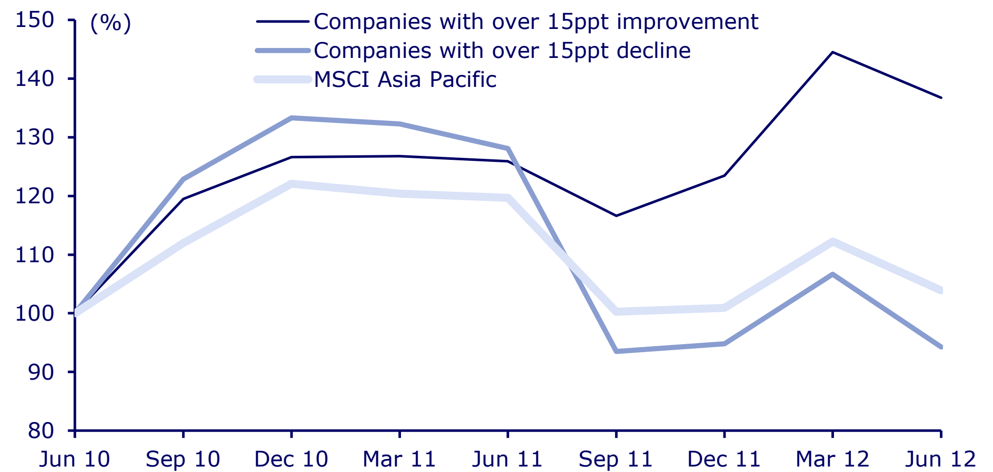
CG analogous to beta in identifying risk

The investment path in Asia, however, is strewn with potholes. A check on the braking system of the vehicles invested in, ie, the governance of the companies, is key to understanding the risks an investor is taking in the markets. In poor market conditions, it would likely pay to derisk including making a shift to higher-CG names. But when markets are expected to rally then a shift towards riskier stock names may lead to better performance. High or low CG itself does not determine performance, but like beta as an indicator of risk, it can be a guide to investors on which names to own given their read of market direction.

Big outperformance for companies that saw CG improvement

Figure 12

Performance of stocks with significant change in CG since 2010



Source: CLSA Asia-Pacific Markets, Bloomberg

Rising CG correlated with stock outperformance

Much clearer, however, is the impact of a significant change in CG score, as shown in Figure 12. Ten companies saw a change in CG score of 15ppts or higher since our scoring in 2010, stripping out the effect of the change in the scoring system (they are shown in Appendix 7). On average, the median outperformance was 14.1ppts against MSCI Asia Pacific over the two years to June 2012. Improving stock performance and a greater investment following may well lead the corporates to be more transparent and analysts to be more generous in their overall view of management. Even with the possibility of reverse causality, ie, better business conditions and rising stock performance leading to more transparency and better CG scores, rising CG is seen to be correlated with stock outperformance.

Companies with declining CG saw stock underperformance

This year, 26 companies saw a 15ppt decline in CG score (see Appendix 7); the median underperformance of their stocks against the regional index was 11.1ppts in the two years to mid-2012. Half of them underperformed by more than 10ppts. Seven, or about one-quarter, of the names with significant CG declines, underperformed by 50ppts or more. The average underperformance was mitigated by stocks in the Philippines that went up with the market even though their individual CG rating declined. Stripping out the four Philippine companies on this list, those with deteriorating CG underperformed regionally by a median of 20ppts.

Not easy to anticipate CG changes

The evidence is that it is not levels of CG that are correlated with stock performance but rather changes in CG. Whether CG is likely to improve or decline is difficult to anticipate but in the sections to follow we set out first what market conditions on CG are like, and then corporate practices and some pointers on real CG commitment.

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Market CG scores - Southern comfort

If there is one constant in Asian corporate-governance reform over the past 15 years it is that the process is usually non-linear: few countries or markets have been able to sustain improvements year in, year out, political will rises and falls in inverse proportion to the stock market, and the average investor only becomes enthused following a corporate or financial crisis. It is perhaps inevitable, therefore, that three of the four markets that did well in our last CG Watch survey in 2010 - Japan, China and Indonesia - performed less impressively this time around and all dropped points. The fourth, Thailand, has bucked the trend and improved slightly. But the good news is that all three markets that fell badly last time - India, Korea and the Philippines - have bounced back.

Most markets with rising CG scores in Southeast and South Asia

A quick glance at the market rankings and scores this year (Figure 13) reveals something more curious, however. Most of the markets rising are in Southeast and South Asia. The increases may not be large - 2ppts for Singapore, 3ppts for India, Malaysia and Thailand, and 4ppts for the Philippines - but the direction is positive. In contrast, most of the markets falling are in North Asia: Japan and Taiwan are both down 2ppts, while China has fallen by 4ppts. Korea is an exception: it rose 4ppts, but its overall score remains lower than Japan or Taiwan.

No obvious common reason

We cannot see a common reason as to why markets in the south are improving. It would be neat and tidy to be able to say that plans for an Asean Economic Community by 2015 with accompanying economic and capital-market integration are helping to drive standards higher, but it is too early to make such a claim (although over time this may well be true).

Markets in the south are improving

Figure 13

CG Watch market scores: 2007-12

(%)	2007	2010	2012	Chg 2012 vs 2010 (ppts)	Trend of CG reform
1. Singapore	65	67	69	(+2)	Improving, but culture needs to open more
2. Hong Kong	67	65	66	(+1)	Static, but reinvigorated regulator positive
3. Thailand	47	55	58	(+3)	Improving, but corruption a major issue
4. = Japan	52	57	55	(-2)	Government stalling, companies opening
4. = Malaysia	49	52	55	(+3)	Culture at last showing signs of openness
6. Taiwan	54	55	53	(-2)	Rules improving, but still behind the curve
7. India	56	48	51	(+3)	Enforcement up, Delhi an obstacle
8. Korea	49	45	49	(+4)	Government more open, *chaebols* closed
9. China	45	49	45	(-4)	Rules improve, but culture still weak
10. Philippines	41	37	41	(+4)	Improving, but will it be sustained?
11. Indonesia	37	40	37	(-3)	Regressing, but new regulator may help

Source: ACGA

Each country motivated by different factors

Instead, each country has been motivated by different factors: Singapore has rejuvenated its CG policies and is becoming more open; Malaysia produced a five-year "CG Blueprint" and its companies are performing better; India knows it has some deepseated problems to fix; and the Philippines has a new government that is making some progress in the fight against corruption and for better administration.

Northern chills

Cultural issues partly impede CG reform

The situation is somewhat different in North Asia. While generalising about societies as different as China, Korea, Japan and Taiwan is risky, they do share certain cultural, legal and political similarities that, in our view, place obstacles in the way of sustained and fundamental corporate-governance

reform. This is not to suggest that all characteristics of these places are negative from a CG point of view. Each place has numerous individuals, companies, organisations and regulatory officials trying hard to improve their system. The challenge is that conservative mindsets still dominate most business thinking.

Closed corporate cultures

One issue is the rigid hierarchy present in most companies combined with generally closed corporate cultures. With decision-making power concentrated in one or a few key leaders (or, in China's case, the institutions of the Party and government as well as key men), the average company in North Asia is rarely keen to discuss corporate governance or accept that their existing governance systems could be improved. The same companies, ironically, will often be delighted to discuss corporate social responsibility! This is seen as good public relations and less contentious than governance.

Few senior executives engage on CG

In our experience, it is difficult to find senior executives in China and Korea willing to talk about, and knowledgeable on, corporate governance. It still seems an alien concept to most of them, an odd set of rules required by the government but which have little relevance to the way they run their businesses. In China, private-sector firms seem more out of the loop than state enterprises on this score. In Korea, few of the family conglomerates (*chaebols*) have any top executives responsible for governance - a task that is typically delegated to the investor-relations team. Interestingly, Japan is more diverse and has more chairmen and chief executives willing to engage in a dialogue with shareholders. Yet, overall the Japanese corporate sector has strongly resisted core governance reforms (see below). Taiwan is also more of a mixed bag than China or Korea, but its corporate sector in aggregate can be equally stubborn.

Companies not persuaded on the value of good CG

Evidence from North Asia over the past 15 years shows that it has been tough for governments and regulators to persuade companies about the value of good CG. Perhaps some of this is due to self-confidence (or hubris) - many of the companies in the region have done well in those years and may feel their ways of doing things work just fine. Some is also the result of doubts on the part of regulators themselves - who should they believe, powerful companies and business interests determined to maintain the status quo or a fragmented coalition of minority shareholders, nongovernmental organisations (NGOs) and governance experts?

Company law a battleground between regulators and business

A key battleground between regulators and business has been company law, which dictates board structure and various aspects of shareholder rights, among many other things. All four North Asian jurisdictions historically have "civil law" legal systems based directly or indirectly on German law, which provides for a different structure to the board of directors than is prevalent in the rest of Asia (except Indonesia, which follows Dutch law). The issue here is not so much the structure of the board and which one is better (English single-tier or German two-tier?), but rather that most North Asian governments have struggled to reach a clear decision on what is the best form of board governance.

China has dual-tier board structure

For a range of reasons, China has maintained its dual-tier "supervisory board" system alongside unitary boards of directors with executive, non-executive and independent. While supervisory boards may fulfil some helpful functions, most people in China with experience of them believe they cause a great deal of unnecessary duplication in listed companies.

Japan does not mandate independent directors

Japan has shown the greatest ambivalence by refusing to mandate independent directors for listed companies, while allowing firms a choice between the longstanding and fairly weak "statutory auditor" (*kansayaku*) system and US-style boards with committees. Needless to say, the latter option has failed miserably, with a tiny takeup rate. For this reason, a third option is in the works. It, too, will be voluntary.

Independent directors not mandated for all listed companies in Taiwan

Taiwan has steadily broadened the scope of its rule on independent directors, but has still not mandated them for all listed companies. Nor does it require audit committees - companies can continue to appoint "supervisors" to watch over the management board instead. Supervisors play a similar role to statutory auditors in Japan, yet act individually rather than as part of a board. They are not seen as a strong governance mechanism either.

Korea does require "outside" directors

Korea, meanwhile, has done the most to move away formally from its legal legacy. It does mandate "outside" directors, while firms above a certain size must all have audit committees (although many smaller firms do too). The issue in Korea is not so much ambivalence on the part of the government about board structure, but more ambiguity around the role of outside directors - are they really supposed to supervise the controlling shareholder and management? Is this even possible given the huge power wielded by most *chaebol* chairmen, the strict hierarchies and closed corporate cultures described above, and the contradictory messages that successive Korean governments send in pardoning business leaders convicted of fraud, embezzlement, tax evasion, assault and any number of other crimes?

Korean language has no proper term for "independent director"

It is worth noting here that board independence in Korea is also limited by two other factors: many independent directors come from organisations connected to the *chaebols*, which control huge and sprawling corporate and social networks (some conglomerates even control universities, from which many outside directors are drawn!); and the fact that the Korean language has no proper term for "independent director". Indeed, as in China, the term for corporate governance in Korea is somewhat misleading and implies a greater degree of government control or intervention than would be understood in the West.

Lack of consensus in North Asia how to proceed with reform

On balance, therefore, North Asia lacks consensus on how to proceed with corporate governance reform, especially as it relates to board independence and management accountability. Resistance from powerful sections of the business community (and, to a lesser extent, tradition-bound law professors) in Japan, Korea and Taiwan forced weak governments to reach some fairly unconvincing compromises on CG reform.

Korean government making progress on director reforms

It is possible that this situation may change. The Korean government, to its credit, is starting to drag itself out of this regulatory quagmire and showing more determination to proceed with substantive director reforms. It has already made progress on rules governing board decisions on related-party transactions. As a result, the country's score has risen in this year's survey, albeit from a low level. But as we note in our Korea chapter, this renaissance may be short-lived.

Southern warmth

Big gap in score for Singapore versus other Asean markets

In critiquing what we perceive as some entrenched opposition towards CG reform in North Asian business communities, we do not mean to imply by contrast that all is proceeding smoothly in Southeast Asia's top markets.

"Many companies are no more enthusiastic about CG than their counterparts in the north and overall scores in our market survey are not especially high. Singapore stands out at 69%, but there is then a large drop before Thailand at 58%, followed by Malaysia at 55%.

Momentum in CG reform

Yet, there are some substantive differences between these rising markets and those in North Asia. All have managed to develop clearer policies on basic aspects of corporate governance, particularly board independence. All require independent directors and audit committees, encourage other board committees, and are seeking to strengthen shareholder rights. There is not the same war of attrition over these ideas as you find in North Asia. For some hard evidence to back up this claim, see Figure 14. Singapore, Thailand and Malaysia all score higher in "CG rules & practices" than markets in North Asia, excluding Hong Kong, which in any case is not included in our North Asia group above.

Singapore and HK score near 70% while China, Indonesia, Philippines and Korea at below 50%

Figure 14

Market category scores

(%)	Total	CG rules & practices	Enforcement	Political & regulatory	IGAAP	CG culture
1. Singapore	69	68	64	73	87	54
2. Hong Kong	66	62	68	71	75	53
3. Thailand	58	62	44	54	80	50
4. = Japan	55	45	57	52	70	53
4. = Malaysia	55	52	39	63	80	38
6. Taiwan	53	50	35	56	77	46
7. India	51	49	42	56	63	43
8. Korea	49	43	39	56	75	34
9. China	45	43	33	46	70	30
10. Philippines	41	35	25	44	73	29
11. Indonesia	37	35	22	33	62	33

Note: Category scores above are rounded. However, total scores are an average of the category scores to the second decimal place. Source: ACGA

Asean 3 have government-led reform

As the table shows, the "Asean 3" have a mixed record on enforcement compared to North Asian markets and are not necessarily ahead on "CG culture". But they do shine on "IGAAP" (accounting and auditing) and mostly do better on "political and regulatory". What this clearly indicates is that CG reform in these markets is government-led and that the state has the upper hand in setting policy. Corporate resistance in such markets is not absent, but where it exists is usually more subtle and invisible - companies will pretend to follow the rules, while all the time carrying on business as before.

Consistent increase in scores for Singapore, Malaysia, Thailand

This government leadership is shown strikingly in Figure 15, which tracks total market scores for our 2007, 2010 and 2012 surveys. The only places to have shown a consistent, if gradual, increase in scores from one survey to the next are Singapore, Malaysia and Thailand. All other markets have gone up and down, or down and up.

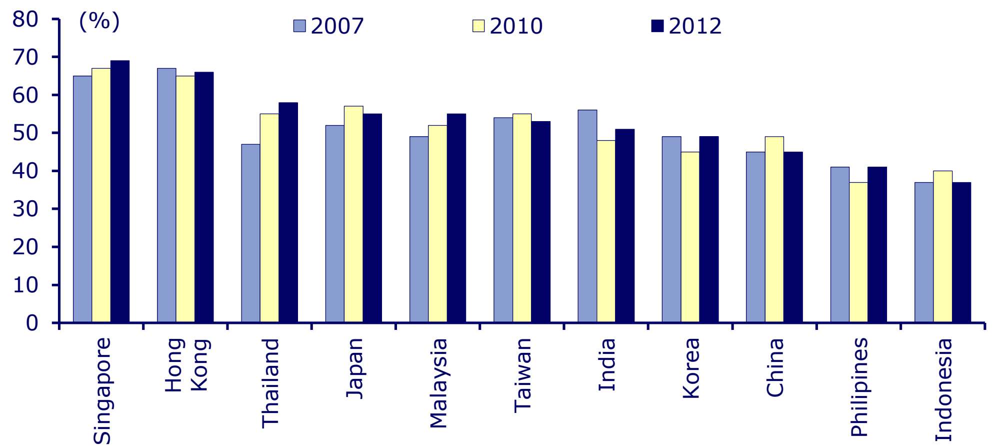
All form rather than substance?

It is easy to be cynical about this result and say that it reflects a lot of form over substance - a charge which is certainly true in part. But the counter arguments are that reform often starts with "form" not "substance", that the same charge can be levelled in any case at all markets, and that it is surely better to have a government keen to do well than one that is not, whatever the motivation. A government that sets a high standard for itself can then be judged against that standard.

Most markets' CG direction not consistent from 2007 through 2012

Figure 15

CG Watch market scores



Source: ACGA

Eco-systems that support director training and board development are crucial

A further differentiating factor reflecting substance more than form is that Singapore, Malaysia and Thailand all have fairly well-established eco-systems supporting director training and board development. These variously include director training institutes, associations of company secretaries, business chambers, stock exchanges and, in the case of Malaysia, the central bank. These networks of training organisations are, arguably, far more advanced and/or independent than anything you will find in China, Japan, Korea or Taiwan (although there are some more developments in Japan on this front).

Singapore versus Hong Kong

Large gap between Singapore, Hong Kong versus the other markets surveyed

It is no surprise that Asia's two international financial centres take first and second place in our survey again - there is such a large gap between them and third, fourth and fifth that it will take some time before the rest of the region catches them.

Strong on independent regulation of auditors but weaker on CG culture

Singapore maintained its hold on first place mainly because of efforts by its government to focus greater attention on corporate governance, improve rules and regulations and strengthen regulatory enforcement. The city state also sets the benchmark for the region in the independent regulation of auditors. The area where it is weakest is in CG culture (ie, the sum total of efforts by companies, investors, professional bodies, the media and others to voluntarily raise CG standards). We believe that Singapore is becoming a more open society, with some leading companies becoming relaxed in their dealings with stakeholders, and some retail shareholders showing greater willingness to exercise their rights. But overall market participants seem content to let government set the pace.

HK ahead of Singapore on enforcement but behind on rules & practices

Hong Kong continues to outflank Singapore in regulatory enforcement, but scores about the same in political/regulatory environment and CG culture (although the makeup of Hong Kong's scores in these categories is different to Singapore). The SAR falls behind, yet again, on rules and practices: slower financial reporting by leading companies; lack of quarterly reporting (which we continue to believe is a net positive, despite all the criticism it has taken); and slightly weaker rules on private placements. There are areas where Hong Kong beats Singapore: mandatory voting by poll; disclosure of director remuneration; and deadlines for the release of AGM notices. But overall, Singapore edges ahead.

Singapore has surged ahead on audit regulation

The one area where Singapore has surged ahead of Hong Kong is in audit regulation. Singapore has the Accounting and Corporate Regulatory Authority (ACRA), a government agency independent of the audit industry and which has developed a multiyear track record of reviewing the quality of audit and auditors in Singapore, publishing its detailed findings, and pushing auditors to improve. Hong Kong's main audit regulator is still the local industry body, the Hong Kong Institute of Certified Public Accountants (HKICPA), which takes a sincere, though largely collegial approach to its work in this area. Although HKICPA is supported by a government agency, the Financial Reporting Council (FRC), the latter only has investigatory power; it cannot sanction auditors. In short, Hong Kong does not have a proper independent audit regulator, something that is becoming an increasing embarrassment.

Challenges for Hong Kong regulators

A final comment about comparing Hong Kong and Singapore. While our survey looks at the implementation of rules and best practices as well as what is written on paper, and we seek to assess the effort made by regulators and governments as well as tangible outcomes, we do not apply a "degree of difficulty" adjustment to our scores. If we did, it is likely that Hong Kong would regularly beat Singapore purely on the basis that its capital market is considerably more complex and difficult to manage, and that its government lacks the authority over companies that Singapore's enjoys. When regulators in Singapore seek to penalise listed companies for breaching rules, those issuers and their directors do not fight back as much as their counterparts in Hong Kong. And when the stock exchange in Singapore announces a new rule, local tycoons do not take out full-page advertisements attacking the bourse for its idiocy (as they did in Hong Kong in 2009 over a proposed extension of the closed period for director trading prior to results announcements).

Assessing systemic CG quality

Despite blatant scandals, scores on the various categories balance out

We are often asked why certain markets, such as Japan, do not score lower in this survey, given the blatant governance scandals that occur from time to time. Our response is that the aim of the survey is to assess the systemic strength of CG in each market, hence a country may not necessarily lose points overall following a recent high-profile corporate scandal. This is because while the country will definitely lose points in one part of the survey (eg, CG culture), it may gain them in another part (eg, enforcement) if a scandal forces the government to take tougher action. To some degree, therefore, scores balance out.

Our CG assessment of markets has 90 questions

This survey, specifically, looks at 90 questions across five categories:

- **CG rules & practices** (25 questions): Mostly assesses the quality and depth of regulation on CG, with some questions looking at implementation of rules by companies. We believe it is important to look at rules in context, not just what is written on paper.
- **Enforcement** (18 questions): Includes both public enforcement by the regulator and "private enforcement" by investors.
- **Political & regulatory environment** (13 questions): Examines the clarity of government policy on CG, the structure of the regulatory system, progress made by regulatory bodies in enacting new reforms, the quality of the judiciary, and media freedom.
- **IGAAP (accounting & auditing)** (15 questions): Looks not only at accounting and auditing standards, but also practices with large and small caps, auditing firms, and the extent to which there is an independent audit regulator.

- **CG culture** (19 questions): Assesses whether companies, investors, professional firms, the media and others are making voluntary efforts to improve CG.

The following graphs show the performance of each market for each category our 2007, 2010 and 2012 surveys. As our survey questionnaire is almost identical over this period, these scores are comparable. (For our detailed questionnaire and answers, see Appendix 2.)

CG rules & practices

Unstable scores given erratic practices

Scores for most markets have been quite unstable in this category, since we look not only at CG rules that exist on paper in company law, securities law, listing rules and codes of best practice, but also how companies are implementing them, whether market participants can actually make use of a regulation (eg, on shareholder litigation), and whether rules are keeping pace with evolving global and regional best practice. We mark countries down, for example, if they have not updated their code of corporate governance for a long period while other countries have. This situation played out in this survey with Hong Kong, Malaysia and Singapore receiving higher scores for extensively updating their codes, while most other markets lost points because they did not (or only made smaller changes).

Markets generally do better on financial reporting, disclosure of share transactions, etc

Markets generally do better in this category for rules relating to the timeliness and frequency of financial reporting, disclosure of director share transactions, disclosure of substantial ownership stakes (5% and above), whether audit committees are mandatory, and the release of final AGM agendas and meeting documents.

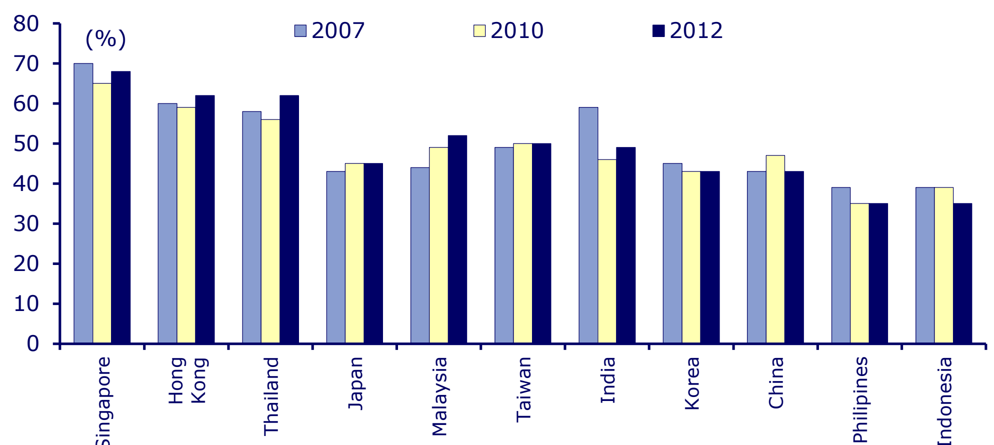
Ongoing weakness on nonfinancial reporting and other disclosures

Areas of ongoing weakness or variability across the board include: the quality of nonfinancial reporting, the disclosure of material price-sensitive information, rules on related-party transactions and insider trading/market manipulation, the availability of legal remedies for shareholders, whether voting by poll is mandatory, and definitions of "independent director". Most markets also do badly on questions relating to audit committee effectiveness, whether minority shareholders can nominate directors and expect them to be elected, and the protection of pre-emption rights for shareholders. All of which explains why few markets score above 60% in this category.

Few markets score above 60% on rules and practices

Figure 16

CG rules and practices



Source: ACGA

Enforcement improving in Asia

Enforcement

This is one of the more promising sections of the survey, with higher scores this year in eight of the 11 markets indicating that enforcement is improving in Asia. In four of the eight, scores show a clear rising trend over the past five years. In two of three markets whose score fell in 2010 before bouncing back this year - namely India and the Philippines - the latest score is higher than its previous high in 2007.

Greater enforcement by SGX as well as HK's SFC

In Singapore, the higher score is a product of greater enforcement over the past two years by the Singapore Exchange, improved disclosure of enforcement activity by regulators and more active retail shareholder participation in annual meetings. In Hong Kong, the rise was primarily due to increased efforts by the Securities and Futures Commission against insider traders, market manipulators and companies engaging in false disclosure.

In some countries, improving private enforcement by institutions

In Thailand, Japan, India, Korea and the Philippines, improved regulatory enforcement and/or greater investment in enforcement initiatives was largely behind the better scores. In some of these markets, notably Thailand and Japan, quite extensive voting by institutional shareholders contributes to the private-enforcement score, as it does now in India following a requirement that institutions vote their shares. Thailand and Malaysia also have active retail shareholder bodies (which, in Malaysia's case, accounted for its slightly higher score).

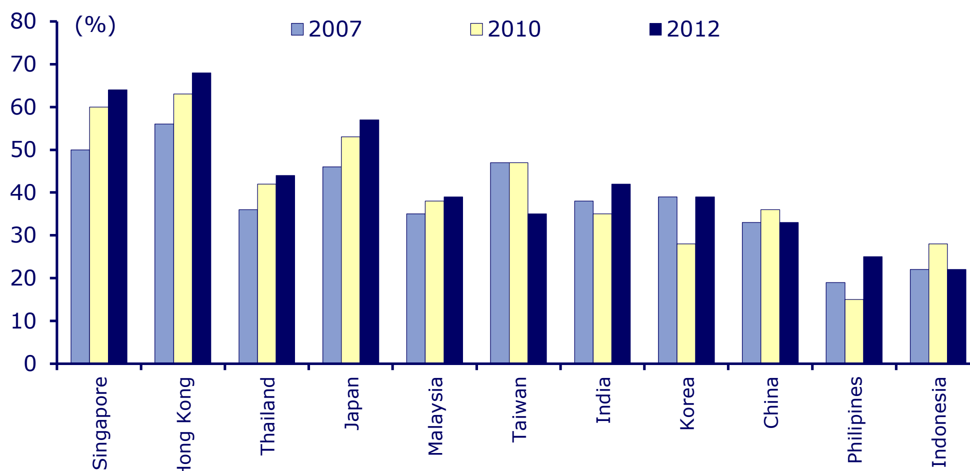
But lower enforcement scores for China, Indonesia, Taiwan

Scores fell in two countries, China and Indonesia, because we could not see marked improvement over the past two years and because of doubts as to whether the regulatory system was fair and consistent. Taiwan's score fell significantly in large part due to a surprising lack of updated enforcement data and weaker efforts by minority shareholders.

Lower-CG markets tend to have weaker enforcement

Figure 17

Enforcement



Source: ACGA

Political and regulatory impetus been mixed

Political & regulatory environment

The mixed picture in Figure 18 reflects the challenges governments face in sustaining a CG reform policy, introducing new laws and regulations, enhancing the governance of banks, ensuring that all regulations are easily accessible on websites (and, preferably, translated into English), improving the skills and independence of the judiciary, and allowing a free media.

Singapore and Malaysia have seen consistent improvement

Only two markets, Singapore and Malaysia, have risen consistently over the past five years, although this does not mean they tick all the boxes above. Hong Kong has performed better, after a poor result in 2010, but this is almost entirely due to a rejuvenated Securities and Futures Commission, not because the government has any firmer grip on CG reform.

No significant change in Thailand or Taiwan

Thailand's score is flat, with no major progress or regress in its political and regulatory environment despite the change of government in 2011 (an event which many, including us, had too quickly forecast would be negative for corporate governance). Taiwan's overall score also stays the same, with some higher scores (eg, introduction of new regulations, signing the International Organisation of Securities Commissions (IOSCO) multilateral memorandum of understanding) cancelled out by lower scores (eg, government commitment to CG reform, accessibility of regulations, governance of banks).

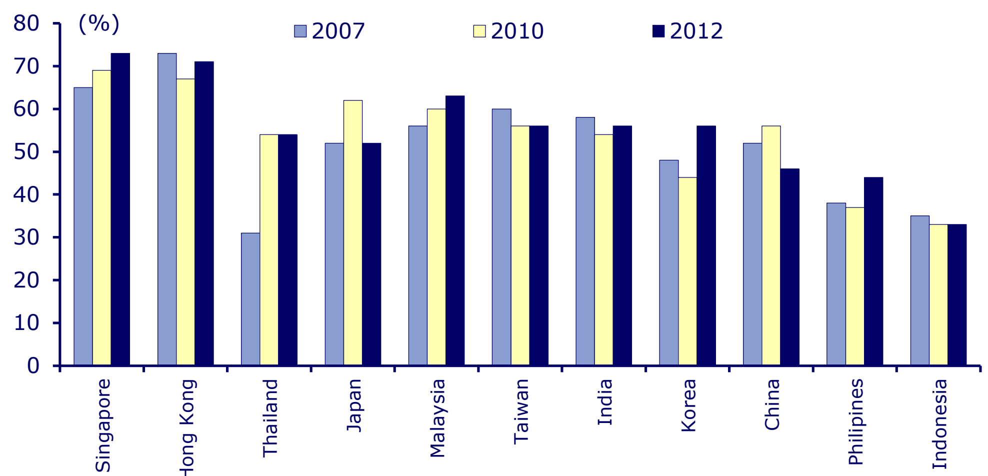
Japan and China's scores dropped

Japan's score dropped because of its government's excessively incremental approach to reform, especially on company law and board independence. China fell partly because of the increasing contradictions between competing policy objectives, namely promoting the interests of state enterprises and the state as a major shareholder, while trying to develop a capital market built on transparency, accountability and minority shareholder protection. China also lost points because of its undeveloped legal system.

Singapore and HK stand higher on enforcement category

Figure 18

Political & regulatory environment



Source: ACGA

IGAAP (accounting and auditing)

Audit regulation is the big issue

The big issue here is not accounting or auditing standards, since almost all Asian markets have a stable policy of following International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA), but audit regulation. Does the market have an audit regulator that is genuinely independent and not controlled by the auditing industry? Is this regulator exercising stronger and more effective supervision of auditors? And is it publishing reports that contribute to our understanding of audit quality in different markets?

Singapore takes the lead

The market that leads this category by a significant margin is Singapore and it answers yes to all the questions above. Its score dropped slightly this time, however, because while it does undertake a detailed annual review of audit-

firm and audit-engagement quality, it has yet to take firm disciplinary action against errant auditors. Before it can do so, it needs to clarify its powers in this area and recently published a consultation paper on amendments to the Accountants Act.

Uncritical trust in auditors often a casualty when reviews undertaken

Other markets performing commendably include Thailand and Malaysia, although the latter's score has not increased overall. This is not a criticism of the audit regulator. Rather, it is a product of concerns about audit quality that have come to light, ironically, because of reviews undertaken by the regulator. Indeed, as audit regulation improves and becomes more transparent, one of the first casualties is the uncritical trust that people place in auditors (a trend given added impetus by the global financial crisis and the failure of banks).

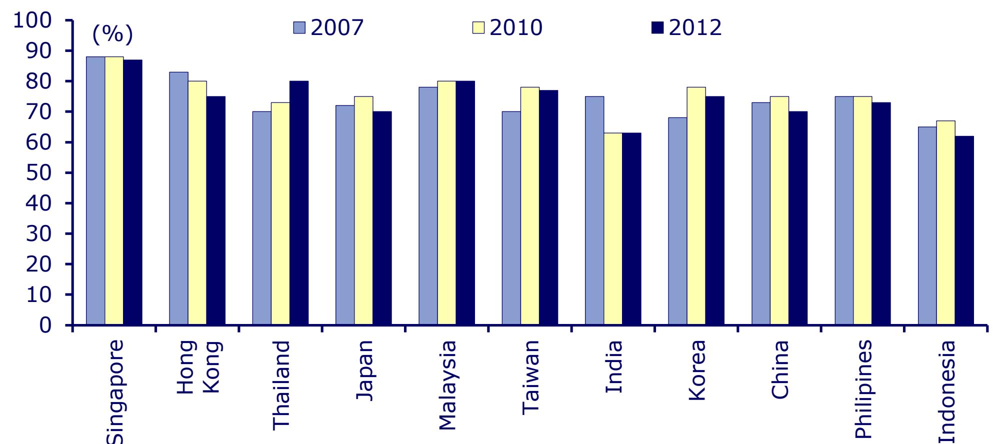
No progress in setting up independent audit regulators in Hong Kong and India

While several markets have been downgraded here for weaknesses in audit regulation, the two that continue to stand out for their lack of progress in setting up independent audit regulators are Hong Kong and India.

HK's score on IGAAP slipped and significantly below Singapore

Figure 19

IGAAP



Source: ACGA

CG culture

Limited progress on CG culture

Few markets stand out for making a great deal of progress on their CG culture. This is perhaps not surprising since it is even harder to change corporate, investor and social behaviour than to develop a new policy or regulation (as hard as the latter may be). But what is most striking is that so few markets have shown any improvement in score. Six of the 11 are either flat or declining, while three of the remainder recorded only minimal increases. While the Philippines showed a noticeable jump, its score is clearly less than in 2007. The only market significantly above its two scores is Malaysia, albeit from a low base.

Most listed companies don't see CG adding value

One factor slightly holding down scores in this section was our decision to score all markets "No" for the first question, which asks whether the "average listed company" believes CG adds value? Many large caps and better managed SMEs believe it does, but we are not convinced that most listed companies would agree.

Civil society institutions getting stronger

Areas where practices are generally improving include: efforts made by listed companies to improve shareholder communications, a trend towards voting by poll at company meetings, the quality and scope of director training, the

involvement of professional associations in CG reform and education, and media reporting on CG. Broadly, we believe that civil society institutions are getting stronger in most Asian markets.

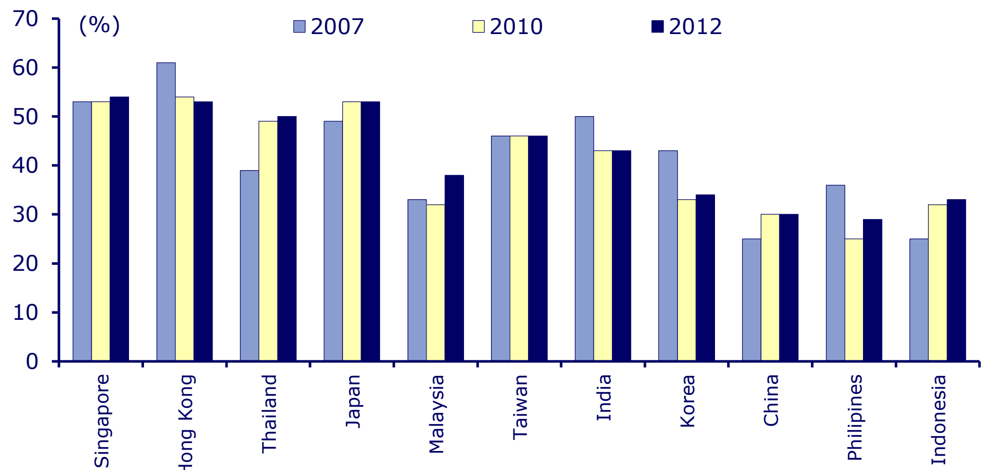
A compliance mentality holds back acceptance of the spirit of rules

But these positives are cancelled out by persistent negatives: a compliance mentality among most companies (ie, not trying to understand the spirit of rules); the lack of separation between chairmen and CEO; weak reporting on internal controls and risk; poor disclosures of executive remuneration policy; lack of effort by market intermediaries to strengthen the governance of firms going IPO; and, with some notable exceptions, a general free-rider mentality and apathy among minority shareholders (especially institutional).

Most markets' score on CG culture flat or declining

Figure 20

CG culture



Source: ACGA

Conclusion

Despite the somewhat depressing picture painted by the CG culture scores above, and the fairly stubborn resistance to reform in certain markets, the analysis in this section hopefully provides a balanced picture of the strengths and weaknesses in Asian CG.

Fraud and malfeasance spur regulators and other parties to take governance seriously

Seven of the 11 markets show higher scores than in 2010 (though not all are above their 2007 levels), while most of those that fell did so only by a few points and could well bounce back next time. Overall, we believe that the systemic quality of CG in Asia is gradually getting better, despite the appearance of numerous frauds and other market malfeasance around the region. Indeed, it is precisely such crises and challenges that spur regulators, investors, the media and others to take governance more seriously. Given there seems no let-up in the volume of CG scandals coming down the pipeline, we predict a bright future for reform in Asia!

Calibrated governance

Australian firms ahead followed by Singapore and Hong Kong on our CG rankings

We have streamlined our governance scoring of corporations, narrowing the focus of our main CG questionnaire down from 46 to 30 questions. The change in scoring system is net neutral on the average CG score. However, some companies' CG scores did change by over 10ppts, underscoring that the rankings are sensitive to the weighting and criteria applied. Australian companies, included in this year's scoring, lead in the CG scores of Asia-Pacific firms. Singapore and Hong Kong remain among the better markets for corporate standards, with a slightly wider gap in favour of Singapore. CG perceptions are coloured by the worst companies: China, Korea and Indonesia are thus generally seen as markets where CG is a major issue.

Independence of the board a key issue

Asian companies fare worst on the independence of boards. The composition of the audit committee is a genuine test that most regional firms fail. Few corporations have an independent chairman, and not many have a majority of independent directors. Instead, about 40% in Taiwan, Hong Kong, Singapore and the Philippines have three or more family members sitting on the board. The potential for conflict of interest is a major issue. Around half the companies in these markets are deemed not to be the primary financial interest of the controlling shareholder. The analysis on these issues presents insight on the actual level of CG commitment in each of the markets.

Streamlining the questionnaire

CG scoring has evolved with changing focus on CG issues

Our CG scoring has evolved since we started scoring companies 11 years ago. The weightings of the questions have changed to reflect the evolving focus on various CG issues. We also have negative scoring - where a negative answer would not just have a zero score but would pull down the score for some of the most pertinent questions - in order to properly reflect the importance of certain aspects of CG.

Major streamlining in CG scoring this year

This year sees a more radical streamlining of our CG scoring. The Clean and Green (C&G) and corporate social responsibility (CSR) questionnaire that is sent out to corporates continues to make up 10% of our CG scoring. The questions and weight of this section is unchanged. But for the other 90% of our CG scoring, we used to have 46 questions, which we have streamlined to 30 questions. One reason for reducing the number of questions is that it increases the weight of the more important questions. By reducing the number of questions by one-third, the weight of a positive answer for each remaining question goes up by half. Thus, questions like whether a company has a remuneration and nomination committee, less relevant to the CG landscape in Asia, have now been removed.

Some questions did not discriminate sufficiently

A second reason for reducing the number of questions is that many of the questions were not discriminating enough where the assessment for most of the companies was generally positive. Because these questions had little impact in distinguishing the better and worse companies, they were removed. Among these, for instance, are questions we had previously on whether the company had applied for a waiver on disclosure rules, if it had an English website, or whether the audit committee nominates the external auditors. The list of questions removed is shown in Appendix 4.

Shorter questionnaire, more accurate scoring?

The third but also relevant reason is that a shorter list of CG questions would more likely see more careful attention in the scoring by analysts than a longer one. Note that other than the C&G and CSR section, the bulk of the CG scoring is done by CLSA's analyst covering the company. For the analyst, CG

is just one of the many issues he/she has to look at, and usually not the most relevant for the 12-month view of whether a stock is likely to outperform. Although poor-CG companies could see issues arise which might affect the stock, for the bulk of them, this is not usually a factor that will materialise and impact share-price performance on a 12-month view. Most stock analysts would not usually give CG too much attention. A shorter questionnaire should, however, be scored more carefully than a longer-one.

Net reduction of 16 questions

The overall questionnaire was reduced by 16 questions, which was the net impact of eliminating or merging 20 questions while introducing four new ones. Of the four new questions, two are on the composition of the board and whether independent directors were attending board meetings. One new question is whether anyone with a criminal conviction is a director or senior executive, and another is on whether company has introduced non-voting common shares. The four new questions introduced are:

Four new questions in the CG questionnaire

- Does the board composition reflect an attempt to bring diverse talents and backgrounds to the board? Are family members not more than two individuals on the board?
- Is it disclosed that independent directors attended at least three quarters of board meetings over the past financial year?
- Is it true that there are no persons with criminal conviction that reflect negatively on integrity sitting on the board or having a senior executive position in the company?
- Is it true that the company has not issued non-voting common shares?

Two revisions to current questions

We also tightened the criteria for a few of the questions. The question on audit committee (Q16 in our revised CG questionnaire, see Appendix 3) introduced an additional criteria that all members of the audit committee should have financial expertise. Most companies that had previously scored positively for having an audit committee now have a negative answer on this question because not many ensure that all the appointees to the audit committee have financial experience. This stricter criterion makes Q16 in effect a new question as the answers this time around are not comparable with previously. Our like-for-like comparison of CG scoring thus excludes this question. The other revision to the existing questions was on timing of release of full-year results. Previously a company scored positively if it released full-year results within three months, this has now been shortened to two months as best practice has moved towards shorter reporting periods.

From seven subsections to six

With the reduced number of questions, we also rationalised the CG sections. Inclusive of the C&G/CSR section, we previously had seven sections to our "core" CG score (ie, CG score excluding C&G/CSR). This has now reduced to six sections. Independence and accountability used to be two sections with a total of 15 questions. We now collapse the accountability questions into the independence section, which now has seven questions. The accountability questions that were removed are generally those that an analyst is not in a good position to determine. The analyst is unlikely to know, for instance, whether board members are well briefed before board meetings, whether the audit committee supervises internal audit and accounting procedures. We previously had two questions on voting by poll: the first on whether votes are tallied according to the percentage of shareholding and a second question on whether the result is announced by the next day. These two questions have been collapsed into one.

The C&G/CSR section continues to have a 10% weight in the CG scoring as before. Previously the six other "core" sections of the CG questionnaire (ie, excluding C&G/CSR) had an equal 15% weight each to make up 90% of the overall CG score. With the core CG section reduced to five, each of these sections now has an 18% weight.

Weight of main CG subsections increased from 15% to 18%

Figure 21

Change in CG score of corporates from amendments to questionnaire

	Overall CG score change (ppts)	Largest CG score increase (ppts)	Largest CG score decrease (ppts)
Taiwan	3.8	(+16.3)	(-9.4)
India	3.5	(+15.2)	(-12.1)
Indonesia	2.6	(+14.4)	(-6.7)
Hong Kong	0.2	(+16.8)	(-9.2)
Singapore	(0.1)	(+19.3)	(-24.6)
China	(0.1)	(+12.7)	(-12.5)
Korea	(1.0)	(+8.4)	(-17.2)
Malaysia	(1.4)	(+13.9)	(-18.8)
Japan	(1.9)	(+14)	(-13.7)
Philippines	(2.7)	(+5.1)	(-15)
Thailand	(3.6)	(+2.8)	(-13.9)

Source: CLSA Asia-Pacific Markets

Reducing the number of questions by 1/3 had no impact on the average score but some effect on individual markets

The net impact of changing the questionnaire did not have any change in overall average score for the region. However, on a market basis, the new scoring improves the average corporate scores in four of the markets but reduces the average scores in the other seven. On average, the impact is most positive for Taiwanese (+3.8ppts on average) and Indian companies (+3.5ppts). Thailand (-3.6ppts on average) and the Philippines (-2.7ppts) saw the biggest decline owing to the change in questionnaire. For 97% of the 464 companies that were scored in 2010 and also this year, the change in score was within 14.5ppts, which contributed to a meaningful change in their overall score.

Sizeable change in scores for a handful of companies

However, 15 companies had a significant change in overall score resulting from the change in questionnaire. Bank of India's overall CG score rose by 14ppts while Midland in Hong Kong increased 17ppts. In Korea, SK Telecom's score declined by 22ppts because of a change in questionnaire/scoring system. In Singapore, CapitaMall Trust's overall CG score fell by 14ppts entirely driven by the questionnaire change.

Reducing questions by 1/3 increases weight of remaining questions by half

A 15-20ppt change for a handful of companies is a very significant difference to come from changing the scoring system. This underscores issues with getting a suitable scoring system. Having too many questions in a CG metric will dilute the relevance of individual questions, while reducing the number of questions (as we have done in the current exercise) gives the existing questions a much higher weight. By reducing the number of questions by one-third, the weight of existing questions goes up by half.

Figure 22

Questions with negative scoring

Discipline	
Q1	Does management stick to clearly defined core businesses?
Q3	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?
Q6	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?
Transparency	
Q11	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 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.)
Q12	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 proforma or unaudited result statements are notably different from actual audited accounts, answer "No".)
Independence	
Q16	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".)
Q19c	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 "No"; if number of independent directors is the same insert "0".
Q21b	Are family members (including in-laws) no more than two individuals on the board?
Responsibility	
Q24	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.)
Q26	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.)
Fairness	
Q27	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 revenue or profits would mean "No".)
Q29	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".)
Q30b	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.)

Source: CLSA Asia-Pacific Markets

Impact magnified by negative scoring

The impact on the scoring gets amplified by negative scoring on 13 of the 30 core CG questions. Negative scoring has been part of our CG scoring for the past eight years. This was introduced because some of the questions had greater significance and where just zero for a negative answer did not really represent how significant it is seen for the perception of the company's CG. Thus, for instance, the first question in our CG questionnaire is whether a company sticks to clearly defined core businesses. If a company scored negatively on this, or any of the other 12 questions that had negative scoring, they would not just get zero but see their score for the section reduce by one-quarter of the total score for that section. Each of the core CG sections has an 18%; thus a negative answer for a question with negative scoring would result in a score of minus-4.5ppts. Figure 22 enumerates the 13 questions that have negative scoring.

97% of our companies had a change in score within 14.5pts because of change in questionnaire

A change in questionnaire used will result in different scores and rankings of companies. For two-thirds of our sample the change in score is within 10ppts and 97% of our sample saw a change in score of up to 14.5ppts. Only a handful had a change in score of around 20ppts resulting from the scoring system.

Under 3% of the sample have 15ppt change in core because of new scoring system

The CG score that we get on a company is a result of the interplay of at least three factors: 1) the company's actual commitment to CG; 2) the system used to measure and rank CG; and 3) the analyst's perception of how closely the company satisfies the criteria used for scoring. There will be some cases where a 15ppt or greater difference in CG score comes from just a different system of scoring. However, we find this applies to just less than 3% of our sample.

CG quartile a company belongs to is more meaningful than its exact CG score

We would, however, downplay the exact numeric for the CG score, but rather give greater weight on which CG quartile a company falls into. In many cases, the shades of difference between the lower end of one quartile and the next may not be significant. However, we have greater confidence in providing a ranking that distinguishes those that are among the best in the market (top-quartile CG), others that are above average (second quartile) and contrast these with those that are among the worst (lowest quartile) as well as those that are below average (third quartile).

Criteria used in the CG scoring

Other than C&G, five core sections in the CG scoring

Other than the C&G/CSR section, the other five sections in the core CG scoring are discipline, transparency, independence, responsibility and fairness. Our current questionnaire is provided in Appendix 3. The main issues under each of them are enumerated below.

Discipline

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

- Whether management sticks to clearly defined core businesses.
- If management has a realistic estimate of its cost of equity.
- Whether the company has issued equity when it was questionable if it was necessary and that options or shares to staff do not increase the share base at a rate higher than 5% over three years.
- That the company has not increased cash on its balance sheet and thus brought down its ROE.
- That the company does not have a history of restructurings that reflect mismanagement or abandoning earlier strategies.

- Whether there is undue political interference in the ability of the company to maximise shareholder value.
- Whether management discloses ROA or ROE targets.

Transparency

Are results announced promptly and similarly for other announcements?

- Whether the company publishes half full-year results within two months of the end of the financial year.
- Whether the company announces semi-annual and quarterly results within 45 days of the end of the period.
- Announcement of results within two working days of the board meeting to approve them and that the share price does not move in the direction anticipating the results.
- That the 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

Whether chairman is an independent director, the company has a proper audit committee, etc

- If the chairman is an independent, non-executive director.
- That the company has an audit committee chaired by an independent director, with more than half the members of the committee being independent directors and all members of the audit committee with financial expertise.
- Whether external auditors are in other respects unrelated to the company, provide a breakdown of audit and non-audit fees, and that the audit partner or auditing firm is rotated every five years.
- That independent directors make up more than half of the board.
- If there has been any increase or decrease in the number of directors over the last three years.
- Whether the company has voting by poll at AGMs and EGMs with detailed results released by the next day.
- If the board composition reflects an attempt to bring diverse talents onto the board and that family members do not account for more than two members of the board.

Responsibility

If independent directors attend board meetings, no convicted criminal in senior position, etc

- That the company discloses if independent directors have attended at least three-fourths of board meetings over the past fiscal year.
- That no person with a criminal conviction reflecting negatively on integrity is on the board or having 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.

Any controversy on decisions that disadvantage minorities, on placement of shares, etc

Fairness

- If there has been any controversy over whether the board or senior management have made decisions in the past five years benefiting them at the expense of investors.
- Whether the company has issued non-voting common shares.
- That there has been no controversy about share trading by board members, or that placements by the company have been fair, fully transparent and well-intentioned.
- Whether directors' remuneration has increased faster than net profit after exceptionals over the past five years.

Governance of companies

Market rankings are based on ACGA criteria

We use the ratings of ACGA for the rankings of markets, rather than the bottom-up average of the company scores. ACGA's ratings are much more comprehensive, encompassing the regulatory front, enforcement, accounting and auditing practices and CG culture, all of which are assessed in their 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 with our coverage generally selecting larger companies as well as those that we believe have better businesses. These are likely on average to score higher on CG than other companies in the market not under our coverage.

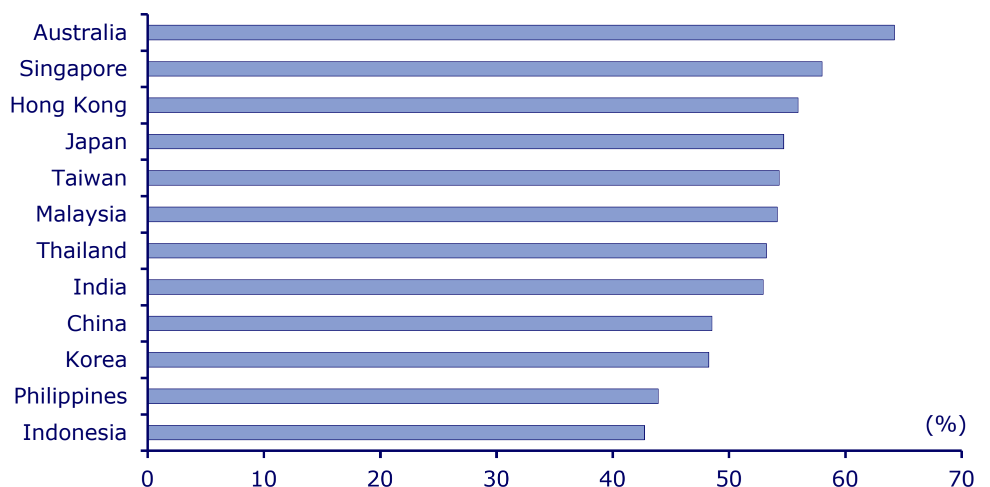
Clear distinction between top and bottom markets for corporate CG scores

The bottom-up tally of CG scores of corporates in each market is useful, however, to indicate the extent of CG issues that investors are likely to face in these markets among stocks that represent the main investment universe for international investors. From Figure 23, Australia is notably ahead in the corporate scoring with an average score of 64%, but Singapore and Hong Kong are at the top for the rest of Asia with companies in each market having an average CG score of 56-58%. Indonesian and Philippine firms are at the other end, with average CG scores of approximately 43%. The CG averages for the corporations in the other markets are fairly close at between 53% and 55% but those in China and Korea score lower, averaging 48% on our metric.

After Australia, Singapore and HK are on average ahead of other Asian corporations on CG

Figure 23

Average CG scores of corporates



Source: CLSA Asia-Pacific Markets

CG score for Singapore corporates moved up relative to those in HK

Our Singapore coverage with an average CG score of 58% moves ahead of Hong Kong companies, which score an average of 56%. Scores in Hong Kong have been pulled down in the property sector: SHKP used to be seen as one of the highest for CG in the market, before the falling apart of the Kwok brothers and the recent arrest of two of the brothers charged with corruption together with a former senior government official. Our tightened criteria that all members of the audit committee should have financial experience and a shorter scoring cutoff for reporting results penalised some of the Hong Kong companies. The large banks, HSBC and StanChart, had very high CG ratings earlier but their scoring come down a notch owing to disclosure not providing a full representation of risks. Notably, Hong Kong companies score 46.5% on average for C&G/CSR 10ppts below average, while Singapore corporates get an above-average 62% score on this segment.

Figure 24

Overall CG scores and by category for companies

(%)	Discipline	Transparency	Independence	Responsibility	Fairness	C&G/CSR	Overall CG
Australia	58.4	74.4	51.3	73.9	83.8	69.6	64.2
China	55.8	67.0	25.4	48.7	71.2	46.4	48.5
Hong Kong	61.7	74.9	32.1	68.3	77.7	46.5	55.9
Indonesia	44.4	64.2	18.7	58.5	77.6	54.7	42.7
India	51.6	78.8	26.3	55.3	77.4	54.3	52.9
Japan	60.1	91.8	14.3	71.1	70.7	63.1	54.7
Korea	47.0	71.6	21.9	47.6	82.7	61.4	48.2
Malaysia	57.9	82.7	17.6	53.2	86.4	48.6	54.2
Philippines	59.5	68.7	13.9	51.3	47.8	57.2	43.9
Singapore	53.5	89.9	36.4	45.1	78.2	62.2	58.0
Thailand	56.5	69.0	22.0	44.5	79.5	56.4	53.2
Taiwan	59.5	64.7	30.2	64.5	74.3	66.9	54.3
Average	**55.5**	**74.8**	**25.8**	**56.8**	**75.6**	**57.3**	**52.6**
Average ex-Aus	**55.2**	**74.9**	**23.5**	**55.3**	**74.9**	**56.2**	**51.5**

Source: CLSA Asia-Pacific Markets

Five markets where corporate average scores are just under 55%

Five of the markets have average corporate scores between 53% and 55% with Japan coming in at 54.7%, scoring better than average on transparency but poorly on independence. Imperceptibly behind are Malaysia and Taiwan at 54%. Thailand had been one of the markets with corporates scoring much higher than their rankings by the ACGA metric. However, with our tightening on certain measures, eg, the composition of the audit committee, their scores have declined to 53%, very close to the average for the region.

China and Korea scoring 48%

China's corporate average at 48.5% is dragged by lower scores on transparency, responsibility as well as C&G/CSR compared to other markets. Korea is at a similar average score, scoring worse than the region on responsibility.

Difference of 1ppt in average Indonesian and Philippine corporate scores

Like our previous survey, Indonesian corporates on average come at the bottom of our CG rankings but with only a 1ppt difference with the average score for the Philippine companies. On average, the firms in these markets score about 43% on our CG scoring.

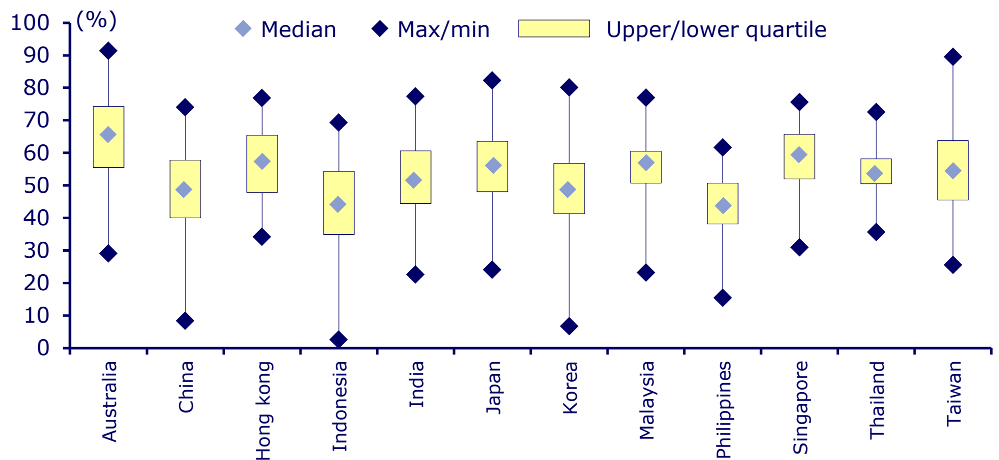
Independence criteria has lowest average score and greatest dispersion

Of the CG sections, independence has the lowest average across the markets at just 26% across our total sample. Australian corporates came in at 51% but in the other Asian markets the scores were no higher than 36% for Singapore and below 20% for Japan, the Philippines, Indonesia and Malaysia. This section scores companies for the independence of their boards, composition of their audit committee, whether the company has voting by poll at AGM/EGMs, etc.

Widest range of CG scores among corporates in China, Indonesia, Korea, Taiwan and Australia

Figure 25

Dispersion of company CG scores



Source: CLSA Asia-Pacific Markets

Lowest corporate scores in Indonesia, Korea and China

Averages often hide more than they reveal. The range of CG for the corporates is generally wide in any given market, and particularly so for Korea, China, Indonesia, Taiwan and Australia as shown in Figure 25. Australia has the highest CG scoring companies in our coverage, including some scoring 90%, but at the bottom they have companies with CG scores as low as 30%. Taiwan has the highest-scoring corporate on our CG criteria (TSMC) but it has other companies where the CG is as poor as in most of the other markets. The perception on CG is usually coloured by the lowest-scoring companies. It is not surprising that investors find greatest CG issues in Indonesia, Korea and China, which have corporates that have the lowest CG scores on our rating. Greater details on these scores are available from our research heads or through our evalu@tor database.

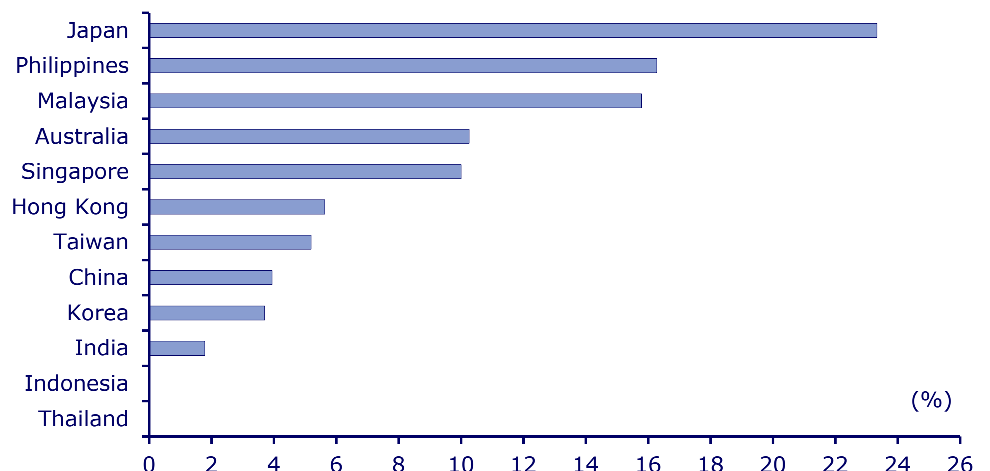
Snapshot across markets

Below we present a snapshot on how the companies in Asia perform on some of the more objective criteria of corporate governance. The snapshots illustrate some of the strengths and weaknesses in governance typically found in the region.

On average, only 9% of firms publicly disclose ROA or ROE targets

Figure 26

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



Source: CLSA Asia-Pacific Markets

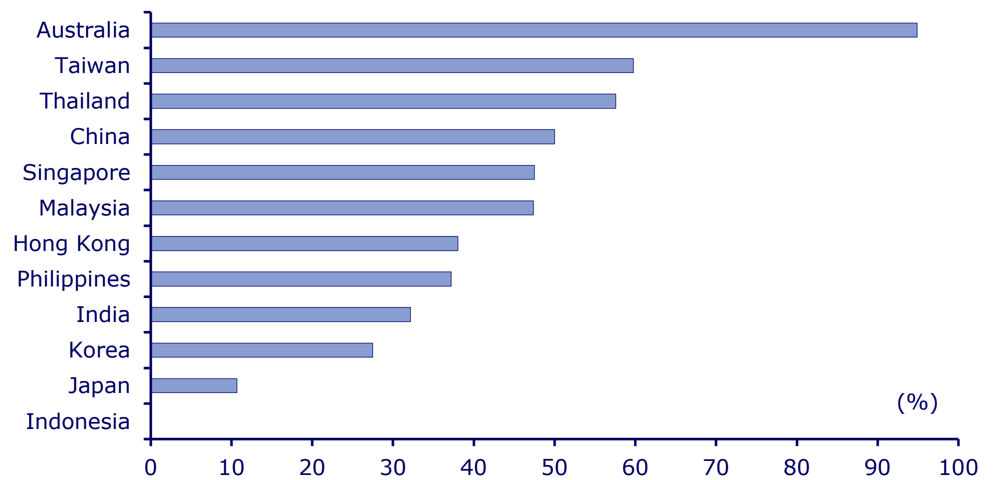
None in Indonesia and Thailand provide targets for financial returns

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 9% of companies publicly disclose ROA or ROE targets. Less than 10% of our sample in Hong Kong, Taiwan, China, Korea and India and none in Indonesia and Thailand provide any return targets. Only about half the companies across the region give reasonable estimates of cost of capital within 10% of our estimates (see Figure 27). Less than half of the Hong Kong, Philippine, Indian and Korea corporates provide estimates of cost of capital, in Japan only about 10% while in Indonesia none does.

Just over half of firms in China, Thailand and Taiwan give appropriate cost of capital estimates; none does in Indonesia

Figure 27

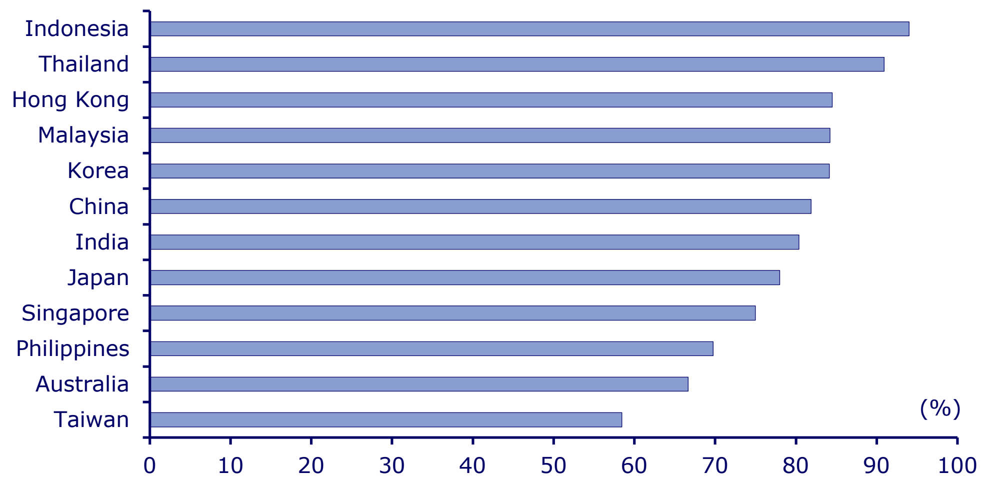
Companies that disclose an appropriate cost of capital



Dilutive equity issuance a problem in Taiwan, Australia, the Philippines as well as other markets

Figure 28

Companies that have not engaged in dilutive issuances



Source: CLSA Asia-Pacific Markets

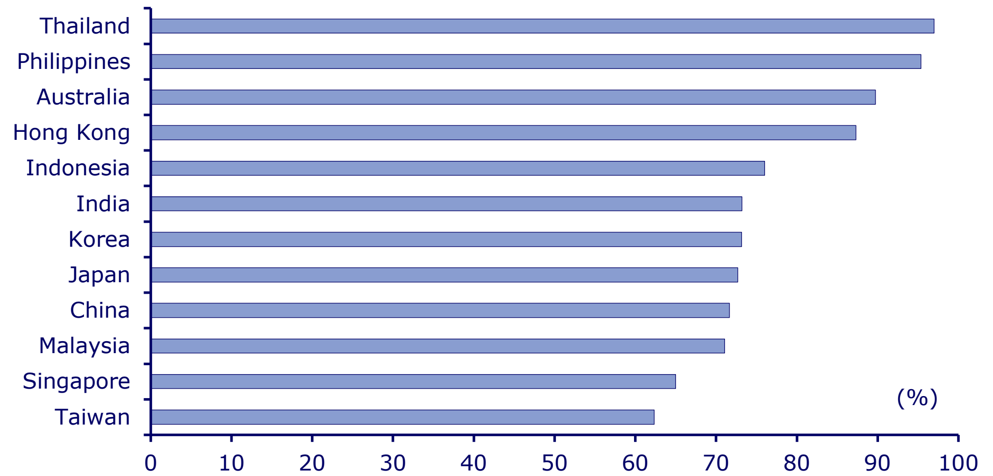
Companies diluting shareholders is a concern for around 40% of the companies in the region

Only about 60% of the companies across our sample in all markets have not had questionable or dilutive equity issuance in the past five years. Corporates issuing equity is a greater concern in Taiwan, Australia, Philippines as well as Singapore and Japan, where more than 20% of our coverage are seen to be diluting existing shareholders. Indonesian and Thai companies, however, appear much better for not diluting existing shareholders.

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

Figure 29

Companies that have not built up cash thus diluting ROE



Source: CLSA Asia-Pacific Markets

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

A lazy balance sheet with excess cash building up 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, Korea and India.

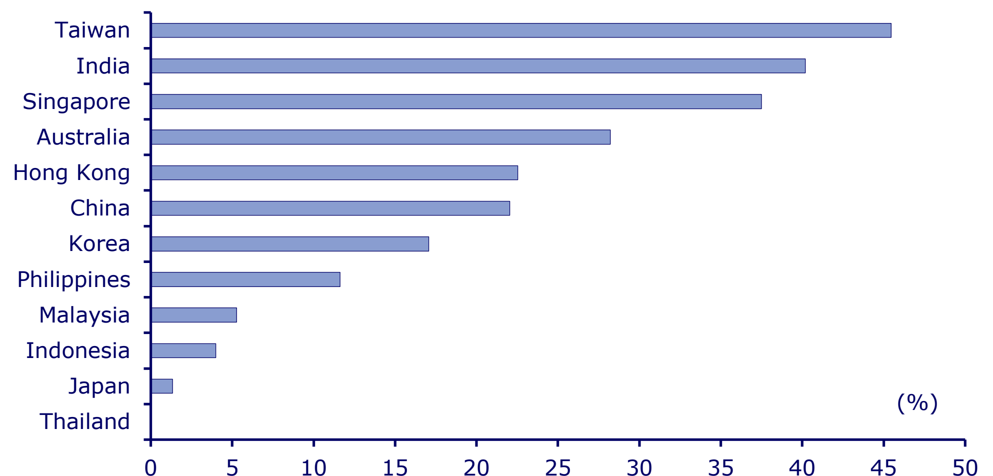
Stricter criteria on audit committees in our questioning

Our criteria for having a properly constituted audit committee were tightened this year to require that all members of the audit committee have financial expertise. A person without financial expertise is not going to be able to detect potential issues in the management accounts or the statement from the external auditors. Having the right people in the audit committee, all with financial expertise to bring to bear, especially where this is not a requirement of the listing rules, is a test of a company's real commitment to CG. This distinguishes which companies set up an audit committee simply because they have to, from those that take the extra effort to consider who the suitably qualified directors are to play the role required of them on this committee. It is thus an excellent question to discriminate form and substance in the CG practice of companies.

On average, only 18% in our coverage have a properly constituted audit committee

Figure 30

Companies with properly constituted audit committees



Source: CLSA Asia-Pacific Markets

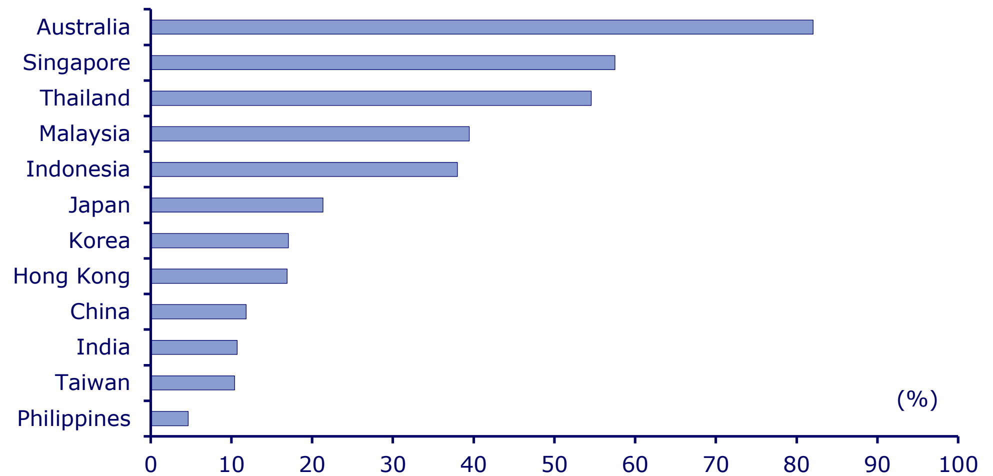
Less than 1/5 of companies in the region have an audit committee fully manned by those with financial expertise

Most companies have an audit committee as it is a requirement of the listing rules. But in Asia, less than one-fifth of the companies in our sample have an audit committee that meets the requirements including that all directors have financial expertise. Even in Australia, only 30% of the audit committees are manned entirely by directors with financial expertise. Taiwan, India and Singapore are better in this regard; but even in these markets, less than half of the companies meet our criteria of a properly constituted audit committee.

Only one-quarter of the Asia sample (ex-Australia) have an independent non-executive chairman

Figure 31

Companies with an independent Chairman



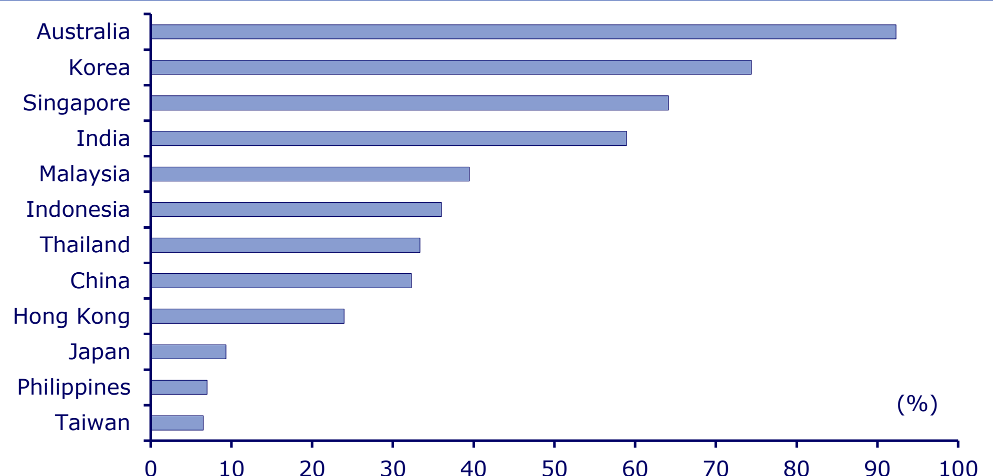
Source: CLSA Asia-Pacific Markets

Only a quarter 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 very same person as the chief executive. This is especially rare in the Philippines, Taiwan, India and China, where barely 10% of the boards have an independent chairman.

More than half of the companies in India, Singapore, and Korea have a majority of independent directors on the board; only 8% of companies in Taiwan, the Philippines and Japan

Figure 32

Companies with independent directors who are over half the board



Source: CLSA Asia-Pacific Markets

Independent directors are usually a minority on the board

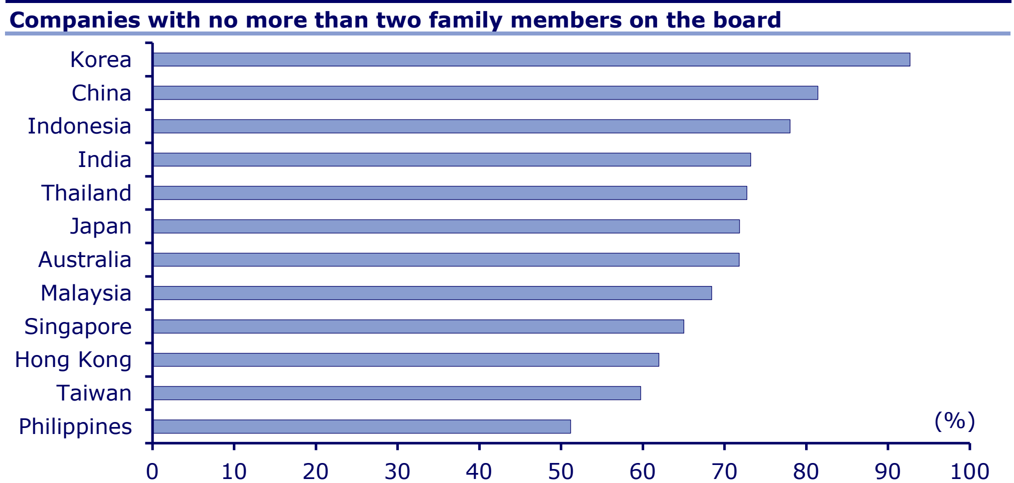
A measure of having a properly functioning board, exercising oversight over management, is for independent, non-executives to be at least half of the board. This is largely the case in Australia. Korean companies appear to score favourably on this question, but whether the directors are truly independent

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. Barely 10% of the companies in our Taiwan, Philippine and Japan coverage have boards with independent directors being a majority.

Almost half of listed firms in the Philippines, Taiwan and HK have three or more family members on the board

Figure 33

Companies with no more than two family members on the board



Source: CLSA Asia-Pacific Markets

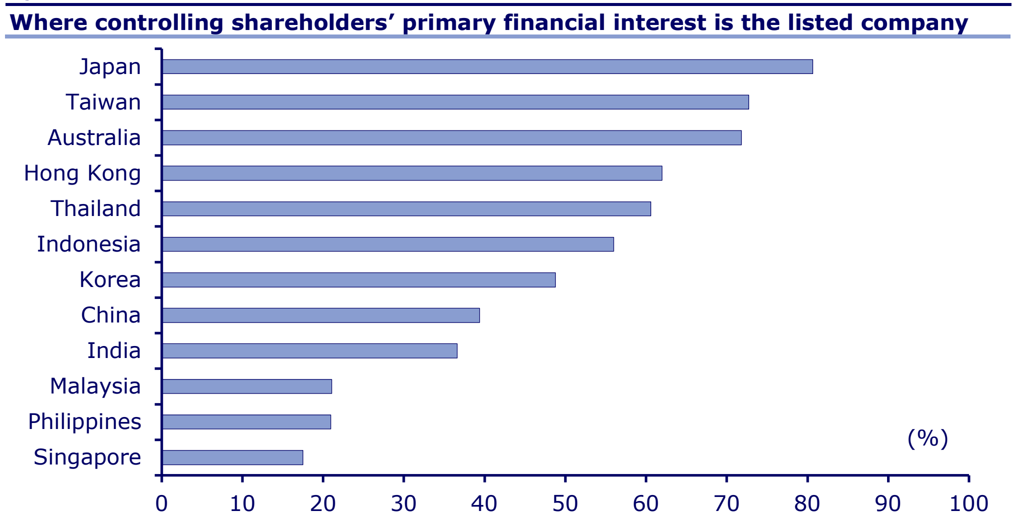
A number of family members on the board is quite common

Where there are three or more family members on the board of directors, it is a valid concern whether the board will be sufficiently independent to exercise proper checks on management. In the Philippines, half of our coverage has more than two family members on the board. Around 40% of the coverage in Taiwan, Hong Kong and Singapore have more than two family members on the board.

In Singapore, the Philippines and Malaysia, most listed firms are not the main financial interest of controlling shareholder

Figure 34

Where controlling shareholders' primary financial interest is the listed company



Source: CLSA Asia-Pacific Markets

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, around half of the companies have controlling shareholders whose primary financial interest is not the listed company. We score negatively on the question if the company is held via a convoluted shareholding structure, or is a subsidiary of another listed company, or where the controlling shareholder is the government.

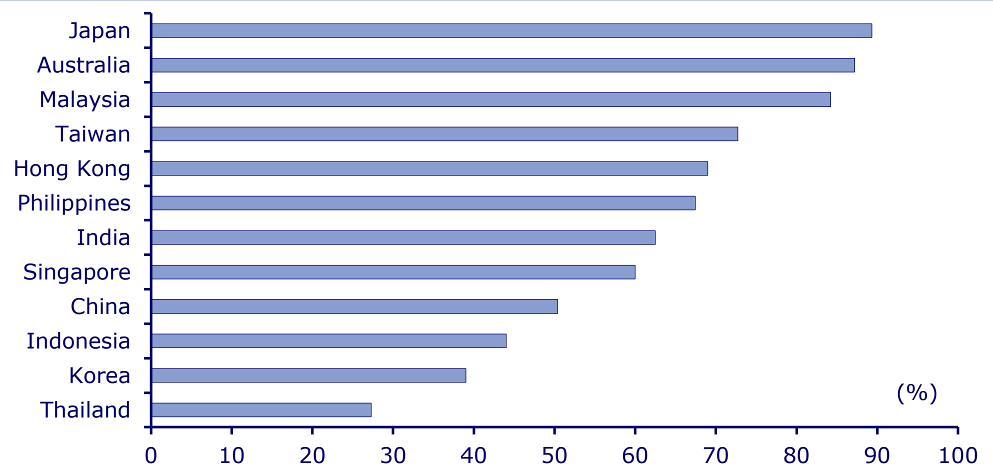
GLCs not usually main financial interest of the government

For around two-thirds of the companies in our coverage in Singapore, the Philippines and Malaysia, the controlling shareholder's primary financial interest does not appear to be the listed company. A large number of government-linked companies (GLCs) in our coverage in Singapore and Malaysia brings down the score on this question. Even for 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 interest of the controlling shareholder not being aligned with investors.

Related party transactions an issue, particularly in Thailand, Korea, Indonesia, China

Figure 35

Companies that do not engage in material related-party transactions



Source: CLSA Asia-Pacific Markets

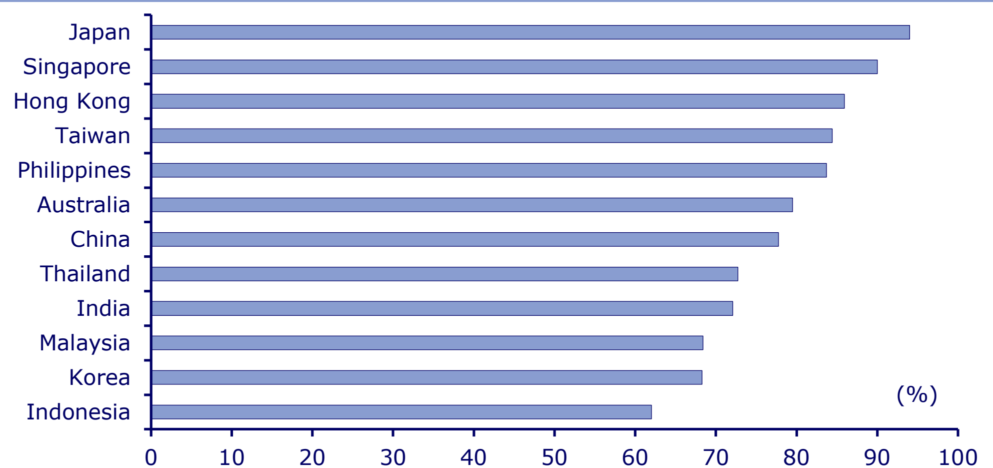
Watch for related-party transactions

A 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 Malaysia had made decisions that disadvantaged investors

Figure 36

Companies without controversy over decisions made at the expense of investors



Source: CLSA Asia-Pacific Markets

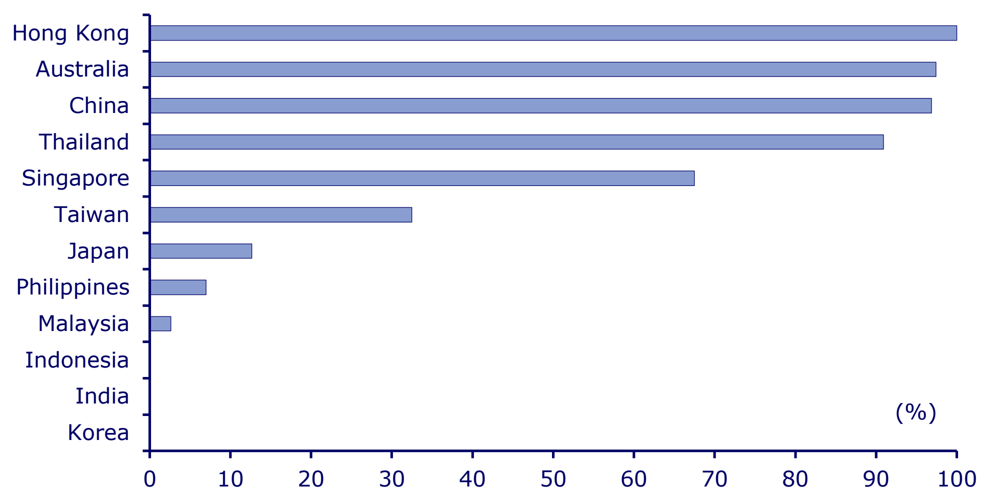
Without voting by poll, shareholders could be disenfranchised

For 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 of the 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 these investors they represent who might have chosen to vote the other way, their vote gets lost. The standard way of voting in a large number of AGMs and EGMs in the region thus often disenfranchises shareholders.

All companies in HK vote by poll at AGMs as it is mandatory; it is still non-existent in Korea, India and Indonesia

Figure 37

Voting by poll at AGMs and EGMs



Source: CLSA Asia-Pacific Markets

Growing acceptance for voting by poll

Voting by poll, however, 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. Hong Kong was the first market which has made this mandatory and it is now followed by mainland companies generally including those listed on the Shanghai and Shenzhen markets. It has become standard practice in Thailand, is being introduced in Singapore and more companies in Taiwan are also adopting it. However, voting by poll is non-existent in Korea, India as well as Indonesia and very much the exception in Malaysia, the Philippines and Japan (where there is a form of voting often deemed to be voting by poll, but in reality does not count as such).

Compensation is not a major issue

Directors' remuneration is a much bigger issue in the Western markets 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 of the benefits of family or individual-controlled companies is that compensation to senior executives are kept in check. Li Ka-shing, for instance, collected a director's fee of HK$50,000 (equivalent to US$6,700) but no salary in 2011 from Cheung Kong, but picked up HK$3.2bn in dividend income.

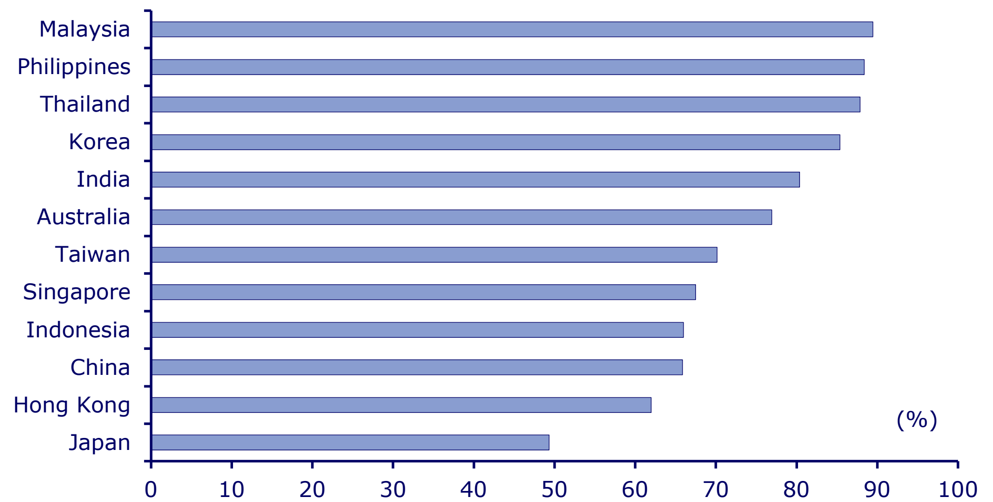
Directors' fees tend to be sticky

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, Japan has done worst on this criterion with many companies seeing earnings decline but directors' fees not falling equally. In China, Hong Kong and Indonesia, about 40% of our coverage have seen directors' fees over the past five years rise faster than earnings.

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

Figure 38

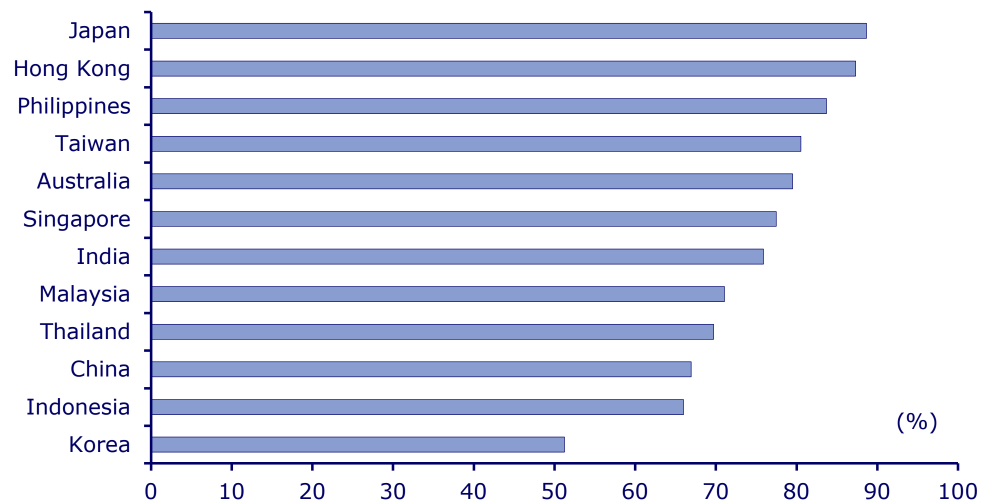
Companies where director's remuneration has not increased faster than earnings



The government has significant influence on business decisions for around half of Korean companies

Figure 39

Companies able to make decisions independent of government interference



Source: CLSA Asia-Pacific Markets

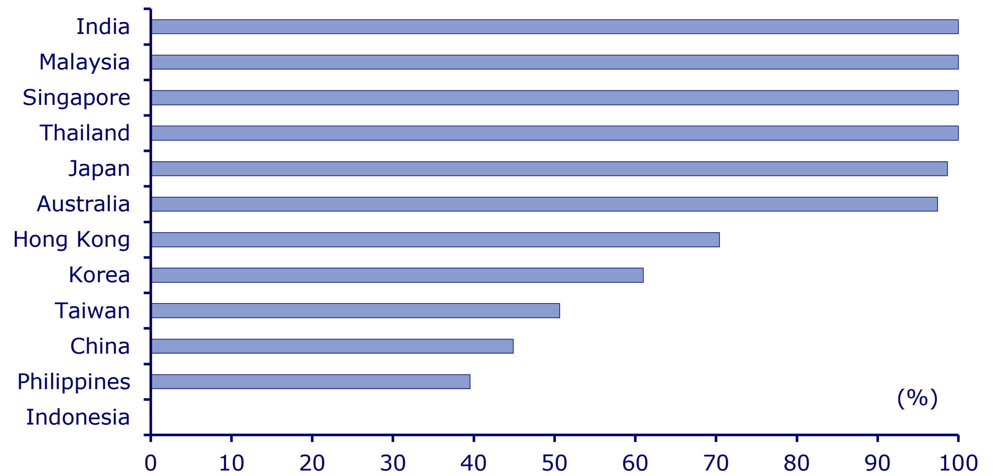
Governments can also affect company's ability to maximise value in Indonesia, China and Thailand

Government interference can impact the ability of companies to maximise shareholder value and is an issue particularly in Korea, Indonesia and China, but less of an issue in Japan and Hong Kong. However in Hong Kong, for around 10% of the companies, investors have to keep alert for government interference, for instance in recent years for the electric utilities and going forward possibly also the property companies.

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

Figure 40

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



Source: CLSA Asia-Pacific Markets

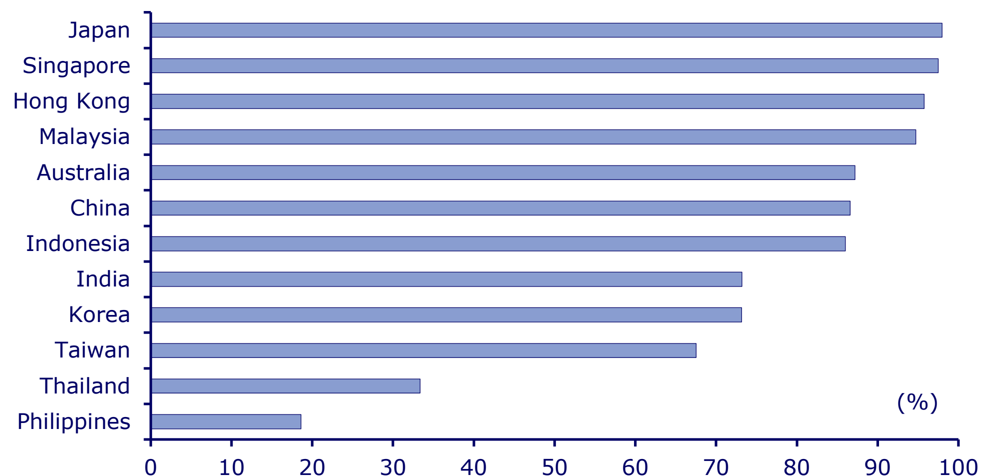
Indonesian companies slow in reporting results

In India, Malaysia, Singapore and Thailand, most listed companies are now publishing full-year results within two months of their financial year-end. But given 90 days to announce results, none of companies in our Indonesia coverage report full-year numbers within two months; more than half of the companies we cover in China and the Philippines also take more than two months to announce full-year results.

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

Figure 41

Companies that disclose major and market-sensitive information punctually



Source: CLSA Asia-Pacific Markets

Slow disclosure encourages insider trading

Prompt disclosure of market-sensitive information is important for guiding the market on the most current business developments and to discourage the temptation for insider trading. Poor disclosure of such information is an issue in particular in the Philippines and Thailand.

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Don't get caught in shifting ESG plates

Moving rules from the books to reality on the ground

People across Asia are fighting for better natural and working environments, bringing laws that have long been on the books to reality on the ground. To anybody who's spent time in the environmental train wreck that is China, or seen the statistics for child labour (still) in the region, this is obviously a good thing. For investors, there will continue to be pitfalls as companies are forced to deal with, at a real cost, issues that would previously have been swept under the rug.

ESG scores help screen out potential bombs

Reporting standards to help investors understand and quantify these risks are still a work in progress. However, they are improving, driven both by tightening disclosure standards at regional exchanges and improving subscription to global environmental, social and governance (ESG) reporting standards by Asian companies, particularly the Global Reporting Initiative (GRI). Our Clean & Green (C&G) and corporate social responsibility (CSR) scores are down slightly from 2010, but the sample size has nearly doubled. We see meaningful improvements in Northeast Asia. Our scores provide investors a good initial screen to weed out potential bombs from their investment portfolios.

Figure 42

Some major Asian ESG issues over the past two years

Date	Company	Code	Event
03 Jul 10	Zijin Mining	2899 HK	Cyanide spill at gold and copper mine. Chairman and VP were fined Rmb1.2m on 28 December 2010 for waiting nine days to reveal the spill.
21 Sep 10	Zijin Mining	2899 HK	Dam collapse killing four people.
11 Mar 11	Tokyo Electric	9501 JP	Partial nuclear meltdowns at Fukushima plant after the devastating tsunami. Implications reverberating across Japan and the region, as the nuclear renaissance stops.
11 Apr 11	China Coal	1898 HK	Four miners killed in flood at a coal mine run by a subsidiary.
12 May 11	Nanya Plastics	1303 TT	Fire at Formosa group's Mailiao petrochem complex.
04 Jun 11	CNOOC	883 HK	Spill at Penglai oilfield - operated by ConocoPhillips, not CNOOC, however. Leak reported 31 days later.
07 Jun 11	Sinar Mas	SMAR IJ	In March 2010, Nestle stops buying palm oil from Sinar Mas on back of Greenpeace campaign; in June 2011, Greenpeace targets Mattel to cut off Sinar Mas with a Barbie campaign.
Jul 11	Youngor	600177 CH	Supplier to Nike, Adidas and A&F accused by Greenpeace of dumping hazardous chemicals into local rivers.
17 Sep 11	Jinko Solar	JKS US	500 people protested, stormed the offices of the solar-panel maker, accusing it of fluoride pollution.
11 Jul 12	Formosa Chemicals & Fibre	1326 TT	Chiayi county government charges NT$2bn (US$67m) - 15% of 12CL net profit - for pollution fees allegedly evaded from 3Q06-2Q11; we counted 13 small (<NT$1m) fines for violating air/water pollution acts over June 2011-May 2012.
18 Jul 12	Maruti Suzuki	MSIL IN	One company official and 100 managers injured in violent protests flare up on dispute over a dismissed worker. Plant reopened on 21 August, after ceasing to hire contract workers.
01 Aug 12	Philex	PX PM	Operations halted at Padcal mine due to leakage; expected to be shut for five months, with fines and risk of being blocked in further bids.

Source: CLSA Asia-Pacific Markets

What's changed?

A legacy of industrial mishaps

The fires at the Formosa Plastic Group's (FPG) Mailiao complex in southern Taiwan last May and September were all too predictable. The group, whose publicly listed companies include Formosa Plastics, Formosa Chemical and Fibre and Nanya Plastics, has a long track record of industrial mishaps, including eight fires over 14 months in 2010-11.

Relevant CLSA C&G question: Has the company ever received a fine for environmental infraction?

Finally starting to be punished?

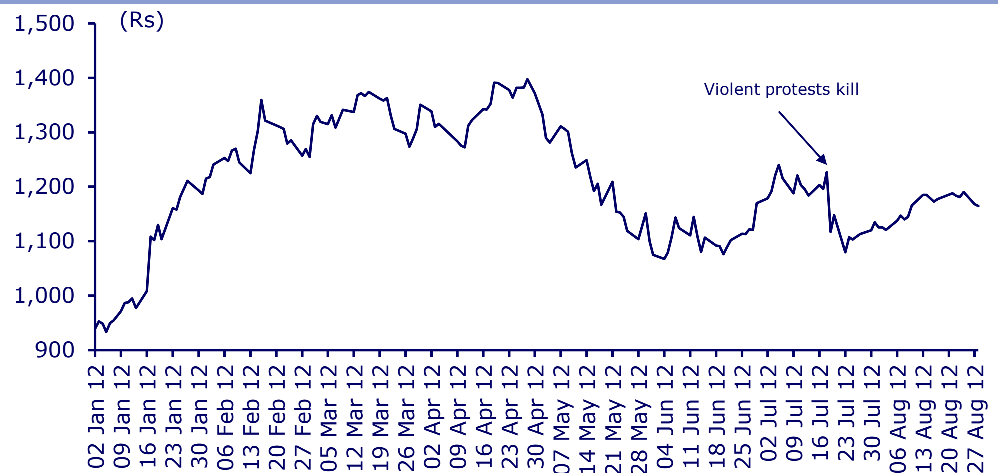
The government's harsh condemnation and temporary shutdown of nearby plants for inspections was less predictable than the event itself and highlights tightening norms on environmental protection around the region. Both the accidents and government reaction underline the growing importance of environmental and social issues to investors in Asia.

Maruti Suzuki likewise hit problems in July of this year, after violent protests left 100 managers injured and one dead at an auto plant in Manesar (northern India). The specifics are still a little hazy, but the event seems to have been kicked off when workers demanded that a fired employee be brought back. (India research head Anirudha Dutta, looks at this event more closely on page 96.)

Were there warning signs at Maruti Suzuki?

Figure 43

Maruti Suzuki annotated share price



Source: Bloomberg, CLSA Asia-Pacific Markets

Could it happen elsewhere?

Nobody could have predicted the conflagration that followed at Maruti Suzuki, just as nobody could have predicted the spate of suicides at Foxconn in 2010. However, any experienced investment manager would intuitively know that there is a heightened risk of worker conflict across the region. The purpose of ESG research is to try to codify and, where possible, quantify those risks that many serious investment managers have internalised.

ESG in Asia: Labour and the environment

Tightening environmental standards and labour unrest are key issues

The key ESG issues that investors in Asia face are tightening environmental standards and labour unrest. Climate change and carbon emissions have fallen from headlines, but are still relevant. Specifically, water promises to be a key issue across sectors. Insufficient availability of fresh water across the region will drive up input costs, influence project approvals and lead to better enforcement of existing discharge rules.

China has some of the most enlightened environmental laws in the world on the books

These problems are not new and the laws and regulations meant to alleviate them are largely in place. China has some of the most enlightened environmental laws in the world on its books. Unfortunately, they have not ventured out from the books too often. Therein lies the rub, and that is what is changing. There are three key drivers (and many smaller ones) for better enforcement of ESG issues: rightful resistance, supply-chain naming and shaming and shareholder activism.

Righteously rightful resistance

Rightful resistance in Sichuan

Management and investors in Sichuan Hongda Chemical (600331 CH) spent American Independence Day (4 July) this year watching the company's stock drop 9%. Local authorities in Shifang city, Sichuan, had just cancelled its (previously approved) plans to build a US$1.6bn copper-smelting complex after nearly a week of sometimes-violent protests by tens of thousands of local residents. This was one more wakeup call that the old ways of doing business in China are dying.

Protests are neither new nor rare in China. Nankai University estimates that there were more than 90,000 "mass incidents" (the Orwellian phrase that the Party uses for protests) sparked by environmental concerns in the country in 2011. NGO Landesa put the total number of protests - for land seizures, corruption, workers' rights and the environment - at roughly double that, or 187,000 protests per year.

Figure 44

Protestors and riot police in Shifang

Source: Offbeat China

I fought the law and ~~the law~~ I won

Protests aren't new; successful protests are

What sets the Shifang protest apart is - simply, its success. The copper smelter was meant to be a cornerstone of economic revival for the region, which was devastated by the 2008 Sichuan earthquake. Thus, when residents demanded better transparency around feared environmental impact of the plant, one would assume that their concerns (and possibly the odd stubborn protestor) would be swept under the rug. However, with the help of social media such as Weibo (China's Twitter), the messenger service QQ and online forums, protestors were able to escalate awareness across the country before local officials could act.

Social media plays a part

In this regard, the Shifang situation was similar to protests in the relatively affluent north-eastern city of Dalian last August that successfully shut down a paraxylene (petrochem) plant on environmental concerns. Other recent successful NIMBY (not in my backyard) protests include: a halted coal-fired power plant in Haimen, Guangdong province last December and temporary closure of a solar-panel manufacturer in Jiangsu province last September.

In each of these instances, local protestors were careful to push for rights and regulations enacted by the central government (in China, we could also say 'by the Party') but ignored by local officials. Again taking the case of Shifang, since 2003, companies have legally been required to conduct Environmental Impact Assessments (EIA) and hold public consultations before building major projects. The reality, of course, is that these rules are often not upheld.

Siding with Beijing, not threatening them

By siding with Beijing against local officials, protestors mitigate risk to the Party in acquiescing to the people's demands. And, the people's demands for a clean environment naturally improve along with economic wellbeing. Economists have even charted a standard trajectory for these changes, embodied in the Environmental Kuznets Curve.

Cynically, we could argue that China's motives have not changed: regain social stability as quickly as possible. Whereas previously this would often entail quickly and violently crushing the protests before they spread, the proliferation of social media makes this nearly impossible now in all but the most remote, destitute corners of the country.

Implications for investors

Motives are debatable, the trend is not

While the motives might be unclear, the trend is: enforcement of environmental laws in Asia's biggest economy will continue to improve. Meanwhile, environmental laws on the books are continuing to get more stringent both in China and around the region. For investors, there are very important implications.

No more rubber-stamping capex plans

First, capacity-expansion projections need to be checked against environmental constraints. The government green light on new plants is no longer a given. While we have been focusing on China, this situation is by no means limited to that country. One more prominent, recent example is the Philippine gold miner Philex, whose recent accidents put future growth at risk under the country's new mining law.

Health & safety costs will rise

Second, running costs for health and safety and material inputs will rise. The price of water, for example, ultimately has to rise to reflect improved wastewater-treatment standards; capex costs as a share of sales will rise, all else being equal. Disclosure of efforts to reduce these costs will become more important and more commonplace.

Relevant CLSA C&G question: Has the company set targets for reduction of other waste/pollutants? (If yes, are targets absolute or % reduction)

Fines will be real

Third, fines will no longer be limited to a mere slap on the wrist. Thus, whereas companies with slack environmental enforcement in Asia have historically been rewarded with better ROE and ROIC in many cases (see our comparisons below), since non-compliance has historically been so cheap, that will no longer be the case.

Formosa Group: NT$2bn fine versus NT$1m previously

We can see this in the case of Formosa Chemical and Fibre. While the company has received numerous fines over the years for environmental infractions, most of them have been obscenely low. For example, we counted 13 small (<US$30,000) fines for violating air/water pollution acts from June 2011 to May 2012 in Taiwan. But then in July of this year, the county government charged the group NT$2bn (US$67m) - about 15% of 12CL net profit - for pollution fees allegedly evaded from 3Q06-2Q11.

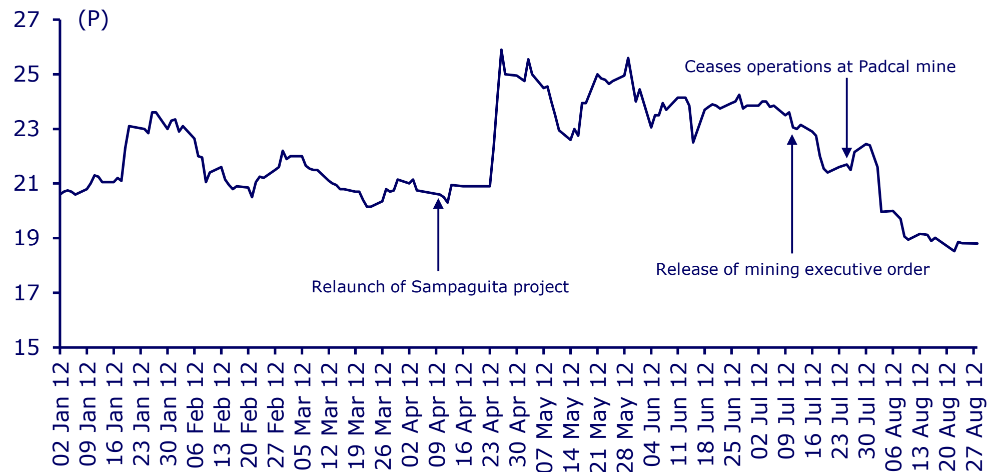
Redemption is possible: prove it

Based on the above, companies should at least be able to identify key environmental issues for their operations and indicate what they are doing to ensure they comply with relevant regulations. In the case of those with past infractions, like Zijin or Formosa Group, they should be able to highlight specific practices that have changed to prevent the same accidents from occurring.

Philex Mining: accidents put future concessions at risk

Figure 45

Philex Mining - Hit by ESG



Source: Bloomberg, CLSA Asia-Pacific Markets

Rightful resistance and labour

Labour issues have not eased

Chinese labour issues seem to have faded from global headlines after the string of suicides at Foxconn (Hon Hai) and violent strike at a Chinese Honda plant in 2010. Local officials' grubby land grabs and poor working conditions combined account for nearly half of the estimated 187k protests each year in China.

Social media a driver here, as well

According to the China Labour Bulletin, there were 37 major strikes in July (remember, most protests go unreported). Taking a more recent (Aug 24, 2012) strike at auto parts manufacturer Youde, a JV between Dongfeng Motors and Lear Corp (US), in the central city of Wuhan, social media, specifically QQ, played a key part in organising more than 1,000 strikers. The workers reportedly won a raise of Rmb200/month to Rmb1,300/month, versus Rmb1,100/month minimum wage.

Rosey Hurst

Ethical-trade consultant Impactt, whose founder and director Rosey Hurst has spoken at CLSA forums and through CLSA U, sees continued evolution in workers' rights across China and India as inevitable. On their calculations, pay rates in China and India have increased 87% and 73% since 2008. However, average workers' pay still falls 46% shy of meeting their basic needs. We held a conference call with Hurst in April this year, an audio replay is available on www.clsa.com.

Wage inflation to continue

For investors, this means that wage inflation is reasonably assured to continue. Hurst also emphasises that simply bumping up wages will not assuage all, or even most, of the workers' concerns. As employees, particularly in southern and coastal China, become more demanding, workplace quality (and a lot of the fuzzy metrics that investors would tend to have ignored) will become important differentiators.

In extreme cases, we could see repeats of the type of violent protests experienced at Maruti Suzuki. Unions and workers' groups have argued that there were months of discontent over pay negotiations stalled. As this goes to print, police are still investigating.

Figure 46

China wages and costs

(Rmb)	Minimum wage in Impactt data set	Avg take home wage	Living wage est.	Wage gap (%)
2007	663	1,130	855	32
2,008	716	1,275	1,100	16
2,009	761	1,315	1,300	1
2,010	890	1,595	1,639	(3)
2,011	989	2,110	2,100	0
Increase (%)	49	87	146	

Figure 47

India wages and costs

(rupee)	Minimum wage in Impactt data set	Avg take home wage	Living wage est	Wage gap (%)
2008	2,459	2,479	4,213	(41)
2009	2,898	3,631	5,590	(35)
2010	2,566	3,367	6,968	(52)
2011	3,653	4,282	7,967	(46)
Increase (%)	49	73	89	

Source: Impactt

Supply-chain shame

Reputational risk was a driver for Apple . . .

A big part of the reason that contract manufacturing juggernaut Foxconn has come under so much scrutiny for its labour practices, which are arguably better than average for China, is its close relationship with Apple. A worker's suicide in some dreary factory halfway around the world is not news. The suicide of somebody at a plant making bits for Apple notebooks - possibly even the one you're using, is news. And since that became news across the West, it became an issue for Apple as well, which means that management at Hon Hai (aka Foxconn) could not ignore the issue.

. . . and thus for Foxconn

Soon after taking the helm at Apple, CEO Tim Cook responded to a damning report about labour conditions at Foxconn by joining the Fair Labour Association and committing to fixing the problem. This was a sea change for Apple, which has traditionally ignored complaints about its suppliers' working conditions. While activists are still sceptical, the Fair Labour Association has reported improving conditions at Apple's Foxconn factories.

Relevant CLSA CSR question: Does the company engage in appropriate sourcing practices to ensure social responsibility in terms of its suppliers?

Enforcing the law

This whole incident with the world's largest company (by market cap, as of August 2012) exemplifies the rising reputational risk for Western brands stemming from working conditions and environmental issues at their suppliers. For the most part, the end result for investors in Asian stocks is the same as the increasing efficacy of rightful resistance: Companies will be forced to follow the rules already enshrined in law. For the best-run companies, this will not be an issue. But as a starting point, companies should at least *know* best practice and be able to define their own practices.

Reputational risk

Walmart has been greening supply chains since 2006

Greening of supply chains is nothing new. Probably, the best-known example is behemoth retailer Walmart, which at the enterprise level began pushing for better environmental performance at its many suppliers as early as 2006. For Walmart and the army of smaller retailers and brands, this will be a very long, drawn-out process. But it is ongoing, and there have been concrete incremental improvements in disclosure. But all of this is too slow for some.

New push to shock supply chains into action

Recently, there have been more cases of shocking the supply chain into greening, with more direct and immediate impacts on earnings and share prices. This supply-chain shock and awe is best exemplified by the case of Sinar Mas. Since 2009, the NGO Greenpeace has led a defection of customers away from the giant Sinar Mas group on the back of accusations that it is causing deforestation of Indonesian rainforests (through its Smart Tbk palm-oil producing subsidiary).

Greenpeace has been successfully pushing customers from Sinar Mas . . .

Rather than directly attacking Sinar Mas, Greenpeace has led campaigns targeting its major customers. Probably the best-known is Nestle, for which the NGO made a video clip showing an office worker opening a Kit Kat chocolate bar and finding an orangutan's finger. The video went viral and Nestle quickly stopped procuring palm oil from Sinar Mas pending proof that the allegations were false. Other major Sinar Mas clients hit by the Greenpeace campaign include Unilever, Abengoa, Carrefour and Burger King. The latest Greenpeace campaign against Sinar Mas targets toymaker Mattel, which the NGO is trying to get to switch paper providers away from Sinar Mas' Asia Pulp & Paper.

. . . they are currently trying to push Barbie-maker Mattel from Sinar Mas subsidiary APP

Figure 48

Greenpeace's latest attack on Sinar Mas

Source: Greenpeace (http://www.greenpeace.org/international/en/campaigns/forests/asia-pacific/app/downloads/)

Investors up the ESG ante

US$32tn signed up to ESG principles through the UN PRI

The third major impetus we see for improving enforcement of environmental and social rules in Asia is investor activism. Globally, ESG has already moved well beyond its initial core group of niche investors. Under the United Nations-backed Principles for Responsible Investment (PRI), nearly 1,000 signatories representing more than US$32tn in assets under management (AUM), ie, a fifth of global capital, have agreed to incorporate ESG into investment decisions.

Nearly 1,000 signatories as of end-2011

This implies that ESG AUM should be at least as big as PRI.

- 254 asset owners
- 640 investment managers
- 177 professional service partners.

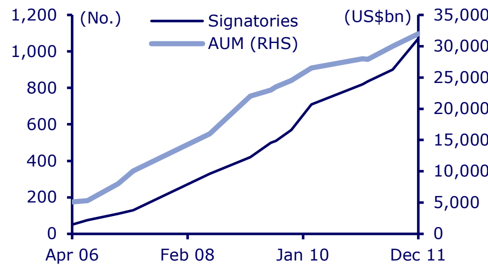
SRI assets represent 10% of the asset-management industry in Europe

As exchanges and investors across Asia begin to incorporate ESG principles, we should see a similar growth pattern to what occurred in Europe. According to the European Fund and Asset Management Association (EFAMA), core SRI assets represent 10% of the asset-management industry in Europe on average, with significant differences from one country to the next. This level has been remarkably resilient in the face of the global financial crisis.

UN PRI: US$32tn in assets under management

Figure 49

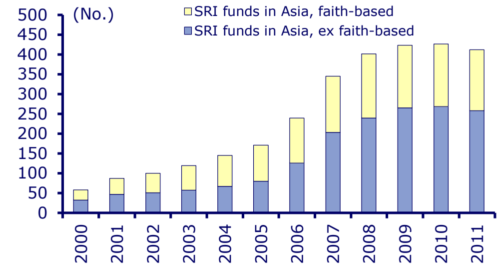
UN PRI assets under management



Source: PRI, CLSA Asia-Pacific Markets

Figure 50

Socially responsible funds in Asia



Source: ASrIA, CLSA Asia-Pacific Markets

Growth in SRI funds has stalled

According to the Association for Sustainable & Responsible Investment in Asia (ASrIA), the number of SRI funds (excluding faith-based) has grown from 80 to nearly 270 over 2005-11, where it has stalled. While in the past decade many funds were manufactured in Europe and distributed in Asia, there is a maturing local industry much capable of managing and operating these types of funds. In Asia, large institutional investors have not yet been the impetus of growth, compared to their European peers. Specialist investment managers (CG, environmental-themed) have tended to be the pioneering force.

C&G and CSR in CLSA's CG surveys

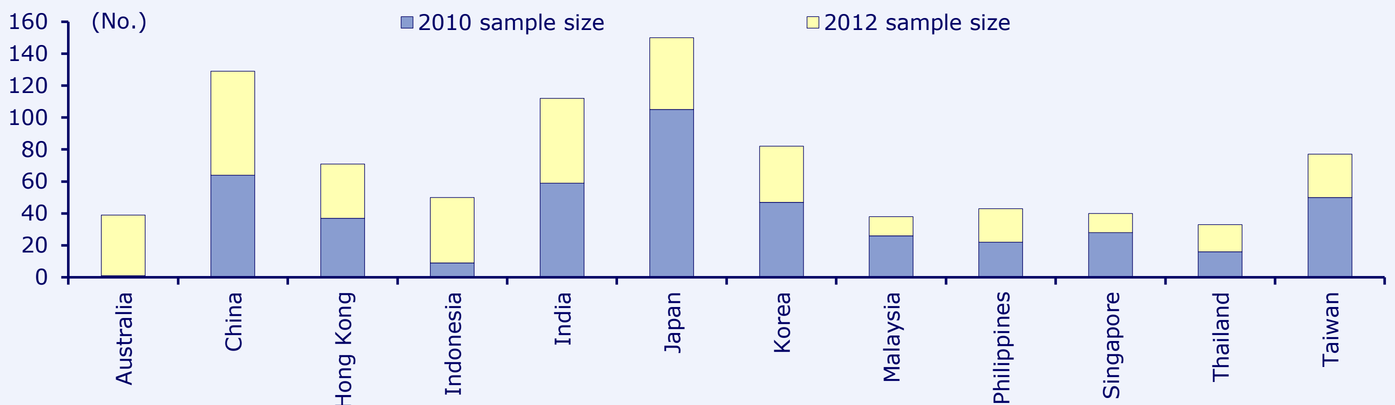
Since 2007, we have included C&G and CSR scores in our overall corporate CG scores. Combined, the two questionnaires contribute 10% to each individual company's score.

Methodology: Our C&G and CSR surveys, essentially the "E" and "S" of environmental, social and governance (ESG) issues, are directly filled out by the companies. Translations are given for Chinese and Japanese companies. The rest are given in English. Companies have two months to fill out the surveys, at which point they are vetted by covering analysts.

Questions: In general, our scoring for C&G/CSR focuses on disclosure and awareness of issues. For example, 'Has the company set targets for reduction of water use?' As data permit, we will move this forward to quantitatively show how a company is (or is not) improving water consumption.

Changes: We initially built our C&G survey around a carbon audit conducted in 2006. From 2010, we shifted to focus on broader pollution measures and introduced social responsibility questions. Questions are largely unchanged in 2012 but our sample size jumped from 464 to 864 markets. This has a natural dampening effect on scores as mid and small caps are added to the original list of big caps. As a general rule (albeit with plenty of exceptions) the greater amount of resources available to larger firms enables them to report more stringently.

Near-doubling in sample size impacts scores



Source: CLSA Asia-Pacific Markets

Mostly voluntary for now

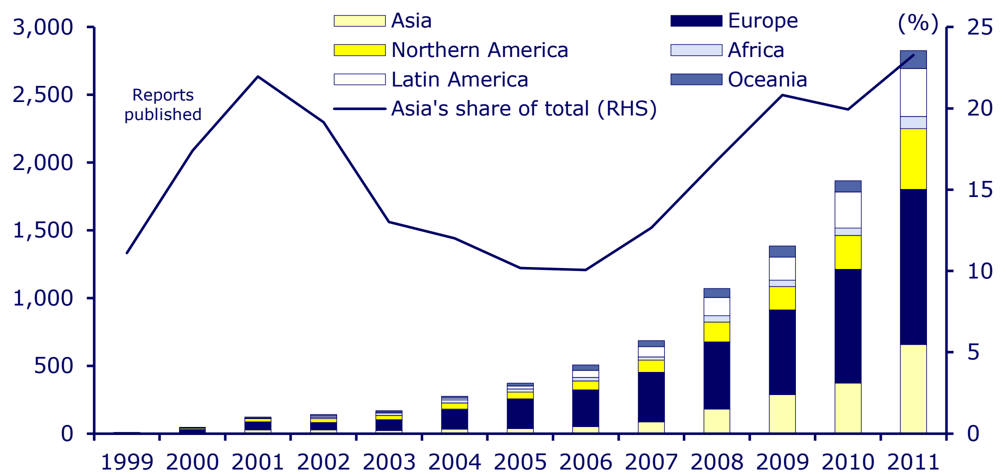
Proliferation versus harmonisation

Below, we look at regulations governing ESG reporting in each market. Broadly, the current ESG disclosure regime operates on a largely voluntary basis. The Global Reporting Initiative (GRI) is a voluntary reporting standard. Although it has many limitations for extra-financial analysts, the framework is a de facto standard, often mentioned as a reference in local regulations. GRI breaks out relevant topics to report on by sector, helps companies meet the standards and rates sustainability reports according to these criteria. In 2011, Asian companies submitted 658 sustainability reports (23% of the total) to GRI, up from 87 reports (13% of total) in 2008.

Asian sustainability reports up from 87 in 2008 to 658 in 2011

Figure 51

GRI reports by region on the rise



Source: GRI, CLSA Asia-Pacific Markets

Overall, the quality of reports is also improving. Whereas early reports focused mostly on charity support and fluffy pieces congratulating the companies' corporate efforts, the better more recent reports break out key metrics and policies, highlighting trends rather than just data in isolation.

Asian exchanges are starting to ramp up requirements

Asian exchanges are ramping up reporting requirements. Most recently, the Hong Kong Exchange has initiated plans to incorporate ESG reporting by the end of 2012. Looking at regulatory developments, the trend is clear.

Implications for investors

UN PRI tepidly starting to kick out members

Given the pool of capital ostensibly committed to the UN PRI, one in five investors/asset owners should already be incorporating ESG metrics into decision-making. Ostensibly, however, because to date there has not been much enforcement, as the UN has not given itself much real power to punish signatories that sign on to the UN PRI but then do not follow the principles. However, they do have the power to kick signatories out, an option they have started using slowly.

For those companies that are not linked to the UN PRI either directly or indirectly, it is still worth following the moves of SRI funds. For one, they can become forced major sellers of equities that fall foul of ESG criteria.

What should be measured?

Ideally, disclosure for ESG metrics should vary significantly from subsector to subsector, depending on which issues are material. The European Federation of Financial Analysts Societies (EFFAS) and Society of

Hong Kong Exchanges has proposed ESG KPIs across sectors

Investment Professionals in Germany (DVFA) have come out with a detailed breakdown of important ESG indicators by sector and subsector. It is a nice target, but in Asia we have to crawl before we can walk. With ESG reporting in its early stages, we see investors more focused on a base-line standard of disclosure. Below, we list the proposed key performance indicators (KPIs) set out by the HK Exchange as it prepares for ESG reporting potentially by end-2012.

Figure 52

HKEx proposed ESG key performance indicators (KPIs)

Number	KPI	Aspect
KPI A1.1	Total workforce by employment type, age group and geographical region.	Working conditions
KPI A1.2	Employee turnover rate by age group and geographical region.	Working conditions
KPI A2.1	Fatality number and rate.	Health and safety
KPI A2.2	Lost days due to work injury.	Health and safety
KPI A2.3	Description of occupational health & safety measures adopted, how they are implemented, monitored.	Health and safety
KPI A3.1	Description of training activities provided and if relevant, the percentage of employees trained by employee category (eg, senior management, middle management).	Development and training
KPI A3.2	The average training hours completed per employee by employee category.	Development and training
KPI A4.1	Description of measures to review employment practices to avoid child and forced labour.	Labour standards
KPI A4.2	Description of steps taken to eliminate such practices when discovered.	Labour standards
KPI B1.1	The types of emissions and respective emission data.	Emissions
KPI B1.2	Greenhouse gas emissions in total (in tonnes) and where appropriate, intensity (eg, per unit of production volume, per facility).	Emissions
KPI B1.3	Total hazardous waste produced (in tonnes) and where appropriate, intensity (eg, per unit of production volume, per facility).	Emissions
KPI B1.4	Total non-hazardous waste produced (in tonnes) and where appropriate, intensity (eg, per unit of production volume, per facility, per store).	Emissions
KPI B1.5	Description of measures to mitigate emissions and results achieved.	Emissions
KPI B1.6	Description of how hazardous and non-hazardous wastes are handled, reduction initiatives/results.	Emissions
KPI B2.1	Energy consumption by type (eg, electricity, gas or oil) in total (kWh in '000s) and intensity (eg, per unit of production volume, per facility).	Use of resources
KPI B2.2	Water consumption in total and intensity (eg, per unit of production volume, per facility).	Use of resources
KPI B2.3	Description of energy use efficiency initiatives and results achieved.	Use of resources
KPI B2.4	Description of whether there is any issue in sourcing water that is fit for purpose, water efficiency initiatives and results achieved.	Use of resources
KPI B2.5	Total packaging material used (in tonnes), and if applicable, with reference to per unit produced.	Use of resources
KPI B3.1	Total paper used.	The environment and natural resources
KPI B3.2	Paper use efficiency initiatives and results achieved.	The environment and natural resources
KPI B3.3	Description of the significant impacts of activities on the environment and natural resources and the actions taken to manage them.	The environment and natural resources
KPI C1.1	Number of suppliers by geographical region.	Supply-chain management
KPI C1.2	Description of practices relating to engaging suppliers, number of suppliers where the practices are being implemented, how they are implemented and monitored.	Supply-chain management
KPI C2.1	Percentage of total products sold or shipped subject to recalls for safety and health reasons.	Product responsibility
KPI C2.2	Number of products and service related complaints received and how they are dealt with.	Product responsibility
KPI C2.3	Description of practices relating to observing and protecting intellectual property rights.	Product responsibility
KPI C2.4	Description of quality assurance process and recall procedures.	Product responsibility
KPI C2.5	Description of consumer data protection & privacy policies, how they are implemented and monitored.	Product responsibility
KPI C3.1	Number of concluded legal cases regarding corrupt practices brought against the issuer or its employees during the reporting period and the outcomes of the cases.	Anti-Corruption
KPI C3.2	Description of preventive measures/whistle-blowing procedures, how they are implemented/monitored.	Anti-Corruption
KPI D1.1	Focus areas of contribution (education, environ concerns, labour needs, health, culture, sport).	Community investment
KPI D1.2	Resources contributed (eg, money or time) to the focus area.	Community investment

Source: CLSA Asia-Pacific Markets

Roughly nine out of 10 companies responded - to some extent - to our C&G/CSR survey

CLSA C&G and CSR scores

Overall, 88% of the companies we scored in the CG survey came back with answers to the C&G/CSR survey in 2012, similar to 2010. Using a more stringent definition that only counts companies including comments rather than just ticking the boxes, the return rate is a less impressive 47%.

When we released our inaugural corporate-governance report 11 years ago, CG was still a novel concept for Asian companies and exchanges. In the interceding years, both understanding and enforcement of CG practices in Asia has matured dramatically - albeit in fits and starts, with a coinciding elevation in investor expectations. We are at a similar inflection point for extra-financial reporting in environmental and social issues, known as ESG (environment, social, governance).

Average scores fell 3ppts to 57ppts, but sample size nearly doubled

Scores down slightly across the region

Across the region, scores fell by 3.1ppts to 57.3ppts. However, that can be explained somewhat by the much larger sample size, up from 464 companies to 864. If we only consider the companies that were marked in the 2010 CG Watch, scores fell by 2.9ppts to 57.5ppts.

We believe this masks an overall slight improvement. First, there is a natural decline as coverage has expanded from the bigger caps only down to mid caps and small caps, which naturally have fewer resources for governance. Stricter scoring led to drops in Indonesia, Malaysia and Thailand, which was partly offset by tremendous improvement in feedback ratio from Japan. We break outperformance by country below.

Tying C&G to performance - Still inconclusive

As with core CG, we see our C&G/CSR scores as a useful additional screen to add on to traditional financial metrics and help to weed out potential mines in a stock portfolio. For C&G/CSR in particular, simply trading around scores is not a winning strategy. As enforcement across the region continues to improve for both environmental and social measures, we expect correlations to begin to improve somewhat. The table shows absolute five- and 10-year returns of companies with top and bottom-quartile scores in three sectors:

- Asian petro/chems
- Asian materials
- HK/China materials (to strip out market effects)

With the exception of 10-year returns at HK/China materials firms, the lower-scoring group outperformed.

Earnings and returns

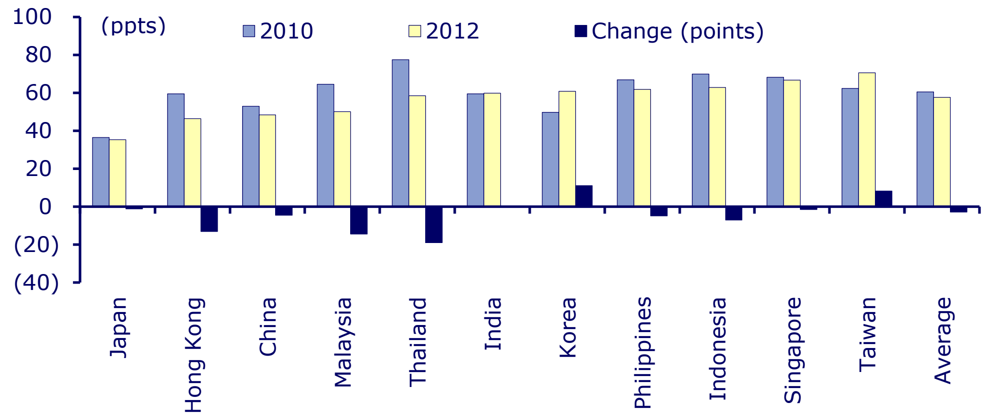
When we look at the returns and dividend yields for high-C&G versus low-C&G stocks (below), the results are more mixed. ROIC for companies with better C&G scores is higher both for Asian petro/chems and HK/China materials, but lower for Asian materials. Somewhat surprisingly, dividend yield is slightly higher for the lower-scoring companies in each group.

Again, this could be a reflection of the fact that, historically, corporate bad guys in Asia often have either not been punished, or have received derisory punishments for misdoing. As these punishments become more meaningful, from fines to revoked licences, the impact on returns will be more meaningful for those companies at the bottom quartile of our list. Of course, this will be a multiyear process, but it is well underway.

The 464 companies previously scored dropped 2.9 points in 2012

Figure 53

C&G/CSR scores by country (only those scored in 2010)



Note: The sample size in Australia was too small in 2010. Source: CLSA Asia-Pacific Markets

Standout countries, beyond the changes brought on by the larger sample size are concentrated in Northeast Asia: Korea, Japan and Taiwan.

Improvement

Korea

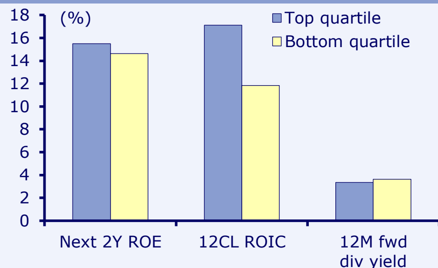
Korea's C&G/CSR scores improved by a punchy 12ppts to 61ppts. As in Japan, Korean firms have been early to push through stricter environmental and social reporting. In all, an impressive 72 Korean companies achieved a high (B or above) rating for their ESG reports from the GRI.

Korean and Japanese companies show increased interest in global dialogue. There are ongoing improvements in governance, transparency and stakeholder engagement. There have also been a number of initiatives to align Korean business practices with those of the UN Global Compact.

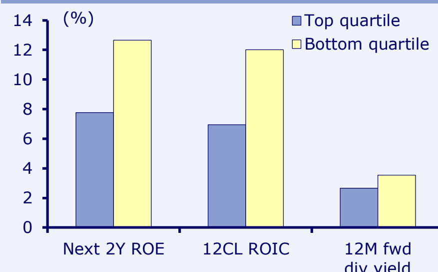
Total returns - No ties to C&G

(%)	5Y total returns in US$	10Y total returns in US$
Asian petro/chems - Top quartile	26.4	925.9
Asian petro/chems - Bottom quartile	82.5	934.2
Asian materials - Top quartile	(43.8)	263.2
Asian materials - Bottom quartile	101.8	1,456.8
HK/China materials - Top quartile	(12.7)	1,979.7
HK/China materials - Bottom quartile	(11.9)	756.8

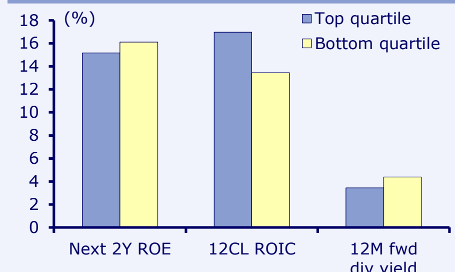
Asian petro: Top vs bottom C&G



Asian materials: Top vs bottom



HK/China materials: Top vs bottom



Source: CLSA Asia-Pacific Markets

Samsung stands out

Poster child - Samsung Electronics. Samsung Electronics' 2011 sustainability report, *Global Harmony with People, Society & Environment* (http://www.samsung.com/us/aboutsamsung/sustainability/sustainabilityreports/download/2011/2011%20Samsung%20Electronics%20SR%20report%20final.pdf), broke down a wide range of relevant data on everything from emissions, water consumption and recycling, to accident rates and supply chain checks. The consumer-electronics sector in Korea will likely follow Samsung's lead.

Japan

Scores up sharply

Japan's C&G/CSR scores were up sharply to 63ppts in 2012. This was mostly a reflection of improved level of feedback. Japan's treatment of environmental and social issues has been in keeping with its status as a developed economy.

The Japanese government has demonstrated itself as an advocate for CSR, in particular through environment-related and climate-change specific legislation. With its Environmental Reporting Guidelines and the Law Concerning Promotion of Environmental Consideration in Business Activities, enacted in 2004, it has been promoting environmental reporting far earlier than other governments in the region. With the introduction of a mandatory greenhouse-gas (GHG) accounting and reporting system, entities emitting large amounts of GHGs are obliged to calculate and report these emissions.

Poster child: Kuraray

Poster child - Kuraray Chemical company. Kuraray achieved a C&G/CSR score in the top-5 across the region. Trends for emissions of all sorts, from carbon to waste water, are given, with clear targets and strategies. (http://www.kuraray.co.jp/en/csr/pdf/kuraray2011e.pdf).

Taiwan

Up five points

Taiwan's C&G/CSR scores rose 5ppts to 67ppts in 2012. As of our last CG Watch, the Taiwan Stock Exchange and Gretai Securities Market had just launched CSR best practice principles, requiring companies to "comply or explain". Taiwan started sustainability reporting requirements already in 2008 and again ratcheted up reporting standards in 2011 to benchmark CSR implementation.

Poster child: TSMC

Poster child - TSMC. Taiwan Semiconductor stands out across the region for its leadership in core CG. Likewise, is its lead in sustainability reporting. In addition to the standard environmental consumption and emissions metrics and targets including indirect emissions, TSMC includes disaster (ie, earthquake, flu outbreak) contingency plans. The company belongs to third-party groups like the Electronics Industry Citizenship Coalition (EICC), a sustainable supply chain group.
http://www.tsmc.com/download/csr/2011_tsmc_csr_e/pdf_e/e_all.pdf

Scores by sector - Dirty first

Environmental and social measures often do not travel as well across sectors as core corporate governance metrics. Whereas a proper, independent audit committee is undeniably important to investors in any kind of company, whether a coal miner or an investment bank. However, water consumption and contingency plans or deaths per tonne of material produced would obviously only be important factors for one of those companies. Thus, we often focus on comparison groups within sectors. Scores are broken down below.

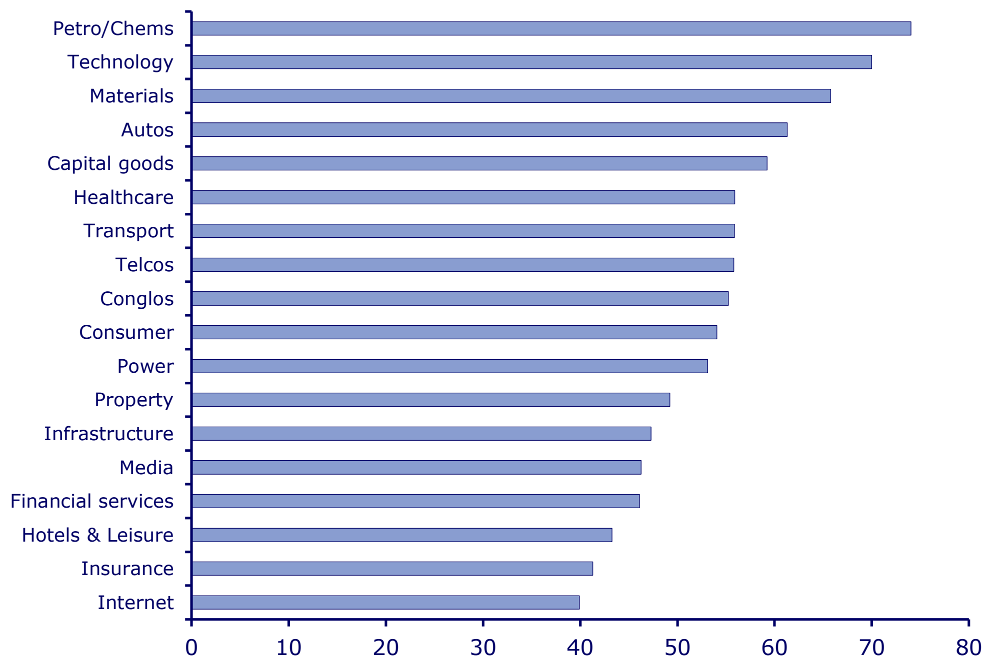
Resource intensive sectors score highest

At first blush, our C&G/CSR sector scores might appear counterintuitive. The resource intensive sectors (ie, those most likely to be labelled 'dirty') sit near the top of our C&G/CSR scores. Petro/chems scores the highest as a sector, while materials is third. Power comes in around the middle of the pack, but there are a number of high scores hidden in there. Both CLP and Lanco Infratech scored at the top of their respective markets, for example. Technology stocks, which face significant issues both around hazardous materials and worker unrest, score second as a sector.

ESG metrics do not always travel across sectors

Figure 54

Clean & Green/CSR scores by sector



Source: CLSA Asia-Pacific Markets

Focusing on disclosure, not impact

On closer inspection, this is easy enough to explain. Our C&G/CSR questionnaires focus more on disclosure than impact. Those companies that face the greatest risk from C&G/CSR issues have naturally come under the greatest amount of investor and regulatory scrutiny to disclose.

Services companies face more risk than they might realise

Services companies come in at the other end of the spectrum. On one hand, this is understandable. Most of our questions focus on environmental impact, supply chain and health and safety issues, none of which have major direct impact on the business performance of internet or financial-services companies. And where there is clear impact, it is not as easy to quantify. For example, lending screens on resource extractive companies at banks. Following the US charges against HSBC and Standard Chartered that they have helped fund drug cartels and Iran respectively, heightened anticorruption reporting should be expected from financial institutions.

Top scores by company

The top-50 scores all come in above 90 points

Ultimately, we invest in individual companies, rather than countries or sectors. Below, we have the top-50 scores across the region by individual company. The sectors represented are mostly as one would expect based on the sector rankings above.

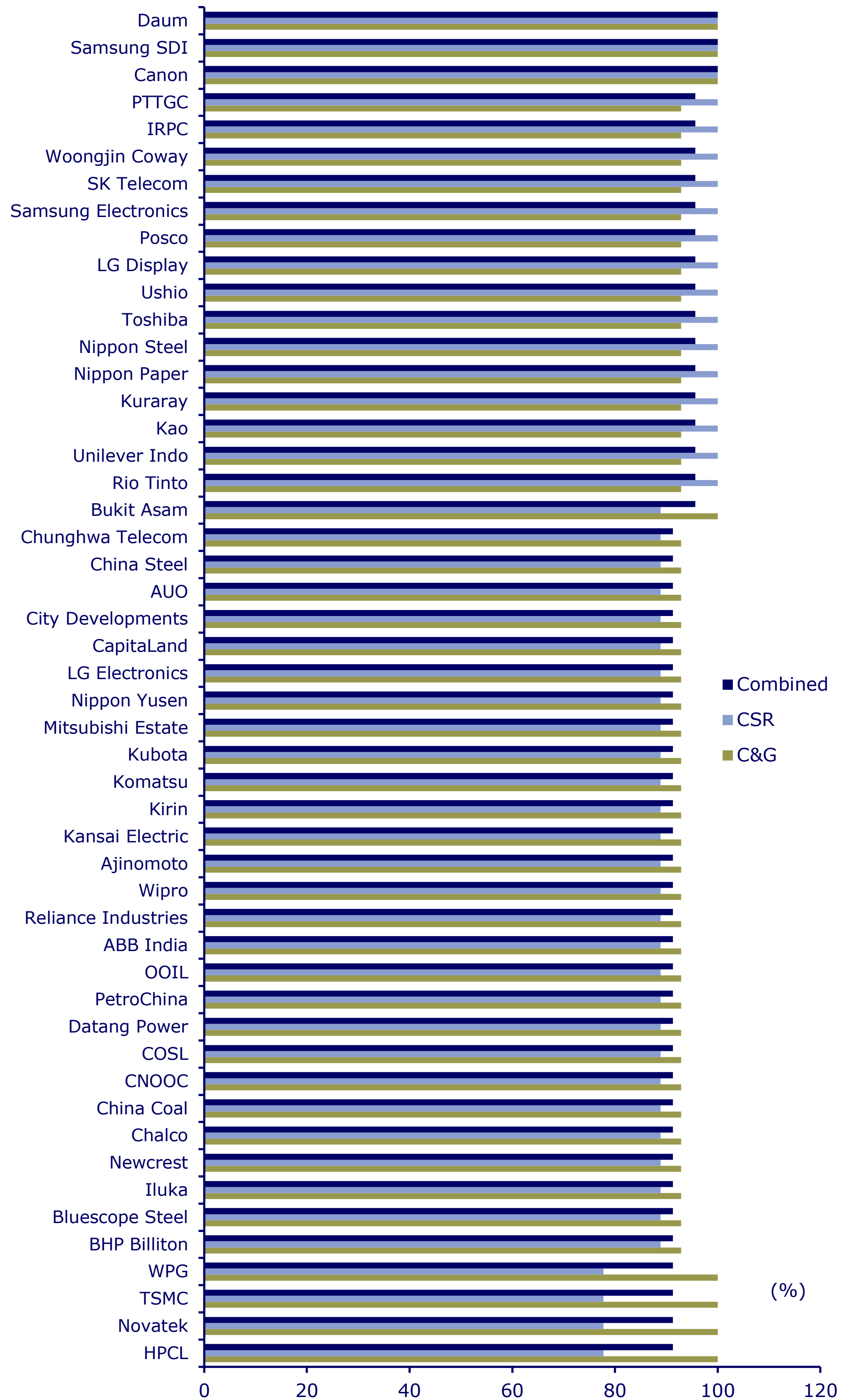
Northeast Asia dominates top scores

With some representation from big Chinese SOEs

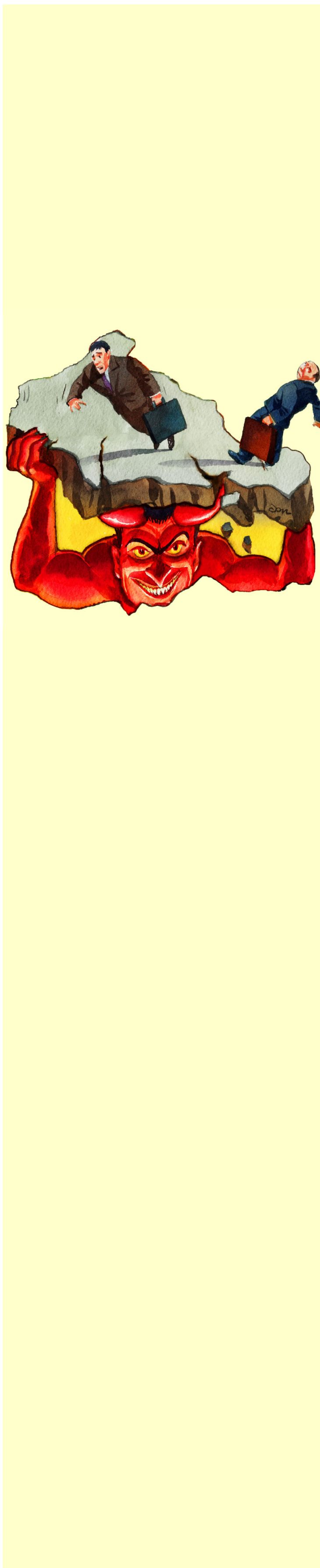
And resources companies from Australia

Figure 55

CLSA C&G/CSR: Top-50 scores around the region



Source: CLSA Asia-Pacific Markets



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Australia - Remuneration the key focus

Given that Australia is a developed market, CG and CSR 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.

Adherence to corporate governance principles assumed to be the norm

Ten years ago, the ASX established its Corporate Governance Council, which comprises various business, shareholder and industry groups. It developed the Corporate Governance Principles and Guidelines (first edition introduced in 2003) to promote investor confidence and to assist listed entities to meet stakeholder expectations. However, following these recommendations is not mandatory. Yet, under the ASX listing rules, listed entities are required to benchmark their CG practices against the council's recommendations and, where they do not conform, to disclose that fact and the reasons why. It gives a listed entity the flexibility to adopt alternative CG standards, if its board considers those to be more suitable to its particular circumstances.

ASX introduced guidelines almost 10 years ago but some flexibility around conforming

The market's Listing Rule 4.10.3 effectively encourages listed entities to adopt the council's recommended practices but does not force them to do so. This level of "enforcement" seems to work in Australia. Nearly every ASX200 company was reporting on these CG guidelines within two years of being introduced. It is also worth mentioning that CSR principles and standards in Australia are largely based on global standards from the United Nations.

Nearly all S&P/ASX 200 companies report on corporate governance

So what issues could sound alarm bells for investors in Australian companies? The major one we identify here is around executive compensation, a hotly contested topic among shareholders and directors alike. We also highlight some isolated instances of longstanding CEOs looking to move to the board of directors. The table below shows companies in the top-two CG quartiles (of the 39 companies assessed at this stage - more fulsome approach to come across all of our coverage).

Major CG issue is around executive compensation

Iluka, Orica and ASX the top three of the assessed companies

Figure 56

Top-10 CG scores of 39 companies under coverage assessed in Australia

Company	(%)
Iluka	91.4
Orica	86.9
ASX	86.2
Newcrest	84.3
Brambles	84.3
CSR	82.6
Transurban	80.2
BHP Billiton	77.3
Amcor	76.0
Boral	74.2

Source: CLSA Asia-Pacific Markets

Executive compensation correlates with company size

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 concerns boils down to an inadequate link between executive compensative and company performance. It is accentuated by a strong Aussie dollar and comparisons offshore.

Across 200-plus firms, we found no apparent link between executive pay and TSR or ROE

Microstrategist John Woods tested for correlation between executive compensation and company performance. Across more than 200 Australian-listed companies that disclose total compensation, total executive pay has no apparent correlation with three-year total shareholder return (TSR) or ROE. The correlation analysis is equally as randomly distributed if we analyse executive pay as a share of market capitalisation of the company (ie, to control for relevance of executive pay to the company).

Figure 57

Exec pay (X axis) versus three-year TSR (Y axis)

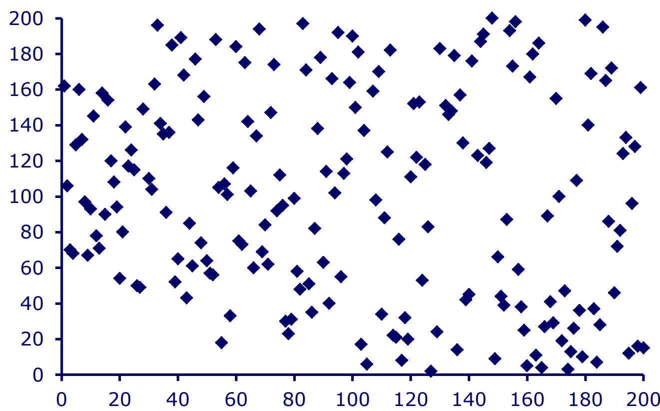
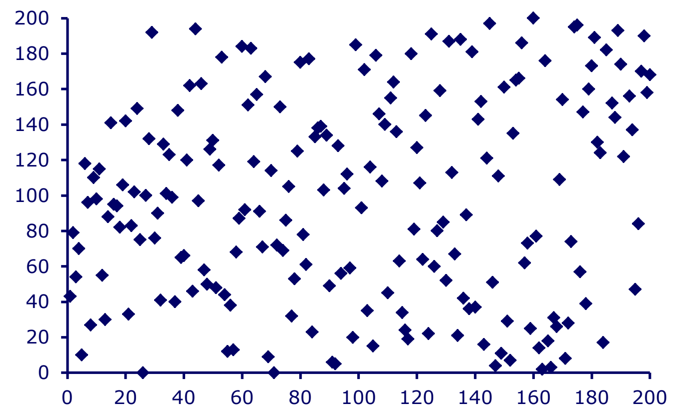


Figure 58

Executive pay (X axis) versus ROE (Y axis)



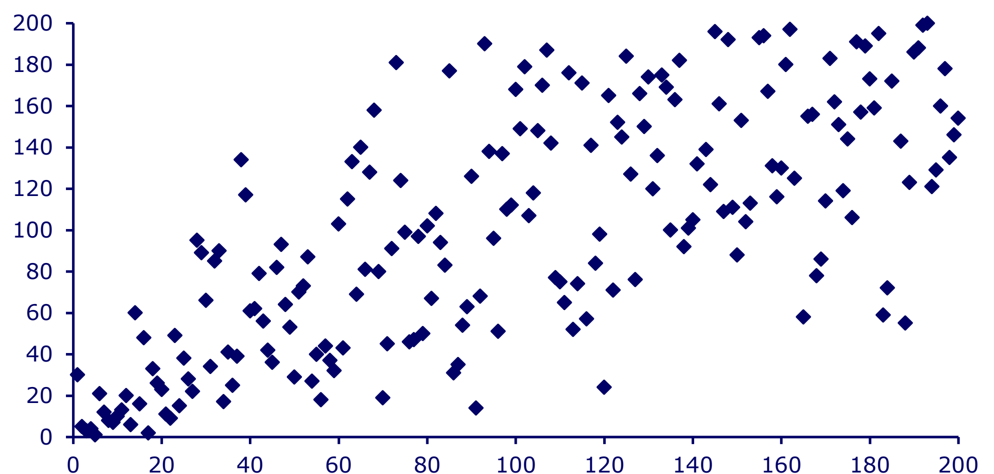
Source: CLSA Asia-Pacific Markets

There is a link between executive pay and size, but even when controlling for size there is no link to TSR or ROE

However, we did find a direct correlation between executive pay and company size (market cap). Somewhat unsurprisingly, CEOs of larger Australian corporations - typically more complex, global operations - are paid more. As above, controlling for company size does not give a stronger relationship between executive remuneration and shareholder returns.

Figure 59

Executive pay (X axis) versus market cap (Y axis)



Source: CLSA Asia-Pacific Markets

CEO compensation relative to earnings

On average, 0.8% of earnings for CEO compensation

Of the 39 companies we have rated, on average directors remuneration is 0.4% of earnings for 2011, but CEOs get paid on average double the whole board making up 0.8% of earnings. CEOs typically take 30% of total executive compensation of these companies. Figure 60 shows the CEOs where

Some companies paying CEOs well despite low or negative earnings

compensation is largest as a share of earnings as well as companies that suffered losses but paid their CEOs more than A$1m in compensation. Gindalbie, on low FY11 earnings, paid its CEO the equivalent of 5% of earnings. Ten and Echo paid off fairly generous retirement benefits to departing CEOs. Similarly, Leighton's outgoing CEO received close to A$11m for a year when the company recorded a net loss of A$253m.

Figure 60

CEO compensation versus net profit (2011)

Company	Code	Net profit (A$m)	CEO compensation (A$m)	CEO compensation as % of profit
Ten Network	TEN AU	74.1	3.8	5.1
Gindalbie	GBG AU	13.9	0.7	5.0
Echo	EGP AU	210.5	7.9	3.8
Transurban	TCL AU	173.3	4.5	2.6
UGL	UGL AU	164.3	4.1	2.5
Aquarius	AQP AU	97.1	2.4	2.4
Transfield	TSE AU	100.6	2.4	2.4
Aristocrat	ALL AU	61.3	1.4	2.3
David Jones	DJS AU	168.1	3.5	2.1
Carsales.com	CRZ AU	58.3	1.2	2.1
Bluescope Steel	BSL AU	(142.0)	2.4	(1.7)
Paladin Energy	PDN AU	(82.3)	1.7	(2.0)
Leighton	LEI AU	(253.0)	10.9	(4.3)

Source: Company annual reports

"Two strikes" policy has increased shareholder engagement

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

The current Australian government introduced a "two strikes" rule to the Corporations Act, effective 1 July 2011. 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 second AGM. The entire board can be voted out if more than 50% of shares present and voting vote against the board. This appears to have been introduced rather than a binding vote on compensation as has been introduced in the UK.

Twelve companies in the top 200 saw a "first strike" last year

Last year, more than 100 companies received a "first strike" against their remuneration reports. The table below shows those companies in the S&P/ASX 200 that registered a first strike. They will be under the most scrutiny during the upcoming AGM season. It is worth noting that while Crown recorded the highest "no" vote, executive chairman James Packer (who owns about 46%) was unable to vote. After the AGM, he indicated that if a second strike was triggered in 2012, he would use his votes to retain the current board of directors.

In our coverage this includes Bluescope, Crown, Dexus, News Corp, Paladin and UGL

Figure 61

Selected major companies facing second strike in 2012

Percentage of votes cast against remuneration reports ("no" votes)

Company	%	Company	%
Bluescope Steel	38	GUD	45
Cabcharge Australia	40	**News Corp**	35
Crown	55	Pacific Brands	53
Dexus Property	28	Paladin Energy	39
Emeco International	26	Perpetual	26
Fleetwood Corp	39	**UGL**	30

Note: Companies in bold denotes ASX100 company. Source: CLSA Asia-Pacific Markets, AFR, Clayton Utz

If spill motion approved, further general meeting required

If a simple majority (50%) approves the spill motion, the company will have to hold a further general meeting within 90 days to vote on whether to keep the existing directors. Implications of a "second strike" could be more dramatic than intended, given the time delay between the spill motion and the vote on the directors. But in the meantime it is clear that Australian companies have been more engaged in remuneration in particular.

Numerous cuts to executive pay in 2012

We have begun to see several companies make adjustments to their remuneration policies in advance of their next AGM. A summary is shown in the table below. Changes include turning down short- and/or long-term incentives and pay freezes/cuts for executives and board members.

Incentives turned down and pay freezes for a number of CEOs

Figure 62

Companies with executive/board pay cuts

Company	Leaders	Cuts
AMP	Craig Dunn, CEO	Forfeited rights to about A$3.15m in shares
ANZ	Mike Smith, CEO	Pay freeze on top executives' salaries
Bendigo & Adelaide Bank	Mike Hirst, CEO	Dropped short-term bonuses for 2012
BHP Billiton	Marius Kloppers, CEO	Turned down bonus
BHP Billiton	Mike Yeager, CEO of Petroleum	Turned down bonus
Bluescope Steel	Paul O'Malley, CEO	Pay freeze and no bonus this year
CBA	Ian Narev, CEO	Pay freeze on top executives' salaries
Goodman Fielder	Chris Delaney, CEO	No bonus
Macquarie Group	Nicholas Moore, CEO	Forfeited about A$1.3m in bonus shares
NIB	Mark Fitzgibbon, CEO	Forfeited about 60% of bonus
Pacific Brands	Peter Bush, Chairman	Entire board to take significant pay cut
Perpetual	Peter Scott, Chairman	Pay cut of 42%
Platinum Asset Mgmt	Kerr Neilson, MD	No bonus or increase in base salary
Qantas	Alan Joyce, CEO	Forgoes short & long-term incentives FY12
Rio Tinto	Tom Albanese, CEO	Turned down bonus
Rio Tinto	Guy Elliott, CFO	Turned down bonus

Source: Australian Financial Review

Longstanding CEOs moving to board/chairman

Support or otherwise tends to correlate with preference for strategy

Unlike in some developed countries, Australian CEOs are restricted from also taking on the chairman position. However, there have been a couple of recent instances of CEOs seeking to move to the board. Unsurprisingly, support or otherwise tends to correlate with support or otherwise for the outgoing CEO's recent strategy. While we understand the reasons for such a move relating to industry knowledge, we note that this could imply the board has done a poor job on managing key-person risk and believe this is prima facie a poor signal for a new management team being unshackled in its consideration of strategy. Recent examples include:

WorleyParsons, QBE and Toll are recent examples of longstanding CEOs looking to move to board

- In July 2012, WorleyParsons announced that CEO John Grill would be stepping down and become non-executive chairman of the board at the company's 2012 AGM in October. Grill owns about 11% of WorleyParsons. CFO Andrew Wood has been appointed to take his place.
- In February 2012, QBE announced that Frank O'Halloran would retire as CEO in August 2012, after handing over to John Neal, formerly CEO of QBE's global underwriting operations. O'Halloran was CEO for 14 years and at the time of the announcement it was indicated that he would return to the board as a non-executive director shortly before the 2013 AGM.

- Paul Little, who was CEO of Toll for more than 20 years, stepped down as CEO at the end of 2011. He announced an intention to return to the board 'after an appropriate period'. Little owns about 5% of Toll. CFO Brian Kruger replaced Little as CEO at the end of 2011.

Other precedent does exist and does not necessarily correlate with poor shareholder returns

Such moves are not without precedent in Australia and do not necessarily correlate with poor shareholder returns. For instance, Westfield Group founder Frank Lowy is now chairman and his sons Stephen and Peter Lowy are co-CEOs. Gerry Harvey, founder and major shareholder (more than 30%) of Harvey Norman, is the chairman and his wife, Katie Page, is now the MD.

In an Asian context

Australian corporations on average rate higher than Asian brethren

Compensation is a more pertinent issue in Australia but much less so in the rest of Asia, where family control usually dampens executive compensation. Australian companies, however, generally rate much better than their brethren in Asia overall on CG. The average score for our Australian sample at 64% is significantly higher than the 52% average CG score for the rest of our Asian coverage. The next highest-scoring market for corporate standards is Singapore, but its companies score on average 8ppts below the Australian sample. Japan, the other large developed market in our survey, had a lower average corporate score of 55%.

A signal from the audit committee

Australian companies rank significantly better than the rest of Asia in particular on independence of the board with a score of 51% compared to 24% for the rest of the region. They also do better on responsibility and C&G/CSR, for which Australian companies under coverage get almost 70%, some 14ppts higher than the rest of Asia. One of the questions that we find to be revealing on CG commitment is whether all directors on the audit committee, including the independent ones, have financial expertise. Most of Asia does not score well on this issue; even in Australia just 30% of the audit committees we examined met the criterion, while more than two-thirds had directors that did not bring with them financial acumen. While the adherence to regulated standards is high, this raises questions about the real commitment to good governance.

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China - A complicated state of play

Of all the markets in this year's survey, China has suffered the most in terms of its standing on CG quality, with its score falling 4ppts from 49% in 2010 to 45%. Although the country continues to make progress in many areas, there remains a wide gap between regulation and practice, and between the ideals of policymakers and the attitude of market participants. More so than other markets in North Asia, China takes an intellectual interest in international CG developments and, over the past decade, has aligned its standards with global best practices as much as possible (but as we note in our regional overview in Section 2, there remain some large systemic obstacles to achieving parity). In contrast, the quality of governance within many firms is dreadful, with little respect for shareholders, low levels of business ethics and a more extreme level of "form over substance" than can be found in most other Asian markets.

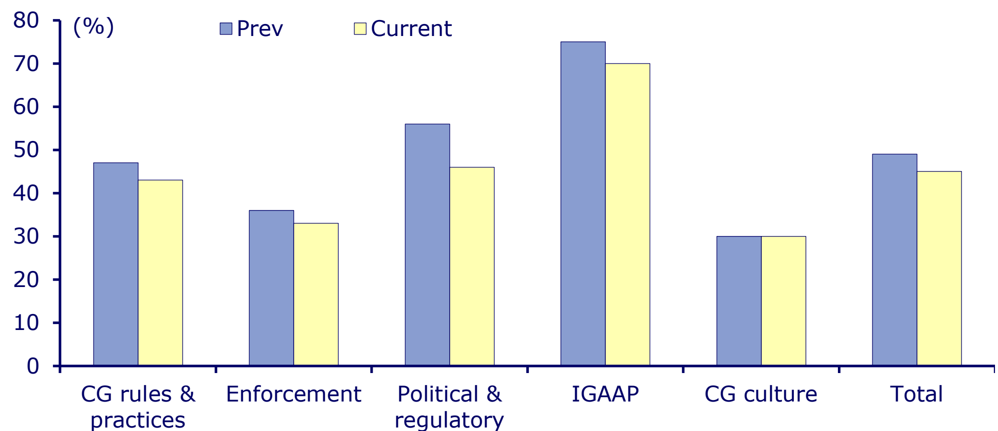
The role of the state continues to complicate CG reform in China

It would be wrong, however, to give the impression that the challenges lie only within companies and the market. One of the biggest issues in corporate governance in China concerns the multifaceted role of the state, which both helps and hinders CG development. The positive side of the equation includes state entities working hard to improve board practices in state-owned enterprises (SOEs), the banking regulator raising governance standards for banks and the securities regulator steadily improving investor protection and enforcement. Key negatives are the conflict between different government agencies over the interests of the state as a majority shareholder compared to the interests of domestic minority shareholders, the political appointment of senior executives and directors to SOEs, and the tight controls on media and state secrets. If China is to advance its corporate governance over the long term, it needs at the very least a more open information environment.

China's scores fall in most categories, especially political and regulatory

Figure 63

China CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

Accounting scandals are a window onto systemic weaknesses in China's CG

Predictably, China's score has also fallen this year because of the numerous accounting scandals and frauds appearing in its companies, many from the private sector. The fact that a large number of these firms were listed outside the mainland, in Hong Kong, Singapore and the United States, is beside the point in our view. These frauds are a window on systemic weaknesses in areas such as internal controls over financial reporting, the quality of audit and the profit-at-all-cost mentality of some entrepreneurs. Whether these cases indicate worse governance in China's private companies than its SOEs is a moot point. But they indicate that as China increasingly privatises, the quality of its corporate governance may not necessarily improve; indeed, it could deteriorate for a period of time.

CG rules and practices

Scores fall because of poor implementation of rules by companies

China's score in this category has deteriorated from 47% in 2010 to 43% this year, largely because we have taken a tougher line on certain questions. This category examines not only basic corporate governance regulations on paper, but the implementation of those rules by companies. Compared to best practice in Asia, we have downgraded companies for the quality of their financial accounts, the release of material price-sensitive information and publication of final AGM agendas and meeting documents.

Rules are often not as good as they appear on paper

The point about AGM documents is a good example of how China's rules often appear more stringent than they actually are: while the company law sets 20 days as the deadline for release of AGM agendas and meeting circulars, most companies including blue chips only publish summary documents at that time (some release earlier); the detailed agenda does not appear until a week or two before the meeting, leaving little time for investors who want to make a truly informed vote.

China's CG Code is falling behind global trends

China's score also fell on the extent to which its code of corporate governance is keeping pace with international best practices. We feel it is not: the code was published in 2002 and has not been revised since, yet a great deal has happened in global CG in that time. While the Chinese government has introduced many new rules on CG in recent years and has produced updated guidelines on the corporate governance of banks, the country's basic CG code remains unchanged. Since the code sets aspirational standards for such things as board practices, the role of directors and the running of shareholder meetings, we believe this is an area that needs to be reviewed.

Enforcement

Enforcement often appears inconsistent

This category also fell slightly this year, losing three points to 33%. While regulators clearly see the need to take a tougher line on enforcement, and enforcement announcements are quite detailed, it is frankly difficult to assess how consistent regulators are being and whether they are treating all listed companies and individuals equally.

The CSRC regularly issues fines and warnings . . .

To be fair, the China Securities Regulatory Commission (CSRC) does have an extensive supervisory programme tracking the disclosure of listed companies as well as the behaviour of investment funds and brokers. Much of its enforcement activity involves fines and warnings against companies for "illegal information disclosure" (ie, false or non-disclosure of material information) or against intermediaries for deceptive business practices. For example, in May 2012 it issued quite strong penalties against a company called Yaxing Chemical for failing to disclose on a timely basis 'the transfer of large amounts of non-operating funds between it and its controlling shareholder Yasing Group and guarantees provided by it to Yasing Group'. It also sanctioned the company's auditor, Shandong Zhengyuanhexin Certified Public Accountants.

. . . but action against insider trading is limited

While some progress is being made against market manipulation, based on CSRC data, the picture is not impressive on insider trading. To tighten the screws in this area the regulator announced in October 2011 that listed companies must maintain a register of insiders (ie, anyone with access to insider information, such as major shareholders, intermediaries including lawyers and investment bankers, and even officials at the receiving end of regulatory filings). The new regulation is a recognition that insider trading is spreading and becoming more varied and complex, and the CSRC hopes it will have a deterrent effect. Then in May 2012, the CSRC announced that

progress had been made in working with the Supreme People's Court and public prosecutors on a new set of Judicial Interpretations on Insider Trading. This document and one issued the previous year clarified the application of the law on insider trading and would 'improve the mechanism of coordinating executive enforcement with criminal sanction and further develop the relevant legal regime governing criminal offenses involving insider trading'. The stage should therefore be set for more cases on insider trading in future.

Domestic institutional investors in China are becoming restless

Despite the fall in overall score in this category, we upgraded China on two questions: whether institutional investors were voting their shares at company meetings, and voting against resolutions with which they disagreed. Anecdotal information suggests that institutional voting is on the rise, including from foreign investors, while some specific cases this year indicate some nascent shareholder activism. In February 2012, shareholders of Chongqing Brewery voted at an EGM called by a domestic minority shareholder, Dacheng Fund Management, to try to oust the company chairman. The vote failed, but what was interesting was that the fund had gone to the trouble of calling an EGM. Minority shareholders were more successful at the AGM of Hong Kong-listed Shanghai Pharmaceuticals in May 2012. They accused company management of accounting fraud and voted to remove its chairman, with almost 85% of shareholders backing the resolution.

Political and regulatory environment

China's policies on CG often seem inconsistent

China's score fell significantly here, from 56% in 2010 to 46% this year, mainly because we are rating the country more critically compared to other markets as to whether it has a clear and consistent policy on corporate governance reform, the legal system allows minority shareholders effective access to courts to settle disputes, and whether the judiciary is independent. We also downgraded scores slightly on the extent to which the regulator and exchanges were enacting new rules to improve corporate governance. The one question that received a marginally higher score related to the skills of judges in handling securities cases.

Some agencies of government are working hard to improve CG . . .

As we noted earlier, different agencies of government in China are working to improve the governance of entities under their control. The State-owned Assets Supervision and Administration Commission (Sasac) has a programme for introducing boards of directors into the parent companies of the 117 central SOEs under its control (so far around a third are in the programme). The China Banking Regulatory Commission (CBRC) released draft guidelines on the corporate governance of commercial banks in July 2011. Among other things, these aim to strengthen the role of the board of directors and curb the power of major shareholders. And the CSRC is steadily raising the bar on governance in the capital markets, including restricting backdoor listings, revising rules on IPOs and, through the two stock exchanges, tightening rules on delistings.

. . . yet contradictions abound in China's approach to reform

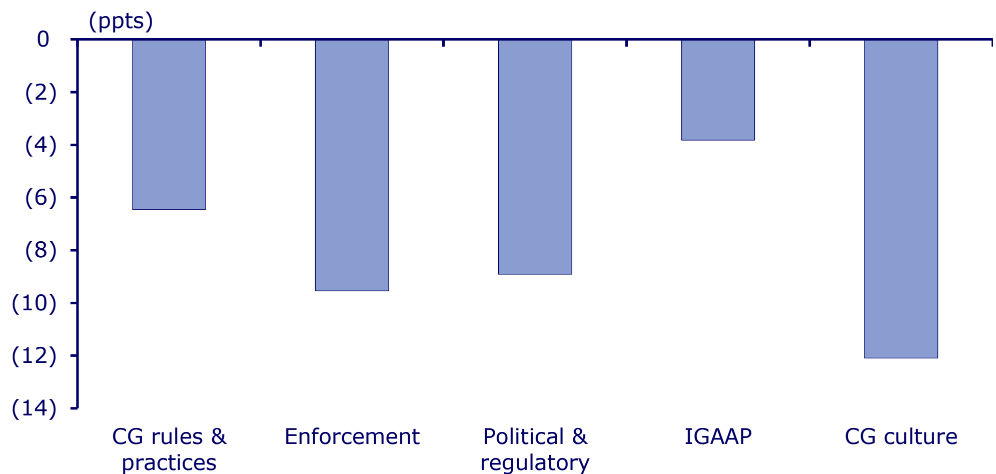
However, contradictions abound in China's CG policies. The stated aim of many reforms is to enhance the transparency and accountability of listed companies and increase protection of minority shareholders. Yet with the government as the majority shareholder of so many listed companies, its interests will invariably override those of other shareholders. For example, the state will reassign senior executives from one enterprise to another, or from an SOE to a government position, according to the logic of its own internal appointments system. The process shows that boards of directors do not really appoint their chairmen (or CEOs for that matter). While this is completely understandable in a political system such as China, it contradicts one of the basic functions of an accountable board and, ostensibly, China's

own code of corporate governance. (Note: Boards of Asian family companies may have little real power over their chairman either, but there is usually more continuity in the person holding that position. This at least gives minority shareholders the sense that the company's leadership is stable and interested in its long-term welfare.)

China is firmly behind regional best practices

Figure 64

China: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

The state is both a regulator and owner in the securities market

Another point of tension derives from the ongoing issue of the state being both a regulator and owner in the securities market. How can the regulatory authorities act independently if they disagree with the agencies responsible for ownership? Far from being monolithic, the state in China is more a collection of often competing agencies and groups with quite different agendas. This came to the fore recently with the publication of a controversial report written by the Development Research Centre, a think tank to the State Council, on the need for more privatisation of SOEs. It raised the question as to whether SOEs should become larger and more powerful, or whether this would ultimately crowd out the more profitable private sector that creates most new jobs in China.

The regulator pushes for transparency, while the government controls the media and state secrets

And, among many other contradictions, there is the obvious conflict between the emphasis placed on the need for transparency and information disclosure in the securities market versus the tight controls set on the media and publication of "state secrets". A new law on the latter issue was released in 2011 and has already had an adverse effect on disclosure by some mainland companies listed in Hong Kong. For example, China High Precision Engineering was suspended for refusing to pass on certain information to its auditor on the grounds that the data constituted state secrets.

IGAAP (accounting and auditing)

A lowered score based on the quality of audit regulation

China scores relatively well in this category, achieving 70% in recognition for the work it has done in recent years to bring its accounting and auditing standards in line with global rules. However, the score represents a 5ppt drop from 2010, largely the result of lower scores for the effectiveness and transparency of audit regulation. While China's audit regulators take a fairly rigorous approach to their work, we are marking down all markets on these questions due to more problems emerging in the quality of audit and our assessment of the relative level of transparency from audit regulators.

China's score also suffers from audit-quality issues

Inevitably, China's score also suffers from the spate of accounting scandals involving mainland firms listed around the world. While such firms are not regulated by financial regulators in China (unless they have a dual listing), many of the auditors are based in China and would also be auditing companies listed in China.

CG culture

Some pros and cons, but CG culture score stays flat

The score stayed the same in this category, at 30%. We marked companies down somewhat for the extent to which they are trying to follow the spirit of the rules as well as the letter, on the issue of whether the average listed company believes that CG adds value (we believe the answer is "No" for all markets), and whether there is a group of SMEs making a name for themselves as well-governed (we struggle to see too many).

CG reports often more form than substance

Overall, we find a great deal of form over substance in the corporate governance reports of listed companies. Even in the best managed companies, it is quite common to see beefy CG statements of 20-plus pages promised in the contents pages of annual reports, only to find that much of the text is boilerplate and not useful (eg, long lists of items discussed at board meetings, yet wholly lacking in any content). The formal descriptions of the role of board committees can also be misleading, especially in SOEs, since they usually recite best practice and give the impression that the board is entirely independent of its controlling shareholder, the state.

Company IR improving, as is voting by poll

Nevertheless, there are some positives in China's CG culture. We feel that some companies are trying to enhance their communication with shareholders (based on meetings we had in Beijing and Shenzhen in February 2012), more issuers are voting by poll (based on our analysis of voting patterns among large listed companies and a selection of mid caps) and some investors are seeking to become more engaged with companies, as outlined earlier.

The creation of Capco heralds positive change

There is also hope that governance culture will strengthen in China following the establishment in March 2012 of a new self-regulatory organisation, the China Association for Public Companies (Capco). The CSRC played an instrumental role in the establishment of Capco, which was also founded with the support of the country's top 200 listed companies. Among other things, Capco will organise training for directors, supervisors and managers, and promote higher standards of corporate governance among its members.

Factors to watch

Figure 65

China: Downgrade watchlist

Factors that could force the country's score to fall in 2014:
❑ No sign of further improvement in the quality of audit
❑ No progress on enforcement against insider trading
❑ Company CG reports still made up mostly of boilerplate language
❑ Lack of transparency over the role of the Party Committee in listed companies
❑ No revision of the code of corporate governance

Actions that could improve overall CG

Figure 66

China: Quick-fix list

Simple actions that government and companies can take to improve overall CG:
❑ Listed companies release detailed agendas 20 days before AGM
❑ CSRC improves its English website
❑ Listed companies write more meaningful CG statements in annual reports
❑ Ensure that companies do not disallow "Against" votes from foreign shareholders

Source: ACGA

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Research perspective - Poor image

During 2012 the leadership in both China and Hong Kong will have changed. Smooth transitions are highly desired, but both markets have been undermined by controversy that is at the heart of CG issues.

The high-profile case that resulted in Bo Xilai's downfall sets the scene for negative perceptions

In China, the removal of Bo Xilai as Chongqing's chief in March and his suspension from the Politburo was arguably the biggest upheaval for China's leaders since the Tiananmen Square prodemocracy protests in 1989. Governance is at the roots of all the allegations that have been made. While Bo's policies brought much progress to Chongqing, the sustainability and implementation of these policies are under heavy scrutiny. Bo's wife, Gu Kalai, has been convicted of murdering British businessman Neil Heywood, and the police apparently initially helped to cover up the offence. These events, at the highest echelons of the Communist Party, have reinforced perceptions of poor governance in China. On the corporate front, multiple serious transgressions exacerbated the perception of poor corporate governance.

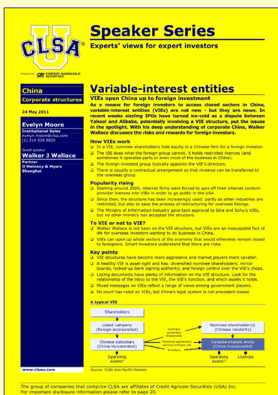
Key CG issues over the past two years

Investors should be wary of reverse takeovers (RTOs)

Chinese companies have faced mounting CG issues, but mainly for overseas listed firms, especially those structured as reverse takeovers (RTOs). The RTO structure faces tougher regulations in Hong Kong and the domestic market and hence the problems have been higher profile overseas, notably on Nasdaq and in Singapore where multiple ADR-listed Chinese companies and so-called Chinese listed S-chips have succumbed.

SOEs score poorly in our CG survey

We cover about 230 China/HK companies, and there have been limited issues with corporate governance with some exceptions like Yurun and Gome. In general, there have been limited issues with the larger SOE companies as they have lesser incentive to artificially boost share prices, even though SOEs typically score poorly in our corporate governance questionnaire. It's worth noting that SOEs represent a majority of China's market cap. While they tend to trigger the high-profile CG cases, the SOEs' disclosure remains typically poor and there is significant room for improvement.



Speaker Series
Experts' views for expert investors

China
Corporate structures

24 May 2011

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Variable-interest entities

VIEs open China up to foreign investment

As a means for foreign investors to access closed sectors in China, variable-interest entities (VIEs) are not new - but they are news. In recent weeks sizzling IPOs have turned ice-cold as a dispute between Yahoo! and Alibaba, potentially involving a VIE structure, put the issues in the spotlight. With his deep understanding of corporate China, Walker Wallace discusses the risks and rewards for foreign investors.

How VIEs work
- In a VIE, nominee shareholders hold equity in a Chinese firm for a foreign investor.
- The VIE does what the foreign group cannot: it holds restricted licences (and sometimes it operates parts or even most of the business in China).
- The foreign-invested group typically appoints the VIE's directors.
- There is usually a contractual arrangement so that revenue can be transferred to the overseas group.

Popularity rising
- Starting around 2000, internet firms were forced to spin off their internet content-provider licences into VIEs in order to go public in the USA.
- Since then, the structure has been increasingly used: partly as other industries are restricted, but also to ease the process of restructuring for overseas listings.
- The Ministry of Information Industry gave tacit approval to Sina and Sohu's VIEs, but no other ministry has accepted the structure.

To VIE or not to VIE?
- Walker Wallace is not keen on the VIE structure, but VIEs are an inescapable fact of life for overseas investors wanting to do business in China.
- VIEs can open up whole sectors of the economy that would otherwise remain closed to foreigners. Smart investors understand that there are risks.

Key points
- VIE structures have become more aggressive and market players more cavalier.
- A healthy VIE is asset-light and has: diversified nominee shareholders; mirror boards; locked-up bank signing authority; and foreign control over the VIE's chops.
- Listing documents have plenty of information on the VIE structure. Look for the relationship of the listco to the VIE, the VIE's function, and which assets it holds.
- Mixed messages on VIEs reflect a range of views among government players.
- No court has ruled on VIEs, but China's legal system is not precedent-based.

A typical VIE

Source: CLSA Asia-Pacific Markets

www.clsau.com

The group of companies that comprise CLSA are affiliates of Credit Agricole Securities (USA) Inc.
For important disclosure information please refer to page 20.

Variable-interest-entity (VIE) structures have become an issue as shareholders do not have direct ownership rights to the underlying operating asset. VIE has been used to get around Chinese laws concerning foreign-ownership limits for strategic industries and licensing requirements. This structure operates in the grey area of Chinese laws, but the government has taken a practical approach and has not opposed it. However, the uncertain legal status of these structures implies firstly investors are at some risk of officials deciding to clamp down on them. Secondly, management of these firms might use the excuse of VIEs to change the company structure in a way that could be detrimental for investors - as was the experience of Yahoo with Alibaba where the payment subsidiary was taken out of the vehicle that Yahoo had its interest in.

The SEC and the CSRC have been in a tussle over getting access to Chinese audit papers of Chinese companies listed in the USA. There is a regulatory issue being argued by respective securities regulators, but it affects all Chinese companies listed in the USA including ADRs. Before this issue escalates to any delisting of China companies, it will likely be elevated to becoming a higher-level political issue and be resolved through discussions at a senior level of regulators.

Governance concerns among mainland corporations

We list a number of companies that have gotten tangled in CG issues publicly in China, some are under coverage but often we do not cover these names:

Banks

Teetering with noncore businesses

In 2009, Chinese banks provided the financing for China's massive infrastructure stimulus with total loans in the banking system increasing by one-third. Much of the loans went to special project vehicles of state governments with limited servicing ability the loans. The real earnings of these banks, if they undertook more aggressive provisioning policies, are unclear; this flows through to uncertainties about their true book value.

The government using SOEs as vehicles for policy remains a general risk for investors in other sectors as well including petrochemicals and telecoms.

Equipment makers: Shanghai Electric, Dongfang and Harbin

Companies should focus on their core activities

China IPPs are the largest shareholders of equipment makers. To uphold IPPs' share prices and support their equity issuance, equipment makers bought IPPs' A shares in recent years, even when the businesses were clearly unattractive in 2010 and 2011. As a result, in 2011 Harbin Electric booked an Rmb395m loss from its trading in the IPPs.

Gome

Underestimation of losses and poor communication

Following serious CG lapses in earlier years involving insider trading that led to the chairman being jailed, management this year underestimated the negative impact of a new ERP system and losses of its e-commerce business and failed to communicate this change to the market in a timely fashion.

Teetering with noncore businesses

The company cancelled its controversial proposal to set up a property JV with the majority shareholder amid resistance from investors in late 2011.

Yurun

Ownership of multiple businesses outside of the listed entity

Yurun's ex-chairman and largest shareholder Zhu Yicai is widely known to have sizeable private business including property development, logistics, among others. Zhu has reduced his holding in Yurun from 53.5% to a low of 25% over the past five years, possibly to fund his privately owned business, before buying back 10m shares, raising his holdings to 26% in July 2011.

Poor PR hits bottom line

The company's reported net profit declined by 94% in 2H11 and it is likely to record another significant profit decline in 1H12, due to continuous negative press coverage which tainted the company's reputation and pricing power for its products. Yurun recently restructured its senior management team and Zhu stepped down from his roles as chairman of the board and executive director, but remains the single largest shareholder of the listco.

China Gas

A run-in with the law has clear negative corporate governance implications

China Gas' cofounder and former executive director Liu Ming-hui was arrested due to embezzlement allegations in December 2010. He was jailed for close to a year before being released recently. In July 2012, Liu was cleared of embezzlement allegations by the legal authorities in Shenzhen, due to insufficient evidence. Liu subsequently rejoined China Gas as a director. The company will also consider appointing Liu as executive director once regulatory and procedural requirement has been met.

The company and in particular the board are still dominated by one or two powerful individuals.

Huabao

Huabao's chairlady Chu Lam-yiu has reduced her holding in the company from 98% to 38% since 2006. Common concerns on company's CG include: back-door listing in 2004; significant amount of connected-party transactions; and concerns over the financial statement with curiously higher margins shown than peers.

Inconsistency draws the attention of short-sellers

An April 2012 third-party report questioned Huabao's financials and the discrepancies between State Administration for Industry and Commerce (SAIC) filing and reported figures. The company suspended the trading and provided some explanation in the week after to address the allegations.

The use of derivatives leads to the perception of hefty trading

Huabao disclosed that Chu had entered a derivative transaction with a long position equivalent to a hefty 3% of total outstanding shares through a contract that expires January 2013.

Related-party transactions stirs controversy

Perfect World

In August 2011, Perfect World sold its film-making business to CEO Michael Chi for Rmb360m (US$55m). Almost immediately after the transaction, the film studio released a hit movie and a hit TV drama, which stirred controversy.

Change in the auditor is a red flag to investors

China High Precision

The company was suspended following its auditor's resignation as an audit could not be completed due to the company's involvement in sensitive industries ("state secrets").

VEI structures are under hefty scrutiny

New Oriental Education

The company is being investigated for its VIE structure as well as being accused of inflating its accounts by short sellers like Muddy Waters.

Change in the auditor is a red flag to investors

Longtop Financial

Deloitte's inability to not confirm the company's bank balances was one of the reasons for resigning.

China MediaExpress

Deloitte resigned as auditor with irregularities found in the bank account balances of the company's PRC subsidiaries.

Shengda Tech

KPMG resigned as auditor citing serious discrepancies regarding bank balances among other items.

Companies should communicate management changes

Shanghai Pharma

The company has seen big management changes without clear explanation. The vice president in charge of business development resigned at the end of 2011 and the board chairman was dismissed right before the AGM at the end of May 2012.

Companies that have seen CG improvement

Perceptions of poor corporate governance is overstated

Undeniably, there are multiple examples of poor corporate governance impacting China and Hong Kong companies. These examples can easily lead to perceptions that CG across the board is bad. In our view, this is not the case as many of the Chinese companies that have been implicated are governed by regulations in other countries such as the USA and Singapore, where regulations are less stringent.

Consumer names Belle, Anta Sports, Want Want, Tingyi among the highest scorers in China

Tech companies AAC and Digital China among the highest scorers regionally

Figure 67

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

Company	Code	Company	Code
AAC	2018 HK	Golden Eagle	3308 HK
Agile Property	3383 HK	Hengan	1044 HK
Agricultural Bank	1288 HK	Hollysys	HOLI US
Anta Sports	2020 HK	HPH Trust	HPHT SP
Antonoil	3337 HK	ICBC	1398 HK
Baidu	BIDU US	Lenovo	992 HK
Bank of China	3988 HK	Lilang	1234 HK
Belle Intl	1880 HK	Longfor	960 HK
CCB	939 HK	Longyuan Power	916 HK
Changyou	CYOU US	Mindray	MR US
China Automation	569 HK	NetEase	NTES US
China Life	2628 HK	Parkson Retail Grp	3368 HK
China Taiping	966 HK	PetroChina	857 HK
Coli	688 HK	PICC	2328 HK
Conch	914 HK	Shanda Games	GAME US
COSL	2883 HK	Shanghai Electric	2727 HK
Country Garden	2007 HK	Shenhua	1088 HK
CR Land	1109 HK	Sinoma	1893 HK
CR Power	836 HK	Sinopec	386 HK
CRE	291 HK	Sinopharm	1099 HK
Daphne	210 HK	Soho China	410 HK
Datang Power	991 HK	Sun Art	6808 HK
Digital China	861 HK	Tingyi	322 HK
Dongfang	1072 HK	Tsingtao	168 HK
Dongxiang	3818 HK	Vanke	200002 CH
EVA Precision	838 HK	Vinda Intl	3331 HK
Everbright Intl	257 HK	VisionChina	VISN US
Everbright Ltd	165 HK	Want Want	151 HK
Evergrande	3333 HK	Weichai Power	2338 HK
Evergreen Intl	238 HK	Weigao	1066 HK
GAC	2238 HK	Yingde Gases	2168 HK
Giant Interactive	GA US	Zoomlion	1157 HK

Source: CLSA Asia-Pacific Markets

Companies that have seen CG deterioration

We list the biggest gainers and decliners in China from our most recent CG in Figure 68.

Recent turnaround in business prospects at Lenovo has had a positive effect on ratings

Lenovo's track record has been patchy over time, given several restructurings since 2001 and inability to consistently remain in the black. Restructuring commenced during the financial crisis, under the new management and 2011 saw a sizeable turnaround, with overseas acquisitions under new structure contributing positively.

Insurers are focusing on improving bottom line

Everbright has added an investor relations department and in the process improved access and disclosure. Meanwhile, Chinese insurers such as China Life and PICC have started campaigns to restructure their businesses and improve risk management and returns.

SOEs like Magang are simply not responsive when outlook deteriorates

As the conditions for the steel industry have worsened over the past two years, steel producers have become less responsive to investors. Magang, in particular, saw its scores decline. As this industry is a state-controlled sector there is little incentive to be responsive.

The miners lost points for late reporting and losing independent directors

For Chalco, Shenhua and Yanzhou, the reasons for the decreases in corporate governance rankings were similar. The companies did not report annual results within two months after end of a financial period. They all had a decrease in the number of independent directors. SouthGobi also did not report interim results timeously and selected disclosure in its annual report was unclear. Furthermore, the company was slow to release market-sensitive information.

Late reporting, dodgy investments, etc

Late reporting lowered China Coal and Jiangxi Copper's CG ratings this year. Sina's patchy investments made in 2011 have led to significant paper losses for the company this year and deterioration in its CG ranking. Meanwhile, Suntech Power has been embroiled in controversies over disclosure and oversight culminating in the recent departure of the CEO.

Intergroup restructuring and late reporting pulled down CRE's scores

CRE's failure to make tighter reporting deadlines and its inter-group restructuring that involved asset swaps with the parent have weighed on the company's CG score.

At Zhaojin, an increase in management's remuneration from a low base and a diversification from gold to copper resources put pressure on its rating.

Business turnaround at Lenovo helped improve its CG score

Figure 68

China: Biggest CG gainers/decliners (alphabetical order)

Biggest gainers		Biggest decliners	
China Life	2628 HK	Bank of China	3988 HK
Everbright Intl	257 HK	Bocom	3328 HK
Lenovo	992 HK	CCB	939 HK
PetroChina	857 HK	Chalco	2600 HK
PICC	2328 HK	China Coal	1898 HK
		CMB	3968 HK
		CRE	291 HK
		ICBC	1398 HK
		Jiangxi Copper	358 HK
		Magang	323 HK
		Shenhua	1088 HK
		Sina	SINA US
		Suntech Power	STP US
		Yanzhou Coal	1171 HK
		Zhaojin	1818 HK

Source: CLSA Asia-Pacific Markets

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Hong Kong - Accountability & audit slide

Hong Kong remains a step behind Singapore in this year's survey, ranking No.2 again but on a marginally higher score of 66%. The securities regulator, the Securities and Futures Commission (SFC), continues to put its foot on the pedal in terms of enforcement, Hong Kong has a new Code of Corporate Governance, and the Financial Reporting Council (FRC) is making some progress in investigating audit irregularities.

Corruption scandals mar the picture

That is the good news. On the other side of the equation, corruption scandals involving government officials and business tycoons, as well as numerous financial irregularities at Hong Kong-listed mainland companies, have managed to keep down the scores for the territory.

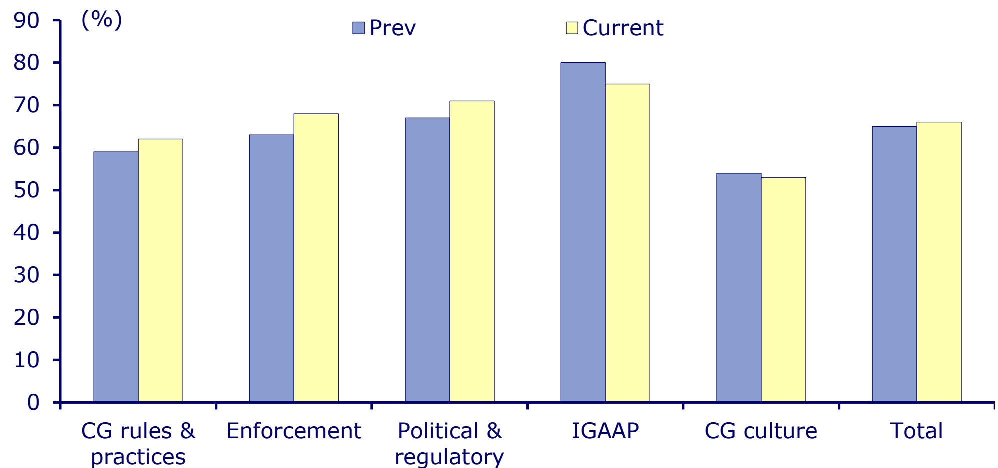
Cosy relationship between government and tycoons cross the line

It is well known that the government and business community in Hong Kong have a cosy relationship. Witness the way officials did the bidding of tycoons over the "blackout period" fiasco in 2009 and rolled back reforms (this was an attempt by regulators to extend the closed period for director share dealings). But until this year that relationship had not crossed the line, at least publicly. Sadly, Hong Kong's reputation as a corruption-free city has been sullied. Earlier this year, property tycoons and a former senior official were arrested by the Independent Commission Against Corruption (ICAC). Even more surprisingly, former Chief Executive Donald Tsang became the subject of scrutiny by the ICAC for accepting favours from business tycoons. And if all that was not bad enough, three senior ICAC officials were jailed for perjury in May 2012.

Hong Kong scores mostly rise, but fall in accounting and audit and CG culture

Figure 69

Hong Kong CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

CG rules and practices

Regulators review rules and guidelines

Hong Kong's score in this category rose by 3ppts to 62% in 2012. The new code of corporate governance and better practices by listed companies regarding financial reporting practices raised the score in this section.

New code raises the bar on CG practices

On 18 December 2010, the Stock Exchange of Hong Kong (SEHK) published a Consultation Paper on Review of the Code on Corporate Governance Practices and Associated Listing Rules. Just under a year later, it announced its consultation conclusions on 28 October 2011 and made the new code effective from 1 April 2012. Key changes included:

Nomination committees

- Upgrading a "recommended best practice" (RBP) on the formation of nomination committees to a "code provision" (CP), which triggers a "comply or explain" requirement. Such committees should have a majority of independent non-executive directors (INEDs) and be chaired by an INED or the board chairman;
- Introducing a new CP stating that the board should be responsible for corporate governance;
- Introducing a CP stating that a company's management should ensure that the external auditors attended the AGM to answer questions about the conduct of the audit the preparation and content of the auditors' report, accounting policies and auditor independence - a requirement that we feel is necessary as shareholders rarely have access to the external auditors; and
- Upgrading an RBP to a CP on shareholders voting on a separate resolution to retain an INED who has served for more than nine years.

Listing rules also get a makeover

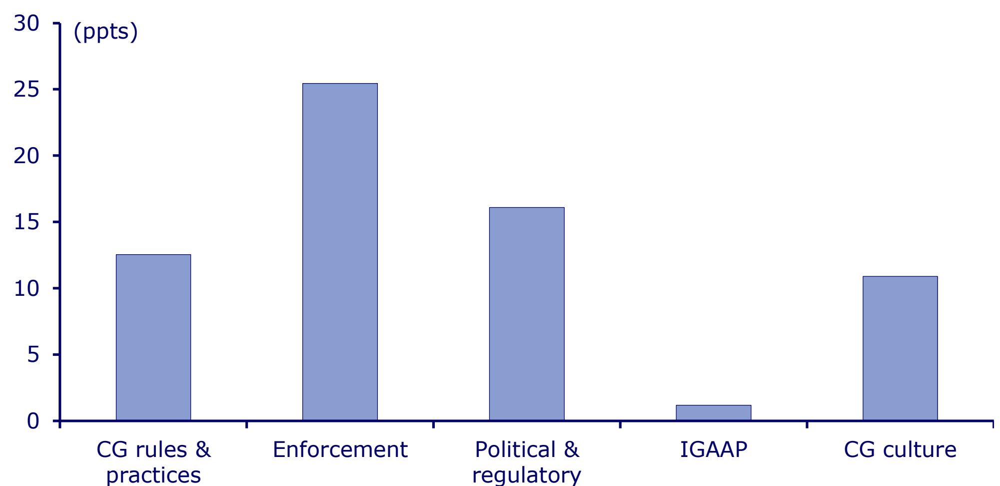
The SEHK also amended a number of listing rules at the same time, most of which became effective on 1 January 2012, including:

- At least one-third of a board should be INEDs, but companies need only comply with this rule by 31 December 2012;
- All issuers must establish a remuneration committee with a majority of INED members, with an INED as chairman of the committee; and
- An expanded rule on directors' duties, requiring them to take an active interest in a company's affairs and follow up on any untoward matters that come to their attention. The rule also cautions directors that the exchange can discipline them if they fail to discharge their duties and they could also attract civil and/or criminal liabilities.

Hong Kong scores above regional average across all categories

Figure 70

Hong Kong: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Disclose or be prepared to be pursued by the SFC

In April 2012, the Legislative Council passed the Securities and Futures (Amendment) Bill 2011, giving the Securities and Futures Commission (SFC) the power to pursue Hong Kong-listed companies and their senior executives who fail to disclose price-sensitive information in a timely manner and fine them up to HK$8m (US$1.03m). However, the rules lack the teeth the

government originally sought in 2003, when it proposed to make non-disclosure a criminal offence that carried a jail term of 10 years and a fine of HK$10m. The new rules will come into effect in January 2013.

Reporting deadlines improved but fall short of regional best practice

Reporting deadlines have improved from two years ago, with companies now having to publish their audited annual results within three months. Though not quite up to regional best practice of 60 days, this is a big improvement on the four months previously allowed. And while rules are all well and good, it is how the market behaves that is far more important. In this regard, we note that some large caps, as well as a few SMEs, have started to publish audited annuals within 60 days.

Vested interests continue to hold back CG reforms

Despite all this good work, vested interests in Hong Kong's business sector continue to hold back sensible CG reforms. One of the recommendations for the new code of corporate governance was an RBP suggesting companies conduct regular board and individual director evaluations. According to the exchange, many 'respondents opposed' the proposal because most Hong Kong companies were 'not ready for board evaluation' and would only support it if the Exchange omitted the individual directors' evaluations. Guess what happened?

Reforms stalled due to vociferous opposition

Other reforms that have stalled because of vociferous opposition include quarterly reporting, an issue on which debate no longer seems possible in Hong Kong (although, ironically, some major companies are starting to do a version of it), and revisions to rules on general mandates governing private placements.

Enforcement

Enforcement a bright spot in Hong Kong

Enforcement was one of the bright spots for Hong Kong in our survey, with the score rising five percentage points to 68%. This was mainly due to the SFC, which continued to pursue cases that many felt were out of reach. Unfortunately the exchange, as we noted in 2010, continued to be a lacklustre frontline regulator.

SFC pursues Hontex to give back IPO proceeds back to its shareholders

The case that made everyone sit up and take notice was the SFC's pursuit of Hontex, a mainland sportswear-fabric maker. Hontex had its IPO in December 2009, after which the SFC obtained orders in March 2010 to freeze its assets as well as the assets of four of its subsidiaries. It then directed the exchange to suspend trading of the company's shares and began seeking an order to distribute the funds from the IPO to investors who had subscribed for the company's shares and those who bought shares after the IPO.

Hontex accused of contravening provisions in the SFO

The SFC charged that Hontex had contravened a number of provisions in the Securities and Futures Ordinance, including disclosing materially false or misleading information in its IPO prospectus that probably induced investors to buy shares of the company. In June 2012, the Court of First Instance ordered it to buy back shares from its shareholders and thereby return their money. This was a first for the regulator since Hontex is not incorporated in Hong Kong, none of its directors live there and its business is not based in the territory.

SFC revokes sponsor licence for failing to discharge its duties

The regulator also revoked the licence of Mega Capital (Asia), the sole sponsor of Hontex, to advise on corporate finance and fined it HK$42m (US$5.4m) for failing to 'discharge its sponsor's duties' with regard to the listing of Hontex. It was the first time the regulator had revoked an IPO

sponsor's licence over due diligence failings and the fine was the highest it had imposed on a sponsor to date. While criticising the SFC for 'going too far' is a minor sport in Hong Kong among commentators who reminisce about the free-wheeling days of the 1980s and 1990s, its doggedness has been appreciated by investors, the media and others.

Government and business caught with hands in the till

Indeed, Hong Kong's score for this section would have been higher were it not for the scandals involving high-profile government officials and business tycoons. In July 2012, in the biggest corruption case to hit the city, the ICAC charged Thomas and Raymond Kwok, co-chairmen of Sun Hung Kai, a large property developer, two other businessmen and Rafael Hui, former Chief Secretary for Administration, with corruption. The Kwok brothers were charged with giving bribes to Hui in exchange for information on land sales between 2005 and 2007.

Hong Kong deluged with government scandals

As noted earlier, while this was definitely the worst scandal, it was not the only one:

- In May 2012, three senior ICAC officers were found guilty of coaching a witness to give false evidence in a warrants fraud case.
- Candidates for the Hong Kong Chief Executive election were caught up in scandals: former Chief Secretary of Administration Henry Tang lied about an illegally built 2,250sf basement at his family home; while another candidate, Leung Chun-ying, came under attack as the Legislative Council passed a resolution to investigate a possible conflict of interest involving his property firm when he was a member of the jury in the West Kowloon Reclamation Concept Plan competition during 2001-02; and
- Finally, then Chief Executive Donald Tsang lowered the bar on personal integrity and conduct by accepting favours from local tycoons, including trips on luxury yachts and private jets, which led to him being investigated by the ICAC.

Political and regulatory environment

Despite ongoing issues, regulatory and political environment improves

Hong Kong also showed improvement in this category, gaining 4ppts to 71% in 2012, largely due to the efforts of financial regulators to modernise the rule book. While we know that the exchange and the SFC do not always see eye to eye and that the business community interferes in the design of rules and regulations, the past two years have nevertheless seen both regulators pushing through some positive reforms. The exchange did compromise on several proposals in the new CG code, but the final document is more robust than many of its counterparts in the region.

Recent developments could have far-reaching effects

Some other more recent developments:

- On 12 July 2012, the Legislative Council passed the Companies Bill, which had been tabled in January 2011 and which contains a number of measures that should help to improve CG broadly in Hong Kong over time (such as a clearer statement on director duties); and
- In late July 2012, the SFC concluded a consultation on enhancing the regulation of sponsors, the investment banks that play a gatekeeping role in bringing companies to IPO. The outcome of this consultation, which could be quite far-reaching in improving the quality of IPO due diligence, is not yet known.

Government lacks long-term view of CG reform

One area that has persistently kept Hong Kong's score down in this category is the government's ongoing lack of any overall strategy for promoting long-term CG improvements. Pronouncements that come out of the executive branch are often contradictory - do we want high standards in Hong Kong or flexible standards that attract business? - and reforms emanating from the SFC and the exchange are mostly driven from within those two organisations. If left to its own devices, one feels the government would be quite content with the status quo. We hope that the new administration under Chief Executive CY Leung comes up with some fresh ideas.

IGAAP (accounting and auditing)

Audit regulation and audit quality bring down the scores

Hong Kong's score fell in this section by a significant 5ppts to 75%, mainly as a result of issues relating to audit regulation and audit quality. The city is now home to the Financial Reporting Council (FRC), an independent statutory body that is responsible for investigating alleged auditing and financial reporting irregularities of Hong Kong-listed companies. It has:

- Widened its scope of review by introducing a new risk-based financial statements review programme, allowing it to perform comprehensive reviews of entire sets of financial statements selected from various categories in addition to reviewing issues identified in modified auditors' reports; and
- Maintained a watchlist of Hong Kong-listed mainland private enterprises that have reported irregularities 'for the purpose of continuous monitoring'.

FRC's powers limited

However, the FRC's powers are limited. It can only:

- Investigate relevant irregularities;
- Enquire into non-compliance;
- Prepare reports from the findings of their investigations and enquiries; and
- Refer those reports to a specified body for appropriate follow-up action.

HK still lacks an independent audit regulator

The core issue that we noted in CG Watch 2010 remains: Hong Kong does not yet have a fully functioning audit regulator that is genuinely independent of the audit industry. Disciplinary and sanctioning powers remain with the Hong Kong Institute of Certified Public Accountants, a self-regulatory body that represents the auditing industry. We consider the lack of progress in this area to be a serious failing in Hong Kong's overall CG regime.

Locally listed mainland companies involved in financial irregularities

We also marked down Hong Kong because a number of locally listed mainland companies have had their shares suspended because of financial irregularities. In some cases, their auditors have resigned. These include:

- In May 2012, Ports Design, a mainland high-end fashion group, announced that it had entered into a number of transactions from 2010 to May 2011 that 'should have been disclosed in the past as discloseable transactions and connected transactions', which caused the delayed release of its financial results for the year ending December 2011;
- In March 2012, Shenzhen-based Shirble Department Store had its shares suspended because its auditor needed more time to complete its work; and
- Boshiwa, a Shanghai-based children's apparel maker, and Daqing Dairy, a milk formula products maker, had their shares suspended on the exchange following the resignation of their auditor, Deloitte Touche Tohmatsu.

Auditor resignations may not always be bad

Auditor resignations do not in themselves reflect problems with audit quality. Indeed, they can indicate the opposite - that the auditor is trying to do its job properly, but is being impeded by its client (hence the decision to resign). On the other hand, companies with significant financial irregularities or that need to restate their accounts do raise doubts as to whether the audit was done adequately in the first place.

CG culture

CG culture score falls despite some positive developments

Another section that took a slight tumble was CG culture, which saw a fall of 1ppt to 53% in 2012. There were some positives, such as Li Ka-shing, chairman of Cheung Kong, recently announcing a well-crafted succession plan in advance of his retirement, and a group of institutional investors becoming more actively engaged in the regulatory consultation process. The investment industry is becoming more mature and skilled in its approach to corporate governance - certainly a change from five years ago when there were no dedicated CG staff working in Hong Kong-based funds.

Corruption scandals overshadow improvements

These improvements, however, have been vastly overshadowed by the corruption scandal at Sun Hung Kai, the various financial issues at Hong Kong-listed mainland companies and the findings by the securities regulator in 2011 that the work of sponsors fell far short of what is needed when a company chooses to list.

Factors to watch

Figure 71

Hong Kong: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- No revision in financial reporting (audited annual results) deadlines.
- No quarterly reports.
- No independent audit regulator.

Actions that could improve overall CG

Figure 72

Hong Kong: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- Publish audited annual results within 60 days.
- Have more meaningful interim reports.
- Improve non-financial reporting practices (stop using boilerplate language, provide some meaningful text!)

Source: ACGA

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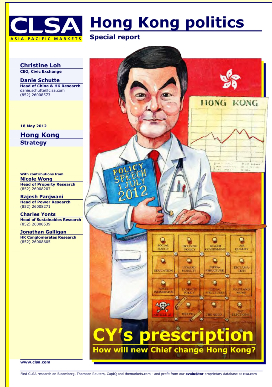

Research perspective - New leader

Just as in China, 2012 sees a leadership change in Hong Kong as well. Both transitions have been undermined by controversy that impacts corporate governance perceptions.

In Hong Kong, the election of the chief executive revealed a lack of leadership and integrity. The campaign of Henry Tang unravelled when it was revealed that there was a 2,250sf illegal basement that included a cellar in his property. Early during the campaign, CY Leung also came under scrutiny after charges of undisclosed conflicts of interest, but he has denied the allegations and the focus rapidly shifted to Tang's property woes. Ironically, it was revealed late in the election process that CY Leung had some questionable structures at his property on the Peak, but the revelations came late in the election process and did not derail his campaign. Meanwhile, outgoing Chief Executive Donald Tsang was smeared with scandals involving him being too cosy with many of the city's tycoons, while the bribery allegation against the Kwoks at SHKP involves payoffs to the city's then second-highest official.

Governance issues in corporate Hong Kong

Investors generally view family-controlled companies with suspicion. This may not always be well-founded; often the financial interest of the family in the business is aligned with long-term investors. But one reason for being concerned about family control is the potential fallout of squabbling among siblings. Unfortunately, that is what investors in SHKP have had to witness.

Squabbling Kwoks

Walter Kwok, the former chairman and elder son of the founder of the company, had been booted out by his two younger brothers who were also on the board. The official reason was that he was not focused on the business and they were concerned about his mental health. Unofficially, it was widely known that the brothers did not approve of his affair with a mistress who was given a position in the company. Upon his removal, the elder Kwok filed a complaint against his two younger siblings involving payoffs for favours from the government. The brothers have since been charged with bribing a high-ranking former government official.

Is it prevalent?

Without the fallout of the Kwok brothers, none of this would have been exposed. SHKP had been widely seen as one of the most conservatively run of the property groups in Hong Kong. The question this raises is how prevalent was the payoff to government officials by the oligarchy of companies that control Hong Kong's property market. Not encouraging is that the chairman of Chinese Estates has been charged separately for bribing a cabinet secretary in Macau to obtain rights to develop a choice site in the enclave. And Hong Kong's retiring Chief Executive Donald Tsang got sullied with accusations that he was offered free stay at properties in southern China from Hong Kong developers. It is hard to avoid the conclusion that the relationship between the government and the developers has been extremely cosy. That also raises questions about whether property companies in China are on the straight and narrow.

Beyond the territory but related to the large banks listed in Hong Kong, a CG issue involves risks in global finance and tighter regulatory oversight even on previous practices.

HSBC faces additional challenges given changes in regulations

For HSBC, fines regarding money-laundering problems in its Mexican operations and violations of US financial sanctions against selected countries (ie, Cuba, Iran) represents another layer of regulatory risk and burden which

has increased materially since the global financial crisis, most particularly in the UK and USA. HSBC has also been exposed to remediation claims on the mis-selling of insurance and interest-rate swap products in the UK and mortgage-related issues in its US operations. To a large extent, these regulatory issues reflect a change in the regulatory environment that the board and management of HSBC did not anticipate - but should have - as a contingent risk to a large global bank operating in highly regulated financial-services industries. At the same time, these represent legacy/historical issues dating back to the previous decade, not ongoing corporate governance failures. The significant increase in compliance burden, regulatory costs and increased vigilance at the board and management are testament to the accepted change in the environment and the response of the company to the "new normal" for banks in the West.

Standard Charter's reputation intact after disagreement with New York State Department

Standard Chartered's recent settlement with the New York State Department of Financial Services highlights two issues: that even a bank with a (previously) good reputation for managing regulatory and compliance requirements can fail in this regard; and the investor shock is much greater when the scale of potential fines and settlements is unexpectedly large - arguably as a result of poor disclosure to the market by the bank, but also due in part to the unpredictable regulatory environment. The regulatory issues that befouled StanChart in this instance related to bank transfers involving Iranian counterparties in the period up to 2008. In that respect, these issues are "legacy" and/or "historical" problems that stem largely from onerous US government requirements that have largely been enforced retrospectively via aggressive Federal and State investigations. Nevertheless, StanChart's board and management clearly did not manage this risk appropriately in the past decade and, like other large banks, it is playing catch-up with regard to effective management of regulatory/compliance issues to avoid regulatory losses in future.

We have marked down somewhat the CG scores for both banks mainly as these risks are not clear in the financial accounts, even if arguably for now they can't be. Below we look at other companies that got entangled in CG issues

Esprit

Management changes drags down share price

Esprit's CEO Ronald van der Vis and chairman Dr Hans-Joachim Körber resigned within 24 hours in mid-June 2012, citing personal reasons. The company, however, did not host a conference call until two days later, during which the stock fell by 32%. Upon the chairman's resignation, the board appointed Raymond Or, former vice chairman and CEO of Hang Seng Bank as the new chairman. These changes occurred only two months after new CFO Thomas Tang was appointed. Former CFO Chew Fook Aun resigned in December 2011.

On 7 August 2012, Esprit announced that it will appoint Jose Manuel Martinez Gutierrez, former group director of distribution and operations for Inditex, as CEO by the end of September this year.

Ports Design

Disagreement with auditors and late reporting erodes shareholder value

Trading was suspended on 28 March 2012. Ports Design announced that its auditor KPMG required additional time to 'perform and complete their audit procedures in respect of the company's annual results'. The company expected that it would be unable to publish its annual results by 31 March and might not be able to dispatch its annual report to shareholders by 30 April 2012.

Related-party transactions are risky when not well controlled

On 21 May 2012, the company released its annual results for 2011. Regarding the suspension of its stock, it explained that there were some presentation errors in the 2010 accounts, which were restated. These adjustments have had no impact on the income statement or total equity and related to omitted disclosures of certain transactions and balances involving Edward Tan, former chairman and CEO Alfred Chan's brother. He has since resigned. The company offset certain receivables and payables, which should not have been offset so the adjustment increases the accounts receivables and accounts payables.

The regulators have intensified attempts to erode insider dealings

Rongsheng Heavy Industries and Glorious Property

The chairman of the companies was accused of insider trading by the SEC in August 2012. Glorious Property also faces other issues: weak business execution and high concentration of short-term debt, which matures this year.

Perceptions of poor corporate governance is overstated

Companies that have seen CG improvement

Undeniably, there are multiple examples of poor CG impacting China and Hong Kong companies. These examples can easily lead to perceptions that corporate governance across the board is bad. In our view, this is not the case as many of the Chinese companies that have been implicated are governed by regulations in other countries such as the USA and Singapore where regulations are less stringent.

The regulators are incentivised to change negative corporate governance perceptions

The Hong Kong Exchanges' acquisition of the London Metal Exchange takes Hong Kong a step closer to the global stage. As this plays out in the background, the market can least afford a perception of deteriorating corporate governance in the city.

For Bank of East Asia, the scores come down because not all members of the audit committee have financial expertise, though its audit committee only comprises independent non-executive directors, but it still ranks first-tier among the Hong Kong corporations.

HSBC, StanChart, and Hang Seng Bank among top scorers regionally

Figure 73

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

Company	Code	Company	Code
ASM Pacific	522 HK	Magnificent	201 HK
Bank of China (HK)	2388 HK	Midland	1200 HK
BEA	23 HK	MTRC	66 HK
Cafe de Coral	341 HK	OOIL	316 HK
Cheung Kong	1 HK	Oriental Watch	398 HK
CLP	2 HK	Power Assets	6 HK
Emperor Watch	887 HK	Prada	1913 HK
Great Eagle	41 HK	Prince Frog	1259 HK
Haitian	1882 HK	Sands China	1928 HK
Hang Seng Bank	11 HK	SHKP	16 HK
Hongkong Land	HKL SP	Shun Tak	242 HK
HSBC	5 HK	Standard Chartered	2888 HK
Hysan	14 HK	Swire Pacific	19 HK
Kerry Properties	683 HK	Techtronic	669 HK
Kosmopolito	2266 HK	Trinity	891 HK
Lifestyle	1212 HK	VTech	303 HK
L'Occitane	973 HK	Wharf	4 HK
LotSynergy	8161 HK		

Source: CLSA Asia-Pacific Markets

Timely reporting and new IR department lifts Rexlot's ranking

Of the companies in our coverage with significant CG improvement, smaller-cap Rexlot stands out. It clearly has further room to improve its CG ranking, but its score this year has improved through more timely reporting of results, which was a problem of the past but now fixed by a mandatory requirement. Access to management has improved with the addition of a professional investor relations department.

The number of companies with real improvement in CG in our Hong Kong/China universe, however, has been overwhelmed by those with declines, a reflection on the state of play on corporate governance in the recent years.

Companies that have seen CG deterioration

Late reporting and composition of audit committee see CLP's ranking decline

Among those that saw declines in our CG scoring, CLP is a notable one. Its score moved down partly because of our tighter criterion requiring all members of the audit committee to have financial expertise. However, relatively slow reporting of the Yallourn accident despite the fact that the Australian subsidiary TruEnergy had issued a press release on this issue also contributed to the decline in CLP's CG ranking. Nevertheless, the company remains in our top quartile on CG for Hong Kong.

Li & Fung insiders' share dealings are in contrast to their advice to investors

Meanwhile, concerns about Li & Fung's disposal of shares by a director at a time when he was sharing bullish comments with the market, combined with the fact that the stock significantly underperformed following an earnings miss led to a decline in the ranking of the company.

Independence of chairman and an expensive acquisition weighs on HKEx's rating

We have lowered HK Exchanges' score materially, due to two key issues: independence, with the turnover of the chairman reminding us that this post at HK Exchanges is effectively an appointment of the HKSAR government, thus not truly independent; and the expensive acquisition of London Metal Exchange (LME) raises questions from a CG perspective. LME is the first major acquisition of the group, at a high price that will be dilutive to shareholder returns and in a form that did not require shareholder approval. The company has stated that the financing for this transaction is likely to involve the issue of equity, but at the most recent AGM the issuance threshold requiring a shareholder vote was lifted from 5% to 10% of outstanding shares, further reducing the ability of shareholders to check the authority of HK Exchanges' board and management.

SouthGobi failed to release results timely

Coal producer SouthGobi's lower ranking was mostly due to its slow financial reporting. The accounts are also not clear enough and the company has been slow in releasing market-sensitive information.

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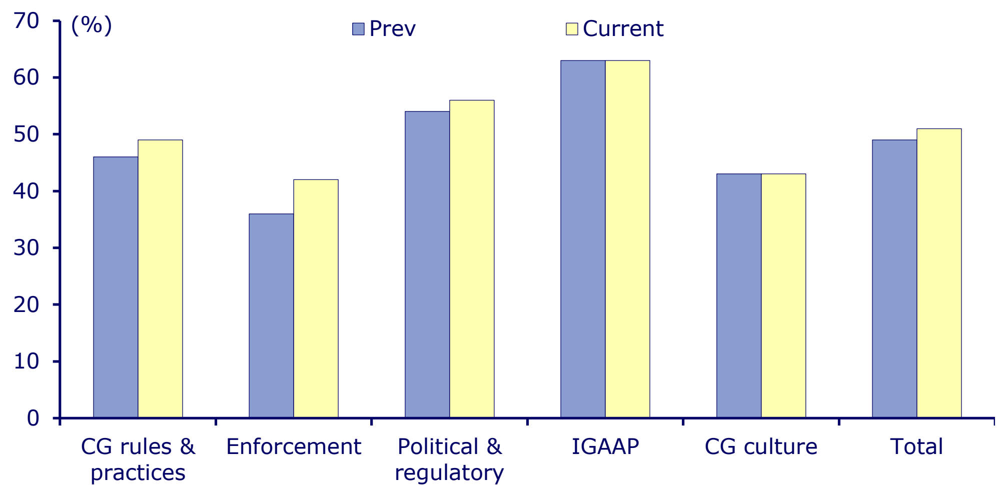
India - Edging forward

Corporate governance in India has moved forward a couple of steps since our 2010 survey, with the overall score up from 49% to 51%, but the ranking staying at seventh place. This is not due to a lack of awareness by the regulators, but rather a piecemeal approach to reform and a lame duck government unable to do anything meaningful given infighting among its allies.

Scores improved most in enforcement category

Figure 74

India CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

Failure to address core governance issues

Despite efforts made by the corporate sector and individual regulators to raise corporate governance standards, these mostly fail to address core governance issues such as accounting standards, the regulation of auditors and obstacles to voting for investors who are unable to attend company meetings. These were all issues raised in ACGA's *White Paper on Corporate Governance in India* in 2010.

Enforcement on the rise

What has been a pleasant surprise is a noticeable improvement in enforcement, due to increased efforts on both the regulatory and private-sector fronts. Two home-grown proxy advisor firms are starting to prompt institutional investors to take action on resolutions that undermine minority shareholder interests and, while still at a nascent stage, this is a far cry from a few years ago when domestic institutional investors largely voted with their feet.

High-profile government corruption scandals

Unfortunately, everything is overshadowed by the government and the embarrassment caused by high-profile corruption cases involving its members, leaving the ruling Congress Party vulnerable to the whims of the opposition party and even its own allies. Badly needed reforms, such as the Companies Bill 2011, continue to languish in Parliament, while the government has had to reverse course on decisions, due to a lack of support from its coalition allies. Its about-turn in late 2011 over whether to allow foreign multibrand retailers to own 51% of their Indian operations marked a new reputational low and reflected its limited political capital. Hardly surprising then that it has dared not to venture into controversial areas of corporate governance.

CG rules and practices

SEBI addresses issues raised in ACGA's white paper and CG Watch 2010

India's score moved up 3ppts in this category from 46% in 2010 to 49%. Despite a lacklustre performance overall, there are some bright spots worthy of mention. While policy reform has not been stellar, the Securities and Exchange Board of India (SEBI), the principal securities regulator, has taken note of some of the issues raised in CG Watch 2010 and ACGA's *White Paper on Corporate Governance in India* in 2010.

SEBI now requires audited annual results within 60 days

In CG Watch 2010, we marked India and most other markets down for not requiring companies to release audited annual results within 60 days, which is regional best practice at the country level. At the time, we noted that SEBI had issued a circular in April 2010 stating that the timeline to submit audited annual results would be reduced from 90 to 60 days for companies that did not publish unaudited fourth-quarter reports, but that the Listing Agreement (ie, listing rules) had yet to be amended. To its credit, SEBI took this policy a step further and changed the listing rules to require all listed companies to submit audited annual financial results within 60 days of their financial year-end. An assessment we undertook of 40 Indian companies showed that all met this new standard in 2012.

Progress in shareholder meetings and voting

India has also made progress in several areas relating to shareholder meetings and voting, a key area of concern for institutional investors. For example:

- In 2011, the Ministry of Corporate Affairs (MCA), which regulates the company law, issued a circular stating that shareholders could participate in general meetings electronically, including having their votes counted in this way. Having recognised the need for a secure electronic voting (e-voting) platform, MCA authorised the National Securities Depository and the Central Depository Services to develop them. The development of e-voting systems should indirectly help address the issue of voting by poll at annual shareholder meetings. (Note: E-voting refers to dedicated platforms that, at their best, deliver shareholder votes directly to companies, rather than through the complicated chain of agents and custodian banks, and allow shareholders to vote up to one day before meetings. This facilitates voting by poll, which refers to the counting of each vote cast, although it does not force companies to count the votes of shareholders attending the meeting in person as well as those voting by proxy beforehand.)

Top 500 companies to use e-voting for postal ballots

- SEBI then mandated the top 500 listed companies by market cap to use e-voting for all postal ballots issued on or after 1 October 2012. This followed an announcement by Pranab Mukherjee, then Finance Minister, in his budget speech of March 2012 that big companies would be required to set up e-voting facilities to provide 'opportunities for wider shareholder participation in important decisions of the companies'. (Clearly, the motivating factor here is more populist politics than a desire to please institutional investors who would like their votes counted.)
- SEBI has also mandated companies to report the voting results of their annual meetings from 2012 (as opposed to a general statement saying 'all resolutions were approved'). The regulator will not mandate companies to vote by poll until the Companies Act has been amended, but they acknowledge the importance of investor votes being counted.

Rule changes do not fully address core issues

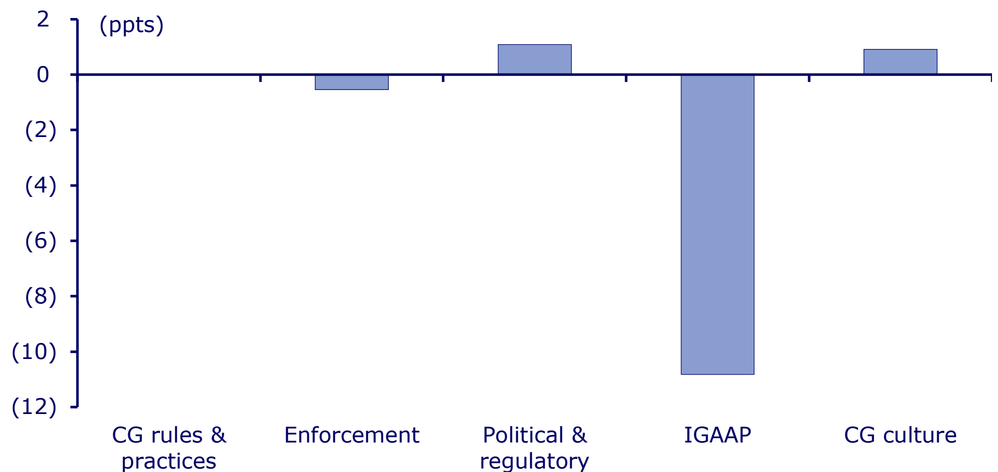
While these rule changes are positive, they do not fully address the lack of voting by poll at AGMs and EGMs in India - a practice well-established in Hong Kong, China and Thailand, and on the way to being resolved in Singapore and

Taiwan. Since the rules have yet to be implemented to any great extent, it is hard to know how well they will work in practice. And there is also confusion as to who will be able to use the new e-voting systems - the depositories claim that only retail investors can, but regulators argue that all investors will have access. Still, these changes mean that companies will find it harder in future to say they cannot count votes and so must pass meeting resolutions on a show of hands.

Below regional average on IGAAP and enforcement

Figure 75

India: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

SEBI fails to clear major roadblocks

Less positively, SEBI has failed to clear some other major roadblocks in Indian corporate governance. One relates to the format of quarterly reports, which lack cashflow statements and balance sheets, and could be improved in other ways (eg, more detail on revenue). At present, balance sheets are only provided every six months and even then come in a condensed form with no notes to accounts (in the half-year report), while cashflow statements are still missing from interim reports. One investor complained that few companies provided adequate P&L, cashflow and balance sheet disclosure on a quarterly basis - some large-cap companies provided incremental details such as balance sheet and consolidated results every quarter, but most did not. It is only if the company is listed abroad do the quarterly reports improve - and then depending on where the company is listed. However, not all investors agree that financial reporting in India is lacking (see our discussion on accounting and auditing below).

Inadequate continuous disclosure of price-sensitive information

Another weakness in India is the continuous disclosure of price-sensitive information, which is generally seen by investors as inadequate. Clause 36 of the Listing Agreement, which governs continuous disclosure, provides an "indicative list of events" that companies should follow in deciding whether an event is material. However, the list is not exhaustive and companies use their discretion when interpreting the regulation. One ACGA member complained that he often finds out critical information about companies via the media rather than through formal announcements to the stock exchanges. Auto and cement companies, for example, will release monthly production numbers to the press before sending it to the exchanges, while additional details behind these numbers would not be disclosed publicly but only on a selective basis to people with privileged access. However, our reading of Clause 36 suggests that if the regulator wanted to enforce it properly, there is enough in the regulation to sanction companies for non-compliance.

Governance of related-party transactions continues to be weak

In CG Watch 2010, we also highlighted India's weak regime governing related-party transactions. The rules require only board approval, offer a limited role to audit committees and mandate disclosure only in quarterly compliance reports and annual reports. We recommended that SEBI incorporate stronger checks into the listing rules, but instead it recommended an amendment to the company law to the Ministry of Corporate Affairs (MCA) in February 2011. While the content of the proposal was sound - that interested shareholders should not be allowed to vote on special resolutions approving related-party transactions - putting it in the company law guaranteed an inefficient outcome. Not only does the company law cover all types of incorporated firms (listed and unlisted), but amending this law has been tortuously difficult in India (as noted earlier).

Comprehensive review of Clause 49 needed

Meanwhile, India lags more advanced markets in Asia in its failure to undertake a comprehensive review of its code of corporate governance (or Clause 49 of the Listing Agreement), last comprehensively revised in 2004. Instead MCA formed a new Corporate Governance Committee in April 2012, chaired by Godrej Group chairman Adi Godrej. The aim is to produce a 'national corporate governance policy' providing a roadmap 'without impinging' on the 'internal autonomy' of companies. The policy document is to bring together 'the disparate elements in diverse guidelines, draw on innovative best practices adopted by specific companies, incorporate the current international trends, and anticipate emerging demands on corporate governance in enterprises in various classes and scales of operation'. Since the document has not been published as yet, we are unable to comment on it.

Enforcement

Enforcement is the standout area this year

Enforcement is the standout area in India's record on corporate governance over the past two years, with the score rising from a poor 35% in 2010 to a much-improved 42% this year.

Asset managers mandated to have voting policies and vote

One catalyst has been SEBI's new rule of September 2010 mandating fund managers to have a voting policy and to report how they voted at all meetings of portfolio companies. This led to two home-grown proxy advisory firms setting up shop and engaging institutional investors to actively vote against resolutions that are detrimental to minority shareholders. Early in 2012, for example, one of the firms, Institutional Investors Advisory Services, rallied investors to vote against a merger proposal by AkzoNobel India, a listed subsidiary of Akzo Nobel NV, the largest global paints and coatings company in the world. The company managed to eke out a victory, but not before 23% of institutional investors voted against the merger. While this case reflects the beginnings of private enforcement in India - which has been SEBI's goal all along - the two proxy firms say there is a long way to go before domestic institutional investors become more active in voting, especially voting against resolutions.

SEBI makes enforcement a priority

SEBI has also stepped up its efforts in enforcement, most notably by fining Reliance Infrastructure and Reliance Natural Resources Rs25 *crore* (1 *crore* = 10m) (US$4.5m) each in 2011 for breaching securities rules. It also fined a former independent director of Ranbaxy Laboratories, V K Kaul, and his wife Rs60 *lakh* (100,000) in early 2012 for insider trading of shares in Orchid Chemicals and Pharmaceuticals based on unpublished price-sensitive information. And it fined Manoj Gaur, chairman of Jaiprakash Associates (JAL), Jaypee Group's engineering and construction arm, and his relatives and three senior executives Rs70 *lakhs* for insider trading in the company's stock in 2008.

Market takes note of SEBI's efforts

SEBI admits that it does not have a good track record in insider-trading cases. However, the fact that it went after, and succeeded in fining, two fairly high-profile people has made the market take note (even though the fines themselves were paltry). The regulator continues to pursue the insider-trading case against Reliance Industries, alleging that the company engaged in this when reducing its stake in Reliance Petroleum in 2007. Reliance Industries has tried unsuccessfully to settle the case through a consent order, an out-of-court settlement where the defendant does not admit any guilt, but the regulator has so far refused the amounts offered by the company. Market observers believe that when SEBI eventually settles the case, it could be the largest settlement it has received to date.

Political and regulatory environment

Allies and opposition alike stymie lame duck government

The government finds itself between a rock and a hard place: reforms and bills that were expected to have passed are still stuck in Parliament as the administration clings to power, making compromises to satisfy allies. Yet, because regulators have managed to push some reforms through, the score in this section has increased slightly from 54% in 2010 to 56% this year.

Half-baked reform keeps score down

The score in this section could have been higher if reforms in India had not been so half-baked. For example, SEBI could have mandated listed companies to vote by poll at all meetings, but apparently would not do so because it did not want to step on MCA's toes. Meanwhile, in December 2011 MCA decided to amend the Companies Bill further and encroach on SEBI's turf, including introducing a definition of the concept of independent director (INED) for listed companies and the minimum number of INEDs on a board. The new version of the bill (still unpassed) even went so far as to provide a code for independent directors in a new schedule that is 'a guide to professional conduct for independent directors', as well as a proposal for a databank of INEDs to be maintained by a body/institute authorised by the government to facilitate the appointment of INEDs. This constant confusion in regulatory roles is detrimental to the healthy development of the capital market, in our view.

Judiciary steps in to provide stability

One surprisingly positive development has been in the judiciary, where the Supreme Court has stepped in and provided a measure of steadiness in response to government crises and ministerial corruption scandals. For example:

- The 2G telecom scandal where the Auditor General of India concluded that the Department of Telecommunications had effectively deprived the government of Rs176,645 *crore* (US$40bn) in revenue by issuing 122 2G spectrum licences in 2008 at 2001 prices. The Supreme Court, in December 2010, stated that it would monitor the investigation by the Central Bureau of Investigation (CBI) into the scam as the Bureau was taking too long with its inquiries. CBI arrested a former telecoms minister, A Raja, for allegedly manipulating procedures in allocating the 2G spectrum, along with other former telecom officials. In February 2012, the Court squashed all 122 licences and ordered them to be redistributed via an auction; and

Government appointment challenged

- In September 2010, a government committee recommended a civil servant with a criminal case pending against him, P J Thomas, for the post of Commissioner of the Central Vigilance Commission. The appointment was challenged in public-interest litigation by an NGO working with retired bureaucrats and police officials. The Supreme Court, in March 2011, ruled the appointment unconstitutional.

IGAAP (accounting and auditing)

India scores poorly again in this category, with its flat score of 63% indicating that we feel it has made no real progress.

India will not fully converge with IFRS

One major factor keeping the score down was the government's decision in February 2011 to issue 35 Indian Accounting Standards (Ind AS) intended to be in line with IFRS, but without setting any timeframe within which they would be adopted. In 2007, the Institute of Chartered Accountants of India announced that it would fully converge with IFRS for accounting periods commencing on or before 1 April 2011. However, when MCA announced the Ind AS, neither were they fully convergent with IFRS nor was there any announcement as to when companies would be adopting them. Now the rumour is that companies will have to adopt them by April 2013, but nothing official has been stated.

Some things will be lost with global convergence

While investors are looking for parity in financial statements across borders, there might be some things that will be lost in the global convergence. One investor stated that as reporting standards become aligned internationally, 'some of the disclosures will slowly cease going forward, even as others like geographical mix of revenue/Ebitda, etc, and one year liabilities are beginning to get disclosed'.

India continues to lag the rest of the region, with the exception of Hong Kong, in that it does not have an independent audit regulator, an issue that we had also raised two years ago.

CG culture

Marginal improvement does not shift scores

CG culture has also stayed the same this year, at 43%. While we note that there has been marginal improvement in areas such as institutional investors voting at meetings due to the SEBI initiative that we discussed earlier, and the e-voting platforms that SEBI has mandated need to be used for postal ballots, there is nothing much to crow about in this area.

Mutual funds fear voting against resolutions

As both proxy advisory firms noted, while asset companies have been forced to publish a voting policy and also report on how they voted at each meeting, most mutual funds fear voting against resolutions because of the close connections between listed corporations and asset managers: the former have large amounts invested with domestic funds, hence to vote against would result in companies cutting off access completely.

No leadership among companies on voting issues

There are a number of issues that keep the score flat in this section. We acknowledge that companies are quite open to meeting with investors and answering questions but shareholder meetings are still poorly run, especially in terms of how institutional investors' votes are counted at meetings, an issue that we raised two years ago in our white paper. And not one company has shown leadership in this arena by voluntarily choosing to vote by poll at their meetings. It is interesting that companies love to quote chapter and verse of the Companies Act as to why they cannot voluntarily vote by poll, since the act states: 'At any general meeting, a resolution put to the vote of the meeting shall, unless a poll is demanded under section 179, be decided on a show of hands'. But the moment a law becomes inconvenient for a company, it manages to find a loophole. Loophole to holding a vote by poll - the chairman can call for one on all the resolutions!

No credible organisation offering director training

Another area that continues to be problematic is qualified directors. In a country of 1.2 billion people, it is odd that companies seem to have a choice of maybe 25 people (and we could be miscounting here) who are qualified and respected enough to sit on a board. Yet there is no credible organisation providing training for new directors, nor much ongoing training for old hands (which is needed because director duties continue to grow). India could do so much better if it chose to, but it doesn't.

Factors to watch

Figure 76

India: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- ❑ No revision to Clause 49 of the Listing Agreement.
- ❑ No progress in revising related-party transactions.
- ❑ No improvement in how votes are counted at shareholder meetings.
- ❑ No progress in establishing an independent audit regulator.

Actions that could improve overall CG

Figure 77

India: Quick-fix list

Simple actions that government and companies could take to improve overall CG:

- ❑ Do a consultation on Clause 49 and amend it to meet international standards.
- ❑ SEBI provides well-organised data on enforcement (take a look at Malaysia's SC enforcement data), while keeping the detailed data.
- ❑ Vote by poll at meetings, the e-voting platform has already been approved, SEBI has mandated its use, so use them at meetings!
- ❑ Set up a director training programme, if you need help, ask Bank Negara about its FIDE programme.

Source: ACGA

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Research perspective - Gradual progress

Work in progress

India continues to make incremental progress on CG issues and standards. A majority of the corporations take these problems far more seriously now than five years ago. The solid CG image of Indian companies was damaged in 2009 when Satyam Computer Services blew up due to alleged scam by its promoter. Since then, greater scrutiny and no other major blowups of perceived reputed firms gave some reassurance that Satyam was an aberration.

Politician-corporate nexus has roiled markets in the last two years

Recent scandals involving the nexus between politicians and business houses, primarily in the telecom and mining sectors have dented India's overall image as an investment destination and a transparent place to do business in. Top-down progress in regulations is gradual, primarily where laws need to be passed in the parliament. However, institutions like the Competition Commission of India (CCI), the Comptroller & Auditor General (CAG) and regulator SEBI are making progress in their efforts to bring probity and transparency into public and corporate life. On ESG issues, we see greater sensitivity among private companies as well as the government.

Main CG issues over the past two years

Governance is improving . . .

Progressively over the past few years, there is an improvement in governance within the Indian private sector and also an acknowledgement of the need for better CG and a more open discussion. In 2009, the Satyam scandal rocked the markets, shocked investors and damaged the image of corporate India. Since then, there has been no case of any large fraud in any major company. The scale of fraud of Satyam was an aberration. While there have been a few corporate blowouts, none was as high-profile as Satyam, most were related to poor business models and/or highly leveraged balance sheets, rather than corporate fraud and defalcation of funds.

Alleged scams and scandals have damaged Brand India

In this intervening period, the biggest blow to Brand India has come from the various alleged scams and scandals involving politicians and firms, with the most notable being the Niira Radia tapes and then a 2G scam. The Niira Radia tapes were taped phone conversations between public-relations professional and founder of PR firm Vaishnavi Communications and various journalists, politicians and corporate leaders, which indicated attempts to influence government policies and decision-making, including appointments of key ministers to further interests of select corporations or industrial houses.

The 2G scam embroiled many corporations in real estate, telecom sectors

Then came the 2G spectrum-allocation scam, which broke out in the public domain in late 2010. While everyone knew that corruption is widely prevalent in India and the country has ranked fairly low in the annual rankings of Transparency International, the alleged scam brought the nexus between corporate India and politicians out in the open. Given the high-profile personalities involved and the grave nature of the allegations, India's image within the global community suffered serious reputational damage.

Other major alleged scams were in the mining sector

Two other alleged scams came from the iron-ore and coal-mining industries. The Supreme Court banned iron-ore mining in the Bellary-Hospet and Tumkur-Chitradurga areas of Karnataka in mid-2011, citing rampant violation of environment norms by miners in the state and also illegal exports or purchases by companies that resulted in loss to the exchequer. The Central Empowered Committee (CEC), a Supreme Court appointed committee, found that the iron miners in the state, mostly unlisted private companies, have benefitted from mining beyond permissible limits, illegally mining in forest areas and exporting ore without valid permits.

Iron-ore mining in Karnataka was banned

CEC classified the iron-ore mines in the state into three categories: mines with no violations; mines with minor violations; and mines with major violations. Sesa Goa's sites in Karnataka fall into the second category. As per industry data and media reports, the first two categories accounted for about 15-20m tonnes of iron output each of Karnataka's total production of 40-50m tonnes before the ban came into effect. JSW Steel and other smaller steel producers in the region have been adversely impacted due to shortage of iron ore and have been operating at low utilisation.

Coal-mining scam, although exaggerated, highlights the non-transparent nature of mine allocations

A draft report by the CAG alleged that the government extended undue benefit totalling US$214bn to various coal miners by allocating 155 coal blocks without auction over 2004-09. The report listed about 100 private several public-sector companies in industries such as power, steel and cement as beneficiaries from the coal-block allocation of the government.

The fallout is likely to lead to greater degree of transparency

As per the report, major beneficiaries included JSPL, Adani, Lanco, Tata entities, Aditya Birla, Essar group's power ventures, Vedanta, NTPC, MMTC, Electro Steel Castings and Bhushan Steel & Power. The report highlighted that the government had started the process to introduce competitive bidding for coal-block allocation as early as 2004, but the process had seen significant delays and was yet to materialise. We believe the fallout will lead to greater transparency, especially in government allocation of scarce resources.

For the first time, high-profile politicians and corporate leaders went behind bars

Noteworthy is that many high-profile people went behind bars during the course of the investigation. This is a first, in a country where the legal process is frustratingly slow and takes an inordinate amount of time and often the rich and famous, particularly the politicians, are believed to be able to influence the process. Judicial action and media exposes highlight the independence of the press and the court as well as the role of different NGOs as the conscience keepers. Under Chief Justice S H Kapadia, the judiciary is also focused on speeding up trials in a judicial system that's known for its slow process.

The market regulator has also been doing its bit

In a landmark case, SEBI passed a consent order to settle a probe into alleged violation of regulation for foreign investment and unfair trade practices by Reliance Infra and Reliance Natural Resources (RNRL). The terms of the order included a payment of Rs500m by the directors of the companies involved. In another case involving an employee of HDFC Mutual Fund, a dealer investigated for insider trading and front running was banned from the securities market and association with any SEBI-regulated entity.

Half-yearly disclosure of balance sheets is mandatory

In 2010, SEBI made it mandatory for companies to disclose their balance sheets half yearly along with their results. Subsequently in May 2012, SEBI set a new framework under which it shut the window for settling serious market offences through consent. Overall, SEBI's objective is to align India's corporate governance norms with global standards.

New Companies Bill is a major step forward

Other steps in the pipeline are the new Companies Bill that will limit the term of an independent director, requiring companies to rotate auditors every four years and appoint at least one woman director. Reflecting the growing importance of corporate governance issues in the country, two investment advisory firms have started operations in this area. One of them, India Investment Advisory Services (IIAS), has reputed names like Bombay Stock Exchange, ICICI Bank and HDFC as investors.

Figure 78

Politicians, bureaucrats and corporate executives under investigation in major scams

Name	Position	Organisation	Case	Arrest	Grant of bail	Days in jail
Politicians/bureaucrats						
A Raja	Telecom minister	GoI	2G spectrum	2 Feb 11	15 May 12	468
Siddharth Behura	Telecom secretary	GoI	2G spectrum	2 Feb 11	16 Dec 11	317
R K Chandolia	Telecom secretary	GoI	2G spectrum	3 Feb 11	1 Dec 11	301
Kanimozhi	Member of parliament	MP, DMK	2G spectrum	20 May 11	28 Nov 11	192
Yeddyuappa	Karnataka CM	MP, BJP	Karnataka mining	15 Oct 11	8 Nov 11	24
G Janardhana Reddy	Tourism minister	Karnataka govt	Karnataka mining	5 Sep 11	Judicial custody extended to 7 Sep 12	368[1]
G Somashekara Reddy	Brother of Janardhana	MLA, BJP	Bribe to bail out Janardhana	7 Aug 12	In judicial custody	5[1]
Corporate executives						
Shahid Usman Balwa	Promoter	DB Realty, Swan Telecom	2G spectrum	8 Feb 11	29 Nov 11	294
Asif Balwa	Director	Kusegaon Fruits & Vegetables	2G spectrum	29 Mar 11	28 Nov 11	244
Rajeev Agarwal	Director	Kusegaon Fruits & Vegetables	2G spectrum	29 Mar 11	28 Nov 11	244
Vinod Goenka	Promoter, MD	DB Realty, Swan Telecom	2G spectrum	20 Apr 11	23 Nov 11	217
Sanjay Chandra	Owner, MD	United Wireless	2G spectrum	20 Apr 11	23 Nov 11	217
Gautam Doshi	Group MD	ADAG group (RCOM)	2G spectrum	20 Apr 11	23 Nov 11	217
Surendra Pipara	Senior VP	ADAG group (RCOM)	2G spectrum	20 Apr 11	23 Nov 11	217
Hari Nair	Senior VP	ADAG group (RCOM)	2G spectrum	20 Apr 11	23 Nov 11	217
Sharath Kumar	MD	Kalaignar TV	2G spectrum	20 May 11	28 Nov 11	192
Karim Morani	Promoter, director	Cineyug Films	2G spectrum	30 May 11	28 Nov 11	182
Srinavasa Reddy	MD	Obulapuram Mining	Karnataka mining	5 Sep 11	Judicial custody extended to 7 Sep 12	368[1]

[1] Still behind bars. Source: Media articles, CLSA Asia-Pacific Markets

A step back . . .

. . . but in line with global norms

The Ministry of Corporate affairs, however, disappointed some in granting blanket exemption to companies from disclosing quantitative operational data. Press Note 2/2011 dated 8 February 2011 issued by the Ministry of Corporate Affairs says: 'These requirements date back to the era when there was industrial licensing, etc, and there was a regulatory purpose in monitoring quantitative aspects of production, etc. Their relevance in the present economic and regulatory environment has been reassessed. Such disclosures are not required in other countries. Indian companies have represented that such disclosure puts Indian companies at a competitive disadvantage where their details are known to foreign competitors, but they cannot get the details from the other side.' In fairness, this is in line with international norms where quantitative details with such granularity are not disclosed.

Competition Commission of India is also getting active

The Competition Commission of India (CCI) was constituted in March 2009 and has been active over the past few months. CCI, under the Ministry of Company Affairs, administers the Companies Act 1956 and other legislation related to the corporate sector. It will act against cartelisation, abuse of dominance, bid rigging, etc, thereby promoting a healthy business environment.

CCI has imposed penalties on real-estate and cement sectors for anticompetitive activities

In June 2012, CCI imposed penalty (equivalent to half of company profit for FY10 and FY11) on 11 cement companies including ACC, Ultratech and Jaypee Cement for price cartelisation. Similarly, CCI's order against DLF in August 2011 alleges that the company abused its dominant position in its Gurgaon market to enter into one-sided agreements with buyers and fined the

company Rs6.3bn, or 7% of its average turnover over the previous three years. The agency's role is not restricted to only the private sector. CCI entertains and investigates cases against public-sector undertakings (PSUs) and government departments as well. The cases that the CCI has admitted and investigated include ones against Sail, Coal India and IOC, among others.

CAG has emerged as a watchdog of public resources

The CAG is the official auditor of all the receipts and expenditure of the federal government as well as states. It is also the external auditor of government-owned companies, as well as the statutory auditor. Its reports are taken into consideration by committees in parliament and state legislatures. CAG has assumed a larger mandate beyond book keeping and compliance processes of the public sector over the past couple of years. The office is gradually evolving into a watchdog for public resources.

CAG has released performance audits in recent times relating to allocation of 2G spectrum and controversial allocation of coal mines. The auditor has accused India's largest private-sector company, Reliance Industries, of violating terms of the production-sharing contract (PSC) with the government and is seeking to access the company's KG-D6 accounts. CAG holds an important constitutional position. Its head cannot be removed from office other than through a procedure of impeachment in parliament, similar to what is applicable to Supreme Court judges.

Companies that have seen CG improvement

Companies being rated in this survey up 72%

Overall, we have rated 112 companies this year against 65 in 2010, up 72%. Of the companies that were rated in 2010, seven show an increase of 10ppts or more in scores. The specific reasons for the improvement are highlighted in the table below. As is evident, no restructurings in the past five years helped Bajaj Auto's score, no equity issuance in this period has helped Sail and no accounting issues in the past few years have improved M&M's scores.

Seven firms have seen their scores improve by more than 10ppts

Better management access has helped improve the score of Tata Steel. TCS enjoys higher scores due to no restructurings in the past five years (in 2006 there were issues with the merger of Tata Infotech). Earlier there had been issues about the controlling shareholder selling shares while guiding the market positively, but this has not been the case in the past five years. HCL Tech's score improved as it has raised the number of independent directors; it also scores well in the new questions introduced in this year's ranking on diversity of board composition, independent directors and non-voting shares. PNB's CG score has risen through a higher number of independent directors.

Increasing number of independent directors has helped improve HCL Tech and PNB's scores

Figure 79

Companies that have seen CG improvement

Company	Code	Comment
Bajaj Auto	BJAUT IS	No restructuring as in 2010.
HCL Tech	HCLT IB	No restructuring as in 2010.
M&M	MM IB	No negative score on accounting issues as in 2010.
PNB	PNB IB	Increase in independent directors; positive scores in new questions.
Sail	SAIL IS	No equity dilution where co had scored negative in 2010.
Tata Consultancy	TCS IB	Negative scores in 2010 on restructuring and sale of shares by controlling shareholder.
Tata Steel	TATA IB	Positive score on better access to management.

Source: CLSA Asia-Pacific Markets

Better response to C&G this time than 2010

On C&G issues, we see an increased sensitivity among Indian companies and greater discussion in annual reports on sustainability and environmental issues. The response to our C&G questionnaire was also encouraging with 102 companies' C&G scores being included as part of the present rating exercise, even if the quality of responses could improve.

Large industrial groups are more focused on C&G issues now

We believe companies are yet to find significant interest or questions from investors and/or analysts on ESG issues, which impact the quality of response. Much of their reporting and disclosure are geared towards those of regulatory authorities and statutory requirements. However, large industrial groups like Tata, Reliance, Vedanta and ITC are taking the lead to bring out detailed annual sustainability report cards. Companies are also seeing increasing ESG analyst visits. With environmental issues becoming important globally, we expect an improvement in disclosure in the years to come. Annual reports in India also carry data on specific energy and water consumption as well as efforts taken towards conservation.

Titan Industries and Yes Bank among the highest scorers in the region

Figure 80

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

Company	Code	Company	Code
ACC	ACC IB	Infosys	INFO IB
Ambuja Cements	ACEM IB	ITC	ITC IB
Apollo Tyres	APTY IB	Jubilant Food	JUBI IN
Axis Bank	AXSB IB	Larsen & Toubro	LT IB
Bajaj Auto	BJAUT IS	M&M	MM IB
Bank of Baroda	BOB IB	Marico	MRCO IB
Bank of India	BOI IB	Max India	MAX IB
Bharat Forge	BHFC IB	NTPC	NTPC IS
Bharti Airtel	BHARTI IS	Oberoi Realty	OBER IN
BHEL	BHEL IB	ONGC	ONGC IB
Bhushan Steel	BHUS IB	Page Industries	PAG IN
Colgate India	CLGT IB	PNB	PNB IB
Corporation Bank	CRPBK IB	Power Finance	POWF IB
Dabur	DABUR IS	Shoppers Stop	SHOP IB
Dr Reddy's	DRRD IB	Sobha	SOBHA IS
eClerx	ECLX IB	Sun Pharma	SUNP IB
Gail	GAIL IB	Tata Consultancy	TCS IB
Godrej Consumer	GCPL IB	Tata Power	TPWR IB
Grasim	GRASIM IB	Tata Steel	TATA IB
GSK India	GLXO IB	Thermax	TMX IB
Havells India	HAVL IB	Titan Industries	TTAN IB
HCL Tech	HCLT IB	TTK Prestige	TTKPT IN
HDFC	HDFC IB	UltraTech	UTCEM IS
HDFC Bank	HDFCB IB	Union Bank	UNBK IB
HUL	HUVR IB	Voltas	VOLT IB
ICICI Bank	ICICIBC IB	Wipro	WPRO IB
IDFC	IDFC IB	Yes Bank	YES IB
IndusInd Bank	IIB IS	Zee Entertainment	Z IB

Source: CLSA Asia-Pacific Markets

MOEF has come into the limelight thanks to its strong stand

Regulators, particularly the Ministry of Environment & Forests (MOEF), have been stringent in granting approvals and scrutinising projects. Many high-profile projects like that of Posco and Vedanta group have not been able to progress because of permissions not granted on environmental grounds. Similarly the Supreme Court has been active on environmental issues. Active intervention of the courts and MOEF means that corporations are increasingly mindful of ESG issues.

Investors rising - Exercise your vote

Amit Tandon is the Founder & Managing Director of Institutional Investor Advisory Services India Limited (IiAS), a proxy advisory firm dedicated to providing participants in the Indian market with voting recommendations on shareholder resolutions. IiAS offers independent opinion, research and data on CG issues. Prior to setting up IiAS, Tandon set up Fitch Ratings business in India and was its CEO.

Investor activism in India has been practically non-existent. Thus, the news of TCI threatening action against the management of Coal India has made big headlines and forced everyone to take notice. Prior to this there have been run-ups of Templeton with Sterlite and Sun Pharma management. Meanwhile, India has seen a series of initiatives to guide corporate behaviour since the economy opened up. It was the first Asian economy to put forward a comprehensive code of corporate governance in 1995 when the Confederation of Indian Industry (CII) appointed a task force to draw up a voluntary CG code. This was followed by a series of committees over the years. A new Companies Bill has been in the making for close to a decade, so companies should expect another string of checks and balances to be legislated soon.

Although regulators continue to nudge corporations, investors have been more sanguine in their dialogue with companies. In part this is because investors believe there is a more durable alignment of interests between them and the management of companies they invest in. Unlike in the West, where company management is usually divorced from its ownership, 74% of the BSE500 firms are owner-managed. Consequently, any engagement is seen as between two sets of shareholders - with shared interests. In instances where investors have disagreed with management strategy or have concerns regarding governance, they have preferred to exit companies rather than to stay invested and engage with the owners. And many others will avoid buying shares in companies whose managements they do not trust thus not engaging at all.

This is changing as regulators have now prodded investors. In March 2010, SEBI asked mutual funds to publish their voting policy and disclose how they voted on shareholder resolutions in firms whose shares they owned. Although mutual funds have more often recorded that they abstained from voting than voted, slowly but surely they have started to engage with company managements.

Last October, Akzo Nobel India, which decided to merge three unlisted “group companies” with itself, found that not all institutional investors were convinced about the valuation at which these unlisted companies were being merged. The investors then chose to broaden the list of issues being discussed to include the increase in royalty payments that the parent decided to take. (Increase in royalty does not require shareholder approval; Akzo India decided to increase royalty paid to its parent). 23% of the shareholders chose to oppose the merger in a court convened meeting. They created enough clatter to get the company to offer a buyback to aggrieved holders - sending a message that if the merger proposal has caused shareholder value to be destroyed the buyback will let aggrieved investors recoup their loss. Akzo India also announced a partial roll-back of the increase in royalty.

While not all instances have been as successful, investors can take heart in the direction of the move. In the recent Vedanta restructuring, where a complex group holding structure was being simplified, shareholders in Sesa Goa, one of the companies affected, overwhelmingly voted against the merger. Even as the restructuring was approved by the courts, one significant development is that a majority of the minority shareholders voted against the merger.

These skirmishes have taken place behind closed doors, unlike the public battle TCI is fighting with Coal India; each meeting between the investor and the company or the Indian government was followed by a media release and threats of legal action. In contrast, the foreign-currency-convertible-bond holders in Zenith Infotech and KSL and Industries have gone legal, with early signs of success.

The issues are important especially when it comes to the small and mid-cap companies since they are often not well covered and are likely to be less transparent. Issues that investors should be aware of include the preponderance of family members and associates on the management team, salaries paid to family members, lack of or ineffective independent directors, preferential issue of warrants, promoters charging fees for brands, shared services or office premises and family interest in similar or related businesses.

The media, too, is starting to build pressure, highlighting instances where controlling shareholders are taking payments (Nowrosjee Wadia & Sons from Britannia, Bombay Dyeing, National Peroxide and Go Air), amending its articles to give one set of shareholders affirmative rights (Manappuram Finance), or compensation that promoter CEOs are paying themselves (Sun TV, Apollo Hospital). Equity research highlighting corporate governance and accounting malfeasance is helping analysts stand out in this market and putting more pressure on companies and investors. This trend is likely to increase.

Clearly no one size will fit all: there are times when it is better for investors to engage, times for them to exit, times to go legal. There is, however, one data point that gives a clear message - the difference in the share price between voting and non-voting shares. Tata Motors is one of the few companies listed on the Indian exchanges that trade both voting shares and shares with differential voting rights (DVR). Since its listing, the DVR shares have mostly traded at a discount to the ordinary share (with this discount being as much as Rs500 per share). Embedded in this is a message to investors: your vote has a value, exercise it.

Figure 81

Projects stalled due to environment issues

Project	Comments
Hindalco Captive power plant - linked to Mahan coal mine	Mahan coal block was denied clearance multiple times by the earlier minister. The coal block was finally cleared by the Empowered Group of Ministers (EGOM) given that the project is close to commissioning. The block now needs Forest approval (stage 2).
Essar Mahan power project - linked to Mahan coal mine	Mahan coal block was denied clearance multiple times by the earlier minister. The coal block was finally cleared by EGOM given that the project is close to commissioning.
Adani Tiroda project - linked to Lohara mines	Lohara mines were overlapping the buffer zone of the tiger reserve and thus MOEF denied the clearance for the project. Adani is trying to get a clearance for the coal block with reduced boundaries which do not violate the buffer zone. No decision has been taken on this yet.
Reliance Sasan UMPP - linked to Chattrasal coal block	Chattrasal coal block was part of the erstwhile "no go" area for coal mining. The clearance has been granted by EGOM for the mine given the project progress.
JSPL Tamnar II project	Developer started work on the project without getting the forest clearance for the whole project. The work was stopped after MOEF order and project work started only after the final clearance came through.
JSPL - Gare Palma coal block clearance	National Green Tribunal cancelled the clearance given to the coal block stating that public hearing procedure was not followed.
Vedanta bauxite mining project in Orissa	Forest Advisory Committee (FAC) submitted the report to the Environment Ministry after reviewing the suggestions given by the NC Saxena panel seeking ban on the mining project in Orissa's Niyamgiri Hills in view of various violations at the site. The Saxena report has citied many violations of the in-principle environment clearance given to Orissa Mining Corporation in 2008 including non-compliance with the provisions of the Forest Rights Act. The environment clearance was eventually cancelled and the forest clearance was not granted either.
Posco' steel plant in Jagatsinghpur, Orissa	The environment clearance granted on 31 January 2011 was suspended by National Green Tribunal in March 2012 as the environment impact assessment (EIA) report has been prepared only for 4mtpa steel production in the first phase and not the entire 12mtpa for which environment clearance was granted.

Source: Company, media reports, CLSA Asia-Pacific Markets

Companies that have seen CG deterioration

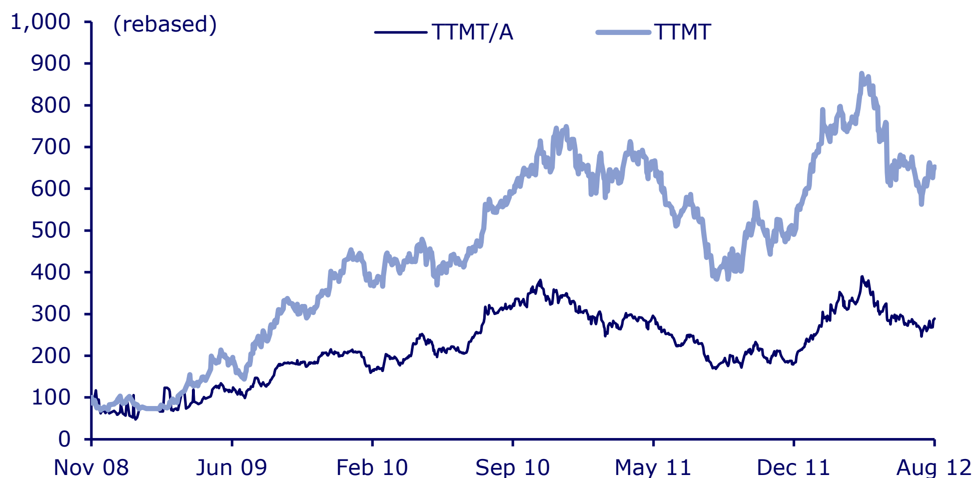
No surprises in companies that have seen their scores decline

Of the companies rated in the present exercise, eight have seen their scores down more than 10ppts. The largest score declines in our coverage universe are for Suzlon, Crompton Greaves, Cadila, United Spirits, Indian Oil, JSW Energy, Hindalco and HPCL. There have been issues around these companies related to diversification, disclosures, gearing, accounting policies and investments in unrelated assets, which have brought down their scores. Cadila's score declined due to no response to the C&G questionnaire, while Hindalco's deteriorated due to changes in its accounting policies. Indian Oil and HPCL's declines were due to no increase in the number of independent directors in the past three years and directors pay has risen faster than profit, which have seen the impact of huge underrecoveries from the sale of petroleum products.

Voting rights has its value

Figure 82

Tata Motors' share-price performance - A shares versus ordinary stock



Source: CLSA Asia-Pacific Markets

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Indonesia - That sinking feeling

Indonesia sank back to the foot of Asia's corporate governance rankings after a brief flirtation with improvement under the first administration of President Susilo Bambang Yudhoyono (SBY) (see CG Watch 2010). The country's overall score fell 3ppts from 40% in 2010 to 37% this year - back to its score in 2007, which neatly sums up the current state of Indonesian CG.

Politics is hampering governance reform

When we summarised the Indonesian result in 2010, we wrote, 'Improving, but weak political system'. Those words proved prescient as SBY's second administration turned out to be a pale imitation of his first. Increased politicisation of domestic business has stalled meaningful governance reform, while recent moves to claw back foreign-ownership limits in the country's natural resources sector suggest a creeping programme of renationalisation.

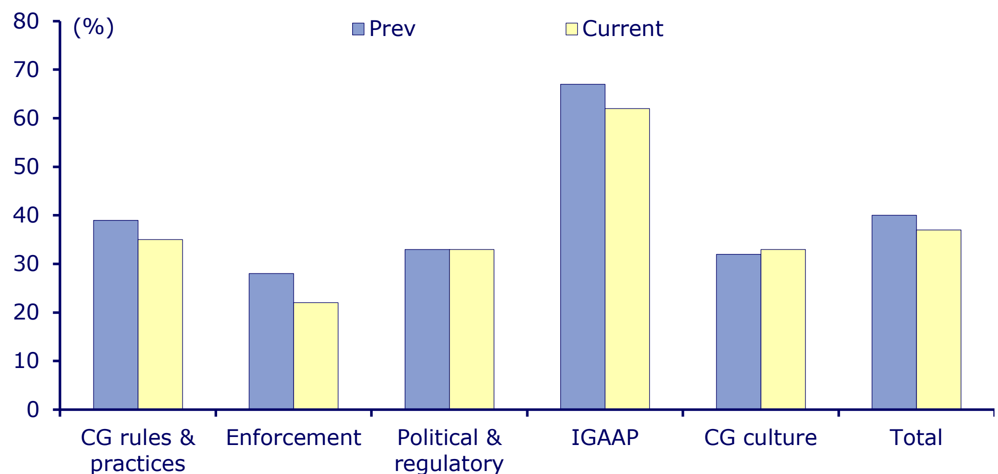
Inadequate anti-market manipulation measures

Amid such politicking, it is perhaps unsurprising that CG reforms have stalled. There has been no revision of the country's main code of good corporate governance since 2006, rules to prevent insider trading and market manipulation are inadequate and enforcement of securities regulations is so woeful as to render the discussion almost academic.

Scores have slipped back

Figure 83

Indonesia CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

New super regulator offers a ray of hope

These are just a few of the more serious corporate governance failings Indonesia needs to address if it wants to improve standards of transparency and disclosure among its listed companies. One cause for hope is the new super financial regulator, the Financial Services Authority, known locally as Otoritas Jasa Keuangan (OJK), which is scheduled to open for business on January 1, 2013. The OJK will assume all of the responsibilities of the current securities regulator, Bapepam-LK (Bapepam), as well as some from Bank Indonesia, the central bank, from 2014. Crucially, it will be officially independent of government. If it is able to demonstrate true independence from government and can manage its own budget, this will mark the start of much-improved oversight of the securities markets in Indonesia.

CG rules and practices

The rules are there but the practice isn't

Indonesia's score in our 2012 survey for its CG rules and practices fell by 4ppts from 39% in 2010 to just 35%. While we believe that a major overhaul of the governance framework in Indonesia is long overdue, the overall

weakness of this section is due as much to the implementation of existing rules by market participants (ie, "practices") as by the rules themselves. Indonesia's basic rules on financial reporting are largely in line with international standards, its Ccode of Good Corporate Governance requires reasonably detailed CG statements and, somewhat surprisingly, the country has the toughest protection of minority shareholder pre-emption rights (ie, the right to buy new shares) in the region.

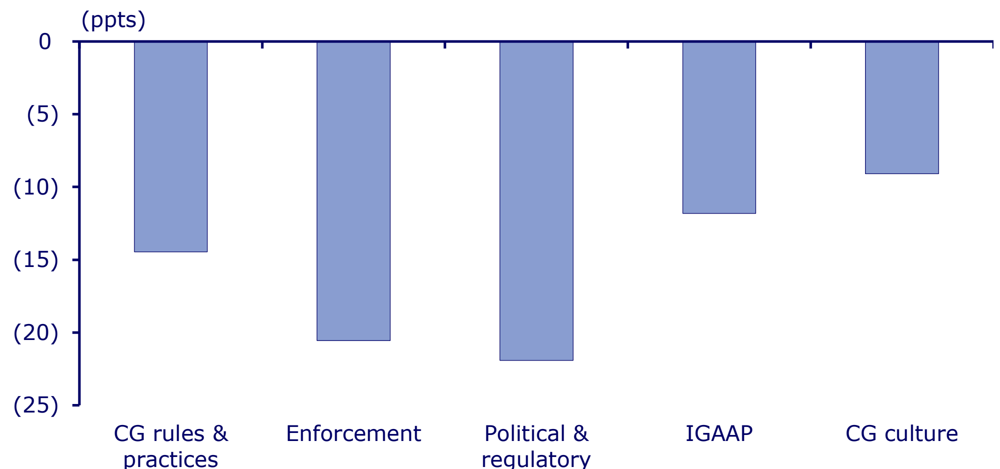
Weak disclosure rules mean opaque ownership

But the good work is undermined by problems in areas such as ownership disclosure, insider dealing and market manipulation. For example, while Indonesia requires disclosure of substantial ownership positions of 5%, the market consensus is that it is often impossible to find out who really owns and controls companies - information typically shows only the legal owner of the company, not the beneficial owner and disclosure of acting-in-concert situations is limited.

Enforcement and politics are the culprits

Figure 84

Indonesia: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Insider disclosure weak . . .

Unlike most jurisdictions in Asia, there is also no separate rule on disclosure of share dealings by directors and commissioners: they are treated within the substantial shareholder rules (ie, a 5%) and a long notification period of 10 business days (compared to much shorter two- to three-day deadlines in most other markets).

. . . especially for related-party deals

Related-party transaction (RPT) disclosure is especially weak and industry regulator Bapepam admits that this area is one of its biggest enforcement headaches. Getting companies to hold votes when they should to get minority approval for major RPTs is very difficult: 'Many don't bother,' lamented one official. And under current rules, there is no requirement for a company director involved in a conflicted transaction to make any special disclosure to the board.

Enforcement

Enforcement is sorely lacking

If the rules covering insiders are inadequate, the effective enforcement of the rules that do apply is almost non-existent. As one local fund manager stated, when responding to a question as to whether enforcement was sufficient on insider dealing: 'A resounding "NO"! Penalties for insider trading are not nearly enough and enforcement is sorely lacking.'

Regulators suffer from a lack of resources

Indonesia's score for this section fell 6ppts from 28% in 2010 to 22%. It is clear that Bapepam and the Indonesian Stock Exchange (IDX) are suffering from a lack of resources to tackle enforcement and there is no evidence of cooperation between the authorities to catch clear market manipulation. One market practitioner explained that when faced with egregious and suspicious share price movements, IDX only tends to 'issue a "cooling-off notice" suspend the shares for one or two days and then lift the suspension. There's no attempt to investigate and little cooperation between IDX and Bapepam'.

Investigations increased . . . but few are convicted

According to data on Bapepam's website - but irritatingly, only on the Bahasa version of the site (why is Bapepam incapable of producing a reliable English version of its website?) - formal investigations by Bapepam increased from 130 cases in 2010 to 178 cases in 2011. Of those, just 63 cases were completed, leading to administrative sanctions in 59 cases, while 115 cases remained open. Criminal investigations, on the other hand, numbered just 12 in 2011, the same number as in the previous year. We found evidence of just three successful insider-dealing prosecutions to date in Indonesia. None carried a custodial sentence.

Regulator's budget remains unchanged

Part of the explanation for this poor performance appears to be a lack of financial and human resources that can be applied to investigations. Bapepam's total 2011 budget allocation from parliament, including enforcement, was approximately US$21m, of which it spent just US$15.4m. The 2012 budget remained unchanged.

Little engagement from the market

While regulatory enforcement is clearly a problem, market enforcement is hardly better. Our survey found little evidence of efforts by independent minority or outside shareholders to vote against resolutions with which they disagreed, independent shareholders rarely or never nominate candidates for appointment to Indonesian company boards, and there is little evidence of shareholder litigation against errant companies, despite the fact that existing Indonesian laws allow such cases (another area where the rules on paper in Indonesia are more liberal than much of Asia).

Political and regulatory environment

Banking oversight has improved. . .

Indonesia's score for its political and regulatory environment stayed flat at 33%. Positives included continued improvements in banking oversight by Bank Indonesia, widely regarded as an effective and fair regulator, as well as a higher score for an improved website from IDX containing a better organised database of issuer announcements and reports.

. . . but government CG policy is half-hearted

As the score implies, however, the negatives dominate and much needs fixing in Indonesia's political and regulatory environment as it relates to CG. Government policy on CG is half-hearted at best. Not only has the code of corporate governance not been revised for six years, neither Bapepam nor IDX have done any more than tinker with existing securities laws and listing rules. Indonesia has still not signed up to the Multilateral Memorandum of Understanding issued by the International Organisation of Securities Commissions (IOSCO) - it has remained an observer for years - and the country's judiciary, with its poor funding, high levels of corruption and weak securities case law, remains a huge impediment to effective enforcement.

All of this occurs against a disquieting political backdrop of an impending presidential election in 2014 driving greater politicisation of Indonesian business and economic policy. Massive sums of foreign direct investment in

the past few years - reaching almost US$20bn in 2011, or 2.5 times the level in 2005 - have weakened the case for CG reform. With foreign investor appetite for Indonesian risk soaring, it seems that many policymakers believe reform is no longer necessary. Moreover, the country is entering a period of political uncertainty at a time when one of its most laudable initiatives - the financial-services supervisory agency OJK - is about to make its much-delayed debut.

IGAAP (accounting and auditing)

Audit oversight is confused . . .

Indonesia's score for accounting and auditing dropped from 67% in 2010 to 62% in 2012, largely as a result of our more sceptical assessment of audit regulation and quality. Unlike many markets in Asia, Indonesia still has no independent audit oversight body and the country is not a member of the International Forum of Independent Audit Regulators (IFIAR). Regulation of auditors is instead divided between the Ministry of Finance, Bapepam and the Indonesian Institute of CPAs (Institut Akuntan Publik Indonesia, or IAPI). However, once OJK becomes operational in 2013, this situation will change and we would expect Indonesia to join IFIAR well ahead of our next survey.

. . . while qualified auditors remain in short supply

The audit profession in Indonesia still suffers from the key problem identified in our last survey: a dearth of suitably qualified auditors. According to the World Bank's *Report on the Observance of Standards and Codes* (ROSC) for Indonesia in 2010, 45% of all audit firms registered with Bapepam had just one licensed audit partner; while turnover of partners among audit firms remains high, according to our sources.

Audit rules behind the curve

Meanwhile, some audit-related rules in Indonesia are also behind the curve. There is no requirement, for example, for listed companies to provide detailed disclosure on audit and non-audit fees separately in their annual reports and practically none does.

CG culture

Governance reform is lacklustre at best

Indonesia's CG culture score flat-lined in this year's survey, rising just slightly above 2010's 32% to 33%, which reflects how little progress we have seen in genuine CG efforts among companies and shareholders. Involvement of minority shareholders in the CG reform process in Indonesia remains lacklustre at best and NGOs' engagement in the CG agenda seems weaker to us compared to earlier survey years (although, to be fair, Indonesia does have an active Institute of Corporate Directors and director training events organised by different bodies).

Some companies embracing governance

On a more positive note, people we interviewed argued that some firms were seeking to improve governance standards voluntarily as a means to gain the attention of international investors, such as through better investor relations. 'Some . . . companies understand that better valuation comes from better governance,' said one domestic fund manager. 'Institutional investors that are investing into Indonesia from overseas generally make it clear that CG is important . . . Some companies choose to embrace it; others to ignore it.'

Early evidence of engagement from local fund managers

In addition, our research also produced some anecdotal evidence of domestic fund managers beginning to engage companies in discussions about corporate governance with a number of domestic and foreign institutions trying to promote CG within local companies, especially larger domestic funds with international parentage.

CG remains a compliance procedure for most Indonesian companies

That said, there remains a huge amount of work to be done from all constituencies if CG culture is going to improve in time for our next survey. Indonesian companies barely register a score on two of our fundamental questions as to whether they really believe that CG provides tangible benefits and it is hard to escape the conclusion that boards are merely undertaking a CG compliance process rather than genuinely seeking to improve transparency and disclosure. That may not be too far from the attitude of many other Asian companies, but in Indonesia's case further progress is also held back by poor regulation and enforcement. There is no poll voting among Indonesian companies and the stock exchange has no plans to introduce an electronic voting platform. There is no genuine split of chairman and CEO roles (although arguably the commissioners-directors structure may help) and no detailed disclosure on remuneration levels for board members. Also, the lack of a detailed separate rule for directors' interests and dealings is egregious and clearly impedes greater transparency of genuine ownership among Indonesian companies, one of the most opaque systems in Asia. Against this rather depressing backdrop, it is perhaps unsurprising that minority shareholders and independent fund managers have shown little appetite for activism or management engagement.

Factors to watch

Figure 85

Indonesia: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- A demonstrable lack of independence of the OJK, the new single regulator to be launched in 2013, from government.
- No evidence of any improvement in regulatory enforcement.
- No revision of the main Code of Good Corporate Governance.
- No progress in revising regulations on related-party transactions and director dealings.
- No improvement in the management of shareholder meetings, including early disclosure of directors nominated for election and the counting of votes.

What could improve overall CG

Figure 86

Indonesia: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- A new Bapepam website, with a functioning and up-to-date English language version. (If Thailand can do it, so can you!)
- More detailed data from regulators on enforcement.
- A deeper archive of company releases and documents on the IDX (stock exchange) website - five years minimum.
- Follow best practices in the running of shareholder meetings, including voting by poll. It is easier than you think!

Source: ACGA

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Research perspective - Glass half full

In Indonesia, we take an "a glass half full" view on listed companies' CG performance. While there is still much work to be done in order to achieve global best practices, things are moving in the right direction for a number of companies with institutional investor interest.

Second generation moving things in the right direction

Second generation driving change

On the ground, we note the positive influence of second-generation leaders of family-run corporations on the business environment. Much more sophisticated and most often foreign-educated, these successors are much more in touch with capital markets and their inner-workings. A prominent and savvy Indonesian tycoon said in our survey, 'Poor governance and the perception of poor governance are destructive to market valuations.' Clearly, investors of Indonesian companies that practise strong CG and pride themselves on transparency and openness enjoying premium market valuations attest to this.

The rise of reform-minded leaders

As we outlined in our July 2012 *Otonomi Daerah* report, in a country as decentralised as Indonesia, effective policy design and implementation at the local level is crucial for the development of SMEs, which are arguably the backbone of the local economy. The country's transition from a centralised market to a decentralised one has often been marked by corrupt practices or "money politics". However, during the process, a number of progressive, transparent and reform-minded individuals have also emerged.

In the report, we profiled key figures who personify these traits: former businessmen turned reformist mayors Herry Zudianto (Yogyakarta/Yogya) and Joko Widodo (Surakarta/Solo), affectionately known as Jokowi. Both from Central Java, they are well known for their transparency and willingness to listen to people's aspirations and touch people's lives.

Many new ministers from the private sector

Importantly, both Zudianto and Widodo have business and commercial background. This was also a trend we saw late last year during the SBY cabinet reshuffle, in which an increasing number of new ministers were coming from the private sector. Such trend should drive the country's reform agenda, while the upcoming 2014 presidential elections will be critical in continuing the positive momentum. Given that good governance is driven from "top down", we believe a more progressive and transparent leadership will set a good backdrop for broader CG improvement in the country.

Key issues

Below we discuss the issues Indonesia faces in regard to CG.

Regulatory risk

Regulation risk have been an overhang for smooth governance

One of the key issues and hurdles for companies in implementing effective governance standards has been regulatory risks. This concern reached a crescendo in mid-2012 but has now started to ease. The sectors that have been the most impacted have been commodities and banks.

The government's ability to involve itself in the commodities sector has become all too apparent in 2012 and, compared to other sectors in Indonesia, the industry faces higher risk. There have been discussions of changes to the fiscal regime for coal producers and a requirement to upgrade low-rank coal onshore that has the potential to reduce shareholder returns since 2009.

Real threat of government intervention

Further, the government has banned exports of all unrefined minerals for producers of nickel and bauxite without plans to construct onshore refinery in 2014 and requires all to obtain permits to continue exporting in the interim, demonstrating that the threat of intervention is credible.

The Indonesian banking sector has faced much regulatory risk this year, including possible reduction in lending rates, aiming to boost the domestic economy; maximum ownership limit ruling; and a loan/value regulation to minimise the risk of rising NPLs in consumer loans and overheating.

Banks and commodity sectors most impacted

The first issue has subsided as Bank Indonesia (BI) has now moved to focus more on macroeconomic issues, particularly the current-account deficit that may affect the currency, while the ruling for ownership and LTV has been implemented. The ownership limit ruling stipulated a maximum 40% shareholding by banks or can be higher subject to BI's approval. There are some exceptions to this rule based on CG scores, which are somewhat subjective and add to uncertainty and risk in this context.

Meanwhile, the LTV ruling is applied to mortgage (maximum 70%) and auto financing (minimum 30% downpayment for cars and 25% for motorcycles). Previously, sharia financing is exempted from this ruling, but BI is in discussion to also implement LTV regulation on sharia financing.

Related-party transactions

Large business conglomerates hold wide and vast assets

One area which raises eyebrows is related-party transactions. These often occur due to the wide and vast assets held by large business conglomerates. While not fully optimal, if there is full disclosure on independent valuations conducted and transparency, then such deals are more palatable. However instances of the opposite (limited disclosure of information or probity) is a risk for investors.

Complicated group structures

Another factor that can hinder the development of corporate governance in Indonesia, which is also common in other parts of Asia, is complicated and unwieldy group structures. Some business groups have several separate listings of individual assets and various holding companies, which add complexity and increases the potential for mistreatment of minority shareholders.

Companies take their time releasing results

Report results three months after year-end; best practice is 60 days

One of the criteria for good corporate governance is prompt release of full-year results within two months after financial year-end. While this has become a norm in most markets, Indonesian regulation currently only requires result to be audited within three months. Most local companies report close to this deadline, when across the region corporations have generally moved towards reporting full-year numbers within two months.

Bottom of the pack but focus on quality

More rigorous questions and a big increase in number of firms polled have had an impact

Indonesia recorded the lowest overall score of all 11 markets in our CG survey this year of 42.7% and retains the same ranking as in CG Watch 2010. On a like-for-like basis, Indonesia companies' CG scores have declined somewhat in 2012 versus 2010. Two major factors influence our assessments this year:

1) Our questions are much more rigorous.

2) Overall survey coverage in Indonesia has expanded from nine companies in 2010 to 50 (our full Indonesian coverage universe).

Companies scored better in transparency and fairness categories this year

Figure 87

CG scores by category

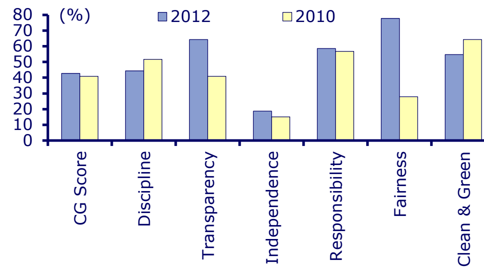
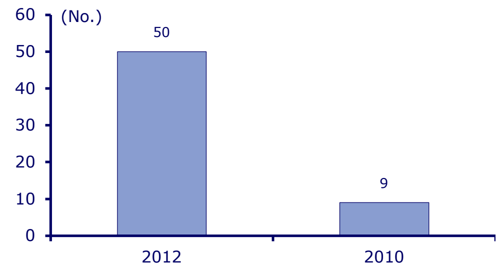


Figure 88

Covered stocks that are polled this year



Source: CLSA Asia-Pacific Markets

Focus on the quality

Among the 50 Indonesian companies we cover, Astra International remains the cream of the crop in terms of CG score with 69.3%. Unilever Indonesia, United Tractors, ITM, and Jasa Marga rounded up the top-five CG scoring Indonesia companies.

Indonesia has the lowest average CG score

Figure 89

Average CG scores of Asian markets

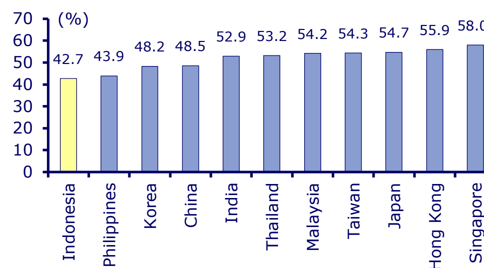
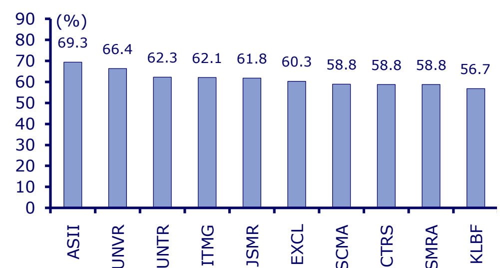


Figure 90

Top-10 Indonesia firms based on CG



Source: CLSA Asia-Pacific Markets

Corporate governance has improved in Indonesia

We have seen CG improvement among Indonesia's companies since the previous survey. The level of disclosure to investors, standards of governance demanded by foreign regulatory authorities and the existence of foreign controlling investors previously separated CG practices between companies with and without foreign presence in the board.

Companies with high institutional shareholding tend to rate better on CG

Among the top-10 companies for CG in Indonesia, seven are large corporations with high institutional ownership. While Astra International remains Indonesia's best CG practitioner, local companies without foreign influence have stepped up their CG practices and leapfrogged big companies. ITM continues to exhibit the highest corporate governance score in the coal sector by adhering to international best practices, avoiding the pitfalls described above and paying out all excess cash to shareholders.

We like AKR for its CG as well as fundamentals and growth prospects. The company's divestment of its sorbitol division, Sorini, demonstrates good governance. The exercise resulted in debt reduction and a special dividend to shareholders, allowing it to share its gains with minority stock holders.

Bank Mandiri saw improvement over past five years

Bank Mandiri has seen significant improvement in its CG rating. Firstly, its five-year track record from 2007 is strong under CEO Agus Marto, who has been cleaning up the bank since he joined in 2005. Secondly, BI is making a big effort to push Indonesian banks to improve their corporate governance. The central bank has been assessing banks' CG since 2010 and as a result we find Mandiri's annual reports have become much more informative. It has thus seen an 11ppt improvement in its CG score from our 2010 survey, the largest of companies in our coverage.

Astra Intl and Unilever Indo in the top quartile in the region

Figure 91

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

Company	Code	Company	Code
Astra Agro	AALI IJ	ITM	ITMG IJ
Astra International	ASII IJ	Jasa Marga	JSMR IJ
Bank Danamon	BDMN IJ	Kalbe Farma	KLBF IJ
BTPN	BTPN IJ	Mayora Indah	MYOR IJ
Bumi Serpong Damai	BSDE IJ	MBSS	MBSS IJ
Ciputra Development	CTRA IJ	Semen Gresik	SMGR IJ
Ciputra Surya	CTRS IJ	Summarecon	SMRA IJ
Gozco Plantations	GZCO IJ	Surya Citra Media	SCMA IJ
Gudang Garam	GGRM IJ	Tower Bersama	TBIG IJ
Harum Energy	HRUM IJ	Unilever Indo	UNVR IJ
Holcim	SMCB IJ	United Tractors	UNTR IJ
Indocement	INTP IJ	XL Axiata	EXCL IJ
Indosiar Karya	IDKM IJ		

Source: CLSA Asia-Pacific Markets

Japan - Bad news, good news situation

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In recent months, the international coverage of business news in Japan was dominated by a series of corporate scandals featuring some spectacular governance failures - including at Nomura, Olympus and Daio Paper. While these certainly did not help Japan's cause in this year's rankings - it slipped one notch to a fourth-place tie with Malaysia, from third in 2010 - the news coming out of the country in the past two years was not all bad. For one, a mounting sense of dismay and embarrassment prompted Japanese regulators to take a tougher line on enforcement. For another, some Japanese companies took it upon themselves to pursue voluntary CG changes, apparently in a bid to differentiate themselves from the muddling majority. Unlike in most other Asian markets where the regulator is taking the lead, Japan is one country where pockets of bottom-up reform are spreading.

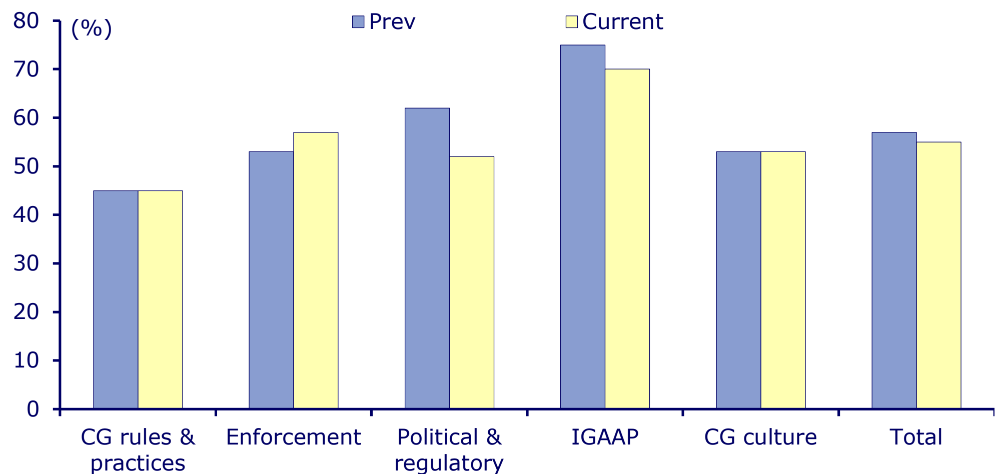
Stiff resistance from the business sector scuttled CG reforms

We should not, however, embellish Japan's situation too much. The country's overall score dropped 2ppts in our current survey, to 55% from 57% two years ago. Its category performance either fell or remained unchanged for all except enforcement, which rose 4ppts to 57%. Thanks to stiff resistance from the corporate sector, little progress has been made in mandating independent directors and audit committees for all listed companies (along with Taiwan, Japan is the only Asian market not to do so). The three-year-old government led by the Democratic Party of Japan (DPJ) has offered no coherent vision or leadership on CG reform. And the recent corporate scandals have exposed some serious deficiencies in Japan's audit practices. In short, even though Japan is one of the world's leading economies, it still lacks world-class CG to match.

Japan fell in score and ranking this year

Figure 92

Japan CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

CG rules and practices

Many CG rules in Japan are behind the curve

We gave Japan the same score (45%) in this category as two years ago. While there has been progress in some areas (eg, earlier reporting of audited annual results and accurate counting of proxy votes), in other areas there has been either no change or a deterioration (eg, formulaic non-financial reporting practices, weak sanctions on insider trading, untimely disclosure of related-party transactions and a possible delay in full implementation of International Financial Reporting Standards, or IFRS).

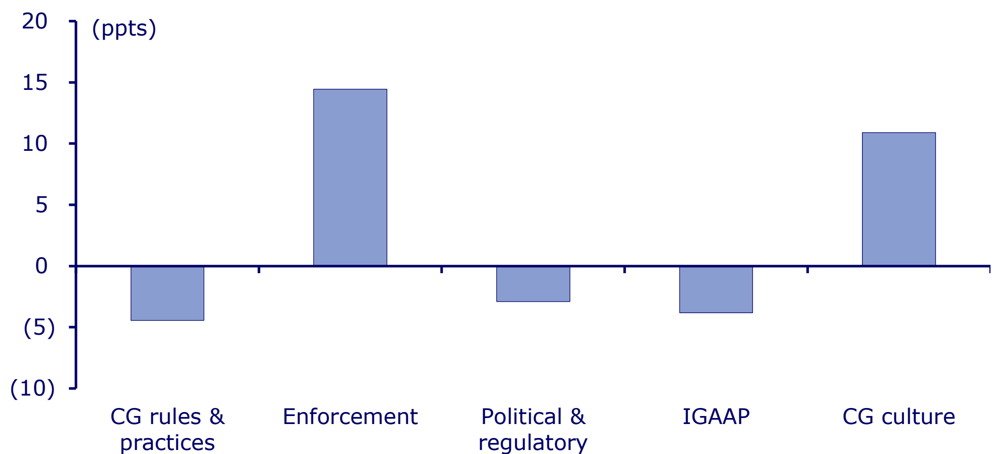
MOJ passes the buck on independent directors to the stock exchanges

However, the biggest disappointment has been the government's continued ambivalence towards mandating independent directors (called "outside directors" in Japan). In a December 2011 consultation paper on amending the Companies Act, the Ministry of Justice (MOJ) floated the idea of requiring 'Companies that are required to submit annual securities reports... to appoint one or more outside directors', but decided not to include it in the July 2012 draft amendments in the face of opposition from the business lobby. Instead, the MOJ passed the ball to the stock exchanges by declaring that, 'there is the need to establish discipline in the rules and regulations of financial instruments exchanges to the effect that listed companies shall strive to secure at least one independent board member that is an outside director' and that listed companies that do not do so must disclose 'why appointing an outside director would be inappropriate'. In other words, the MOJ has signaled that it expects the Tokyo Stock Exchange (TSE) and others to introduce a "comply or explain" provision into listing rules on the appointment of outside directors. If all of these come to fruition, it would represent a small step forward in promoting board independence in Japan. But the obvious caveat is the MOJ's proposed legislation remains only that and there is no guarantee that further modifications will not be introduced before it becomes law.

Below regional average on three of five categories

Figure 93

Japan: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Solving problems by adding complexity

Another provision of the MOJ's draft amendments to the Companies Act that concerns us is the introduction of a new board structure with an "audit and supervisory committee" - which represents a third type of board in Japan in addition to the traditional "company with board of auditors (*Kansayaku*)" and US-style "company with committees" (namely, audit, nomination and compensation committees). In ACGA's submission to the MOJ, we wrote that adopting a third kind of board 'will likely cause confusion among investors. It would be fair to say that most global investors do not fully understand the precise role of the *Kansayaku* system, since the same system does not exist in any other developed or emerging market . . . a third voluntary system would surely only add to the complexity. Why not seek to clarify and strengthen the existing two systems instead?' The MOJ, however, seems to believe that it must provide a new, hybrid option to companies, since most (about 98% of all listed companies) have chosen not to voluntarily switch over to the US-style board structure from the *Kansayaku* system which, although dominant, has been criticised for not being as effective as the latter.

TSE requires more disclosure of director independence

On a more positive note, the TSE in May 2012 made a number of changes to its listing rules to enhance the disclosure of director independence. The TSE told ACGA that the proposals were in direct response to recent corporate scandals involving Olympus and others, and were meant to restore confidence in the Japanese stock market. Key revisions included:

- If a person designated as an independent director/auditor falls under any of the following categories, the listed company shall disclose the matters outlined in the corresponding item:
  - A client of the listed company or a current or former officer, board member or employee of such a client: such facts and an outline of transaction(s) with such a client;
  - A current or former officer, board member or employee from a party with a relationship of cross-directorships: such facts and an outline of such cross-directorships; and
  - A person or a current or former officer, board member or employee of a party to which the listed company makes donations: such facts and an outline of such donations.
- Listed companies shall strive to provide shareholders with information regarding independent directors/auditors in a form that is useful and easy to use when exercising voting rights at a "general shareholders meeting". The current problem is that the meeting agendas do not need to specify which outside directors/auditors are considered "independent" by companies.

Enforcement

More scandals mean more enforcement

A spate of corporate and insider-trading scandals roiling headlines in recent months has triggered a correspondingly more vigorous response from Japanese authorities. Japan also saw a continued development of private enforcement, as many institutional shareholders vote their shares actively. All this has contributed to a significantly higher score for enforcement this year (57% versus 53% in 2010). But it remains to be seen what impact this pickup in enforcement action will have on Japan's broader CG landscape over time.

The Olympus fraud has exposed deep systemic weaknesses in Japan CG

When a massive fraud at Olympus came to light, both the Securities and Exchange Surveillance Commission (SESC) of the Financial Services Agency (FSA), the single financial regulator in Japan, and the TSE were quick to react. In late 2011, a boardroom squabble at Olympus exploded into one of corporate Japan's biggest accounting and CG scandals. On 14 October, the world's leading maker of medical endoscopes suddenly fired its first non-Japanese president, Michael Woodford, six months into his job, citing cultural differences. But the British national immediately countered that Olympus dismissed him after he questioned huge fees the company had paid to M&A advisors several years earlier. With suspicions of wrongdoing mounting, Olympus admitted the next month that the payments had been part of an elaborate accounting scam to disguise investment losses stretching back two decades. The revelation set off an investigation by the SESC as well as a delisting procedure by the TSE.

TSE backs off from delisting Olympus

Although TSE rules stipulate automatic delisting for a company that fails to submit its quarterly report within one month of the statutory deadline - as Olympus did after the scandal erupted - the exchange in January 2012 announced that it would not do so. The company was instead designated as a

"security on alert" and fined ¥10m (US$130,000) for violating listing rules. This was not a case of leniency, but a sign of flexibility and subtlety on the part of the TSE. In November 2011, ACGA had written a letter to the exchange, arguing against an automatic delisting of Olympus, because the company remained a going concern and a delisting would hurt investors and stakeholders even more. For its part, on the recommendation of the SESC, the FSA slapped a ¥192m fine on Olympus in July 2012.

Busting insider traders now all the rage in Tokyo

The SESC and FSA have also put market cheaters on notice. Since early this year, they have launched a string of successful investigations into alleged insider-trading schemes tied to public share offerings. In March, Chuo Mitsui Asset Trust and Banking (now part of Sumitomo Mitsui Trust Bank) was fined for trading on inside information in connection with a public share offering in 2010 by Inpex, an energy company. Two months later, Sumitomo Mitsui Trust Bank was again accused of insider trading on a new share offering by Mizuho Financial Group the same year. Then in June, the SESC turned its attention to a foreign financial institution, First New York Securities, moving to fine it for insider trading on shares of Tokyo Electric Power Company (Tepco) in September 2010. It turned out that employees of Nomura were involved in all three cases and, on 26 July, the cascade of accusations against the investment bank triggered the resignation of CEO Kenichi Watanabe. Meanwhile, the FSA has ordered Nomura to improve its internal control system.

Political and regulatory environment

Too cautious and too slow for too long

Our 2012 score for this category, at 52%, is 10ppts lower than two years ago. In fact, this dismal performance was the biggest factor in pushing down Japan's ranking this year. We do feel Japan has been too cautious and too slow in its approach to CG reform for too long. Witness the MOJ's decision not to mandate independent directors. Its proposed revisions to the company law are the most significant update it has undertaken in almost a decade, yet the direction the ministry is headed will leave Japanese standards on board independence some way below even regional benchmarks.

Meek political leadership does not help

Japan still suffers from meek political leadership. Given the high expectations for reform following the DPJ's wresting of parliamentary control in 2009 from the Liberal Democratic Party, which had dominated the country's post-war politics, the new government has been a disappointment. The DPJ does not have a consensus view on corporate governance and the relevant ministries remain more sympathetic to management, rather than shareholder, interests. The FSA is keener on advancing CG reform, but has limited authority to do so.

The FSA has chalked up a number of wins

But to its credit, the FSA has chalked up a number of small achievements. In May 2011, the Diet (parliament) passed an amended Financial Instruments and Exchange Act that improved the process for undertaking rights issues by, among others, allowing electronic distribution of prospectuses. The FSA followed this up a few months later with the adoption of a version of a US securities law known as Regulation M. This rule prohibits any investor who has shorted the shares of a company that has announced a public offering from buying the new shares. These two regulatory steps were related to the crackdown on insider trading and came in response to complaints (including from ACGA) that some brokers and investors were exploiting weaknesses in Japan's process for public offerings to make illicit trading gains based on advanced information of new share issuances.

Penalties for insider trading are low

Regulators, however, have not taken action on requiring harsher penalties for insider traders, even though critics have called the current laws toothless. The Japanese rules lead to only small fines (eg, about US$600 in the Inpex case) because there are no punitive levies for insider trading or penalties for those leaking inside information.

Still no progress on sensible private placement rules

Likewise, regulators have yet to adopt global best practices on other common capital-raising mechanisms, such as private placements or third-party allotments, as they are known in Japan. Since the publication of ACGA's *White Paper on Corporate Governance in Japan* in 2008, we have been urging Japanese authorities to tighten the rules governing these transactions to protect the rights of existing shareholders who are not invited to participate. In a letter to the FSA in June 2011, we again recommended adoption of certain rule changes to strengthen the market's regulatory framework for private placements:

- The maximum amount of shares that can be issued through private placement in any 12-month period should be limited to 10%. (TSE rules imply 25% as the upper level under normal circumstances.) If companies wish to exceed 10%, they should seek shareholder approval in an EGM.
- Annual shareholder approval at the AGM should be required for the right to issue new shares through private placements for the subsequent 12 months.

We will be closely watching progress in these areas to inform our assessment of Japan for CG Watch 2014.

IGAAP (accounting and auditing)

Japan's reputation for auditing takes a dive

This was the strongest category for Japan. Nonetheless, its 2012 score fell to 70% from 75% in 2010. One reason is because we are giving closer scrutiny on auditing practices across the region. And Japan certainly has seen more than its share of problems in accounting and auditing. The most blatant example of cooking the books was that of Olympus. But there have been other egregious cases.

Hand in the cookie jar: the Daio Paper scandal

In October 2011, Daio Paper sued its former chairman for borrowing ¥10.7bn in company money for personal use. The Japanese tissue maker had discovered that Mototaka Ikawa, who was the chairman until he resigned the previous month, borrowed the amount from seven Daio Paper subsidiaries between May 2010 and early September 2011, but had paid back less than half of it. Ikawa reportedly lost the money in gambling in Las Vegas and Macau. Daio Paper's internal investigators blamed company executives and auditors for failing to question Ikawa's loan requests.

Another one the auditors missed: AIJ Investment

Then in February 2012, hundreds of billions of yen of client money was found to be missing at AIJ Investment Advisors, a pension-fund asset manager. Two months later, AIJ president Kazuhiko Asakawa admitted at a sworn parliamentary testimony that he had personally orchestrated a systematic fabrication of its fund-performance reports to hide losses stretching over nine years in the vain hope that his firm could eventually recoup them.

Olympus auditors get off with a slap on the wrist

Despite the total failure of company accountants and auditors in these cases, the subject of accounting integrity and auditor independence is rarely discussed in Japan. In July 2012, the FSA merely issued a "business improvement order" on KPMG and Ernst & Young, auditors of Olympus, to improve their internal controls - a slap on the wrist, really. Japan's independent audit regulator under

the FSA, the Certified Public Accountants and Auditing Oversight Board (CPAAOB), is seen as a fairly weak regulator and did not opine on the quality of audit in the Olympus and other cases (indeed, it has no remit to do so). In contrast, in December 2011, the Public Company Accounting Oversight Board (PCAOB), the CPAAOB's counterpart in the USA, released an inspection report on Kyoto Audit Corp, which is loosely affiliated with PricewaterhouseCoopers, critical of its audit of two large firms, reportedly Kyocera and Nidec (both have securities listed in the USA). The PCAOB, without naming the companies because of its confidentiality policy, said: 'The deficiencies identified in both of the audits reviewed included deficiencies of such significance that it appeared to the inspection team that the Firm at the time it issued its audit report, had not obtained sufficient competent evidential matter to support its opinion on the issuer's financial statements.'

Full adoption of IFRS delayed

Lastly, although Japanese firms have been allowed to use IFRS since March 2010, the Japanese government announced in June 2011 that it would consider postponing the mandatory adoption of IFRS by a few more years after the original target date of 2015. The reason: many complained that dealing with the aftermath of the March 2011 earthquake and Fukushima nuclear crisis has stretched their administrative resources too thin.

CG culture

Belief in good governance may be thin on the ground . . .

We did not detect major changes in Japan's overall CG culture in the past two years and so have given the same 53% score as in 2010 for this category. As in all other Asian markets, we do not feel the average listed Japanese company believes that good governance provides tangible benefits, which means most firms continue to do no more than to meet the minimal letter, rather than the broader spirit of CG rules. Cases in point were board overhauls at Olympus and Tepco. In 2012, these companies elected entirely new boards, with a majority of outside directors (six out of 11 for both) for the first time - only after they suffered existential crises the previous year.

. . . but some companies are experimenting with CG reforms

There were, however, some positive outliers as well, raising hope that more constructive views on CG reform are seeping through traditional Japanese boardrooms. In June 2012, Hitachi, the venerable industrial conglomerate, elected a new board consisting of six inside and seven outside directors. What is more, two of the three newly appointed outside directors were foreigners: George Buckley, executive chairman of 3M Company of the USA, and Philip Yeo, chairman of Singapore's Standards, Productivity and Innovation Board (one of the six inside directors is also a foreigner: Stephen Gomersall, who is chairman of Hitachi Europe). Hitachi said it decided to pursue these voluntary changes 'to promote management with enhanced global outlook and to ensure rigorous demarcation of management supervision and execution'. Then there is the phenomenon of a growing number of listed companies voluntarily separating the role of chairman and CEO. They include Shiseido, Eisai and Asahi Breweries, among others.

New "engagement fund" launched

Apart from listed companies, Japan also saw encouraging steps being taken by other market participants in recent months. In May 2012, Governance for Owners (an ACGA member) and Tokio Marine Asset Management (TMAM) unveiled a Japan Engagement Fund, the first joint-venture fund of its kind involving Japanese and non-Japanese institutional investors, with a target fund size of ¥100bn. The seed investors included the Fourth Swedish National Pension Fund, a UK-based private holding company, a Japanese institutional client of TMAM and 10 partners of Governance for Owners.

More focus on board training

Meanwhile, a group of CG experts in Japan set up a new non-profit organisation, the Board Director Training Institute (BDTI), to offer continuing education of this type. BDTI is the only group in Japan certified by the government as a tax-exempt "public-interest organisation" working in this field. This is a significant achievement and marks the first time that the Japanese government has acknowledged corporate governance training as being in the public interest.

Japan will fall more in our next survey if it doesn't undertake bold reforms

Figure 94

Japan: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- ❑ No progress in mandating the adoption of independent directors for all listed companies.
- ❑ No progress in mandating the adoption of audit committees for all listed companies.
- ❑ No move to adopt a national CG best-practice code.
- ❑ No progress on tighter regulation of capital-raising exercises that hurt minority shareholders.
- ❑ No improvement in rules to deter insider trading.
- ❑ Failure to show progress in the regulation of auditors.

A shortlist of ideas for where to start

Figure 95

Japan: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- ❑ Strengthen non-financial reporting standards and practices (eg, board and CG reports).
- ❑ Enhance corporate disclosure of internal-control and risk-management functions.
- ❑ Release detailed AGM agendas at least 28 days before the meeting.
- ❑ Increase director training.

Source: ACGA

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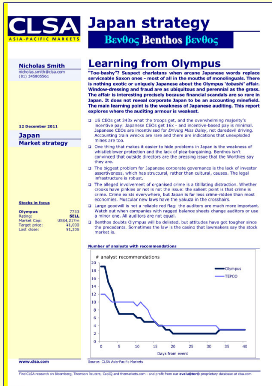
Research perspective - Driving Miss Daisy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Japan
Market strategy

Learning from Olympus

"Toe-bashy"? Suspect charlatans when arcane Japanese words replace serviceable Saxon ones - most of all in the mouths of monolinguals. There is nothing exotic or uniquely Japanese about the Olympus '*tobashi*' affair. Window-dressing and fraud are as ubiquitous and perennial as the grass. The affair is interesting precisely because financial scandals are so rare in Japan. It does not reveal corporate Japan to be an accounting minefield. The main learning point is the weakness of Japanese auditing. This report explores where the auditing armour is weakest.

- US CEOs get 343x what the troops get, and the overwhelming majority's incentive pay: Japanese CEOs get 16x - and incentive-based pay is minimal. Japanese CEOs are incentivised for *Driving Miss Daisy*, not daredevil driving. Accounting train wrecks are rare and there are indications that unexploded mines are too.
- One thing that makes it easier to hide problems in Japan is the weakness of whistleblower protection and the lack of plea-bargaining. Benthos isn't convinced that outside directors are the pressing issue that the Worthies say they are.
- The biggest problem for Japanese corporate governance is the lack of investor assertiveness, which has structural, rather than cultural, causes. The legal infrastructure is robust.
- The alleged involvement of organised crime is a titillating distraction. Whether crooks have pinkies or not is not the issue: the salient point is that crime is crime. Crime exists everywhere, but Japan is far less crime-ridden than most economies. Muscular new laws have the yakuza in the crosshairs.
- Large goodwill is not a reliable red flag: the auditors are much more important. Watch out when companies with ragged balance sheets change auditors or use a minor one. All auditors are not equal.
- Benthos doubts Olympus will be delisted, but attitudes have got tougher since the precedents. Sometimes the law is the casino that lawmakers say the stock market is.

Stocks in focus

Olympus	7733
Rating:	SELL
Market Cap:	US$4,217m
Target price:	¥1,000
Last close:	¥1,206

Number of analysts with recommendations

Source: CLSA Asia-Pacific Markets

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Japan is the land of bargain-basement CEOs, who are incentivised take a "driving Miss Daisy" approach to steering companies, not the daredevil way. Accounting wrecks are rare, and there are encouraging indications that unexploded mines are too (see our 12 December 2011 *Learning from Olympus* note). In 2011 in the USA, CEO pay surged 14% to US$12.9m: 380 times the average worker's pay. Japan couldn't be more different: a 2009 PricewaterhouseCoopers study showed that fewer than 300 people in all Japan's 3,813 public companies breached the ¥100m (then US$1.1m) disclosure threshold. At US$583,000 in salary and other compensation, Japanese CEO pay averaged just 16x the typical worker. Incentive-based pay is a minor component of a Japanese CEO's pay package, whereas it is typically 70-80% for a US CEO. A US CEO is therefore looking for a blowout year to get rich quick, while a Japanese CEO seeks longevity through extreme risk-aversion. The Japanese use the expression *genten-shugi* (減点主義) - literally "minus points system", meaning that there are no rewards for doing a good job, but just negative points for failure. A Japanese CEO is expected to fall on his sword and resign when his company stumbles, whether or not he was responsible. This has the effect of making mice out of alpha males.

Japanese CEOs aren't incentivised to take risks . . .

Figure 96

Average CEO pay at S&P500 companies

(US$)	**2010**	**2011**	**YoY (%)**
Salary	1,093,989	1,091,182	0
Bonus	251,413	268,110	7
Stock awards	3,833,052	5,279,828	38
Option awards	2,384,871	2,352,544	(1)
Nonequity incentive plan compensation	2,397,152	2,382,529	(1)
Pension and deferred compensation earnings	1,182,057	1,308,625	11
All other compensation	215,911	252,657	17
Total	**11,358,445**	**12,935,475**	**14**

Source: AFL-CIO

. . . but when they hide problems, the system is ill-equipped to catch them

The Olympus scandal dramatically demonstrated, however, that though Japanese managers are not incentivised to take on risk, they do hide blunders. There is no evidence that they do this more (or less) than their Western counterparts. But when they do hide problems, Japan is ill-equipped to catch them, for two main reasons: weaknesses in the auditor system and a lack of true whistleblower protection.

Japanese auditors are paid to add numbers but not to check if they make sense

Japanese accountants are paid enough to add up the numbers, but not enough to spend the time checking that they make sense. Auditing fees for a typical company in Japan are 20-25% of those in the USA. In return for the higher fees, audits in the USA take typically double the time, doing a fuller job. There are 17,000 certified public accountants (CPAs) in Japan, against 330,000 in the USA. Becoming a CPA in Japan is not considered an attractive career choice because of the low pay and crushing workload.

Auditor changes are a red flag . . .

When Azsa threatened to resign as Olympus's auditor if serious accounting problems weren't dealt with, Olympus merely changed auditors - and the information exchange at the handover was utterly inadequate. Change of auditor should therefore be seen as a red flag: it's easy enough to do because the auditor's signoff is the last page of an earnings report. There were 27 companies that changed auditors in the past year. We list the larger ones in Figure 97.

Figure 97

Companies that recently changed auditors

Company	Mkt cap (¥bn)	FYm/08	FYm/09	FYm/10	FYm/11	FYm/12	Current qtr
SMC (6273)	928	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo	Seiyo Audit	Seiyo Audit
JTEKT (6473)	229	Kyoto Kansa	Kyoto Kansa	Kyoto Kansa	Kyoto Kansa	Azsa	Azsa
Zensho (7550)	122	Azsa	Azsa	Azsa	Azsa	Arata	Arata
Nippon Suisan (1332)	49	Shin Nihon	Shin Nihon	Shin Nihon	S & P Gmbh	Shin Nihon	Shin Nihon
SKY Perfect JSAT (9412)	118	Tohmatsu	Tohmatsu	Tohmatsu	Tohmatsu	Tohmatsu	Tohma Ichiro
Futaba/Chiba (6986)	52	Tohmatsu	Tohmatsu	Tohmatsu	Thomas Davis & Co	Tohmatsu	Tohmatsu
Alpine Electronics (6816)	54	Azsa	Azsa	Azsa	Azsa	Shin Nihon	Shin Nihon
TOC (8841)	58	Tohmatsu	Tohmatsu	Tohmatsu	Shin Nihon	Tohmatsu	Tohmatsu
Aderans (8170)	40	Kyobashi	Kyobashi	Kyobashi	Kyobashi	Bdo Sanyu	Bdo Sanyu

Source: CLSA Asia-Pacific Markets, Bloomberg

. . . and so is a major company with a minor auditor

The larger accountancy firms are tied to the global big four, which have more to lose through reputation risk - that's how the big eight became the big four. Without wanting to suggest an accounting company is a fly-by-night or tied to organised crime merely because it is small, it is worth asking management why a major company has a minor auditor if it does - especially if the company's finances are fragile.

Figure 98

Major companies with minor auditors

Company	Mkt cap (¥bn)	FYm/08	FYm/09	FYm/10	FYm/11	FYm/12	Current auditor
SMC (6273)	928	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo	Seiyo Audit	Seiyo Audit
Suzuki Motor (7269)	845	Seimei	Seimei	Seimei	Seimei	Seimei	Seimei
Dai Nippon Print (7912)	403	Meiji	Meiji	Meiji	Meiji	Meiji	Meiji
Shimano Inc (7309)	529	Seiryo	Seiryo	Seiryo	na	na	Seiryo
Hokkaido Elec Pwr (9509)	160	Yaesu	Yaesu	Yaesu	Yaesu	Yaesu	Yaesu
Yamazaki Baking (2212)	230	Nichiei	Nichiei	Nichiei	na	na	Nichiei
Toyo Seikan (5901)	192	Sokensha	Sokensha	Sokensha	Sokensha	Sokensha	Sokensha
Kamigumi (9364)	175	Shin Young	Shinyo	Shinyo	Shinyo	Shinyo	Shinyo
Kagome (2811)	176	Asami	Asami	Asami	Nagoya Kansa Hojin	Nagoya Kansa Hojin	Nagoya Kansa Hojin
NOK (7240)	239	Nihonbashi	Nihonbashi	Nihonbashi	Nihonbashi	Nihonbashi	Nihonbashi
Nissan Chemical (4021)	156	Yaesu	Yaesu	Yaesu	Yaesu	Yaesu	Yaesu
Don Quijote (7532)	211	Ba Tokyo	Ba Tokyo	Ba Tokyo	Ba Tokyo	na	Ba Tokyo
Koito Mfg (7276)	161	Mizuno	Mizuno	Meiji	Meiji	Meiji	Meiji
Citizen (7762)	150	Nihonbashi	Nihonbashi	Nihonbashi	Nihonbashi	Nihonbashi	Nihonbashi
Kinden (1944)	132	Osaka Kansa Hojin	Osaka Kansa Hojin	Osaka Kansa Hojin	Osaka Kansa Hojin	Osaka Kansa Hojin	Osaka Kansa Hojin
Shochiku (9601)	111	Shinsoh	Shinsoh	Shinsoh	Shinsoh	Shinsoh	Shinsoh
COMSYS (1721)	146	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo	O-Yu Kyodo
Kaken Pharm. (4521)	115	Hijiribashi	Hijiribashi	Hijiribashi	Hijiribashi	Hijiribashi	Hijiribashi
SKY Perfect JSAT (9412)	118	Tohmatsu	Tohmatsu	Tohmatsu	Tohmatsu	Tohmatsu	Tohma Ichiro

Source: Bloomberg

The Whistleblower Protection Act is toothless and there are no punitive damages to share

Even with the most able accountants, skilfully concealed accounting dodges are tough to spot. The most potent weapon against them is the tipoff from an employee in the know. In 2009, four sales representatives from Eli Lilly got to share US$79m for blowing the whistle on their company after it illegally marketed a drug for uses not approved by the Food & Drug Administration. A US$20m payoff would affect most people's willingness to toot the whistle. Japan, however, not only does not permit punitive damages, such as those shared out among the sales representatives, it also has grossly inadequate whistleblower protection. Though it brought in a Whistleblower Protection Act in 2006, it does not actually penalise companies that harass whistleblowers, making it toothless. Nor does Japan have plea bargaining.

What happened at Olympus was like breaking the window, hiding the damage and paying to mend it with your pocket money - rather than an attempt to rob the bank. The board was not attempting to defraud for personal gain - except that, and this is an important point, the board got to keep their jobs and get paid over the long years the fraud remained hidden. They had punted the company's money in the stock market in the go-go Eighties bubble, then hidden the losses when the bubble burst. This was no Japanese Enron, with none of the fast living and gilded lifestyles. Merely a sad case of executives who were too weak to come clean about their blunders.

The biggest - and saddest problem - is the lack of investor assertiveness

What was saddest about the case was that the whistleblower - sacked CEO Michael Woodford - was unable to get one single domestic institutional investor to support him in his bid to take back the company, purge the tainted board and turn the business around. Japanese corporate-governance laws are, on paper at least, pretty robust. But if investors won't assert themselves, all the laws in the world are worthless. The key problem is that asset-management companies in Japan are usually subsidiaries of banks, securities companies or insurers. If they try and assert themselves on corporate governance, they usually meet heavy resistance from their parent company's sales forces, who tell them not to rock the boat.

But there is also the problem of "the quiet American": too often the foreign investor is compelled to display 'modest stillness and humility' when 'hard favoured rage' is called for. Many foreigners invest in Japan through custodians. That means that they don't actually hold the shares and can't vote in extraordinary shareholders' meetings. The *Nikkei* reported that Southeastern, Olympus's biggest foreign shareholder, was in that boat.

Enron was held up as a model of CG till it became a byword for malfeasance

The Olympus scandal triggered a resumption of the calls for independent directors in Japan. Enron, of course, had been held up as a model of corporate governance right up until it became a byword for malfeasance. *Chief Executive* magazine included it in its top five in its 2000 review of the best corporate boards. As Figure 99 shows, it certainly looks impressive.

On paper, Enron had a stellar board

Figure 99

Enron's board of directors

Robert A Belfer	Chairman, Belco Oil and Gas Corp
Norman P Blake Jr	Chairman, president and CEO, Comdisco
Ronnie C Chan	Chairman, Hang Lung Group
John H Duncan	Former chairman of The Executive Gulf and Western Industries
Wendy L Gramm	Former chairman of US Commodity Futures Trading Commission
Ken L Harrison	Former chairman and CEO of Portland General Electric
Robert K Jaedicke	Professor Emeritus of Accounting at Stanford University
Charles A LeMaistre	President Emeritus, University of Texas MD Anderson Cancer Center
John Mendelsohn	President, University of Texas MD Anderson Cancer Center
Jerome J Meyer	Chairman, Tektronix
Paulo V Ferraz Pereira	Executive vice president if Group Bozano
Frank Savage	Chairman, Alliance Capital Management
John A Urquhart	Senior advisor to the chairman of Enron
John Wakeham	Former UK Secretary of State for Energy
Herbert S Winokur Jr	President of Winokur

Source: Company

Certainly Japanese companies with the highest percentages of "outside directors" (not all of whom will or need to be truly independent) have been a very mixed bag: a third of the 15 companies in Figure 100 had five-year average returns on equity that were negative. You might argue that it is because they are so troubled that they need an independent watchdog - and yet Nomura's eight outside directors didn't prevent it from being the centre of a massive insider-trading scandal.

Many companies with model boards deliver clunker returns

Figure 100

Companies with the highest percentage of outside directors

Company	Code	% indep directors	5Y avg ROE (%)	5Y avg ROIC (%)	Mkt cap (¥bn)
Sony Corp	6758	86.7	(4.6)	na	930
Fast Retailing	9983	80.0	18.1	17.4	1,901
Oracle Corp Japan	4716	75.0	28.0	24.7	469
Aozora Bank	8304	66.7	(6.1)	na	337
Shinsei Bank	8303	66.7	(6.0)	na	270
Eisai	4523	63.6	9.5	6.0	1,078
Hoya	7741	62.5	13.6	20.3	793
Resona	8308	60.0	na	3.6	805
Chugai Pharmaceutical	4519	58.3	10.3	10.3	871
Astellas Pharma	4503	57.1	11.6	12.9	1,813
Nomura	8604	57.1	(7.6)	na	1,070
Aeon	8267	55.6	4.5	4.8	764
Sekisui Chemical	4204	55.6	5.0	4.7	345
Hitachi	6501	53.8	(4.3)	na	2,175
NKSJ	8630	50.0	na	na	647

Source: Bloomberg, CLSA Asia-Pacific Markets

Conversely, many companies with no outside or independent directors at all have generated great returns, as Figure 101 shows. A lot of the high-flyers on this list are family-owned companies: the Nitori family at Nitori; the Takahara family at Unicharm; the Shimamura family at Shimamura; and Takizaki Takemitsu at Keyence (though he excludes his family, and those of his board, from the company). Being a family company, of course, didn't help Barings.

Many of Japan's best companies don't have independent directors

Figure 101

Companies with no independent directors

Company	Code	% indep directors	5Y avg ROE (%)	5Y avg ROIC (%)	Mkt cap (¥bn)
DeNA	2432	0.0	42.0	35.6	329
Yahoo Japan	4689	0.0	28.1	24.0	1,598
Nitori	9843	0.0	19.2	14.9	427
Hisamitsu Pharmaceutical	4530	0.0	15.2	12.1	398
Aeon Mall	8905	0.0	14.9	8.1	345
Sumitomo Corp	8053	0.0	14.2	2.8	1,369
Yamada Denki	9831	0.0	13.7	7.5	418
JGC	1963	0.0	13.1	12.6	653
Unicharm	8113	0.0	13.0	13.2	937
Nintendo	7974	0.0	12.9	na	1,235
Shimamura	8227	0.0	12.2	10.7	344
Sysmex	6869	0.0	11.8	11.8	362
Isuzu Motors	7202	0.0	11.7	na	696
Sumitomo Realty & Devt	8830	0.0	11.4	3.4	942
Daihatsu Motor	7262	0.0	10.9	8.4	559
Canon	7751	0.0	10.3	9.3	3,687
Keyence	6861	0.0	9.9	9.3	1,253
FamilyMart	8028	0.0	8.5	10.0	366
Toyota Tsusho	8015	0.0	8.5	3.7	562
Sankyo	6417	0.0	8.4	7.9	366

Source: Bloomberg, CLSA Asia-Pacific Markets

Olympus had some fancy outside directors too

Olympus had outside directors - some of them very impressive. And yet, in Woodford's description, they couldn't get their hands up fast enough to vote to fire him. At the time that Olympus made the four acquisitions at the centre of the scandal, it actually had on its board Robert Mundell - a Nobel laureate for economics (who didn't spot the fraud either). And then there was board member, professor Yasuo Hayashida, who told the *Nikkei* 'I do attend meetings but I have no idea about their content. I only provide medical advice.' This brings us to the problems about competence and training.

The talent pool of hired guns is desperately shallow

In a Nikkei poll in 2009, 28% of outside directors were working for two companies, 12% were working for three and about the same percentage were working for four or more. Given the amount of time required to properly prepare for meetings, it is pretty questionable if outside directors add much to board meetings - particularly the 12% working for four different firms. In the USA, corporate directors tend to be guns for hire, hopping not only from job to job but from industry to industry. The lack of labour mobility in Japan means that it lacks that kind of mobile talent pool to draw on. Companies want boards that understand their businesses. Toyota Motor explained to the *Nikkei* why it has no outside directors: 'we will consider outside directors if they can understand our management policy, but no one comes to mind now'.

There's no quality control on outside directors and no training requirement

Nicholas Benes of the government-credited Board Director Training Institute of Japan (BDTI) told us 'most countries have some sort of rules requiring either director training or the disclosure of company policy about director training. Japan has no rules whatever about training, anywhere. This is stunning when one considers that statutory auditors (監査役) are supposed to be the guard dogs of governance. Their duties are to audit the legality of decisions and the financial statement, yet in order to be elected [statutory auditor] there is no requirement that the candidate know anything or have even studied accounting or law'. As shown in Figure 102, from New York to Bangladesh, but notably not in Japan, CG codes require training of board members. Comprehensive directors' training programmes exist in other countries, but until the creation of the government-credited BDTI in 2009, there was nowhere to learn the skills required to be an effective independent director. When Institutional Shareholder Services (ISS) was certifying director training courses in the USA, there were about 300 on the list.

Figure 102

Examples of requirements for board training in CG rules around the world

Source	Text
NYSE corporate governance rules (listing rules)	9. Listed companies must adopt and disclose corporate governance guidelines. Annual performance evaluation of the board: the board should conduct a self-evaluation at least annually to determine whether it and its committees are functioning effectively.
UK corporate governance code	B.4.2 The chairman should regularly review and agree with each director their training and development needs.
German corporate governance code	The members of the Supervisory Board shall on their own take on the necessary training and 11 further education measures required for their tasks. They shall be supported by the company appropriately.
China - China Securities Regulatory Commission	Notice on Issuing the Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies (2001): Independent directors and nominees for independent directors shall take part in the training organised by CSRC and its authorised institutions in accordance with the requirements of CSRC.
Singapore code of corporate governance	1.6 Incoming directors should receive comprehensive and tailored induction on joining the board. The company should provide training for first-time directors in areas such as accounting, legal and industry-specific knowledge as appropriate. The company should be responsible for arranging and funding the training of directors. The board should also disclose in the company's annual report the induction, orientation and training provided.
Bangladesh code of corporate governance	V. Companies should recognise that a directorship is a professional appointment and therefore they should provide opportunities and funds for training of individual directors and the development of the board. New directors should be required to attend a corporate governance orientation or training offered by a reputed institution or trainer.

Source: BDTI

Corporate law in Japan gives shareholders more power to limit pay increases than in the USA

In conclusion, therefore, Japanese executives are paid around a twentieth of their US counterparts - not because they don't want to be paid more but because corporate law gives shareholders a lot more power to limit pay increases than in the USA. The performance-pay element is small - arguably way too small - and acts as a disincentive for risk-taking. Unexploded bombs, like at Olympus, are likely to be rare, but the systems for detecting fraud are weak. Many companies do not have outside directors, and some of them generate great returns, but investing in them is like driving without a safety belt. The trouble is that the pool of talent for outside directors is small and there are no requirements about competence or training.

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Market strategy
Prescience & stock offerings

Insider trading

I call this the "Wizard of Oz" defence: a Big Twister hit the firm's customer accounts, chaos ensued, and when the dust settled, no one knew where the heck little Dorothy and her money had gone.

Matt Taibbbi explains the MF Global defence in *Rolling Stone*

Insider trading that involves share offering also an issue

Another recent Japanese scandal that has circled the world through the press has been insider trading involving share offerings. 'It seems to have become common practice for securities companies to leak information as part of their business model,' said legislator Okubo Tsutomu to *The Wall Street Journal*. It was ironic that the story was out on the same day that *The New York Times* ran a 'No charges are likely for MF Global top brass' headline and *Huffington Post* published 'Jon Corzine, ex-MF Global CEO, is considering starting a hedge fund'. Two huge financial scandals drawing to a close, with no senior figures being held responsible and no clear understanding of what happened. Corporate governance is clearly very much a work in progress in all markets.

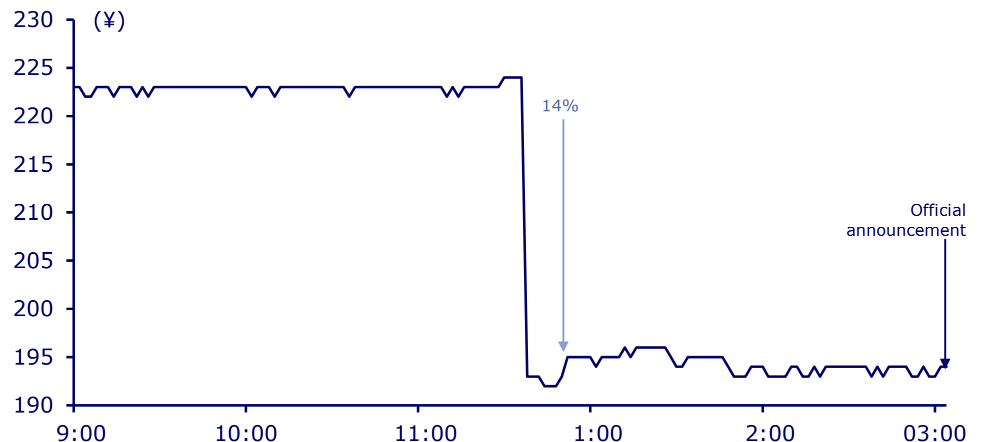
Sadly, insider leaks about equity offerings continue unabated . . .

Our 8 May 2012 *Benthos* note about insider trading, 'Prescience & stock offerings', looked at Mazda's 22 February stock-offering announcement, which was reported as far afield as in *This Irish Times* on the day *before* the firm announced it. Sadly, such abuses abound, still. On the day before ANA's 3 July 2012 announcement, its shares traded the most they had in over three months: 24m shares or nearly three times the daily average of the preceding 25 sessions. On the day of the announcement its shares slumped 14% on 104m shares traded. Then, *after the market closed*, ANA made its announcement. At least one financial-industry publication had reported it the week before.

. . . and ANA was a recent, particularly egregious example

Figure 103

ANA's share-price performance on 3 July 2012 when it announced equity offering

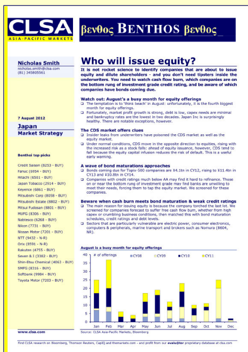


Source: Bloomberg, CLSA Asia-Pacific Markets

It's tough to accuse investors of acting on insider tips when they could have chanced to see it in non-financial newspapers even on the other side of the world. And you have to personally trade on it to be prosecuted, which makes it practically impossible to sue the *source* of the leak. Japanese insider-trading laws have more holes than a teabag. In the USA and UK, tipping is a violation of the law even if the tipster himself does not directly profit.

Insider leaks have similarly poisoned the CDS market

Figure 104 shows a composite of the offerings in 2011. From the peak 24 days before, till the day *before* announcement, shares on average underperformed the Topix by 3.7%. Many tumbled by very much more. In 2009, the decline was as much as 5.4%. By way of comparison, in the USA they *outperformed* the S&P by 0.7% over those 24 days. As we showed in our 7 August 2012 *Who will issue equity?* note, the credit-default-swap (CDS) market has also been poisoned by insider trading, so one way of checking for an offering if you're not getting the tips is to see if the CDS is falling too, because an equity offering reduces default risk for bond holders.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Who will issue equity?
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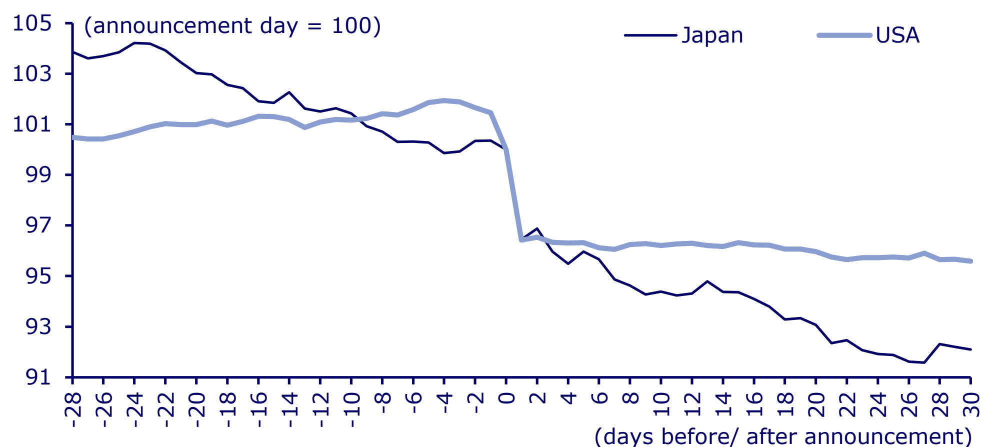
Japan
Market Strategy

In Japan, shares steadily underperform for more than three weeks before an offering

Figure 104

Relative share-price performance around offerings in 2011



Source: Bloomberg, CLSA Asia-Pacific Markets

Companies doing offerings are generally clunkers, hence hard to market

Note that the reason the shares continue to underperform well after the announcement is that most companies do follow-on offerings in Japan because they torched the last lot of capital, so you're unlikely to be investing in a healthy business. That, combined with the long timeline for offerings mandated by the law, makes them harder to underwrite. This would be a plausible reason for underwriters leaking the story, directly and through the media, so that investors will short the stock, guaranteeing a market for the offering to cover the shorts. That way they don't risk getting stuck with the stock in the offering. They are potentially paid 4% for the underwriting, plus stock loans and two-way commission on the stock sales.

Domestic investors and media seem inured to the problem

The problem is as ubiquitous and perennial as the grass. So much so that domestic investors and media are inured to it. In an article on 27 July, the *Nikkei* defended the practice, saying 'the situation surrounding the information leak regarding capital increases at Nomura should not be seen in the same light as the insider trading scandals of the 1990s, when unbelievable illegal activities were rampant. Under the current law, just relaying insider information, in principle, does not constitute a crime'. It described these practices as 'murky grey areas' and cautioned 'regulatory overkill must be avoided. If heightened regulation excessively limits the flow of information, investors and businesses will grow cautious, making

investment and fund procurement difficult'. Again, the biggest problem is the lack of shareholder assertiveness: it is the foreigners that are angrily protesting about the problems of insider trading, while the response from domestic investors has been an eerie silence - for the reason mentioned above: they are generally the subsidiaries of banks, insurers and securities companies, who have told them to not rock the boat.

Insider trading certainly increases information flow, and not everyone thinks it is a bad thing. Nobel laureate Milton Friedman argued 'you want more insider trading not less. You want to give the people most likely to have knowledge about the deficiencies of the company an incentive to make the public aware of that'. But the situation is precisely analogous to your real-estate agent: you pay him to get you the best possible price, but you don't expect him to tell potential buyers that you are desperate and would be prepared to accept a much lower price. Japan enacted its first law against insider trading as late as 1988.

Companies refused to abandon Nomura as an underwriter

You might have expected companies to protect their shareholders by spurning Nomura, the company at the centre of the scandal, which admits lax information handling. In reporting the ANA offering, *The Wall Street Journal* commented 'a spokesman for the carrier said Nomura's involvement in the insider-trading cases was "regrettable", but that ANA chose it for its record in handling corporate finance deals'. A senior executive of Nippon Steel told the *Nikkei* 'we don't intend to exclude Nomura from our list of financing partners because of the insider trading scandal'.

The contrast with other markets is stark

We asked the head of equity capital markets for a major bank in the UK how conditions differ there: 'For a significant transaction, we will often wall-cross days ahead, but we keep the list tight. The wall-crossing is heavily regulated, and I am also careful how many I cross and usually get meetings in diaries on a no-names basis, then tell them who they are seeing nearer the meeting time so that the number of people wall-crossed is kept low and can be investigated. I don't like doing it across a weekend because of leak risk. We often leave any hedge funds to after the market closes on the night before launch. Pre-marketing might be perhaps 6-8 top holders. Sometimes a bit more, but pretty tight. That's not to say that the whole suspicious trading ahead of releases is not an issue, but they are working hard at it and fining people and suspending them from having licences, etc, and they really, really want to put more people behind bars for this kind of thing and every market participant knows that.' The contrast with Japan couldn't be more stark: clearly, clients are brought over the wall substantially earlier than in other markets, more people are involved and the laws to control the flow of information are substantially more porous than in other markets.

The legal response has been lacking

Japanese police like to use the expression *ichibatsu hyakkai* (一罰百戒) - 'the strict punishment that serves as a warning to hundreds'. The punishment meted out to Chuo Mitsui Asset Trust & Banking for trading on insider information was more like a candlelit dinner for two: it amounted to just US$600. Frustratingly, the two-year investigation into insider trading has not only failed to result in high-ranking convictions, the punishments have been astonishingly lenient by global standards - there are few signs that the laws are being tightened up. Japan did introduce laws in December 2011 that essentially copy the US Regulation M. This prevents investors who sell short in the five days before pricing from using newly minted shares to cover their shorts. Since pricing is several weeks after the announcement, it hardly deals

with the fact that the main shorting has already been carried out well before the period covered in the new rule. Other legal upgrades do not appear to be in the pipeline.

What investors can do is avoid fragile companies with FCF burn

What investors can do is to avoid stocks with heavy cashflow burn, credit ratings on the bottom rung of investment grade and bonds coming up for redemption. This is covered in our 7 August 2012 *Benthos* note, 'Who will issue equity?'. For decades, low-PB stocks outperformed year in, year out: Japan was probably the most reliable value investor's market. Since the start of 2009, they have been underperforming. One very likely cause is that investors are shunning these kinds of fragile stocks. Turnaround stories had credibility in Japan while people still believed in the "convoy system" (護送船団) but as bankruptcies multiplied in companies where previously there would have been government support, such as JAL and Elpida, investors came to realise that survival was no longer guaranteed.

Cross shareholdings and anti-takeover measures

Recent scandals give a very negative impression

The impression from Japan Inc's responses to the Olympus and the insider-trading scandals is that Japanese corporate governance is lax and that moves to improve it are lackadaisical and half-hearted at best. This is a pity, because Japan has had a major push over the past decade to tighten up its corporate law, targeting global best practice. The government is short of money, and understands that the best way of being able to tax the corporate sector more is to spur it to make more money.

But Japanese corporate law is now the equal of any in the world

The New Corporate Law, which was introduced in May 2006 essentially cookie-cuttered US Delaware Law apart from where Japanese law was already stricter than US law: de facto, it's now stricter. These codes are now the equal of any in the world. Foreigners who criticise Japanese corporate governance tend to forget how imperfect it is in the USA. In the USA, 40% of companies have poison pills, 45% have staggered boards and 70% have golden parachutes. None of these are issues in Japan. When Steel Partners replaced the entire board of Aderans in one fell swoop, it was making use of freedoms that it did not have in its own home market. Cross-shareholdings long since shrank to insignificance; new accounting rules made them a source of potentially eye-watering writeoffs in a downturn. Capital-adequacy rules forced banks to sell. Laws on fiduciary responsibility require stable shareholders to tender their stakes in a takeover. Many cross-shareholders now have to sell out or buy out their partners - like Nippon Steel and Circle K earlier this year. Our 8 March 2012 *Eye on M&A - Who's calling whose market closed?* report looked at these and other issues in some detail.

CLSA ASIA-PACIFIC MARKETS

Japan strategy

Market outlook

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8 March 2012

Japan
Market

Benthoi top picks

Asics (7936)
Canon (7751)
Hitachi Chemical (4217)
Keyence (6861)
Kubota (6326)
Makita (6586)
Mitsubishi Corp (8058)
Mitsubishi Estate (8802)
Mitsui Fudosan (8801)
Nabtesco (6268)
Nikon (7731)
Nissan Motor (7201)
NSK (6471)
Nomura (8604)
Orix (8591)
Sega Sammy (6460)
Seven & I (3382)
Shin-Etsu Chemical (4063)
TDK (6762)
Toyota Motor (7203)

Eye on M&A
Who's calling *whose* market closed?

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CLSA HAS MOVED TO A NEW RECOMMENDATION STRUCTURE AS OF 1 JAN 2012. PLEASE SEE IMPORTANT DISCLOSURES AT THE END OF THIS REPORT.
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CLSA corporate-governance scores

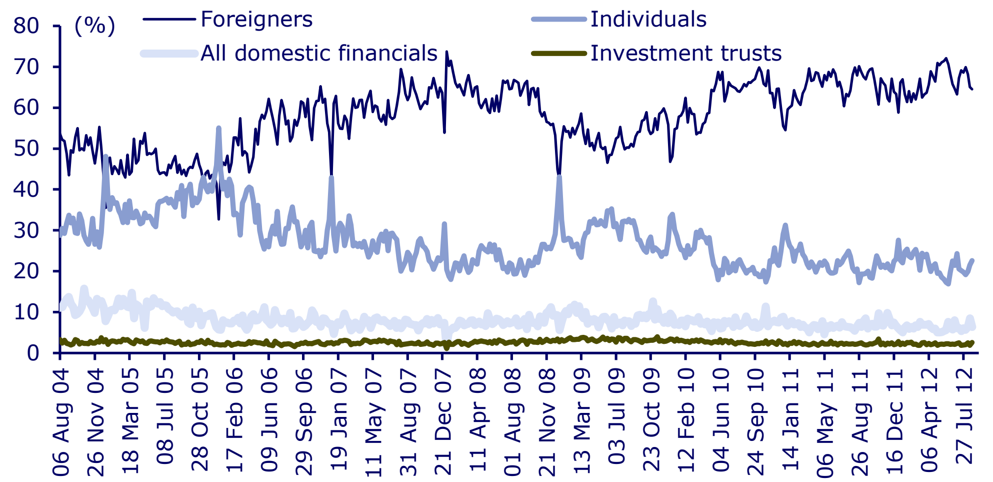
As foreign investors rose in importance, they demanded the CG they knew at home

As foreigners steadily rose to be now by far the most important determinant of share-price movements, their corporate-governance requests gained a new level of importance. Foreigners now typically account for two-thirds of value traded on Topix and, as of the end of FY3/12, they owned 26.3% of Topix market cap. Consolidated accounting became a requirement from 1999; quarterly reporting became a requirement from April 2008 - though most companies had already been providing that disclosure well ahead of the cutoff dates. There has been a little slippage: from April 2011, companies were no longer required to provide quarterly cashflow statements and many quality companies, such as Shin-Etsu Chem, ceased releasing those numbers at that point.

Foreigners account for two-thirds of value traded

Figure 105

Share of TSE value traded by investor group



Source: TSE, CLSA Asia-Pacific Markets

For the banks in particular, it has become increasingly clear that the domestic market is not going to provide them with growth, and that their futures lie overseas. That means they must appeal to a wider shareholder audience. The banks had been known for being the last to release earnings results, but where they used to provide earnings reports within 60 days, now they provide within 45 and they also provide quarterly numbers. Quarterly results meetings mean that access to top management is more frequent.

Improvements stand out for banks

Figure 106

Japan: Biggest CG gainers/decliners (alphabetical order)

Biggest gainers		Biggest decliners	
Ajinomoto	2802 JP	Nippon Paper	3893 JP
Fuji Machine	6134 JN	Olympus	7733 JP
JR Central	9022 JP	Unicharm	8113 JP
JSW	5631 JP		
KHI	7012 JP		
Kubota	6326 JP		
Kuraray	3405 JP		
Mizuho Financial	8411 JP		
MUFG	8306 JP		
Shiseido	4911 JP		
SMFG	8316 JP		
Teijin	3401 JP		
Toray	3402 JP		
Toyo Engineering	6330 JP		

Source: CLSA Asia-Pacific Markets

Olympus, of course, slumped most

On the negative side, the company for which our CG scores fell most was Olympus. Given the scandal surrounding former CEO Michael Woodford revealing serious fraud in the company's accounting, there should be no surprise there, and we have already discussed that above.

Unnecessary equity issuance remains a problem

Unicharm's scores dropped because of unnecessary equity issuance, though it was by no means the only company that succumbed to Nomura's persuasion. It wasn't just that news of offerings were leaked: Tokyo Electric Power's was another of many examples of offerings that were widely regarded as unnecessary at the time.

Nippon Paper has been under massive external pressures

Nippon Paper, another decliner, has been under massive external pressures from the shrinking demand for paper and intense competition from lower-cost Asian competitors. The company was slow to adjust, resulting in losses. Out of desperation, it bought 15% of Lee & Man Paper, but seems unlikely to gain control or enjoy cashflow from its investment. After the Tohoku disaster, it felt a social duty to spend almost US$1bn rebuilding its Ishinomaki plant, which seems unlikely to ever generate acceptable returns.

Tokyo Electron, Osaka Gas, and Tokyo Gas among the top scorers regionally

Ricoh, Kuraray, Ushio and Asahi Kasei also in the top quartile in the region

Figure 107

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

Company	Code	Company	Code
Advantest	6857 JP	Nintendo	7974 JP
Asahi Kasei	3407 JP	Nippon Paint	4612 JP
Bridgestone	5108 JP	Nippon Paper	3893 JP
Canon	7751 JP	Nippon Steel	5401 JP
Chubu Electric	9502 JP	Nissan Motor	7201 JP
CMP	4617 JP	NTT Urban	8933 JP
CyberAgent	4751 JP	Oji Paper	3861 JP
DeNA	2432 JP	Osaka Exchange	8697 JP
Ebara	6361 JP	Osaka Gas	9532 JP
Fujitsu	6702 JP	Panasonic	6752 JP
Gree	3632 JP	Rengo	3941 JP
Hitachi	6501 JP	Ricoh	7752 JP
Hitachi Chemical	4217 JP	Sega Sammy	6460 JP
Honda Motor	7267 JP	Sharp	6753 JP
Hoya	7741 JP	Shin-Etsu Chem	4063 JP
Inpex	1605 JP	Shiseido	4911 JP
Itochu	8001 JP	Softbank	9984 JP
JFE	5411 JP	Sony	6758 JP
JGC	1963 JP	Sumitomo Bakelite	4203 JP
J-Power	9513 JP	Sumitomo Metal Ind	5405 JP
JSW	5631 JP	Sumitomo Rubber	5110 JP
Kansai Electric	9503 JP	Taiheiyo Cement	5233 JP
Kansai Paint	4613 JP	Taiyo Yuden	6976 JP
Komatsu	6301 JP	TDK	6762 JP
Konica Minolta	4902 JP	Teijin	3401 JP
Kubota	6326 JP	Tokyo Electron	8035 JP
Kuraray	3405 JP	Tokyo Gas	9531 JP
Mandom	4917 JP	Tokyo Ohka	4186 JP
Marubeni	8002 JP	Toray	3402 JP
Minebea	6479 JP	Toshiba	6502 JP
Mitsubishi Corp	8058 JP	Toyo Engineering	6330 JP
Mitsubishi Electric	6503 JP	Toyo Tire	5105 JP
Mitsui	8031 JP	Toyota Motor	7203 JP
Mitsui Fudosan	8801 JP	Ushio	6925 JP
Murata	6981 JO	Yahoo Japan	4689 JP
Nabtesco	6268 JP	Yamaha Motor	7272 JP
NGK Spark Plug	5334 JP	Yaskawa Electric	6506 JP
Nikon	7731 JP		

Source: CLSA Asia-Pacific Markets

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Korea - Waking up from hibernation

After a long hiatus, Korea has begun to refocus on CG reform in the past two years. Some notable improvements have already taken place - in particular, in enforcement and the political/regulatory environment - and more progress in upgrading the country's CG regime should take place in the coming months. As a result, Korea's overall score this year rose to 49%, from 45% in 2010, allowing it to move up one rung to the eighth place in our 2012 rankings. Along with the Philippines, the country's 4ppt improvement in overall score is the best showing among the 11 regional markets.

Government, not the corporate sector, leads reform

But Korea's welcome shift towards reform is again led by the government rather than the corporate sector, which remains largely indifferent to pursuing voluntary, bottom-up change. Even as an increasing number of Korean companies grow into world-class enterprises, their governance standards and practices continue to lag considerably behind those of their global peers. To wit, we cannot name a single prominent Korean businessman who champions the CG cause in public discourse and aspires to be a leading light for change. (A piece of unsolicited advice to Korean tycoons: whoever is willing to take on this challenge first will win instant respect and gratitude of the global investing community.)

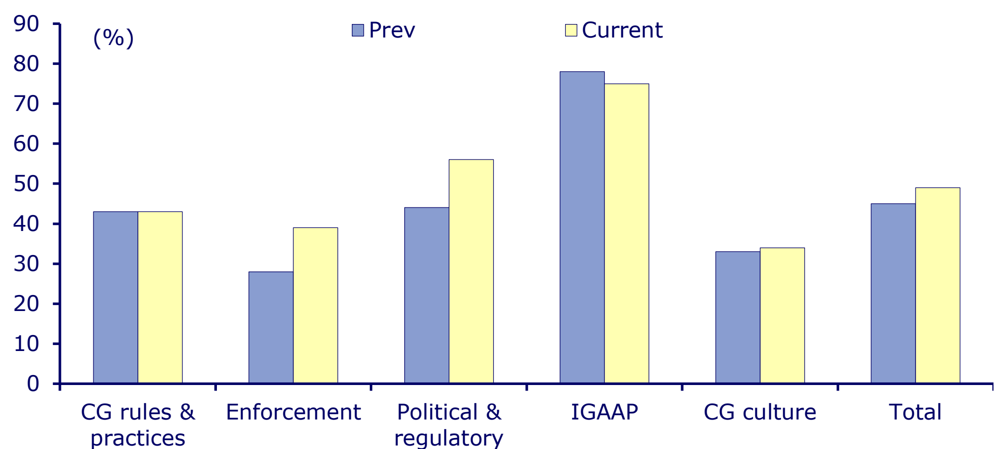
Public backlash against pro-business stance

Given the deeply ingrained conservatism of Korean companies, however, the fact that the government is moving forward again on CG is certainly no bad thing. Two years ago, Korea tumbled closer to the bottom of our rankings because of what we felt was a virtual collusion between the government and business to sweep aside corporate governance and focus on "growth" amid the global financial crisis. But two crucial elections this year - the parliamentary poll in April and the presidential vote in December - have concentrated the minds of politicians on the mounting public backlash against that blind pro-business policy and the widespread anti-*chaebol* (family-owned conglomerates) sentiment it has engendered.

Korea ranks below regional average in CG culture, rules and enforcement

Figure 108

Korea CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

Presidential pardon for tycoons may be limited

Many Koreans feel that big business groups and the families that control them have shamelessly taken advantage of the government's pro-growth agenda to expand and enrich themselves at the expense of smaller firms and ordinary workers. The widening income gap between the rich and the poor has also become a campaign issue potent enough to tilt both the main conservative and liberal parties to the left. Indeed, in the run-up to the National Assembly

elections - won in an upset by the conservative camp - the two sides competed to unveil policies that, if implemented, would greatly clip the wings of *chaebols*. One noteworthy proposal from both camps was to limit the use of presidential pardons for tycoons convicted of economic or corporate crimes.

Will reform continue post elections?

Alas, this political backdrop means there is a distinct possibility that Korea's renewed momentum on CG may lack conviction-and could fade once this year's election season passes (there will be no new national elections until 2016). One worrying sign is that many Korean companies and market participants that we met with still seemed ignorant of, yet unconcerned about keeping up with, major global CG developments and trends. If anything, we sense a widely shared fatalism among most Koreans that the reform process can only go so far, because certain features of the current system - such as the *chaebol* structure - are simply accepted as the Korean way of doing business.

CG rules and practices

Significant regulatory updates in the pipeline

Be that as it may, on the policy front, there has been a clear pendulum swing since 2010 towards reform. As we give credit only for laws and regulations that have been enacted, Korea's rules and practices score has remained the same as two years ago at 43%. But in the pipeline are major regulatory updates that should further strengthen its CG regime. Working in parallel, the Ministry of Justice (MOJ) is updating the Commercial Act and the Financial Services Commission (FSC) is drafting a new Corporate Governance of Financial Companies Act to enhance board independence at public companies and financial institutions. Expected to be tabled in parliament later this year, the key changes the MOJ and FSC are seeking include:

Boards to have majority of outside directors

- Extending the requirement for the board to have a majority of outside directors to all listed companies with assets of more than 1tn won (down from 2tn won), as well as to all financial institutions;
- Prohibiting a person from serving as an outside director at more than two listed companies;
- Requiring the audit committee to be composed of only outside directors;
- Extending the cooling-off period for former employees of the company and its affiliates to three to five years from two before they can serve as an outside director; and
- Requiring electronic voting for all listed companies with more than 1,000 shareholders and cumulative voting for all listed companies, to encourage more shareholder participation in the election of outside directors.

To update the Code of Best Practices

Meanwhile, the Korea Exchange (KRX) and its affiliate dealing with CG matters, the Korea Corporate Governance Service, are working on an update of Korea's Code of Best Practices for Corporate Governance as part of its roadmap to advance the country's listing system. This is a long-overdue task, as the code was last revised almost a decade ago in February 2003 (we have downgraded Korea's score on this question for not keeping up with regional and global standards). Among the positive changes the KRX is considering is the adoption of a "comply or explain" principle for public companies on their adherence to recommended guidelines. If adopted, this would give some teeth to the widely ignored code.

Corporate reaction has been lukewarm

These are all steps in the right direction to bring Korea's CG system closer to global and regional standards. But they are not yet a done deal - and the corporate reaction has been decidedly lukewarm. The business lobby should push back hard to dilute or derail some of the proposals, not least because it is still smarting from the last round of reforms.

Restrictions on *chaebol* insiders

In April 2012, a number of amendments to the Commercial Act intended to curb *chaebol* insiders from gaining unfair business advantages went into force (this development is reflected in our higher score for the political and regulatory environment category, rather than for CG rules, because the effect of tougher rules remains to be seen). Among others, they stipulate that:

- Rules on conflicts of interest are applicable not only to company directors, officers and controlling shareholders, but also to their family members and associated firms; and, for all personal transactions with the company, prior approval by two-thirds of the board is required.
- Directors who want to take advantage of a business opportunity they come across in the performance of their duties must obtain approval from two-thirds of the board. If they violate this rule and make profits for themselves, then those personal profits would be considered a loss for the company and would have to be paid back to the company.

However, a limit set on general liability

- The general liability of directors in other cases, however, is capped at six times the annual compensation for inside directors and three times for outside directors - there was no ceiling previously. We understand that this provision was a concession to the business lobby in view of the stricter new rules governing the first two situations.

Outmoded corporate conduct

Despite all this, another reason why Korea does not score higher in the CG rules and practices category is because of outmoded corporate conduct. Two years ago, we noted weaknesses in non-financial reporting practices of listed companies regarding management discussion and analysis (MD&A), director reports and CG statements, as well as a relatively short lead time in releasing the AGM agenda and non-existence of poll voting at the meeting itself. Regrettably, there has been little improvement in any of these areas.

Enforcement

Enforcement has improved

In terms of enforcement, Korea's score at 39% has risen 11ppts from 2010. Although it may have been partly motivated by a political opportunism to strike at the unpopular *chaebols*, Korean regulators have noticeably stepped up their enforcement efforts in the past two years. There have been some high-profile, litmus-test cases: the embezzlement charges against the two brothers that run SK Group in 2011 and the conviction of the head of Hanwha Group in August 2012, also on embezzlement charges. In the case of Hanwha's Kim Seung-youn, he was given a four-year jail sentence and immediately incarcerated, in a break with Korea's tradition of leniency towards corporate tycoons for their contributions to the economy.

Some reactive regulatory actions

But some regulatory actions have been more reactive than proactive. For example, in suspending a number of severely undercapitalised and sometimes corrupt savings banks since early 2011, the Financial Supervisory Service (FSS), the country's single financial-markets enforcement agency reporting to the FSC, was largely making up for its own failings in monitoring the second-tier banks, which had lent too aggressively in the property sector before the outbreak of the global financial crisis.

NPS urged to deploy its voting power

Meanwhile, Korea is slowly waking to the potential of market-based enforcement by investors. The fact that many domestic asset-management companies are affiliated with big business groups is an obvious hindrance to the exercise of their voting rights in an informed and active manner. One encouraging development, however, has been the possibility that the National Pension Service (NPS) may soon be enlisted to wield its massive voting power

to spur better CG. In April 2011, a top adviser to President Lee Myung-bak sent chills down the spines of *chaebols* when he suggested that the US$300bn state fund should vote its shares more actively to reform the conglomerates in the name of public interest. The NPS is often the biggest institutional shareholder of large listed Korean companies with stakes of 5% or more. Although NPS officials themselves remain cautious about their role for fear of becoming pawns in a political game, in 2011 they launched an environment, social and governance (ESG) fund that follows socially responsible investment (SRI) principles.

Political and regulatory environment

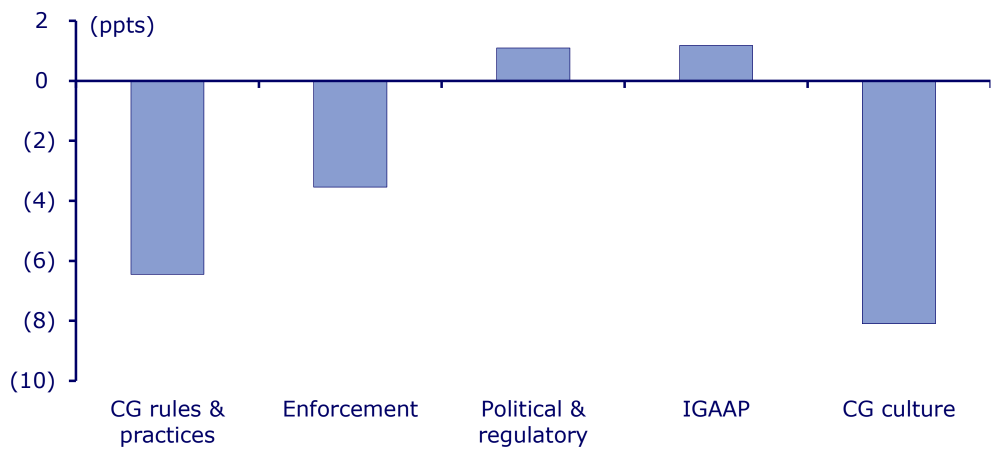
Determination to plug gaps in the laws relating to CG

The score for this category showed the biggest improvement this year, leaping to 56% from 44% in 2010. This is because we feel that the government should get credit for its renewed effort to improve Korea's CG regime, even if crucial changes have yet to be enacted. As noted earlier, it remains to be seen if the political momentum for reform will continue under the new parliament and president through next year and beyond. We have been, however, genuinely impressed with the determination of working-level officials at the MOJ and FSC to plug the gaps in Korea's CG laws and regulations and to bring them closer to global standards. Both agencies are now more receptive to hearing outsiders' views, and our own dialogue with them has much improved compared to two years ago when it was difficult even to set up meetings. But one problem that is likely to persist is the Korean tradition of rotating officials working in government agencies from post to post every few years. This can hinder both skills-building of civil servants and relationship-building with outside parties.

Korea ranks above the regional average in the political and regulatory and IGAAP aspects

Figure 109

Korea: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Courts handing down rulings against *chaebols*

The more CG-friendly political atmosphere extends to the judiciary and the media. Besides the case against Hanwha's Kim, the courts have handed down other major rulings against *chaebol* companies. For example, in February 2011, minority shareholders succeeded in obtaining a Seoul court order against Chung Mong-koo, chairman of Hyundai Motor, to compensate the company 74.6bn won for helping with unfair transactions between Hyundai Motor and its affiliates, Hyundai Mobis and Hyundai Glovis. At the same time, the Korean media, which are free, boisterous and quick to shift with political winds, have become more aggressive in reporting such stories of corporate sins and foibles than a couple of years ago.

IGAAP (accounting and auditing)

Korea scores well on IGAAP

Once again, Korea did best in this category, with a score of 75% this year. But that was a drop from the 78% in 2010. This was because we became more critical of the auditing practices of large Korean companies, given the recurrence of corporate embezzlement scandals. Big Four-affiliated auditors also failed to warn about the brewing crisis at savings banks.

IFRS adopted since 2011

On the positive side, Korea adopted IFRS for all listed companies from 2011, bringing in local accounting rules in line with global standards. Thanks to IFRS, consolidated accounts and segment reporting are now mandatory (the only exception is that small companies with less than 2tn won in assets will not be required to disclose consolidated accounts until 2013). Even here, however, we note that some Korean companies may be using the takeup of new accounting standards to delay the release of audited financial results, as well as to use certain features of IFRS to massage their numbers and accentuate the positive. This shows that the large gaps in rules and practices will continue to challenge the efforts to improve Korean CG.

CG culture

CG treated as a compliance issue

There is, meanwhile, a dearth of news articles about companies pursuing good CG. That is hardly surprising because there are precious few such cases! We believe most Korean companies treat corporate governance as basically a compliance issue, rather than as something that could bring tangible benefits to their businesses. We have met few listed Korean companies that were willing to discuss governance issues by making available board members or senior executives. Most delegate that responsibility to their IR departments, which usually come across as defensive and wary when fielding questions. Consequently, we see no signs that a trend towards voluntary CG improvements among Korean companies will take off any time soon. According to the *Financial Times*, an estimated 90% of listed Korean companies are family-owned, and we suspect that many of them would rather not deal with minority shareholders at all, if they could.

Electronic voting system introduced

Despite our generally negative assessment on corporate attitudes towards governance reform, Korea's score in the CG culture category has risen in the past two years to 34% from 32%. This is partly due to the fact that the Korea Securities Depository introduced an electronic voting system in 2010 to make it easier for retail and minority shareholders to vote their shares. But so far, no major listed company has taken it up and many are hostile to the MOJ's plans to mandate its adoption.

Factors to watch

Figure 110

Korea: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- No progress in enhancing the independence of outside directors and other planned board reforms.
- No update of the Code of Best Practices for Corporate Governance.
- Continued abuse of suspended sentences and presidential pardons for corporate criminals.
- Failure to show progress in the regulation of auditors.

Actions that could improve overall CG

Figure 111

Korea: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- Strengthen non-financial reporting standards and practices (eg, more detailed MD&A, CG statements).
- Enhance corporate disclosure of internal-control and risk-management functions.
- Adopt electronic voting and voting by poll for all resolutions at AGMs.
- Release detailed AGM agendas at least 28 days before the meeting.
- Spread out AGMs to avoid clustering.
- Increase director training.

Source: ACGA

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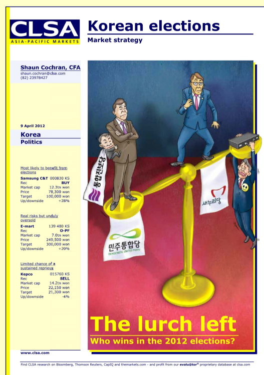
Research perspective - Target *chaebols*

The global push against the 1% is translating to an improved outlook for Korean minorities

In Korea, local governance trends have mirrored the global economic ones insofar as the top-down factors have overwhelmed bottom-up elements. Politics is proving the most important issue to watch in trying to anticipate major changes. The opposition party have tried to demonise the ruling party by casting it as too close to business. However, in response, the ruling party has artfully recrafted its primary policy agenda. It is attacking special interests without the *chaebols*. This is possible from a pro-business party by making a clear distinction between the conglomerates that Korea respects and supports for their past and expected future contribution to Korea's success. On that front, its policies remain steadfastly pro-business. However, where the party has clearly shifted is in its willingness to sponsor targeted legislation that dramatically undermines the ability of the families that control the *chaebols* to extract personal benefits from their privileged positions.



Main CG issues over the past two years

The importance of the shifting political sands was outlined in detail in our April report, *The lurch left*. These changes in Korea reflect a global trend. Voters are questioning the fundamental fairness of the world's prevailing political and economic outcomes. They seek greater social justice. In fact, trust of the political leadership is low. Some see trust for the government as even lower than for that of the *chaebols*. The distinction appears to be that despite the unfair advantages that contributed to *chaebol* success, their role in building Korea as a modern nation is clear. No such consensus exists for Korean politicians.

Korea's incoming president will need to acknowledge the dramatic shift that has occurred in the power balance between government and industry. The risk partnership that characterised the seventies and eighties was enabled by deep government control of domestic financial and product markets. Modern Korean governments must acknowledge they can no longer easily command the actions of privately controlled businesses.

The surge in anti-*chaebol* sentiment is real but policy options must be pragmatic

Ironically, this now means that the government is more open-minded to measures that could help them impose discipline on the, until now, all-powerful *chaebols*. As a result, the recent surge in anti-*chaebol* sentiment is real. Furthermore, some aspects of the policy prescriptions are ethically very difficult to argue against. This is because the most aggressive policies specifically target capital-management practices that are believe to transfer wealth from shareholders towards the controlling families.

Minority investors are not the target of these polices but they will benefit nonetheless

In reality the most aggressive policies will be toned down due to practical constraints and the importance of the *chaebols* to the economy. However, investors should make no mistake; there is a clear push to reduce the ability of families to exploit control of companies that is not driven from legal or economic control. All of this is fundamentally good news for minority investors. While it is critical to acknowledge that enhanced minority protection is not the primary or even tertiary goal of this process, in order to protect the interests of the Korean public, the interests of institutional investors will automatically be advanced as well.

Extraordinary shift already underway

Thus, the aggressive shift left by the opposition coalition is a direct response to the weak global economic conditions. Also, the electorate has long been frustrated with the inability of the Lee Myung-bak government to

The degree of legislative change that has already passed is extraordinary

meaningfully raise households' share of wealth. However, it is critical to acknowledge the bipartisan components of this process. The right have deliberately shifted components of their policy platform towards reigning in the most egregious misappropriations of the *chaebols*. While the primary driver is a political agenda of being seen to deliver social justice, institutional investors become the happy ancillary beneficiaries of the improved minority protection that this ultimately entails. While sceptics will suggest that tightening legislation in Korea has historically been easily outmanoeuvred, we should not underestimate the significance of the changes going on. This is before we consider the more extreme measures being proposed by some of the harder-line members of the opposition now we are headed into presidential elections.

In his April 2012 *Public frenemy* report, senior conglomerates analyst Steve Chung detailed the specific changes in Korea's legislative and regulatory environment. The overarching theme is more restrictive policies around CG and punitive measure to restrict the power of the *chaebols* or, more specifically, the directors that control them on behalf of families who benefit from their privileged positions. In the report, Steve identifies several legislative and regulatory changes that are already in effect. He also highlighted additional legislative changes that have been proposed by leftwing law makers. It behoves investors to understand this shift so we highly recommend reviewing the report, but for the moment Figure 112 provides a summary of the core changes. On the opposite page, we go into detail on what we believe are the three most important changes to Korea's commercial law and tax code.

Figure 112

Actual and proposed legal and regulatory changes in Korea

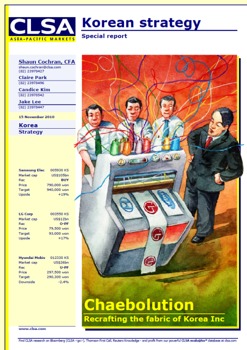
Status	Law / regulation / issue	Intent
Actual law changes	Deemed inheritance tax	Directly tax family members that extract excessive benefit from intra-group transactions.
	Internal transaction reporting	Lower the threshold for internal transaction that companies must report.
	Internal transaction approval	Approval of internal transactions and new business dealings with third parties now require approval by two-thirds of board of directors. Directors have a fiduciary duty to protect their company's interests. If approved transactions or deals prove to benefit families or management at the expense of minorities, the approving directors are personally liable for the losses.
	Corporate opportunity usurpation	
	Personal and corporate taxation	Raise the maximum personal income tax rate to 38% and cancel prior corporate tax cut plans.
Actual regulatory changes	MRO limitation	Limit maintenance, repair and operation (MRO) expansion by *chaebols* to protect SMEs.
	Property development	Delay or cancellation of property development projects to control apartment price.
	Excluding *chaebols* from government-related business	To protect SMEs; prevention on *chaebols'* food companies from operating restaurants at the public offices. Excluding *chaebols* when granting new licences to duty-free shops.
Pending proposals	Holding-company structure	The government was expected to ease restrictions of industrial holding companies owning financial subsidiaries, but this legislation has been repeatedly delayed and looks unlikely.
	Holding-company holding limits	Tied to the above reform an additional loosening proposal to eliminate the requirement for great grand child subsidiaries to be 100% owned has also been repeatedly delayed and looks unlikely.
	Intra-group investment limits	The government is thinking of reimposing investment limits on intra-group holdings to reduce the expansion of *chaebols* into peripheral industries.
	Circular ownership	A more extreme measure that has been actively discussed and is usually championed by the left is to outlaw circular ownership structure which would forces restructuring for some groups.
	Chaebol-specific taxation	There was some discussion of additional taxation on dividends and revocation of tax deductions on debt incurred to buy affiliates, but latest newsflow suggests some retreat from this.

Source: CLSA Asia-Pacific Markets

Anti-*chaebol* regulations have tightened; the degree of change is simply stunning

New, tougher *chaebol* regulations

The central ideological premise of these changes in the law (at least in the language) enshrines a goal of fairness. It directly attacks wealth appropriation practices of *chaebol* families. Decades of history had until now suggested this was implicitly accepted as unavoidable costs of a conglomerates-dominated national business model. Now it is important to note these laws only add value if someone can successfully litigate to trigger them, a very important "if". Nonetheless, it is an extraordinary shift in the implicit social contract between Korea's elite and the common people. Most importantly, given the movement drives the central premise of increasing equality of opportunity and the fundamental fairness of Korea's economic and legal systems, it is highly likely that the right cannot reverse their support for it.



Key legal changes since our original *Chaebolution* report

By Steve Chung, senior conglomerates analyst

Of the changes to the law highlighted above by ACGA, there are three key developments investors should make themselves aware of in particular. Two of these are commercial law changes. They were passed in 2011 and were implemented with a one-year grace period, which came to an end on 15 April 2012. The third change is a change to the tax code that was made in late 2011. All three attack any conglomerate effort to extract personal gains for families or senior management from the businesses.

Directors are now personally liable if they approve unfair internal transactions that hurt minorities

Commercial law: internal transactions. In a change that has attracted limited focus from the market, the revised commercial code now requires that internal transactions related to directors and family members must secure the endorsement of two-thirds of the board of directors. These transactions should be fair business transactions. Now this in itself is not a game-changer. The boards of the *chaebols* are far from truly independent. However, the real surprise of the regulation comes when one asks the all-important 'or what?' question. Under the new internal transaction laws, if the required fairness is violated, the directors directly involved and the directors who approved the transaction will have to indemnify the company's losses, which are very logically defined as equal to the directors' gains.

This same position is being applied to new business opportunities

Commercial law: usurpation of corporate opportunities. An additional revision seeks to prevent the "usurpation of corporate opportunity'. Directors, during the course of normal operation, must not take advantage of a good business opportunity for themselves, at the expense of the company. This kind of transaction also needs approval by two-thirds of the board of directors. If violated, gains by directors or third parties are estimated to be losses for the company. Obviously, judging a good opportunity can be very discretionary. Also, an outside litigant must lodge these charges with the burden of proof on the litigant.

A new direct tax on the families limits future gains from existing privileged structures

Tax code: deemed inheritance. Korea has a new levy. The direct translation of its Korean name is 'deemed inheritance tax on concentrated works between special affiliates'. Put simply, the government now tax gains of companies that generate "easy" revenue from intra-group transactions. Beneficiaries in this context are typically companies where family members of *chaebols* have a controlling interest in. The rule is complex. We understand it will only apply to operating profit generated from self-reported intra-group transactions that are more than 30% of the total. We believe the tax is imposed on major individual shareholders and relatives for that part of their stake that exceeds 3%.

Presidential policy cycle pushing things further

Ruling party's 48-man pack is proposing some aggressive anti-*chaebol* legislation

There is now a 48-man Gathering to pursue Democratisation of the Economy force within the ruling party. It is putting forward a raft of proposals that would severely constrain the ability of controlling *chaebol* families to retain their current control structures. The most important issues are the proposal to abolish the voting rights of existing indirect stakes held by the *chaebol* families that use circular ownership to build large intragroup positions; and the proposed prohibition of any new cross-holding schemes.

The key goal is to strip circular ownership structures of indirect voting rights

The party's goal is to eliminate the value of the final link of circular holdings. As such, the law would limit company D's voting rights controlled by company A in a holding structure where A owns shares in B which owns shares in C that owns share in D. Interestingly, the ruling party's most likely presidential candidate Park Geun-hye is understood to be reluctant to regulate existing circular ownership structures, preferring to ban the establishment of new circularities.

If these laws are passed the change for Samsung and Hyundai would be truly transformational

This internal debate captures the fundamental struggle for the ruling party. If existing circular ownerships are attacked, the degree of change within the Samsung and Hyundai groups will be truly transformational. As such, at a minimum, we should expect at least four-year grace periods (the standard two followed by the request for a two-year extension). We should also remain open-minded to the idea that these laws are never passed or massively diluted through reductions of the limits placed on companies or expansion of the exception clauses.

This is clearly a risk for Hyundai and Samsung

Nonetheless, should these changes go through, they will rock the foundation of Korea's equity markets. Although we are yet to get meaningful details to confirm how the laws would apply, according to CEO Score website's estimates, Hyundai Motor's management rights are most at risk. Out of 15 companies' cross holdings (A → B → C → D → A), when D's share in A was divided by family's stake in A, Hyundai Motor was the highest (4.0), followed by Hanjin (3.17), Dongbu (2.29), Lotte (1.22), Youngpoong (0.98), Hite Jinro (0.96), Hyundai Heavy (0.79), Samsung (0.48), then Hyundai, Hyundai Department Store, Halla, Dongyang, HDV, Hanwha and Daelim - all below 0.3.

Industrial holdings in banks are also being reconsidered

An additional measure being proposed is to reconsider the current regulation where non-financial companies can retain up to 9% voting rights in bank affiliates. This is likely to be lowered, but will not have a major impact on the system as bank stocks are not a huge factor for the industrial sector. It may affect the regional banks from an overhang perspective, if stakes are required to be sold.

Most importantly to Samsung Life, holdings in industrials are being reconsidered

More important is the potential to reconsider the rule that allows non-bank financial holding companies to own non-financials as affiliates or "grandchild" affiliates. This is the key change in that it would make Samsung Life's stake in Samsung Electronics definitively illegal if Everland were to become a holding company. At the moment, there is a debate about if Samsung could argue the stake is not for control.

As a side benefit, these changes could trigger consolidation in insurance and brokerage industries

Finally, given that most bank entities have already been separated from non-financial entities, they will debate on whether similar measures are needed to separate insurance/brokerage assets from large *chaebol* affiliate structures. This would be hugely positive for the insurance and securities industries if it could force divestments and potentially trigger consolidation among the smaller industry players.

Changing CG environment

Traditional governance factor have deteriorated though sustainability is gaining awareness

On aggregate, the CG scores for Korea companies have slightly decline in 2012 versus 2010 (about 2%). The decrease was caused mainly by falling independence, discipline and transparency scores. This was largely offset by better fairness and especially the C&G and CSR score. The action level and interest in answering the sustainability questions has notably improved. Of course, during the past two years our coverage has changed. To test this impact, we reran like-for-like comparison. The results remain broadly in line. The CG scores were slightly down (about 1%). Once again, independence, discipline and transparency still seem to be the causes of this drop with C&G, CSR and fairness providing the offset.

Add independence questions this year favoured NHN

One factor that influences our assessments of companies in these surveys is obviously the changes in the questions we ask. This year, we have added additional questions regarding independence. As a result, this has improved the already strong performance of NHN. The company has steadily added to the number of independent directors since 2008. For other companies like KT&G, we witnessed small but valuable changes like the separation of the roles of chairman and CEO.

Banks are losing relative ground as other pick up their act

This year, we scored 82 companies. Among the 21 companies in the top quartile, three are banks. While this continues to reflect the financial sector's post-crisis cleanup, their distributed ownership (with limited *chaebol* connections) and high foreign holdings, it also highlights the improvements outside the sector. This number was six in the 2007 survey.

Large international firms offer the most globally competitive governance

The second-best-represented group among high-scoring companies remains the large corporations with high institutional ownership. Samsung Electronics, many LG companies and Hynix fall into this category. The drivers of best practice among these companies remain the same legacy arguments like a history of financial distress that required a major cleanup in a similar way as at the banks (Hynix), a concerted group effort to try to improve its structure and governance (LG from 2002-04) or a history of activism among shareholders (Samsung Electronics). It is interesting to note that SK Hynix still retains strong governance infrastructure, much of which has thus far survived the transition in ownership.

Daum one of the top-10 CG scorers in the region

Figure 113

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

Company	Code	Company	Code
BS Financial	138930 KS	LG Corp	003550 KS
Daewoo E&C	047040 KS	LG Display	034220 KS
Daewoo Sec	006800 KS	LG Electronics	066570 KS
Daum	035720 KQ	LG H&H	051900 KS
DGB Financial	139130 KS	Lock&Lock	115390 KS
Dongkuk Steel	001230 KS	LS Corp	006260 KS
E-mart	139480 KS	NCSoft	036570 KS
GS E&C	006360 KS	NHN	035420 KS
Hana Tour	039130 KS	Orion	001800 KS
Hankook Tire	000240 KS	Posco	005490 KS
HDC	012630 KS	Samsung C&T	000830 KS
HMFI	001450 KS	Samsung Card	029780 KS
Honam	011170 KS	Samsung Electronics	005930 KS
Hynix	000660 KS	Samsung Eng	028050 KS
Hyundai Steel	004020 KS	Samsung F&M	000810 KS
Jusung	036930 KQ	Seoul Semicon	046890 KQ
KB Financial	105560 KS	Shinhan	055550 KS
KEB	004940 KS	Shinsegae	004170 KS
Korean Re	003690 KS	SK Innovation	096770 KS
KT&G	033780 KS	S-Oil	010950 KS
LG Chem	051910 KS		

Source: CLSA Asia-Pacific Markets

Our deeper mid-cap coverage contributed to lower CG scores

Of the weaker-performing companies in our governance survey, there was not a clear industry theme. Partly the drop in bank performance can be attributed to some loss of control of the revenue lines in order to support a government policy agenda to contain increases in the cost of living. Beyond this, if we had to isolate a theme, it would be that the expansion in our coverage has primarily been among mid- and small-cap companies that tend to exhibit poor governance as a function of reduced experience dealing with markets, tighter ties to original founders and often simple scale limits to the infrastructure and effort they can afford to allocate in developing their contract and relationship with shareholders.

Samsung SDI has suffered due to the SMD transactions

Some companies' rankings have suffered due to specific events that have disadvantaged minority shareholders. Samsung SDI is an interesting case in point. The company was involved in two controversial decisions related firstly to the reduction of its ownership share in its OLED subsidiary Samsung Mobile Display (SMD) and secondly to the purchase of a loss-making solar business. Both transactions were with its parent Samsung Electronics.

But second transaction of the year redeemed its position in many respects and was direct result of changing regulations

What is interesting about the SMD transaction is that it shows the importance of the changing regulatory environment in action. This is because Samsung SDI has reduced its stake in Samsung SMD in two transactions thus far. The first transaction involved SDI not participating in a very cheap rights issues for SMD, which effectively saw Samsung Electronics increasing its stake at attractive terms. The significance of this deal is that it was completed prior to the new director fiduciary duty laws (discussed earlier on page 127). The second transaction, however, was a merger that saw Samsung Electronics contributing assets at modest valuations and Samsung SDI contributing SMD at substantially higher valuations than the first transaction. We would argue that this significant improvement in the relative terms for SDI shareholders was probably a direct result of the changing legal environment. For a full discussion of this process, please refer to our April 30 *Chaebolution - A silent revolution?* note.

Irion was hurt by a jail sentence for its chairman

Other deteriorations in scores were more straightforward. Woongjin Coway's disclosure has become less detailed under IFRS as it no longer supplies quarterly overseas information. We also have some concerns about some inter-company sales of assets. Looking at the case of Orion, we see another unfortunate incident where the chairman of a Korean company has found himself sentenced to jail time.

Woongjin and Hankook have suffered due to holding-company concerns

Hankook Tire has no benefits from the decision to change to a holding-company structure. This would seemingly penalise minority shareholders at the expense of family members. Given that the company structure and asset holdings are not particularly complex, it is difficult to see a strong reason for the restructuring other than as a highly tax-effective means to transfer ownership and control from father to son. Certainly, we see little evidence of strong shareholder desire for the move.

Kepco, like banks, is hurt by government reluctance to allow price hikes

Finally, Kepco has been impacted by its inability to control its own revenue line. While this is a function of the necessary negotiation with a government price-setter and not of the lack of trying for better pricing from directors, the risk is one that shareholders must face nonetheless. We also do have some concerns about the practice of accruing receivables expectations of future tariff hikes, as there is a question around the degree of certainty one can associate to those revenue streams.

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Malaysia - Culture rising

Malaysia has made progress since CG Watch 2010, with its overall score rising 3ppts to 55% and going up in the rankings to joint fourth with Japan. The government has taken a long-term view and the securities regulator has published a five-year Corporate Government Blueprint last year that covers everything from shareholder rights, the role of investors and board governance to the role of gatekeepers and intermediaries.

Companies more transparent this time around

But more surprising, and definitely welcome, is the fact that companies seem to be taking more interest in improving CG practices. On one level, this may be due to pressure from regulators to be more transparent and improve their governance culture; on another there are companies, and not just large caps, that we have found more open to discussing governance best practices than two years ago.

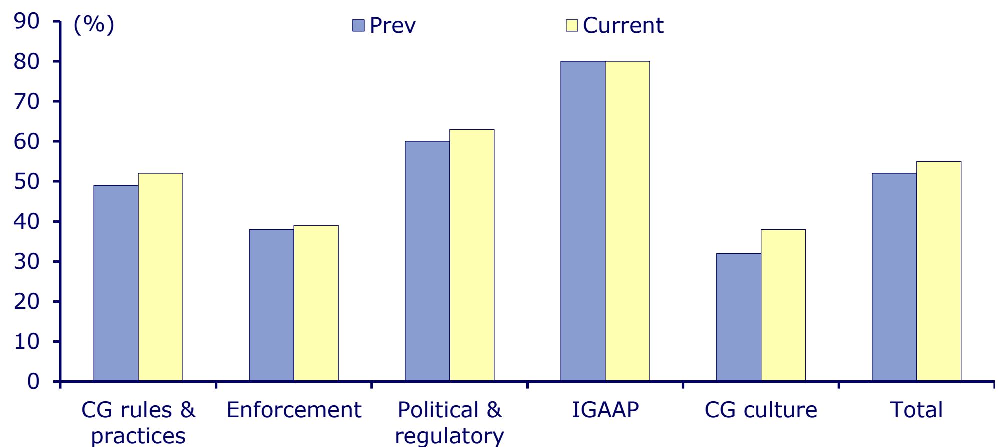
Certain businessmen seen as politically connected

But problems persist in Malaysia: questions continue to be raised about whether the government is making progress to reduce corruption, many believe it favours certain politically connected businessmen, and officials can sometimes come across as insular and somewhat complacent. The success of the stock market on the global IPO scoreboard this year - Malaysia currently ranks third in terms of funds raised - is unlikely to be helping matters.

Scores improved across most categories

Figure 114

Malaysia CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

CG rules and practices

Malaysia has made improvements in its CG rules over the past two years, leading to its score rising 3ppts to 52% this year. While this is commendable, there are some standards that continue to hold Malaysia down.

Both financial and non-financial reporting standards have improved

Financial standards have improved. Malaysia announced that it would be fully convergent with IFRS as of 2012, with the exception of allowing publicly listed plantation companies to have a reprieve of one year to adopt IAS 41 Agriculture. In January 2012, Bursa's amended listing requirements took effect and mandated listed companies to provide segment analysis in notes to quarterly reports and 'minimum content of disclosures in the statement of comprehensive income' as well as better cashflow disclosure, which was previously limited. On the other hand, Malaysia continued to lose points on the timeliness of reporting: it lags regional best practice on audited annual results, which need only be published within four months. Since this section

gives points for practices as well as rules, we did give points for the fact that some large caps, including Public Bank, Maybank, Hong Leong Bank and Bursa Malaysia, publish their audited annual results within 60 days. SMEs, however, continue to follow the guidelines.

Initiatives by Bursa

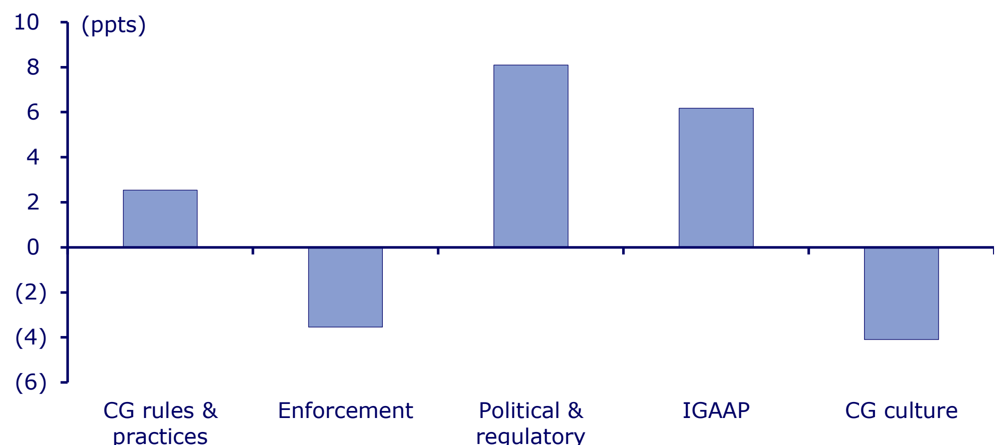
Non-financial reporting standards got a boost because of various Bursa initiatives: it launched its Business Sustainability Programme in November 2010 and at the same time launched a guideline titled *Powering Business Sustainability - Guide for Directors* as well as its Sustainability Knowledge Portal on its website. The online reference provides directors comprehensive information about global sustainability frameworks and case studies.

In September 2011, Bursa published *Corporate Disclosure Guide*, designed to help listed companies 'better understand their disclosure obligations and improve overall transparency in the marketplace'. While the practices of companies have a long way to go, there has been some slight improvements in the practices of companies due to these efforts.

Still lag regionally in enforcement and CG culture

Figure 115

Malaysia: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Tightened continuous disclosure rules

The amended listing requirements that took effect on 3 January 2012 also tightened continuous disclosure rules, including:

- Announcing whether a resolution has been decided by poll. The company must include the total number of votes cast in favour or against the resolution, as well as the total number of shareholders who abstained from voting; and
- The immediate announcement of the reasons why a director, chief executive, chief financial officer, external auditor or independent adviser has resigned his/her position.

Completed a major overhaul of its CG code in March 2012

Malaysia is also one of the few markets in Asia that undertook a major overhaul of its code of corporate governance, which was released in March 2012. This brought the standards expected of boards of directors in line with, or closer to, international standards. For example:

- The tenure of independent directors (INEDs) is limited to nine years. The code sensibly states that if an INED continues to sit on a board, it would have to be as a non-executive director; or if the firm wanted to retain him/her as an independent director, it would have to seek shareholder approval;

- The board is encouraged to put "substantive resolutions" to a vote by poll;
- An obligation on the chairman to inform shareholders of their right to demand a poll vote; and
- Nomination committees to be established, comprising only non-executive directors, the majority of whom should be independent.

Voting by poll still voluntary

While the encouragement of voting by poll is greatly welcome, we were unable to give a full point on this question because it remains voluntary. We do not see the value of voting some resolutions by a poll and some by hand, as there is no real efficiency gained in doing so. Moreover, who decides what is substantive?

Enforcement

This is one area where we struggled to see significant improvement, which is why the score only rose by 1ppt from 38% in 2010 to 39% in 2012.

The more positive developments were:

MSWG provides voice for minority shareholders

- The Minority Shareholder Watchdog Group (MSWG) continues to provide a voice for retail shareholders and is active during shareholder meetings; and
- On 28 January 2011, the Securities Commission (SC) and Bursa jointly announced amendments to the listing requirements on the privatisation of listed companies via disposal of assets, which would strengthen the rights of minority shareholders during such dealings. (Note: Since this section of our survey looks at private enforcement by investors and regulatory enforcement, one question asks whether minority shareholders are adequately protected in takeovers and privatisations/voluntary delistings.)

Regulatory enforcement, however, is still mixed

In terms of regulatory enforcement, the picture is mixed. The SC was pleased that in 2011 the independent directors of Transmile were each given a fine and a one-year jail term (which they will not appeal). A fraud was perpetrated at Transmile when the company submitted misleading statements in its 2006 financial report and the directors were arrested in November 2007. However, as one investor noted, both the chairman and CEO walked away scot-free.

Delays in enforcement are another challenge

Delays in enforcement are another challenge in Malaysia. It is common for cases to take years to resolve and often go on appeal, while few judges have deep expertise in company and securities law. And in the view of many market observers, politically connected people are more often than not likely to get off with a slap on the wrist.

Questionable handling of Sime Darby-E&O deal

Meanwhile, an unfortunate image issue cropped up last year relating to the way in which the SC was seen to handle the Sime Darby-Eastern & Oriental (E&O) case. Sime Darby bought 30% of E&O, after which many minority shareholders of E&O felt that Sime Darby should have been compelled to make a general offer for the rest of the shares. Although Sime Darby had not crossed the 33% general offer threshold, shareholders believed that there was collusion between E&O's managing director and two substantial shareholders. The SC ruled that a general offer did not have to be made under the circumstances, but in a suit brought against the regulator by an E&O minority shareholder, Michael Chow, documents showed that an SC task force had initially stated that Sime should make a general offer, but that this was subsequently overturned. To be fair to the regulator, the issue of collusion was never proved.

SC's reputation hurt

Complicating the picture further, it emerged that the E&O chairman, who was husband of the then SC chairman, Zarinah Anwar, had raised his personal holdings in the company just prior to the Sime Darby acquisition. Not surprisingly, this was widely perceived in the market as tantamount to insider trading. The SC, however, ruled otherwise (since there was no firm evidence that he knew of the Sime deal, which was between it and some major shareholders of E&O). While this may have been the correct decision, it did hurt the SC's reputation in the market and raised allegations, as always happens in such cases in Malaysia, about the politically well-connected receiving special treatment.

Not much progress on prosecution of insider trading and market manipulation

In other areas of enforcement, we do not see a great deal of progress from 2010 in the prosecution of insider trading and market manipulation. The SC did not bring any new insider-trading or market-manipulation cases to court in 2011, but it did settle a number of insider-trading cases or proposed insider-trading cases last year, with defendants agreeing to settle with the regulator but not admit to any wrongdoing. In July 2012, the SC brought an insider-trading charge against Eliathamby Sreesanthan, a lawyer and independent non-executive director at Sime Darby.

On a somewhat more positive note, Bursa has increased its enforcement actions, although many of these cases are against brokers as well as listed companies and their directors.

Political and regulatory environment

New five-year Corporate Governance Blueprint out in 2011

Malaysia's score in this category rose by 3ppts to 63% in 2012, in large part due to the new five-year Corporate Governance Blueprint for Malaysia that the SC released in 2011. Some of its key measures included:

- Facilitating voting through proxies and corporate representatives that would require amendments to the listing requirements, which has been partially achieved. Proxies are now allowed to vote on a show of hands and companies must now allow exempt authorised nominees to appoint multiple proxies for each omnibus account it holds;

Phased approach to voting by poll

- Mandating poll voting via amendments to the listing requirements and CG code, but only for resolutions approving related-party transactions, while for other substantive resolutions, the SC recommended a phased approach. We discussed the CG code earlier. As for amendments to the listing requirements, Bursa issued a consultation paper in November 2011 on independent chairmen and voting by poll, but no final decisions have been announced to date;

- Recommending the formulation of a new code and an umbrella body for institutional investors to promote responsible ownership;

- Improving disclosure and transparency by shortening the submission period for quarterly and annual reports, as well as making it explicit in the new code and listing requirements that companies should move beyond minimum reporting requirements and focus on substance rather than form; and

- Raising public and private enforcement, which included recommendations to undertake a study on litigation funding by third parties to assist investors in instituting private enforcement actions, and undertaking a study on whether the Securities Commission should be empowered to initiate action for oppression or unfair prejudice.

Will they follow through on all their initiatives?

These are commendable initiatives and, as noted, both the code and the listing requirements have been amended to reflect some of these recommendations. However, we are curious to see how Malaysia progresses on some other ideas proposed, including achieving gender diversity on boards by having 30% of board members be women by 2016.

IGAAP (accounting and auditing)

IGAAP rating unchanged

Malaysia's score for accounting and auditing stayed steady at 80%. This is not because no improvements were made, but as a result of a more sceptical view we are taking of account preparation, audit quality and audit regulation across the region. Ironically, this view is partly formed by the good work being done by independent audit regulators, including the Audit Oversight Board (AOB), on reviewing the quality of audits and audit firms.

Considerable effort by large firms to improve reporting practices

According to one of the big-four auditors, over the past five years considerable effort has been made by large listed Malaysian companies to improve their financial reporting practices and they have tried to employ dedicated people to do this. Public Bank is the benchmark that most corporations use. Below the top-level companies, the auditor stated that companies try, but they still have a way to go. Meanwhile, outside the top 100 companies, there is little investment in financial systems and firms struggle with a complete set of IFRS. Since they lack the infrastructure, firms rely heavily on external auditors to get them across the threshold.

Need for rigorous implementation by accounting regulator

The AOB eludes to another issue in its 2011 report, the need for rigorous implementation by the accounting regulator, when it stated that the 'tone set by' the Malaysian Institute of Accountants (MIA) 'with regard to not compromising on its expectations of the highest levels of professional conduct by members, is extremely critical. Consequently, MIA should demonstrate its commitment to regulate its members by continuing to enhance its disciplinary processes and applying them effectively.'

Consistent quality of auditing among external auditors is a challenge

Besides the accountants, the external auditors also have problems that the AOB has noted and wants them to resolve, including:

- While the AOB observed that major audit firms (big four + 2) 'had made positive efforts to balance risk and capacity in 2011 . . . maintaining consistent quality in the performance of audit engagements within the audit firms continued to be the main challenge';
- Other audit firms 'did not have the necessary holistic framework which defines, measures, monitors and rewards audit quality. There is also a need to review their current performance evaluation process to ensure audit quality is given the appropriate emphasis';
- AOB also noted that while the larger audit firms had systems in place to comply with independence policies and procedures, 'there were still instances where annual independence confirmations and independence declarations at the engagement level were not completed on time'; and
- Most of the larger audit firms did not have a written policy defining the people, apart from the partners, who were senior personnel who would be 'subjected to the rotation requirements and the relevant safeguards put in place to mitigate the familiarity threat of such persons'.

Accounting firms asked to submit remediation plans

It was a lot worse in the smaller audit firms. However, the AOB asked each firm it inspected to come up with a remediation plan to address the problem areas that had been unearthed. Progress is likely to be made over the coming year, but we will watch with interest how CPA firms improve and what measures the AOB will take if problems continue.

CG culture

Companies making a difference!

This is the section that saw the biggest rise this year, a 6ppt increase from 32% in 2010 to 38% in 2012. As one investor stated to ACGA, in contrast to two years ago, it is companies rather than the government that seem to be making more of a difference in the country's CG landscape.

More awareness among Malaysian corporations

While that may not be the complete picture, there is definitely more of an awareness among companies, including SMEs, of the importance that shareholders are attaching to CG practices: the need for transparency; the need to answer questions at meetings; and to be seen as responsible corporate citizens.

Some of the positive elements that we have observed:

- Two of the SMEs ACGA talked to were fairly open about the measures they had in place, but one, a construction firm, was also forthcoming about the corruption problems it encounters when it tenders for jobs and the difficulties it faces implementing sustainable measures at its construction sites in more underdeveloped countries;
- Many more companies have separate chairmen and CEOs, although we are not certain how independent the chairmen actually are; and
- Companies are offering more disclosure on their exposure to risks arising from financial instruments, although the actual information on risk management and analysis continues to be quite poor and formulaic.

Factors to watch

Figure 116

Malaysia: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- No evidence of any improvement in regulatory enforcement.
- No improvement in the quality of audits.
- No improvement in the manner that votes are counted at shareholder meetings.

Actions that could improve overall CG

Figure 117

Malaysia: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- Provide better disclosure in annual reports, stop using boilerplate language.
- Start voting by poll at meetings.
- Director training for directors of listed companies, not just the banks.
- Better disclosure of enforcement actions on the SC and Bursa websites.
- Audited annual results within 60 days.

Source: ACGA

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Research perspective - Unseemly Sime

Charges against Sime Darby's ex-CEO

Among the big caps in Malaysia, Sime Darby attracted the CG spotlight twice over the past two years. First in May 2010, it reported provisions of close to RM1bn in the 3QFY10 results for its energy division, due to cost overruns related to the Bakun, Qatar Petroleum and Maersk Qatar projects. The CEO was replaced and has since been charged by the Malaysian Anti-Corruption Commission (MACC) on two counts of criminal breach of trust.

Will Sime make a GO for E&O?

The second event was in August 2011, when it announced it was to acquire a 30% stake in E&O for RM766m or a hefty 60% price premium. There were two controversies surrounding this deal. Firstly, minority shareholders filed a complaint against the SC for not compelling Sime Darby to make a mandatory general offer (MGO) to acquire all remaining shares of E&O. As of writing, the SC has maintained it would not order Sime Darby to undertake a MGO as the three vendors who disposed of their E&O shares were not acting in concert and did not control E&O. However, expectations are that Sime Darby would eventually undertake the general offer voluntarily, in order to ensure better control and reap synergistic benefits for a merged property division.

Change in SC chairman

Secondly, the former SC chairman's husband is the chairman of E&O, and he raised his personal stockholdings in the company just weeks before Sime Darby announced the acquisition. His stated position is that the acquisition was a private transaction between major shareholders of E&O (which did not include him) and Sime Darby. The transaction did not require E&O board approval and it appears was not discussed at the board level. Thus, board members were not privy to the transaction and continued to trade in accordance with the prevailing rules and he had made appropriate fillings with Bursa Malaysia. The SC has stated that no rule has been broken here. The SC chairman, who had held the position since 2006, retired in March 2012 when her contract expired. She has since been succeeded by Datuk Ranjit Singh, who was SC managing director prior to the appointment and has more than 20 years' experience as a regulator.

Khazanah's initiatives include strengthening boards of directors

Besides Sime Darby, there has been little CG issues among large-cap Malaysian companies over the past two years. This is particularly true for companies under the Khazanah stable. Khazanah, the sovereign holding company in Malaysia, introduced measures to transform the GLCs back in 2005, guided by 10 initiatives two of which focused on enhancing board effectiveness and strengthening directors' capabilities.

MSWG at work

Other local institutions have also placed increasing emphasis on corporate governance. The founding members of Minority Shareholder Watchdog Group (MSWG) are the Armed Forces Fund Board (LTAT), the National Equity Corporation (PNB), the Social Security Organisation (SOCSO) and the Pilgrimage Board (Tabung Haji). MSWG's active monitoring of AGMs and EGMs, and dialogues with corporations, have provided some checks and balance on Malaysian companies. According to MSWG's CG index, average scores rose to 57.2% in 2011, from 55.6% and 52% over the previous two years.

Companies that have seen CG improvement

Public Bank at the top of CG ratings in Malaysia

The top-three companies with the highest CG scores in Malaysia are Public Bank, Bursa Malaysia and BAT. Public Bank scored 77%. It has risen from its rank in our 2010 CG survey and rates among the highest of banking groups in the region. The bank's core banking business remains centred around the Malaysian consumer segment. It discloses a long-term ROE target of 26%, and

management is guided by a clear idea of its cost of equity. Interim results are released promptly, ie, within 45 days from the end of a quarter. However, C&G issues are an area where the bank, like others in Malaysia, may see greater progress in the coming years.

Bursa leads on CG by example

Bursa Malaysia has also made an advance in our CG scoring, to 74.5%, which positions it among the top of our regional CG ratings. Bursa Malaysia is one of the few companies in the market that has made it a point that all directors on the audit committee have financial expertise and is pushing for better CG among all listed entities in the market, thus providing leadership by example.

BAT has the highest score on C&G

BAT had one of the highest CG scores in the region at 69.6%, scoring well in transparency and fairness categories. It is worth noting that BAT has the highest C&G score in Malaysia at 82.6%. This cigarette company has clearly stated its commitment to environmental controls where a person is directly responsible for these efforts, reporting straight to the board of directors. The chairman’s statement also states its CSR with disclosure on performance and gaps in its annual reports.

Companies that have seen CG deterioration

Lower CG ranking on YTL Power

Larger-cap companies with an institutional following that have seen CG declines include YTL Power, Genting Malaysia and Genting Berhad. For many years, YTL Power had focused on regulated industries, ie, power generation and water. It has a global presence in regulated industries stretching from the UK to Australia. However it recently ventured into telecommunications, where it has no prior industry knowledge. Competition in this market is stiff and this venture has incurred large startup losses. Our scoring marks negatively for a company that diversifies into different businesses.

Related-party transactions an issue with Genting group

The key concern on Genting Malaysia has been related-party transactions. In November 2008, it purchased a 10% stake in Walker Digital for US$69m from the family that controls the Genting group. In July 2010, Genting Malaysia paid Genting Singapore RM1.7bn for Genting UK. Generating positive Ebitda for Genting UK has been an uphill battle, especially with the difficult macro environment in the UK currently. There is also an issue about independence with a chairman who is also CEO, and holding the same two positions at the listed parent. Genting Berhad, meanwhile, has one of the highest ratios of director remuneration to net profit for companies in our Malaysian coverage universe at 4%, which is a drag on its score.

Public Bank and Bursa one of the highest CG scorers in the region

Figure 118

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

Company	Code	Company	Code
AirAsia	AIRA MK	KL Kepong	KLK MK
AMMB	AMM MK	Kulim	KUL MK
BAT Malaysia	ROTH MK	Maybank	MAY MK
Bursa Malaysia	BURSA MK	MMHE	MMHE MK
CIMB	CIMB MK	Public Bank	PBKF MK
Dialog	DLG MK	Sapura Kencana	SAKP MK
Genting Plantations	GENP MK	Tenaga	TNB MK
Hartalega	HART MK	TM	T MK
IJM Corp	IJM MK	Top Glove	TOPG MK
IOI	IOI MK		

Source: CLSA Asia-Pacific Markets

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Philippines - Back to the future

The Philippines' overall score improved this year by 4ppts to 41%, moving it from the bottom of the barrel in 2010 to second-last this year, a position it occupied in previous surveys until 2010.

Domestic stakeholders seem to have listened to our past criticism . . .

It is tempting to state that the improvement in our survey is a result of a concerted effort among government, regulators, NGOs and companies alike to improve standards. Indeed, there is evidence that our candidly accurate assessment of the dilapidated state of governance under the Arroyo regime along with the reformist impetus from President Benigno Aquino's new administration galvanised interested parties into positive action that has borne some fruit. However, the score of 41% in this year's survey is coincidentally identical to the country score in our 2007 survey. So, basically, the Philippines is only back to where it was.

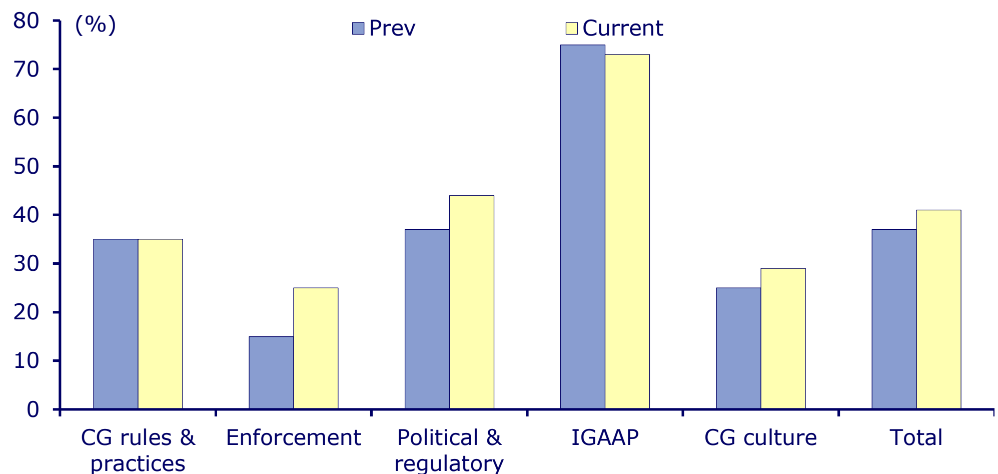
. . . and Aquino's administration has made progress on governance

Hardly a cause for unbridled optimism in its own right perhaps, but there are signs that the Aquino government is making progress on much-needed governance reforms, including tackling government corruption and improving transparency and accountability. In June 2011, the government passed the Governance Act that created a new body to oversee 157 government-owned or controlled corporations (GOCCs). Compensation of directors in GOCCs and other state-owned enterprises has been revised and a new bankruptcy law enacted.

The Philippines bounces off the bottom

Figure 119

Philippines CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

CG needs to transition from compliance to culture

What is still lacking, however, is solid evidence among many companies that their approach to corporate governance is more than a compliance exercise imposed on them by regulators, who still lack the resources and firepower to enforce better corporate behaviour.

Reform of regulatory institutions, of course, takes time. It is encouraging that the SEC's budget has been increased and staff numbers within enforcement have risen, while the surveillance division of the stock exchange has been spun off into an independently managed entity, the Capital Markets Integrity Corporation (CMIC).

CG rules and practices

FDI may have encouraged better CG practices

The Philippines' score for rules and practices stayed flat at 35% this year. We did see marginal improvements in two specific areas. First, financial reporting standards among listed companies have improved a little since 2010, most notably among the larger listed firms where disclosure standards now compare favourably with global benchmarks. One possible explanation for this improvement is the increasing amount of foreign portfolio investment that has entered the country: the market was one of the world's best-performing last year and local companies have raised more than US$5bn of equity capital in the past two years. Much of that capital has been sourced internationally.

Market surveillance system improved

We also increased marginally our score for insider-trading deterrence, not because we believe the problem has dissipated, but at least the stock exchange has hived off its surveillance and enforcement division into the CMIC and a new surveillance software system has been developed and implemented in conjunction with the Korean Stock Exchange. Whether this makes a meaningful difference to market practice will emerge in the next few years and we shall be watching with interest, but it is at least one small step in the right direction.

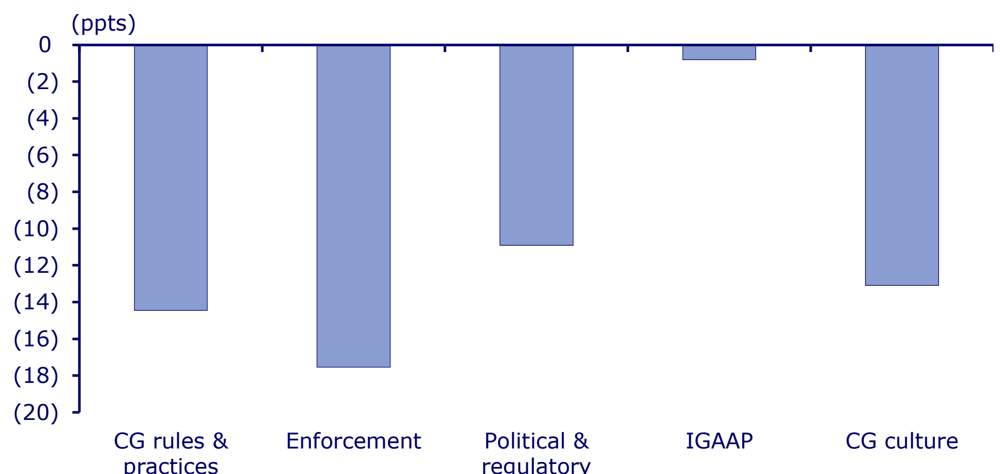
RPTs, pre-emption and voting rights remain problems

Less encouraging is the fact that we were unable to award scores for rules and practices relating to related-party transactions, pre-emption rights and poll voting at shareholder meetings. One simple way for the Philippines to improve its CG scores in our next survey would be for regulators to address some of these basic standards. Poll voting is simple to implement, as is speeding up the release of audited financial results. Even if regulators fail to implement the rules (although there is no reason why they should not) companies can simply choose to protect pre-emption guidelines and provide adequate disclosure of related-party transactions. Were this to be done, the Philippines' score would rise dramatically.

A high level of deviation from regional averages, except for IGAAP

Figure 120

Philippines: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Enforcement

SEC revamped and better funded

Active and effective enforcement in the Philippines remains a problem, but we detected improvements in several areas that warranted a jump in the score for enforcement from 15% in 2010 to 25% in 2012.

Positive areas where the Philippines picked up points included scores, again, for the CMIC and surveillance initiatives already mentioned and a much-needed revamp at the major regulator, the SEC. While the SEC remains a government-controlled entity, its oversight has at least moved from the puzzling Department of Trade and Industry to the more logical Department of Finance. With that move has come a new chairman, a desperately needed doubling in funding, more staff and a plan for a new purpose-built building

PCGG a 'breath of fresh air'

We also increased the score given some improvements under the Aquino administration in terms of anticorruption measures. While there is still no independent anticorruption commission (note, legislators, that Indonesia has had one for several years now - why not the Philippines?), the Presidential Commission on Good Government has been much more active and effective under its new head, described by one businessman we interviewed as 'a breath of fresh air'. We would have to agree with that assessment. In addition, the country's antigraft court, the Sandiganbayan, has been more effective.

Practical enforcement remains weak

Against this more positive backdrop, effective enforcement of capital-market misdemeanours remained weak, a point acknowledged by SEC staff. The commission is undergoing a reorganisation and it will be interesting to review progress in our next survey. As matters currently stand, however, the SEC still lacks effective powers of investigation and sanction. True, the SEC has undertaken some major investigations into investors and broker dealers, with a number of cases ongoing, but prosecution of cases still takes far too long and public data on enforcement remain elusive and/or outdated, one easy fix that would improve the country's enforcement score immediately.

Political and regulatory environment

Aquino 'the real deal'

By far the strongest area of improvement, the Philippines scored 44% in our survey in this category against 37% in 2010, a time of probably the darkest days of the Arroyo administration. Improvement against such a low bar was to be expected, but talk to almost anyone in the Philippines and they will tell you the Aquino government is 'the real deal' when it comes to resolve in fighting corruption. The challenge facing the country, of course, is that with a one-term limit and already half way through Aquino's term, progress made to date could be rapidly undone by an unwise choice for the next president. Such are the politics of the country.

Crackdown on corruption

As already mentioned, President Aquino's government has moved quickly to tighten governance among GOCCs, enacting the GOCC Act in 2011 and increasing salaries at these corporations through Executive Order 25 to discourage rampant corruption. The government's tender processes for public-private partnerships, particularly in much-needed infrastructure investment, have been completely overhauled to improve transparency and try to eradicate graft. The only problem now, according to our sources within the administration, is that government officials are so concerned about breaching new procedures that progress on processing applications has slowed to a crawl.

BSP a CG outperformer

We awarded a slightly higher score this year for the country's progress in its financial regulatory structure. The country's central bank, Bangko Sentral Ng Pilipinas (BSP), already one of the region's best-run bank regulators, tightened governance further over the banking sector in 2012, and capital-adequacy ratios in the Philippine banking sector are among the strongest in the region. Shifting oversight for the SEC from the Department of Trade and

Industry to the Department of Finance makes more sense to us, although we would prefer the regulator to be independent. The new SEC chairman appears to mean business and the government has allocated more funding to hire staff and raise salaries. Still, the institution remains seriously underfunded.

Partial progress at PSE

The Philippine Stock Exchange (PSE) has also revised its governance somewhat, with new rules on board composition and election procedures, although it is still dominated by a small number of domestic brokers who wield disproportionate power over the institution and frankly continue to impede meaningful reform. On a more positive note, the PSE did reinstate its undemanding minimum public-float rules that had been the subject of some abuse by certain listed companies (see CLSA head of Philippines research Alfred Dy's section for a list of issuers that still do not meet the 10% requirement). The PSE knows that weak pre-emption rights are a serious problem for international investors but it is unclear if or when the exchange will reform its rules. To give a sense of the scale of the problem, more than half of companies within CLSA's coverage have waived pre-emption rights for minority shareholders. The PSE has instituted audit committee charters for listed companies with effect from September 2012. It also says that its long-trailed CG market, the Maharlika Board, will launch eventually, but no one seems to be able to say when.

IGAAP (accounting and auditing)

The score for accounting and auditing standards fell slightly, dropping from 75% in 2010 to 73% this year. Like many other Asian economies, the country's financial reporting standards are comparable with international benchmarks.

Audit industry in need of an overhaul

We awarded slightly higher scores for the quality of accounting policies and practices among listed companies, having detected a gradual improvement since our last survey. However, these gains were undermined by lower scores for auditor independence and government regulation of the audit industry. In 2011, the government tried and failed to launch an independent audit oversight body to regulate auditors and raise standards.

According to our sources, the initiative failed after fierce political lobbying by small audit firms fearful of the business implications of such a move. Consequently, the Philippines is not a member of IFIAR, the peak global body for audit regulators. Most other markets in Southeast Asia are members, including Singapore, Malaysia and Thailand, but not Indonesia. It is likely that the latter will be admitted quite soon, assuming its new single financial regulator, the OJK, gets up and running as planned in early 2013. This will leave the Philippines as the only non-member among major Southeast Asian markets, surely justification for a downgrade in our next survey?

CG culture

Time for companies to get real about CG

The Philippines' score for its CG culture moved up slightly compared to 2010, by 4ppts to 29%. In contrast to the clear improvement in public governance, we still see a lack of real commitment from most companies in the Philippines towards CG. There may be plenty of awards and scorecards around, but these recognise compliance with rules and standards rather than a genuine embrace of CG culture. We understand that one of the reasons the Maharlika Board has been delayed is because a number of large corporations lobbied for a watering-down of proposed standards after they realised that their own governance standards were too weak to qualify for inclusion in the index.

Some easy CG fixes . . .

Obvious areas that Filipino companies could work on to demonstrate that their governance is more than box-ticking include: splitting the chairman and CEO roles; fuller disclosure of remuneration structures; voting by poll at shareholder meetings; and reinstating pre-emption rights. These are all relatively easy fixes that would demonstrate a cultural shift in the right direction, not to mention improve meaningfully the country's score in our survey.

. . . and some early signs of progress

On a more positive note, civil-society organisations working on CG are growing. In addition to the well-established Institute of Corporate Directors (ICD), which organises director training, undertakes research and contributes to public policy, this May saw the creation of a new shareholder pressure group called the Shareholders' Association of the Philippines (SharePhil). The ICD was a catalyst in establishing SharePhil along with the Management Association of the Philippines. We will watch its progress with interest.

Factors to watch

Figure 121

Philippines: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- ❑ No investment or progress in the SEC overhaul.
- ❑ No evidence of an improvement in enforcement efforts.
- ❑ No independence for CMIC or it is ineffective.
- ❑ No progress in revising regulations relating to pre-emption rights.
- ❑ Non-membership of IFIAR.

Actions that could improve overall CG

Figure 122

Philippines: Quick-fix list

Simple actions that the government and companies can take to improve overall CG:

- ❑ Publish more detailed data on enforcement and a deeper archive of company releases and documents - five years minimum (SEC and PSE).
- ❑ Speed up release of audited accounts - behind regional and global standards.
- ❑ Encourage/mandate voting by poll.
- ❑ Improve disclosure of directors' remuneration - even bands would be an improvement on the current situation.
- ❑ Encourage/mandate splitting chairman/CEO roles.

Source: ACGA

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Research perspective - Aquino's priority

Good governance a priority of current administration

Since assuming office in June 2010, President Benigno "Noynoy" Aquino III has made good governance one of the key priorities of his administration. For starters, he has set a good example as he has not been linked or even rumoured to be part of any corruption issue. Moreover, he supported the impeachment case against Supreme Court Justice Renato Corona for failing to disclose his Statement of Assets, Liabilities and Net Worth (SALN). He is also supportive of the tax-collection efforts of Bureau of Internal Revenue (BIR) commissioner Kim Jacinto Henares, who has gone on the offensive via the "name and shame" route to expose tax cheats in the Philippine society. Though admittedly there is still a lot of room for improvement, we believe that by setting a good example, the backdrop for good governance improves in the country. The key is follow through and enforcement.

Key issue on hand is PSE requirement that listed companies should have free float of at least 10%

For Philippine corporations, the key issue at hand is the Philippine Stock Exchange (PSE) requirement that listed companies should have free float of at least 10% by the end of 2012. Out of the 269 listed companies , there are still 34 that have yet to comply. Given that the deadline is just a few months away, it remains to be seen whether all of the 34 firms can beat the deadline. Some of the notable companies that have not yet complied are San Miguel Brewery, Filinvest Development and cement giant Lafarge Republic.

Figure 123

Companies non-compliant with 10% free-float requirement and current free-float levels

Free float	(%)	Free float	(%)
Chemical Industries of the Philippines	9.9	Lafarge Republic	3.7
Integrated Micro-Electronics	9.7	Filinvest Development	3.5
Philcomsat	9.6	Century Properties.	3.0
Cebu Property Venture & Development "B"	9.3	PAL	2.3
Marsteel Consolidated "A"	9.1	First Metro Investment	1.9
JTH Davies	8.8	2GO Group	1.8
Alphaland Corp	8.0	Cosmos Bottling	1.8
Manchester International "B"	7.9	Nextstage	1.2
Concrete Aggregates Corp "B"	7.5	Globalport 900	1.1
Synergy Grid & Development Phils	7.4	Maybank ATR Kim Eng Financial	0.9
Manchester International "A"	6.2	PNOC Exploration Corp "B"	0.9
F & J Prince "B"	6.1	Sun Life Financial	0.7
ETON Properties Philippines	5.6	San Miguel Brewery	0.6
SPC Power	4.5	Manulife Financial	0.2
Atok-Big Wedge Company "A"	4.2	Metro Pacific Tollways	0.2
Vivant Corp	4.2	San Miguel Pure Foods	0.1
Mariwasa Siam	3.9	San Miguel Properties	0.1

Source: Bloomberg

CG stars

Top CG scoring are BPI, Ayala Corp, Manila Water, Aboitiz Power and GMA

We have CG scores for all 43 companies in our coverage. The top five in terms of CG scores, in alphabetical order, are Aboitiz Power, Ayala Corporation, Bank of the Philippine Islands, GMA and Manila Water. Some companies with CG issues in the past such as Vista Land, JG Summit, Universal Robina and Robinsons Land were able to get into the top-two quartiles. JG Summit, Robinsons Land and Universal Robina are all part of the Gokongwei group of companies. JG Summit is the holding company of the group, while Robinsons Land and Universal Robina are its subsidiaries. In the 1990s, the group was accused of inter-company transactions and poor disclosure standards. Recently, however, we noticed a marked improvement in its CG. Gone are the days of inter-group deals. Disclosure standards have improved and the group has been hosting conference calls for earnings results and attending investor conferences sponsored by various brokers.

Improving governance at Vista Land

Vista Land is another case of improving governance. The company defaulted on some obligations some time back. Nonetheless, since its re-IPO in 2007, the group has adhered to sound CG practice and like the Gokongwei group,

has improved on its disclosure standards and has been hosting investor and analyst briefing for quarterly results. Vista Land has also been actively engaging with investors through participating in various investor conferences.

Manila Water and BPI make it to the top quartile in the region

Figure 124

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

Company	Code	Company	Code
Aboitiz Power	AP PM	JG Summit	JGS PM
ABS-CBN	ABSP PM	Manila Water	MWC PM
Ayala Corp	AC PM	Meralco	MER PM
Ayala Land	ALI PM	Philex Mining	PX PM
Bloomberry	BLOOM PM	PNB	PNB PM
BPI	BPI PM	Robinsons Land	RLC PM
Cebu Air	CEB PM	Security Bank	SECB PM
Filinvest Land	FLI PM	SM Investments	SM PM
Globe Telecom	GLO PM	URC	URC PM
GMA	GMAP PM	Vista Land	VLL PM
ICTSI	ICT PM		

Source: CLSA Asia-Pacific Markets

Pressure on CG scores

Decline in CG scores for EDC, First Gen, Metrobank

We saw declines in the scores for Energy Development Corp, First Gen and Metrobank. We note First Gen sold the FG hydropower plant to its unit, Energy Development Corp, at a much higher valuation than its acquisition price. Also, it seems like the investing community has been getting mixed signals on final completion date of the rehabilitation of the Bacon Manito geothermal power plant. Metrobank scored relatively low in the transparency and responsibility categories.

Like for like, Philippine CG score declined

In a like-for-like comparison of questions, the Philippine companies in our coverage had 8ppt reduction in their CG scores. Reasons for these include:

- Philex Mining's lower score was due to the company expanding its scope of business from mining copper and gold to also include oil exploration. There are uncertainties over its expansion plans in copper and gold mining with potential delays, as the government has put a temporary ban in issuing mining permits until a new tax structure for mining companies is introduced. There could also be delays in developing its oil concession along the South China Sea, where there are overlapping claims among Asean countries as well as China. The share price, however, often moves in anticipation of announcements.
- There remain questions over PLDT's entry into the free-TV business. The regulator allowed PLDT to purchase Digitel provided that Digitel continues to provide "unlimited" type of services; this may hamper the ability of PLDT to increase tariffs if it wishes to in the immediate future.

Ayala is strong in CG culture in a domestic context

- For Ayala Corp, there were questions on the timing and purpose of a recent equity issuance. In spite of this, the company remains in the first quartile, testimony of its strong CG culture in the domestic context.
- For Banco De Oro, there were also questions on its recent US$1bn fundraising. Investors felt that the magnitude was above what was needed to prepare it to comply with upcoming accelerated and modified version of Basel 3, set to be implemented in the Philippines in 1Q14.

Philippine market score similar to Indonesia's

Our Philippine universe, however, was able to improve on its last-place finish in 2010 to be pretty much tied with Indonesia. Specifically, the Philippines had a total CG score of 43.9, marginally ahead of Indonesia's 42.7. Looking at the categories, the makert did relatively better in terms of discipline, transparency and C&G.

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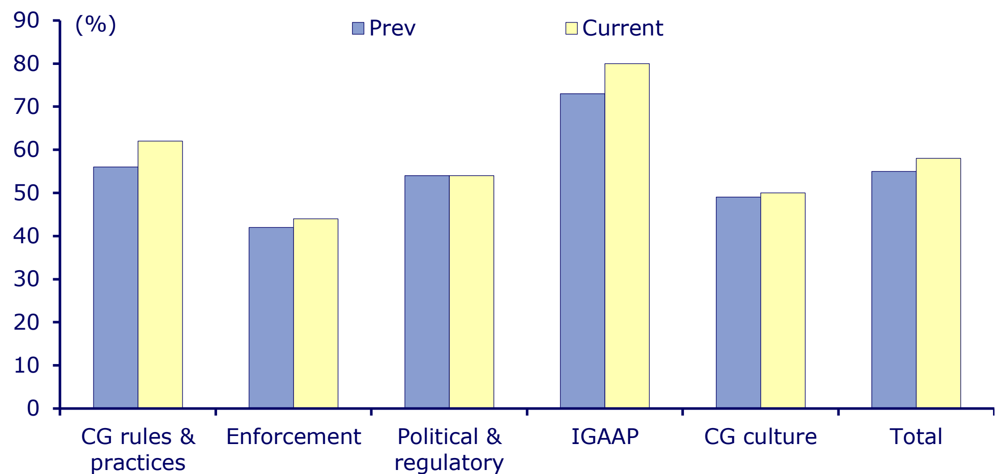
Singapore - Government focus

Singapore retained its top position in the rankings this year, narrowly edging out Hong Kong yet again and gaining 2ppts to 69%. To its credit, the market has responded to most of the recommendations we made in CG Watch 2010 regarding improving non-financial reporting standards, revising its code of corporate governance, tightening its definition of independent directors and encouraging companies to vote by poll. The latter process started voluntarily on the part of the larger companies and was followed in mid-2011 with a consultation paper from the Singapore Exchange (SGX) on whether voting by poll should be mandatory. While SGX has yet to make a final decision, the incidence of voluntary voting by poll increased again this year (with a little encouragement from the regulator, according to some directors).

Scores improved across most categories

Figure 125

Singapore CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

More focus on corporate governance

Overall, we believe Singapore has shown more consistent focus on CG policy over the past two years than in the three years prior to our last survey. Besides last year's major revision to the code of corporate governance, there have been some significant revisions to the listing rules, a new guideline titled *Risk Governance Guidance for Listed Boards* and a consultation paper from the Accounting and Corporate Regulatory Authority (ACRA) on amending the Accountants Act. In terms of enforcement, the exchange has been stepping up to the plate more often, while retail shareholders are becoming more engaged at AGMs.

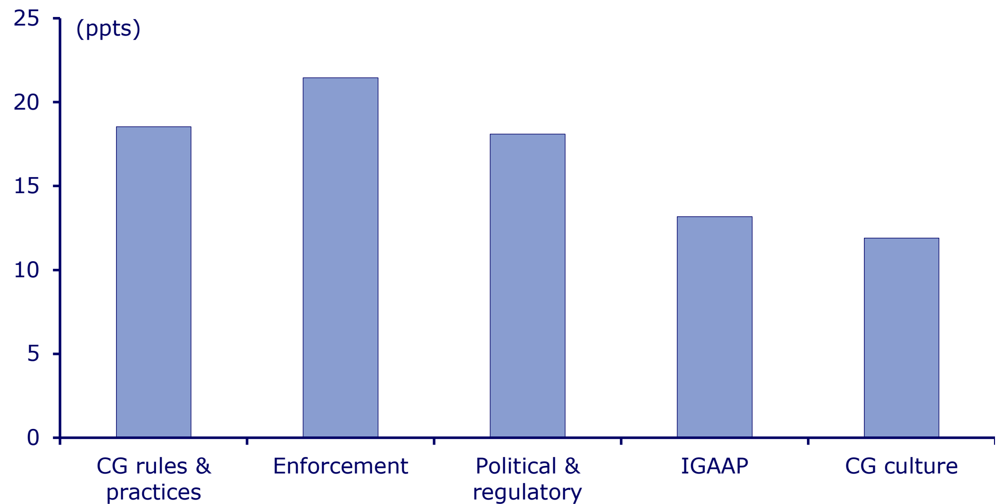
Continuing issues on basic shareholder rights

Yet for all these positives, Singapore continues to lag on some basic shareholder rights and governance best practices. Reforms to the proxy appointment system for shareholder meetings, expected to be included in a long-awaited rewrite of the company law, are taking a long time to come through. ACGA first discussed this issue with officials in 2004/5, then submitted a paper recommending amendments to the company law in late 2007. Meanwhile, voting by poll is still not widespread, with most listed companies continuing to vote by a show of hands. Given Singapore's good reputation for corporate governance and financial regulation, many people in the rest of Asia find it hard to believe that such archaic practices still exist in an international financial centre.

Singapore's scores across all categories higher than the regional average

Figure 126

Singapore: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

CG rules and practices

Enforcement continues to improve

Singapore's score rose 3ppts in this section from 65% in 2010 to 68%. Some of the more significant regulatory changes included:

- In February 2011, the Monetary Authority of Singapore (MAS) issued a set of governance regulations and guidelines for financial institutions - aimed principally at banks - focusing heavily on issues related to directors, board and board committee operation as well as risk management. One of the more important measures was a requirement that nomination committees conduct an annual assessment of the board's skills and specifically identify any areas where director skills are lacking or requiring further training.

Far-reaching amendments to listing rules

- In September 2011, SGX amended its listing rules, following a consultation held in December 2009. Many of the changes were potentially far-reaching, including disclosure of loan agreements that are tied to the interests of the controlling shareholder; having a robust system of internal controls, addressing financial, operational and compliance risks; and requiring all listed companies to be audited by a CPA firm regulated by ACRA or another independent audit regulator.

Extensive changes to board best practices in the CG code

- Finally in May 2012, MAS released the new code of corporate governance, which made extensive changes to board best practices; finally brought the definition of "independent director" almost into line with international standards; and recommended companies vote by poll on all resolutions at meetings and release detailed results, publish more detail on the remuneration of directors and senior executives. Interestingly, the code also stated that independent directors should make up at least half of the board where the chairman and CEO are the same person or immediate family members, the chairman is part of the management team or is not an independent director. (Note: Singapore's listing rules require only two independent directors, while the new code recommends one third for most issuers. Larger companies already have a high proportion of independent directors, hence it will be interesting to see the extent to which smaller companies are influenced by the Code.)

However, MAS watered down some recommendations

The government was not willing, however, to embrace international best practices in all areas of the new code. MAS watered down some Singapore Corporate Governance Council recommendations, including:

- Allowing companies to merely "rigorously review" a director's independence after nine years rather than automatically deeming them non-independent; and
- Making two changes to the recommendation relating to the expanded definition of independence (from substantial shareholders): lowering the look-back period from the proposed three years to the current or immediate past financial year; and raising the shareholding threshold from the proposed 5% to 10%.

Losing ground due to delay of Companies Act

Another area where Singapore lost ground was in announcing rule changes but then delaying the issuance of them: most notably on the Companies Act, which the government began reviewing in 2007, then announced the shape of major amendments in May 2011, but is still pending.

Correction to 2010 survey

Lastly, a correction from our 2010 survey: Singapore firms are not required to publish audited annual results in 60 days - the relevant listing rule only refers to annual results. Many blue chips do release their audited annuals within 60 days and we give them credit for this in our survey. However, other issuers have until two weeks prior to their AGM or, effectively, three and a half months.

Enforcement

SGX more vigorous on enforcement

Enforcement improved 4ppts to 64% this year, a reasonable outcome but one we feel Singapore could improve on. The exchange has made a concerted effort to enforce its rules over the past two years, especially as mainland Chinese firms listed on the Singapore Exchange (S-chips) continue to be embroiled in accounting and auditing scandals. From early 2010, SGX became more vigorous, ordering "special audits" of the cash bank balances of 12 firms, most of them S-chips. It has also, from mid-2010, been reprimanding multiple directors from single companies as well as the corporations themselves. In 2012, it has suspended a broker, MF Global, but otherwise has not taken any new enforcement action against a company or director this year. More positively, it continues to make use of its "watchlist" for problem companies and has revamped its website, with better organised and more detailed enforcement announcements.

Easier access to enforcement announcements

The MAS has also revamped its website, with somewhat easier access to enforcement announcements. However, they are included under "news and publications" rather than being highlighted on the homepage. The website of the Hong Kong SFC is better organised in this regard. While the MAS is usually quite vigorous in its enforcement duties, its sanctions are mostly against financial advisors and investment funds. It continues to take civil rather than criminal actions against insider traders and listed companies, which are far fewer than other enforcement cases. In 2011, for example, there were only three insider-trading cases, and none so far in 2012.

More meaningful participation from retail investors

A newer feature of Singapore's enforcement environment is the much greater participation of retail investors at annual general meetings, with many of them asking intelligent and thoughtful questions, showing evidence that they had actually read the annual reports. This is a change from a few years ago and has pushed up the score for private enforcement by retail shareholders. (It is also very different to the typically quieter culture of AGMs in Hong Kong.)

More needed from institutional investors

Such positive comments cannot be made, unfortunately, about Singapore's cadre of institutional investors. While many exercise their votes, few attend annual meetings or ask questions (some notable and longstanding exceptions aside). It is also clear from the AGMs that we have attended in Singapore that institutional investors are sometimes out of sync with the concerns of local retail shareholders. For example, retail votes will sometimes come in strongly against a director or remuneration issue, while the institutional vote (shown on a poll voting screen) will be 99% in favour. This suggests that many institutions are voting automatically and on the basis of recommendations by proxy advisors. While relying on proxy advisors is the only practical way that most institutions, with their large holdings, can vote, the value of such votes as an accountability mechanism is diminished if everybody blindly votes in the same way.

Political and regulatory environment

Consistent policy on CG reform

Singapore increased its score in this segment by a respectable 4ppts from 69% to 73%. For reasons outlined earlier, we believe the market has followed a clearer and more consistent policy on CG reform over the past couple of years. MAS, SGX and the Singapore Corporate Governance Council have worked hard to bring in a series of regulatory changes (see our discussion on CG rules and practices).

Disclosure better but needs more transparency

Disclosure of regulatory activities has improved, although we believe that more transparency would be in order. To put it colloquially, we find regulators in Singapore more tight-lipped than their counterparts in many other Asian markets, such as Hong Kong, Indonesia, Japan, the Philippines and Thailand, where officials often give a more balanced assessment of the strengths and weaknesses of their financial regulatory regime. The media in Singapore, however, is becoming more critical and expert in its reporting. SGX, meanwhile, has pushed the bar by issuing *Guide to Sustainability Reporting for Listed Companies* in June 2011.

IGAAP (accounting and auditing)

Lower score despite an impressive independent audit regulator

Singapore continues to have an impressive independent audit regulator, the Accounting and Corporate Regulatory Authority (ACRA), but the score for this category fell fractionally this year, from 88% in 2010 to 87% in 2012, because we took a firmer line in answering some questions on audit regulation and quality. Several other markets also fell for the same reason.

More disclosure required on audit fees

On the positive side, SGX has amended its listing rules in September 2011 to require companies to disclose fees paid to external auditors. Meanwhile, it brought in a new rule saying all CPA firms auditing listed companies had to be registered with ACRA or regulated by a recognised independent audit regulator (ie, a member of the IFIAR). Since Hong Kong does not have an independent audit regulator it is not a member of IFIAR, so about 90 Hong Kong CPA firms auditing Singapore-listed firms must now work in collaboration with a Singapore associate.

Questions on capacity and quality of audit firms

But it was questions that ACRA raised in its 2011 *Practice Monitoring Programme* (PMP) report about the capacity and quality of the top-eight CPA firms in Singapore that raised a number of red flags and led to a lower score here. For example, ACRA pointed out that audit quality was suffering due to personnel capacity, structure and incentive problems in most CPA firms. Not only do most firms rely on junior auditors with less than four years of experience, but insufficient partner supervision of junior associates was likely eroding the quality of audit.

Limited disciplinary action taken by ACRA

We also slightly downgraded the score on whether the audit regulator was exercising effective disciplinary control over the audit profession. ACRA is a leader in Asia in terms of its PMP programme, which aims at improving audit quality, but has taken limited disciplinary action against errant auditors. For example, we have not seen the authority directly discipline CPA firms responsible for auditing S-chips that have defrauded investors. The Public Accountants Oversight Committee of ACRA has the ability to strike off an auditor if major problems are found, but to date this has rarely happened. ACRA admits that its enforcement capabilities are limited and for this reason launched a consultation on the Accountants Act in May 2012. This review should clarify and strengthen its sanctioning powers.

CG culture

Not great deal of improvement in CG culture

CG culture is another area that has not shown significant improvement this year, as it rose by only 1ppt from 53% in 2010 to 54%. One bright spot was the large listed companies that have been trying to become more transparent and shareholder-friendly. For example, most now voluntarily vote by poll and publish detailed meeting results (of 25 blue chips that we analysed in detail here, only five had not done so).

E-voting system in the works

Another positive development: SGX is working with Broadridge to set up an e-voting system for Singapore. This will start shortly and is intended primarily for local retail shareholders. Meanwhile, several professional associations continue to be actively engaged in promoting CG awareness and education, such as CPA Australia, ACCA and the Singapore Association of the Institute of Chartered Secretaries and Administrators and major universities.

Companies looking at compliance and not the spirit of the practice

Overall, however, we do not see a great deal of change in Singapore's CG culture. Institutional investors are mostly not involved in CG reform. Most listed companies take a compliance approach to most aspects of CG. And we see few business leaders willing to step up and champion the cause.

Factors to watch

Figure 127

Singapore: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- ❑ No revision in financial reporting (audited annual results) deadlines.
- ❑ No mandatory voting by poll.
- ❑ No change of rule for release of AGM notices to at least 21 days.
- ❑ Questions lingering about the quality of audits.
- ❑ Continued lack of involvement of institutional investors in CG reform.

Actions that could improve overall CG

Figure 128

Singapore: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- ❑ Publish audited annual results within 60 days.
- ❑ Vote by poll and publish detailed results.
- ❑ Improve disclosure of enforcement announcements.
- ❑ Disclosure of non-audit fees with commentary.
- ❑ Improve non-financial reporting practices (stop using boilerplate language, provide some meaningful text!)

Source: ACGA

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Research perspective - S-chips a problem

A large part of Singapore continues to operate without significant CG issues. There are, however, two general governance problems for the market. Firstly, over 60% of the companies under coverage are linked to the government through its investment arm, Temasek. While this provides the companies with significant stability and, from a credit point of view, an implied sovereign backing, it raises questions about the ability of management to set the strategic direction of the company independently of government priorities and to react timely to changing circumstances. The second area of concern is the track record of a number of Chinese-based firms that have listed on the SGX.

Integrity of market maintained, valuations at a premium

This year has seen two high-profile international listings declined or delayed from listing in Singapore: Manchester United (listed on NYSE in August) and Formula One. One of the purported reasons for Manchester United's decision to not list in Singapore was that the SGX does not allow dual-class ordinary shares with preferential voting rights, and the Glazer family has maintained control through its Class-B shares, which have 10 times the voting rights of Class-A shares sold to investors in the IPO. However, SGX does allow preference shares to be issued.

For Formula One, the decision will come down to valuations and investor appetite. At present, the Singapore stocks under our coverage are trading at 15.1x 12CL and 13.6x 13CL core earnings compared to a regional average of 11.9x and 10.5x. The market's valuation is dragged down by the low multiples applied to China as investors remain sceptical about mainland growth estimates.

SGX tightened up on listing criteria

The SGX has been more vigilant in recent years in vetting the credentials and financial position of new listing applicants including orderbook validity and actual operations. Part of the problem is the low valuations applied to Chinese companies listed in Singapore. However, it may also be the outcome of lower-quality companies (without proven franchise and scale) being the ones attracted to the SGX.

The exchange has lately tried to address this by raising the minimum market cap from S$80m to S$150m for companies that are profitable and have at least three years of operating results. The minimum market cap for unprofitable firms or with only one year of financial records has increased to S$300m. In addition, companies must have a consolidated pretax audited profit of S$30m in the last financial year and three-year track records compared to the previous requirement of a cumulative S$7.5m over three years and at least S$1m in each of those years.

Auditors have had problems reconciling accounts of S-chips

These new measures should address the weakness still continuing with the poor quality of a number of S-Chips. This year, management and directors of China Sky Chemical Fibre all quit after the company had ignored an SGX order to appoint a special auditor. The shares have not relisted and investors have seen the market cap decline from a peak of S$2.7bn to zero. This follows a number of high-profile cases where the auditors were unable to reconcile the cash balances and investments such as China Milk, Sino Environment, Sino Tech Fibre and China Gaoxian. The issues have been either fraud or inappropriate investments not approved by the board. One problem for enforcing the SGX orders and/or civil and criminal court case has been the lack of success in bringing action against the directors, who often take flight back to the mainland.

Improvements ongoing

SGX introduced key changes

There have been two further improvements made by regulators in the past year. In September 2011, the SGX released a number of new listing rule requirements aimed at improving CG practices and disclosure, after a number of issues had occurred, particularly with foreign listed companies.

These included:

Firmer rules on independent directors, management and audit committees

- Internal control and risk management;
- Shareholders' loan agreements and pledges; if an issuer enters into a loan agreement or issues debt securities that contain a condition which makes reference to the shareholding interest of any controlling shareholders or restricts change of control of the issuer, and the breach of this condition or restriction will cause a default in respect of the loan agreement or debt securities, significantly affecting the operations of the issuer, it must immediately announce the details of such condition or restrictions. The issuer must also obtain an undertaking from its controlling shareholders to notify it when they enter into share pledging arrangements;
- Appointment of independent directors to principal subsidiaries overseas;
- Prevention of directors, CEO/CFO who are under investigation of irregularities or other wrongdoing;
- Confirmation from the audit committee on the character and integrity of the CFO; and
- Appointed audit firms to be registered with and/or regulated by the ACRA.

Listed companies required to ensure robust system of internal controls

Following the publication of 2011 annual reports, one of the major changes that caught a number of companies unaware was the additional the requirement for confirmation that: 'An issuer should have a robust and effective system of internal controls, addressing financial, operational and compliance risks. The audit committee (or such other committee responsible) may commission an independent audit on internal controls for its assurance, or where it is not satisfied with the systems of internal control.'

Increased SGX queries

With listing rule 1207(10), the annual report is required to contain an opinion of the board with the concurrence of the audit committee on the adequacy of the internal controls, addressing financial, operational and compliance risks. This led to the SGX raising a large number of queries that companies had to publicly respond to. The two main reasons for the SGX query have been: opinion on adequate internal audit, and internal controls; and trading activity and dealing in securities.

In April this year, in the latest review of the Singapore listing rules on CG, the MAS has made several changes although not all of the recommendations made by the Corporate Governance Council were accepted. New regulations accepted by the MAS were matters relating remuneration, board composition and terms of independent directors as summarised below:

Remuneration:

Greater transparency on remuneration

- **Before:** Disclose the pay in US$250,000 bands.
- **Now:** Companies must disclose the remuneration of each individual director and the CEO on a named basis. The top-five key management in S$250,000 bands have to be named as well as the aggregate total remuneration paid to the top five officials.

- **Before:** Companies were encouraged but not required to disclose the link between remuneration and performance.
- **Now:** Companies should disclose more information on the link between remuneration paid to management and performance.

Board composition

- **Before:** Independent directors must make up at least one-third of the board. If the director is an immediate family member of the CEO, he or she is deemed not independent.

Independent directors must make up at least half of the board

- **Now:** Independent directors must make up at least half of the board; if the chairman is also the CEO, or is an immediate family member of the CEO, the chairman is deemed not independent.
- The MAS granted a transition period of five years to 2017 for companies to meet this requirement.

Term of independent directors

- **Before:** No limit to an independent director's period of service.
- **Now:** Companies with independent directors who have served over nine years must explain why they are still independent.

Definition of substantial shareholder impacting an independent director

Tightened terms on independent directors

- **Before:** The relationship with a substantial shareholder did not compromise the independent director's status.
- **Now:** A substantial shareholder is one who holds at least 10% of a company's shares. (Note this does not change the disclosure requirements at 5% of shareholding.)
- A director associated with a substantial shareholder in the current or immediate past financial year is not independent.
- The MAS has granted a transition period of five years for listed companies to make board composition changes to comply with the new guidelines for independent directors.

Companies that have seen CG improvement

SATS delinked from SIA

SIA divested its 80% stake in **SATS** in 2009 via a distribution in specie to existing shareholders. This has allowed for a separation from SIA and provides it with a clearer commercial relationship with its major customers that accounts for 60% of its revenue, rather than the majority of business coming from a related party and majority shareholder.

Independent directors playing their role at F&N

Fraser & Neave (F&N) has increased its independent directors from five of nine to seven of 10 in the past three years. In addition, F&N rates highly in Singapore for the voting at shareholder meetings as it is one of the few that counts by polling rather than the traditional show of hands. The independence of the F&N board has been seen to be working well with the recent corporate action surrounding both its shareholding in Asia Pacific Breweries (APB) and the emergence of Thai Beverage as the single last shareholder. Its partner in APB, Heineken has put forward an offer (subsequently revised upwards) to purchase F&N's direct and indirect stakes in APB. The board of F&N has decided to recommend to shareholders to accept the bid and the offer will go before a shareholders meeting. This despite the potential pressure from Kirin (15% shareholder and one board seat) and the emerging Thai Beverage and APB holding an iconic Singapore brand in its portfolio, Tiger Beer. Thus the

independent directors are, in our view, acting in the interests of all shareholders, including minorities in recommending a value creating offer priced at 36.4x trailing PE and 18.4x EV/Ebitda.

Greater transparency

Ascott Reit has seen its CG score improve due to now disclosing both its WACC and COE (previous management did not disclose these when we conducted our last survey). In addition, it now discloses stated targets for ROE and ROA as well as board compensation.

Companies that have seen CG deterioration

Decline in CG score among some

CapitaMalls Asia's CG scores were dragged down by two factors. Firstly, interested-party transactions - previously we have scored this as a positive as the company was just listed in end-2009. Following its listing, several related transactions were made. Secondly, there has been a decrease in independent directors on the board.

Related-party directors still dominate **Capita Mall Trust**'s board. Although in recent years it has increased the number of independent directors from three to four, unfortunately the board expanded from nine to 11 members, so the proportion of independent directors has only changed marginally.

Ezion, OCBC and Sembcorp Industries amongst the top scorers in the region

Figure 129

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

Company	Code	Company	Code
Ascott Reit	ART SP	NOL	NOL SP
City Developments	CIT SP	OCBC	OCBC SP
CMA	CMA SP	Sembcorp Industries	SCI SP
Ezion	EZI SP	Sembcorp Marine	SMM SP
Frasers CentrePoint Trust	FCT SP	SGX	SGX SP
GGR	GGR SP	Singapore Airlines	SIA SP
Global Logistic Properties	GLP SP	SingTel	ST SP
Keppel Corp	KEP SP	StarHub	STH SP
M1	M1 SP	UOB	UOB SP
Noble Group	NOBL SP	Wilmar	WIL SP

Source: CLSA Asia-Pacific Markets

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Taiwan - Marching forward, but too slowly

Independent directors and audit committees not mandatory

Over the past two years, Taiwan has continued to make incremental improvements to its CG regime. Alas, this was not enough to prevent it from slipping two places to sixth in our 2012 rankings, since some other markets in the region did more, and faster. Taiwan's overall score fell to 53%, from 55% in 2010, with the biggest drop seen in the enforcement category. As we pointed out in our 2010 report, Taiwan authorities still seem to lack a clear organising strategy or overarching vision for CG reform. For one, independent directors are still not required for all listed companies. Although remuneration committees are now mandatory for all listed firms, the more important audit committee is not. And the system for director nominations and election continues to have serious drawbacks. In short, the market continues to be behind the curve in some of the most crucial global CG best practices.

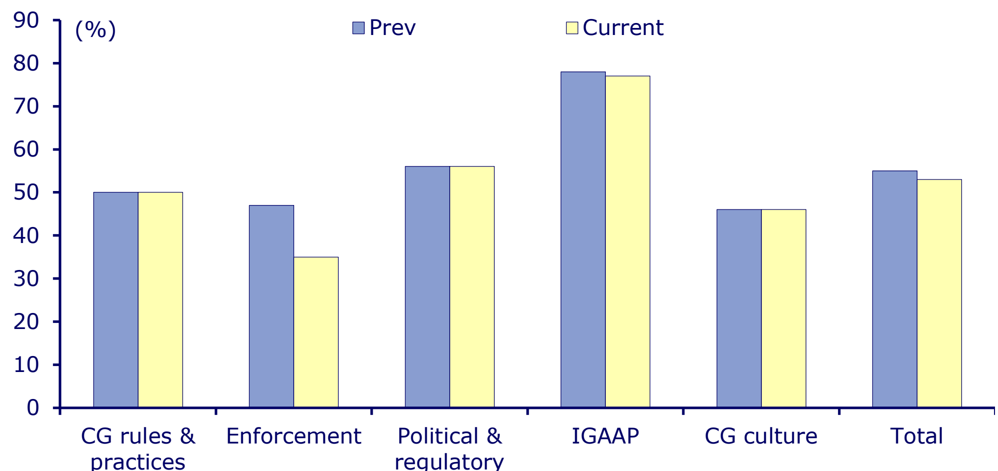
Reform process is top-down

Meanwhile, the average listed company in Taiwan is at best only keeping up with regulatory changes. Apart from a handful of corporate leaders, we do not sense that many Taiwan businessmen appreciate the value of good CG for the long-term performance of their companies. There is also little bottom-up pressure for change from either domestic institutional or retail investors. The reform process in Taiwan, therefore, is very much a top-down affair in which dutiful regulators are trying to compel more modern governance practices on companies and investors, neither of which seem too bothered about business-as-usual.

Scores for enforcement saw the biggest decline

Figure 130

Taiwan CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

CG rules and practices

New regulations only bring Taiwan up to existing regional standards

Despite a flurry of rule changes, Taiwan's score for this category remains unchanged at 50%. This is because many of the new regulations introduced in the past two years merely served to bring Taiwan up to or near existing regional standards. For starters, in January 2012, the deadline for releasing audited financial results was brought forward to three months from four months after the end of the fiscal year, at last putting Taiwan on a par with most major Asian markets (but still behind regional best practice of 60 days). Ditto for allowing split voting at AGMs from this year. This was a longstanding demand of ACGA and our foreign-investor members, who often saw their votes in Taiwan invalidated if shares entrusted to different fund managers did not have the exact same voting instructions. Split voting has been commonplace in most other Asian markets for years.

E-voting for domestic shareholders only

From this year, regulators also mandated electronic voting for listed companies with authorised capital of NT$10bn (US$345m) or more and 10,000 or more shareholders. E-voting in Taiwan, however, is only for domestic shareholders and does not facilitate voting at the AGM itself (since the deadline for casting e-votes is three days before the AGM). Of the 113 companies required to adopt e-voting, 83 of them did so this year and the rest were exempted until next year.

Companies gradually moving towards voting by poll

E-voting is a step in the right direction towards a more efficient share-voting system. Combined with voting by poll at the AGM, which was included as a recommendation in the revised Corporate Governance Best-Practice Principles of the Taiwan Stock Exchange (TWSE) and the GreTai Securities Market (GTSM), a document released in March 2011 with a new "comply or explain" feature-e-voting should enable a more accurate count of "for", "against" and "abstain" votes. Traditionally, listed Taiwan companies voted by acclamation and only disclosed whether a resolution had passed or not. But seeing the clear direction in which rules on voting are headed, 114 companies voted by poll on some or all resolutions (usually with paper ballots) and disclosed detailed results this year.

Remuneration committee mandated

The new regulation that has attracted the most attention among listed Taiwan companies, however, was a requirement to set up remuneration committees by the end of 2011. At the same time, a related regulation was amended to require disclosure of compensation paid to each individual director and supervisor if a company had losses in the most recent fiscal year; previously, a company had to do so if it had two consecutive years of losses.

Might encourage companies to appoint independent directors

We are somewhat sceptical that the problem of overpaid executives and directors in Taiwan is as serious as in some Western countries. But one positive aspect of this reform was that the criteria for members of the remuneration committee (minimum of three who, incidentally, do not have to be board directors) were made nearly the same as those for independent directors. This means that all listed firms are, in effect, now required to have at least three outside advisers who would be fit to serve as independent directors. Despite other laws and regulations that still exempt some firms from appointing independent directors, many companies in time may decide that it would be sensible to do so and assign them to the remuneration committee, thereby eliminating the need to find two groups of qualified people.

Piecemeal rules on board independence

For the time being, however, Taiwan's rules on board independence remain piecemeal and convoluted. In March 2011, the regulators expanded the mandatory independent-director requirement to encompass listed firms with paid-in capital of NT$10bn or more. Previously, listed companies with paid-in capital of NT$50bn or more were required to appoint independent directors, as well as newly listing corporations and financial institutions. Meanwhile, the audit committee is still not mandatory - and this year we have finally downgraded Taiwan for its lack of progress in this area. Companies can choose between setting up an audit committee comprising independent directors and appointing at least three supervisors who do not need to be independent.

Enforcement

This was Taiwan's weakest category in the current survey, with the score dropping to 35% from 47% in 2010. In the past two years, there has been no discernible pickup in regulatory efforts to crack down on market misconduct.

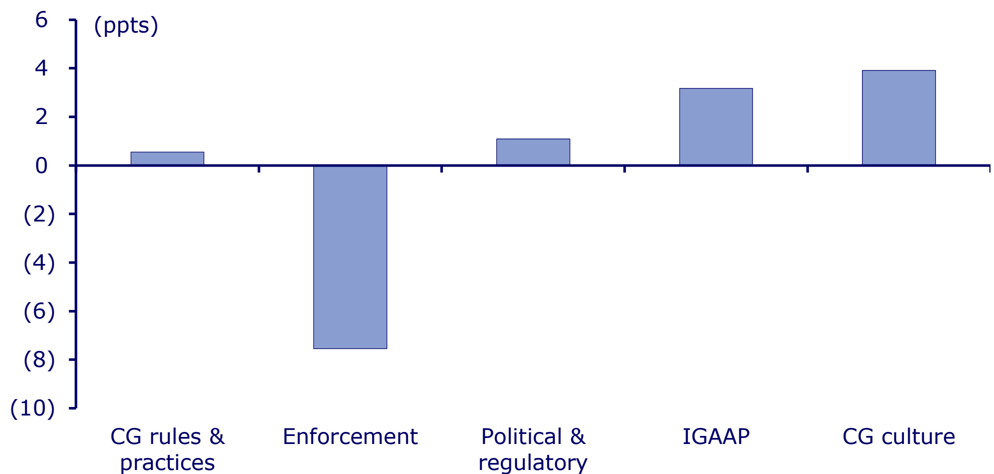
Lack of transparency on enforcement

Neither the Taiwan Stock Exchange (TWSE), which is in charge of detecting insider-trading and market-manipulation cases, nor the Securities and Futures Bureau of the Financial Supervisory Commission (FSC), which oversees the stock exchange's work in this area, devoted significantly more resources to monitoring and investigation as far as we were able to ascertain. Understandably, Taiwan regulators cited legal restrictions against releasing data on ongoing market misconduct investigations, which are carried out by the judicial branch as criminal cases. But there is not even much detailed disclosure on enforcement of any kind, including historical data, and what is publicly available tends to be outdated (eg, as of mid-2012, the latest prosecution data for major securities crimes were for 2009). This lack of transparency was a major reason why Taiwan's enforcement score suffered so much in this year's report.

Weaker on enforcement but slightly better than Asian market average in other categories

Figure 131

Taiwan: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Class action suits being launched

The only exception to this general data blackout is class-action suits launched by the Securities and Futures Investors Protection Centre (SFIPC), a special agency under the FSC to look out for the interests of small investors. In 2011, the SFIPC pursued 86 cases on behalf of more than 80,000 investors and involving false financial statements, misleading prospectuses, stock-price manipulation and insider trading. And in 2010, the agency for the first time also initiated derivative suits against directors and supervisors of listed companies (as of the end of 2011, there had been nine such actions).

Buyout bid of Yageo Corp was blocked

The biggest headline the SFIPC generated, however, was its role in blocking the buyout bid of Yageo Corp in June 2011 by an investment vehicle jointly owned by the chairman of Yageo and Kohlberg Kravis Roberts (KKR), a US-based private-equity fund. Had it been successful, the NT$46.78bn deal would have led to the delisting of the world's No.1 chip-resistor maker. But the SFIPC deemed the public tender offer at NT$16.1/share detrimental to Yageo's minority shareholders, who had no say in the matter since shareholder approval is not needed in Taiwan in cases where privatisation follows a merger. The SFIPC duly raised its concerns with both Yageo and the FSC, and in the end Taiwan's agency in charge of reviewing foreign investments rejected the buyout bid.

Dubious tactics at AGM of CPDC

However, in another high-profile case, Taiwan regulators were noticeable by their absence. On 27 June 2012, a proxy fight for board control between the management of China Petrochemical Development Corp (CPDC) and a group of dissident shareholders led by Lealea Group (which also happened to be a customer of CPDC products) came to a head at CPDC's AGM. Eight of the nine seats on the board were won by management-nominated directors, including CPDC's first two independent directors. However, CPDC management resorted to highly questionable actions to ensure the outcome. The day before the meeting, it reordered voting items on the meeting agenda to bring up the election of board directors as the first resolution from eighth. Then, at the AGM venue, CPDC security guards delayed the entry of Lealea representatives and their allies, preventing them from casting votes on director elections. What is more, on 16 May, the CPDC board had disqualified Lealea's two nominees for independent directors on technical grounds (incorrect filing of required forms) and, despite a court order to reinstate them, it did not do so in time for the AGM.

No counteraction by the regulators

This saga - apparently Taiwan's first proxy fight involving two groups of domestic shareholders - highlighted a number of systemic CG problems in Taiwan. For one, the current regulations on the procedure for director nominations are vague and evidently contain serious loopholes. Also, in the months leading up to CPDC's AGM, there had been a rapid turnover of board members for various reasons but no consultation with shareholders (a point of contention with the dissident shareholders). Nevertheless, as of late August or two months after CPDC's controversial AGM, Taiwan regulators had not taken counteractions of any kind.

(Note: ACGA wrote about the deeply entrenched deficiencies of Taiwan's director nomination and shareholder meeting/voting systems in our *White Paper on Corporate Governance in Taiwan* in early 2011. We recommended comprehensive reforms to achieve a sensible level of accountability, transparency and fairness. As the CPDC AGM reinforced, such reforms are urgently needed.)

Political and regulatory environment

Regulators do feel responsibility to pursue CG reform

At 56%, our score for Taiwan's political and regulatory environment did not change from two years ago. Here, the lack of clear or broader vision from the market's political leadership offset the regulators' sense of responsibility to pursue continual CG reform. We find that senior officials at the FSC and the two stock exchanges are generally accessible and open to dialogue, while working-level staff are prompt in responding to outside queries. In addition, when our *White Paper on Corporate Governance in Taiwan* was published, regulators showed thoughtful interest in many of our recommendations.

Commitment of political leaders unclear

We are, however, less sure about the commitment of Taiwan's political leaders to CG reform. The signature economic initiative of President Ma Ying-jeou has seen closer economic cooperation with mainland China, which has no significant governance implications for domestic companies. Earlier this year, after winning his second four-year term, Ma appointed a former head of the FSC and TWSE, Sean Chen, as his new premier, raising expectations in some quarters that a greater emphasis on corporate governance reform may be in the offing. However, the government has not unveiled any major CG-related policies so far.

Populist motivation for legislation on remuneration committee

The Ma administration's main accomplishment in this area has been the passing of the law on remuneration committees in November 2010. But we feel this move was less motivated by CG concerns than by politicians with populist inclinations wanting to show their solidarity with the international backlash against corporate "fat cats" on the heels of the global financial crisis.

IGAAP (accounting and auditing)

IFRS by 2013

Even though Taiwan is in preparation for full adoption of IFRS in 2013, and its accounting rules have been made more than 90% compatible, the country's score in this category fell slightly to 77% from 78% in 2010. This is because we are taking a tougher line on auditing practices across the board, given the problems that have come to light in many markets in the region. In Taiwan's case, the National Federation of Certified Public Accountant Associations of the Republic of China has found and referred 93 cases of discipline violations to the FSC during 2010-11, according to the Federation's action-plan report to the International Federation of Accountants (IFAC), of which it is a member. (Note: It was unclear at press time what action the FSC had taken on these cases.)

Strengthening audit standards

That said, Taiwan has moved to strengthen its audit regime recently. In February 2012, the market became a full signatory to the IFAC, which sets the International Standards on Auditing and requires members to make continuous improvements in audit practices. And three months earlier, the FSC signed a cooperative agreement with the US Public Company Accounting Oversight Board (PCAOB) for the joint supervision of auditors and audit firms that practise in both countries. (Currently, 12 audit firms located in Taiwan are registered with the PCAOB.)

CG culture

Legal compliance is main impetus for change

In our view, most listed Taiwan companies do not seem strongly interested in pursuing CG best practices for their own sake. Rather, legal compliance appears to be the main impetus for changing the way they do things. For instance, until voting by poll at shareholder meetings was included in Taiwan's Corporate Governance Best-Practice Principles, there had been only a handful of companies (including TSMC, China Steel and First Financial) voluntarily doing so.

Larger companies more open to reform

This does not mean that companies are necessarily trying to duck governance issues. Sometimes they are simply unaware that widespread practices in Taiwan are outdated by global standards and are seen negatively by outside investors (another example: clustering of AGM dates). In fact, when we talk to some of the larger listed corporations, we find that they are generally open-minded and willing to consider reforms. Still, for a country with many globalised companies that have substantial foreign shareholdings (around 32% of the total market value of TWSE-listed stocks at the end of 2011), the mindset of typical corporate executives is worryingly insular.

Institutional investors are passive

Institutional investors in Taiwan are also passive. Most domestic mutual funds do not vote their shares actively. And so far, Taiwan's public pension funds - unlike their counterparts in Korea and Malaysia - have shied away from taking a leading, potentially benchmark-setting, role in voting.

These are key reasons why our score for Taiwan's CG culture remains the same as in 2010 at 46%.

Factors to watch

Figure 132

Taiwan: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- No progress in mandating the adoption of independent directors for all listed firms.
- No progress in mandating the adoption of audit committees for all listed companies.
- No improvements to the director nomination and shareholder-voting systems.
- No improvement in the disclosure of regulatory enforcement.

What could improve overall CG

Figure 133

Taiwan: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- Strengthen non-financial reporting standards and practices (eg, board and CG reports; publication of CSR/sustainability reports).
- More detailed and current data from regulators on enforcement, including information on regulatory resources devoted to enforcement.
- Spread out AGMs to avoid clustering.
- Encourage more voting by poll for all resolutions at company AGMs, with publication of detailed results.
- Greater participation by regulatory and exchange officials in regional and international CG meetings.

Source: ACGA

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Research perspective - Treat them right

Poor treatment of shareholders is often reflected in low cash returns to shareholders

It is a noticeable feature of CG rankings that the worst companies tend to have low cash-dividend-payout ratios and pay high stock dividends. Those with the best CG are all willing to pay retained earnings tax rather than force the tax burden onto their shareholders. Taiwan has the highest payout ratio in the region and the highest PE as well. We believe these two factors are connected. Investors value dividends more highly than retained earnings. DPS growth is more important than EPS growth to share-price performance. For once virtue is being rewarded in share-price performance. Year to date, the 19 companies in the top quartile of our Taiwan CG scores have had an average return of 11.8%, while the bottom 19 have had a return of 4.3%.

Maturity has not lead to diworsification

As industry in Taiwan has matured, companies have not diversified into unrelated areas. Instead, they have generally built a cash pile of around 10% of market capitalisation and moved to a high cash-payout ratio. Unlike Korea, none of the telecom companies have bought a Dram company. In fact, many have had special dividends and stock buybacks. A recent change in the law to eliminate the need for stock buybacks and allow companies to just pay surplus cash to shareholders means that cyclical companies such as TSMC can guarantee a minimum dividend (in this case NT$3 per share), safe in the knowledge they can pay from reserves in a bad year. Also other companies, for example Far Eastone, can now consistently pay out more than 100% of earnings without the old process of issuing and then cancelling new shares.

Companies that want to avoid retained earnings tax but keep the cash pay stock dividends

In Taiwan, the rate of tax on companies is 17% but the top marginal rate of individuals is 40%. In order to prevent individuals deferring tax by leaving it in a company as retained earnings, Taiwan has a retained earnings tax of 10% on any earnings retained after a 10% allowance for transfer to a legal reserve. This tax is calculated on total consolidated earnings (including offshore earnings). For example if a company pays 75% of earnings out as dividends to shareholders, then the retained earnings tax is 10% of (100-75-10) = 10% of 15% = 1.5%. The company was paying the full 17% rate, then its corporate tax rate would become 18.5%. If a company paid no dividends then its tax rate would become 17% + 9% = 26%. Companies that want to avoid retained earnings tax but keep the cash pay stock dividends rather than cash dividends. These stock dividends are taxed at the shareholders' marginal personal income tax rates of up to 40%. For foreign investors, this means the withholding tax rate for their jurisdiction. As many countries (eg, USA, Korea, Japan, Hong Kong) don't have a double tax treaty with Taiwan, that rate is usually 20%.

Despite claims to the contrary, the vast majority of investors do not want stock dividends

If a company were to pay dividends from reserves on which retained earnings tax had already been paid, then shareholders would get a credit for that tax when they calculated the tax on their dividends. Thus,it is in the interests of most shareholders that companies choose to pay all dividends in cash, and to pay retained earnings tax, rather than pay any stock dividends. In our view, paying any stock dividends at all is a sign of bad corporate governance. This is particularly true for any company in a net-cash position, which cannot argue any cashflow reason a stock dividend. The companies scoring highest on CG in Taiwan, such as TSMC and Delta, which choose to retain some earnings beyond the 10% legal reserve, all pay the retained earnings tax rather than shift the burden to shareholders by paying stock dividends. The fact that these companies behave this way shows up as false, the usual excuses you hear from companies that pay stock dividends.

These are:

Why companies claim they pay stock dividends

1. Investors like them as can be seen from the fact that share prices never fully adjust downwards when stocks go ex-dividend. The reason for this is that the person doing the calculation does not take into account withholding taxes on cash and stock dividends. Nor do they deduct some cost for the illiquidity of the stock dividend shares. Once this is taken into account, it is obvious that it is worth paying some premium to purchase the shares ex, rather than cum, dividend.
2. Cash and stock dividends are linked to cash and stock bonuses to employees. This is not true.
3. We need to raise the paid-in capital. This is true for the financial companies as new accounting policies and higher capital requirements mean they must have more capital and share prices react badly to any suggestion of a capital-raising. It is not true most other companies and obviously so for those that are net-cash.
4. We will increase the liquidity of the shares. Investors measure liquidity by value not volume. More shares at a lower price does not increase liquidity.

Good CG, high dividend payout ratios and outperformance are connected

We attribute stock dividends to management's indifference to shareholders and their desire to retain as much cash within the company rather than maximise the after tax value of the business to shareholders. In summary, the global trend of continuing inflow to yield funds and the high valuation of yield plays are results (in Taiwan anyway) of better share-price performance by companies with good corporate governance.

Issues in the financial sector

The financial sector dominates the bottom quartile of our rankings

As in all previous surveys, the financial sector dominated the bottom quartile of our rankings for Taiwan. This is the sector with the greatest history of corporate malfeasance and reported CG issues. It is also the worst sector in Taiwan for value creation and generating good long-term returns to shareholders. The current trend in the sector is to buy out the foreign life-insurance companies.

In Taiwan life-insurance companies offer policy holders guaranteed rates of return on the amounts they invest. Every year the insurance bureau sets minimum and maximum rates of return on the amounts that insurance companies will pay to the policy holders over the life of the policy. These policies can be very long-dated. For instance, parents might buy their children a retirement policy when they are born. The duration of that liability will be 60 years. There is no way insurance companies can find assets with a duration equal to that of their liabilities.

The policy rate in Taiwan is below 2% now versus 7% 15 years ago

Fifteen years ago, the policy rate in Taiwan was over 7%. This is the guaranteed rate of return that can be offered. Today it is under 2%. 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. However, you can imagine the impact on those liabilities if you were to change the discount rate for those policies written 15-20 years ago from 7% to 2%. International accounting standards require the use of market rates of interest to value policy liabilities but Taiwan's do not. Taiwan is introducing IFRS next year but has specifically excluded insurance policy liabilities from this standard.

With the collapse in interest rates globally, international insurers are selling their Taiwan operations due to the rise in the market value of liabilities. In August 2012, New York Life announced to sell its Taiwan business for 2.3% of its Taiwan book value. If Taiwan's regulators were not exempting the insurance sector from the full application of IFRS, we doubt that the listed financials here would be buying these businesses. The groups behind the financials in Taiwan appear to have a greater interest in maximising their size than in maximising ROE other measures that lead to higher long term returns for outside investors.

No proper market for corporate control

Rare for there to be contest for election of directors

In the second quarter, we saw a contested election for directors for a listed company in Taiwan where the votes from foreign shareholders could have tipped the balance. The last time this analyst remembers that happening was in 2005, when Taishin was competing with Sinopac for International Bank of Taipei. In this case, as in 2005, the existing parties dominating the board remained in control. However, in this case they managed to do this with only an estimated 10% of the vote, compared to the challenger's estimated 30%-plus. The more recent episode with China Petrochemical Development Corp (CPDC), where the contesting party was effectively barred from voting, is described in ACGA's Taiwan section.

The government refuses permission for private-equity buyouts

Clearly the market for corporate control does not work properly in Taiwan. The existing board can control a company with a comparatively small shareholding, even in the face of determined opposition. This is also a concern when the major shareholder teams up with a private-equity company and offers to privatise the business. Independent directors do not organise a proper auction for the whole company to get the best price for all investors. As a result, it has been good to see the government refuse permission for these transactions to go ahead.

TSMC still ahead of all the companies in Taiwan and in the region

Figure 134

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

Company	Code	Company	Code
Advantech	2395 TT	Novatek	3034 TT
Ambassador Hotel	2704 TT	PC Home	8044 TT
ASE	2311 TT	Powertech	6239 TT
Asustek	2357 TT	Quanta Computer	2382 TT
AUO	2409 TT	Realtek	2379 TT
Career Tech	6153 TT	Richtek	6286 TT
Cathay FHC	2882 TT	Silitech	3311 TT
China Airlines	2610 TT	SPIL	2325 TT
China Steel Chem	1723 TT	Taiwan Cement	1101 TT
Chipbond	6147 TT	Taiwan Mobile	3045 TT
Compal	2324 TT	Tripod	3044 TT
Delta	2308 TT	TSMC	2330 TT
EVA Airways	2618 TT	TSRC	2103 TT
Far EasTone	4904 TT	TXC	3042 TT
Flexium	6269 TT	UMC	2303 TT
Formosa Hotels	2707 TT	Unimicron	3037 TT
Huaku Dev	2548 TT	Vanguard	5347 TT
Kinsus	3189 TT	Wowprime	2727 TT
MStar	3697 TT	WPG	3702 TT

Source: CLSA Asia-Pacific Markets

Investing in mainland China

Taiwan's China plays are outperforming

This year has seen strong performances by companies with operations in China. Notable outperformers among large caps are Cheng Shin Rubber and Uni-President Enterprises. Taiwan Cement and Asia Cement have substantial businesses in China and they have performed well this year in comparison to cement companies listed in Hong Kong. Finally, we saw a number of new listings of companies that are primarily China plays. In our coverage, these include Wowprime, Ginko and Grand Ocean. These stocks all trade at high multiples reflecting high-growth expectations. With accounting issues facing China plays listed elsewhere, we believe there is a shortage of "trustworthy" China investment plays. In our view, China plays that have their primary listing in Taiwan and are controlled by Taiwanese management will have corporate governance similar to the rest of the Taiwan market. The local regulators will be better placed to discipline these companies than will foreign (Western) regulator dealing with mainland management teams.

Negative influences on state companies

Corruption in government influencing state-owned companies

Some of the best long-term performers in the Taiwan market have been state companies, such as China Steel and Chunghwa Telecom (CHT), and we would point to better-than-average corporate governance as one of the reasons. However, recently we note some negative factors. Firstly the legislature has passed a resolution that effectively prevents CHT from paying out surplus cash. Instead, it seems the legislature wants CHT to invest in rights issues by underperforming state companies. The first of these was China Airlines and we worry that others are forthcoming.

Recently the secretary-general of the Executive Yuan was arrested on corruption charges. He had been taking bribes to influence China Steel's allocation of a contract for the sale of slag - a waste product from the steel-making process. It does not reflect well on China Steel that politicians were able to do this.

A company is defined as "state-owned" if the government holds more than 20%, therefore even though the government has sold down most of its shares in these companies it can still dominate the election of directors.

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Thailand - Quiet achiever

Thailand is proving to be one of the more steady performers in our regional survey: it was the most improved market in 2010 with an 8ppt rise to 55% and has gained a further 3ppts to 58% this year. Thailand is also unusual in that it is one of the more self-effacing countries in the region. While most markets believe they are above-average and should be higher in our survey, Thailand greeted its rise in our rankings last time with a certain amount of disbelief. 'Surely you are being too generous?' was a common refrain. Our reply then was to recommend focusing not on the ranking but on the score, which at 55% was not high in absolute terms and showed considerable room for improvement. The country's high ranking simply meant that most other markets performed worse. We would give a similar response today.

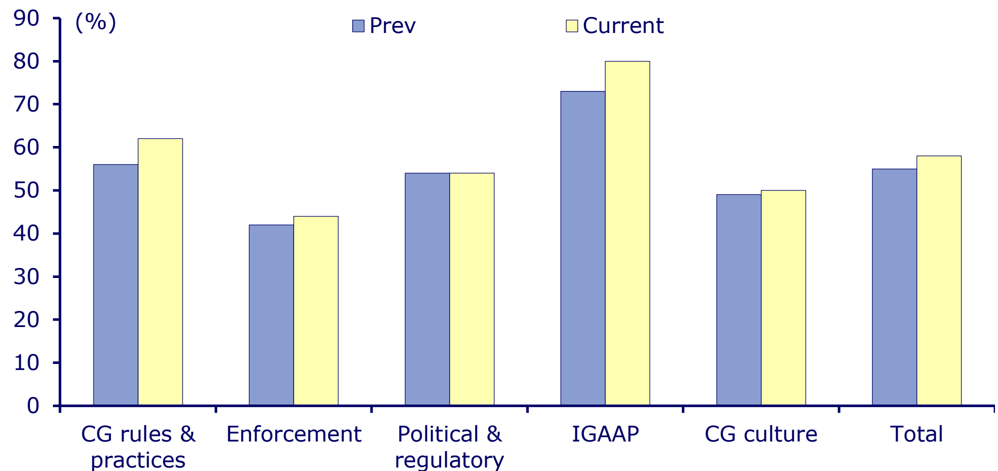
Public corruption a major obstacle to development in Thailand

If Thailand is to continue rising in our survey, then it has some serious obstacles to surmount. Probably the toughest challenge is public-sector corruption, which many in the business community say has gotten worse. The good news is that leading companies and organisations in the private sector are banding together to attack the "supply side" of corruption (ie, payments to officials). Realistically, no one believes this will be easy.

Scores rise across the board, mostly

Figure 135

Thailand CG macro category scores - Current compared to 2010



Source: ACGA, CLSA Asia-Pacific Markets

CG rules and practices

Financial reporting rules in Thailand are among the most robust in Asia

Thailand's score for rules and practices rose a significant 6ppts, from 56% in 2010 to 62%, making this one of its best-performing categories. This is an area where other countries would do well to take note of Thailand's strengths.

Deadlines for audited annual financial statements are effectively 60 days

In terms of accounting and financial reporting standards, Thailand has been making steady progress. It is keeping up with IFRS, having phased in a number of new accounting standards in January 2011, with the remainder to take effect from January 2013. The timeliness of publication of audited annual results is good and better than most Asian markets. Audited annual reports must be submitted within three months of the end of an accounting period, but companies may elect to file an audited annual financial statement within 60 days instead of filing financial statements for the fourth quarter, according to the Stock Exchange of Thailand (SET). The 60-day benchmark is a regulatory best practice in Asia and only one other country matches this - India. Most jurisdictions allow three months and some up to four.

All listed companies we assessed report quickly

Since this section of the survey looks not just at rules on paper but how companies implement those rules (ie, practices), we assessed governance practices at 30 large caps and 10 SMEs. We found that all these firms reported within the 60-day deadline for audited annuals, 11 of the large caps published their results within six weeks and two of the SMEs got close to this as well. We also randomly checked several more SMEs and found that all reported within 60 or 61 days. While this result is not wholly out of the ordinary for blue chips - we see similarly quick reporting among the bigger companies in India and Singapore and, to a lesser extent, Hong Kong and Malaysia - it is quite rare for SMEs. Even among blue chips, it is a minority in the region that report so quickly.

SME financial reporting is improving

Among other things, these results indicate that SMEs in Thailand appear to be raising their game in financial reporting, a weakness we highlighted in our 2010 survey. The Securities and Exchange Commission (SEC), the principal securities regulator, is pushing them to improve through its comprehensive programme for reviewing financial statements. In 2011, the SEC reviewed almost twice as many financial statements as in the previous two years: 242 compared to 128 in 2010 and 137 in 2009. This led to some companies being forced to conduct special audits and/or rectify their financial statements.

Non-financial reporting is much less impressive

While basic financial reporting standards in Thailand are good, we have a less positive view of non-financial reporting standards (ie, the MD&A, CG statements, report of directors, CSR reporting). The MD&A sections of annual reports can be variable. CG statements and director reports range from the useful and interesting to the formulaic and dull, with a lot of repetitious boilerplate. Most CSR reports are brief statements with numerous pictures and few of the large caps we assessed had a detailed and substantive sustainability report.

SET has been raising standards on CSR reporting . . .

Rules are changing in some of these areas. The SET, in particular, has been promoting CSR reporting since it first published guidelines in 2008. In 2009, it worked with the SEC and 27 listed companies to establish a CSR Club. And in June of this year, the exchange unveiled two more CSR guidelines at a conference it organised. While these moves are positive, we believe that non-financial reporting practices in Thailand are not keeping pace with regional and international standards. For example, one sees much greater disclosure required from boards today in Hong Kong and Singapore, and more detailed MD&A sections.

. . . but Thailand's CG code is slipping behind regional standards

For these reasons, we have downgraded Thailand's score on non-financial reporting and on a related question about the country's code of corporate governance, *The Principles of Good Corporate Governance*. The document was published by the SET in 2006 and is now in the process of being revised. Yet, CG standards have moved on around the world in recent years, and since other markets such as Hong Kong, Malaysia and Singapore all recently revised their codes, we had no choice but to mark Thailand down.

Thailand is a regional leader in some AGM best practices

Other areas where Thailand continues to stand out on a regional basis include:

- **AGM agendas:** Remarkably, listed companies release their final AGM agendas and documents 30-45 days before the AGM. Some even provide them 50-60 days before. In Singapore, the rule is still only 14 days, although the better companies achieve 21-28 days.

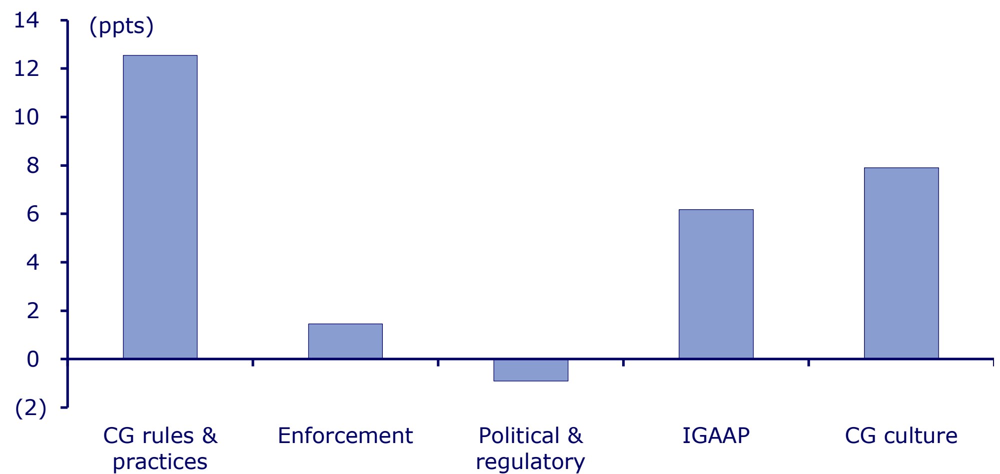
All companies effectively undertake polls

- **Voting by poll:** While polls are still not mandatory, almost 100% of listed companies effectively undertake them. Thailand's voting system is a little odd, since many companies simply count any votes against each resolution and deduct these from the total number of shares represented at the meeting to reach the final tally. While this is not pure voting by poll, it is a close approximation most of the time (unless the system deters some shareholders in the meeting from voting at all, which would be a concern).
- **AGM minutes:** Many Thai companies produce highly detailed meeting minutes, with a summary of all substantive questions asked by shareholders and answers given. This is unheard of in other markets, even in those that produce more systematic voting results like Hong Kong.

Thailand scores well above regional average in CG rules and practices

Figure 136

Thailand: Deviation of CG macro category scores from regional average



Source: ACGA, CLSA Asia-Pacific Markets

Enforcement

More cases settled on insider trading and market manipulation

Enforcement is gradually improving in Thailand, with the country's score rising 2ppts to 44% this year. The SEC feels it is making progress against both insider trading and market manipulation and over the past two years has managed to settle several cases. Its data indicate a marked increase in criminal fines for both market manipulation and insider trading in 2011 compared to 2010 and 2009 (although 2010 saw a big dip). In absolute baht terms, however, the numbers are small.

The criminal-justice system remains a major obstacle

A key challenge in Thailand remains the inefficient and corrupt prosecutorial and judicial process, with criminal complaints filed by the SEC taking years, often more than a decade, to reach any conclusion. Of 93 criminal complaints filed by the regulator against alleged offenders between 1992 and 2011, only 11 have been punished to date. Little wonder that the SEC prefers to settle.

"Untrustworthy characters"

Despite this, the filing of a criminal complaint can have serious and immediate consequences in Thailand, as the SEC clarified in a statement in May 2012. Unusually, its legal system states that any director or senior executive against whom the SEC has filed a criminal complaint will be deemed a person of 'untrustworthy character' and must resign his or her position forthwith. (See sections 89/3 to 89/6 of the Securities and Exchange Act.) Many other regulators in Asia would no doubt love to get their hands on this type of power. Though to put the issue into context, the SEC can only use it sparingly.

The SEC wants minority shareholders to defend themselves

The regulator is also trying to encourage minority shareholders to take a more active interest in defending their rights. A few years ago, it mandated domestic asset-management companies to have a voting policy, vote their shares and attend AGMs. More recently, it has been encouraging minority shareholders to attend EGMs and vote against dubious related-party transactions. The number of cases is not huge - three in 2009, four in 2010 and two in 2011 - but the initiative is an interesting one. An example was the Brooker Group case from May 2012, where the SEC sought to protect shareholders of Brooker from its takeover of another (connected) firm. The company lost the vote.

Unique work of the Thai Investors Association

As for private enforcement, the volume of voting by domestic institutional investors is certainly high, as is their attendance at AGMs. However, their enthusiasm for "active ownership" often seems muted. At the retail level, the Thai Investors Association (TIA) is continuing its yeoman's work of attending and assessing annual meetings and asking questions on behalf of retail shareholders - in the early days, it went to more than 500 but now focuses on about 280 companies that have scored less well in its survey. The breadth and nature of its role, especially in terms of assessing the quality of AGMs, is quite unique in the region.

Political and regulatory environment

New government has not hindered reform

Thailand's score remained flat at 54% for political and regulatory environment. It does not appear that the current government has a particular vision for CG reform, although we have also not witnessed any backtracking on policy or deterioration in the regulatory environment as some had feared when the new government took power in 2011.

Regulators have been consistent in policy and approach

The SEC's approach to CG policy and regulation is serious and consistent, while the SET has a number of governance projects underway (including providing advice and training to listed companies through its Corporate Governance Centre). Both organisations also provide support for a number of NGOs working in Thai corporate governance, including the Institute of Directors (IOD), TIA and the Thai Listed Companies Association (TLCA).

Few major new reforms in the past two years

While the past two years have not brought a large number of regulatory changes - in part because the Thai government has been focusing on working with its Asean counterparts on linking their capital markets - the SEC is pushing to expand its power by securing the right to undertake civil actions. As mentioned earlier, a revision of the country's Principles of Good Corporate Governance is in the works. And in March 2011, the SET amended its listing rules to introduce a general mandate for new share issuances. The thresholds are quite sound - not more than 30% for a rights issue, 20% for a public offering and 10% for a private placement. But one flaw, especially as regards private placements, is that companies can issue new shares to connected parties, subject to some relatively weak restrictions.

More open consultation would be welcome

One mild criticism we would make of the Thai regulatory system is the general lack of consultation exercises open to foreign stakeholders in the country's capital market. Regulators consult locally and broadly take the views of foreign investors into account (if they are offered), but formal opportunities to comment on new regulations are relatively scarce.

Regulatory websites need some redesign

We also believe that there is room for improvement in both the SEC and SET websites. While both have been revamped and are much easier to use, we continue to find that searching for specific rules on the SEC website is complicated (including within documents), and we note that the SET site only archives company announcements for two years (the benchmark we use is five years).

IGAAP (accounting and auditing)

Thailand now has an independent audit regulator

This is where Thailand really showed progress over 2010, rising by 7ppts to 80%. Scores for accounting and auditing standards remained largely the same, but the questions receiving the biggest boost all related to audit regulation. Thailand became a member of the IFIAR in September 2010, the same month that the SEC took over as the country's independent audit regulator from the Federation of Accounting Professions (FAP), which was none too pleased with the change.

First review of 15 larger CPA firms completed

The SEC has set up a team of 10 experts to carry out inspections of both firm-level audit quality control and actual audit engagements. Its first report describes a review of 15 out of 27 CPA firms and covers the period October 2010 to December 2011. It is a useful report with a lot of relevant data on the strengths and weaknesses of the audit industry in Thailand. As with ACRA in Singapore, however, the focus of the SEC at this stage is more on improving the quality of auditing, rather than undertaking enforcement action. It will complete its review of the remaining 12 CPA firms this year.

CG Culture

Thai NGOs are doing solid work on governance

We gave Thailand only a modest increase in score for CG culture, from 49% in 2010 to 50% this year, as on balance improvements are balanced out by deepseated problems. Good developments include some leading companies doing more than the rules require in terms of early release of audited reports, board-committee dislcosure, detailed AGM minutes and so on. The country has an active and experienced NGO sector undertaking director and professional training, including the Thai Institute of Directors (IOD), which sets the benchmark within Asia for the range and depth of its training programmes, and the Thai Listed Companies Association, which actively supports governance developments among its members and, among other initiatives, runs a lively Corporate Secretaries Club.

Collective action against corruption

A major step forward came in late 2010, when the IOD joined the Thai Chamber of Commerce and a number of other business chambers to launch the first major private campaign against corruption in Thailand. Called the Private Sector Collective Action Coalition Against Corruption, the initiative has to date persuaded 67 large Thai firms to sign a declaration of intent to work with the government, civil society and each other to 'foster cleaner business practices'.

The Coalition's long-term and ambitious goal is to cut off the supply of kickbacks to politicians and government officials. Among the companies signed up to the declaration are Banpu (coal mining), Bangkok Bank, Central Pattana (property and retail), Kasikorn Bank, Nation Multimedia, PTT Group (petroleum exploration and production), Siam Commercial Bank and Thai Airways. The list is a who's who of Thailand's blue-chip firms.

Can the private sector really make a difference to corruption?

Despite all this good work, we detect a fairly high degree of cynicism and ennui in Thailand as to whether the private sector can really make a difference to the issue of public corruption. The fatalistic assumption seems to be that this problem is too deeply entrenched in Thai culture to change. Whether or not this is true, the fact that the government itself is not seen as effective in tackling corruption - and this does not seem likely to change soon - gives weight to the naysayers.

The corruption issue also raises some troubling questions about financial reporting in Thailand. If payments to officials are as widespread and large as everyone believes, how are these being accounted for in company accounts? And what are auditors doing about it? This is not to suggest that all companies are paying bribes, but a significant percentage of the listed sector presumably is. If so, this does not sit comfortably with the stated goal of financial regulation, which is to pursue international standards of disclosure, accounting and governance. We hope the good guys win.

Factors to watch

Figure 137

Thailand: Downgrade watchlist

Factors that could force the country's score to fall in 2014:

- Limited progress on enforcement of securities laws.
- Delays in implementation of new IFRS standards.
- Slower-than-expected progress in audit reviews and regulation.
- No civil sanctioning power being given to the SEC.
- No reduction of public-sector corruption.

Actions that could improve overall CG

Figure 138

Thailand: Quick-fix list

Simple actions that government and companies can take to improve overall CG:

- Revise *The Principles of Good Corporate Governance*.
- Improve non-financial reporting standards.
- Improve regulatory and corporate information on SEC and SET websites.
- Consult investors and stakeholders more broadly on regulatory reforms.

Source: ACGA

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Research perspective - Disclosure key

Disclosure has been the main issue in Thailand

The main CG issue facing Thai corporations over the past few years has been information disclosure. CG data reporting varied greatly from company to company with many not releasing or keeping track of the information we look for when conducting our CG survey. There are also some concerns about related-party transactions. Thailand's stock exchange has been actively promoting high standards of governance and thus Thai firms have enjoyed high CG scores (in 2010, on average they scored higher than other Asian markets). Yet, this year the average score has declined, partly because of an illuminating change in our assessment on audit committees.

New criterion on audit committees dragged down CG scoring this year

All Thai companies have audit committees, chaired by an independent director and with independent directors making up the majority. Thus, in our previous surveys, Thai companies scored well in this area. However, our questionnaire this year introduced a new criterion that all members of the audit committee should have financial expertise. None of the audit committees of the Thai companies we cover meet this requirement. This dragged the overall CG score down by 7ppts.

Although it comes from a change in the scoring system rather than any change on the ground, this raises the question of whether CG practices in Thailand are a result of regulatory requirement only or actual commitment of management. Thai companies set up an audit committee because it is mandated but do not seem to be ensuring that the directors appointed have the expertise required to play the role expected of them. The drop of the corporates' average CG score this year has brought Thailand in line with other markets in the region.

A 5ppt drop in average CG score compared to 2010

The average score has dropped to 53% from 58% in our 2010 survey. Just over half of the decline is because Thai companies' audit committees do not meet the new criterion. Energy producers saw an average score decline of 4ppts, while the property sector lost 7ppts. Banks' scores fell slightly more, partly owing to a fresh look with a new analyst for the sector. Consumer names, however, are the only ones with overall CG score rising, by 4ppts, a large part of it owing to improved transparency, with CP All being a notable gainer in this regard.

Better disclosure drives consumer sector's improvement

Better disclosure generally

What we see on the ground is improved information disclosure. In the energy sector, the issues of climate change and environmental responsibility and the general push towards renewable energy has led companies to release more relevant information. Similarly, increasing investments among all banks have led to improved communications with investors. In the property sector, CG may not have been an issue when companies were smaller. As they grew bigger, however, data disclosure has become more comprehensive.

Improvement in particular in the consumer sector

Better information disclosure seems to have affected the consumer sector the most, boosting its overall CG score. A main contributor is CP All, which has improved it performance in discipline, responsibility and environmental responsibility since our 2010 survey. Information disclosure is more comprehensive and management has started holding analyst briefing promptly following quarterly result announcements (previously, it only held analyst briefing every half year or annually). In addition, the company has increased the number of independent directors on its board and has

established a team to deal with environmental responsibility, improving its score on C&G/SRI. While the CP Food group still has ongoing related-party transactions, we see the acquisition of assets from other part of the group as commercially driven and not negative for shareholders.

AIS and Tisco in the top quartile in the region

Figure 139

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

Company	Code	Company	Code
AIS	ADVANC TB	Land & Houses	LH TB
AP	AP TB	LPN	LPN TB
Banpu	BANPU TB	Major Cineplex	MAJOR TB
BEC World	BEC TB	PTTGC	PTTGC TB
CP All	CPALL TB	Robinson	ROBINS TB
Egco	EGCO TB	Supalai	SPALI TB
HomePro	HMPRO TB	Tisco	TISCO TB
Kiatnakin Bank	KK TB	TMB Bank	TMB TB

Source: CLSA Asia-Pacific Markets

Lower scores mainly due to stricter criteria

Tighter scoring system has dragged Thai companies' scores down

Investors should note that the main cause of Thailand's drop in CG score this year is our stricter scoring criteria, particularly regarding independence. For instance, to avoid any deduction in scores, all members of a company's audit committee now need to have financial background. As this is typically not the case for Thai firms, the new requirement brings down their CG scores by around 5ppts. As for the banks, the declines are mainly due to a change in analyst coverage. While the scores have come down, they are still "competitive" relative to other Thai companies.

Figure 140

CG scores across by sector

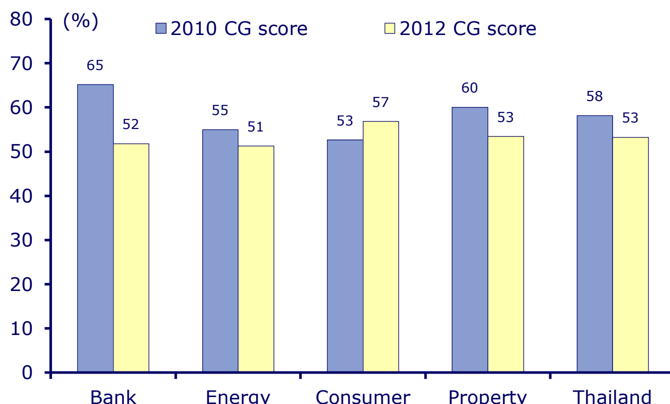
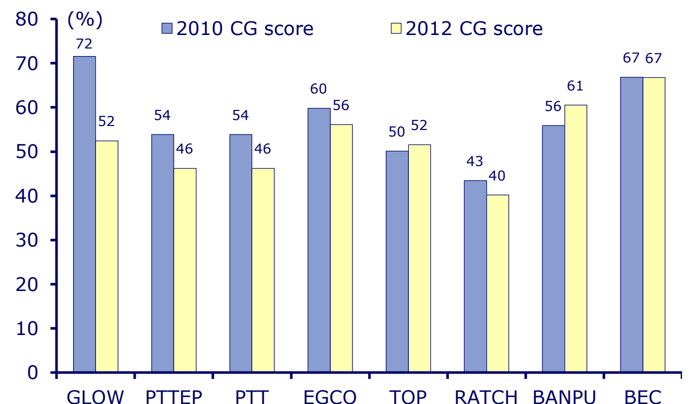


Figure 141

Companies with lower CG scores



Source: CLSA Asia-Pacific Markets

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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 90 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$10tn 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 "Members" page on www.acga-asia.org.

Founding sponsor

CLSA Asia-Pacific Markets is one of the original founding corporate sponsors of ACGA and continues to support the association's work.

ACGA foundation sponsor

NBIM
Norges Bank Investment Management

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

I	CG rules and practices	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; international accounting standards; continuous disclosure rules; and so on)	L	L	L	L	L	L	L	L	L	L	L
2	Do financial reporting practices among large listed companies[1] compare favourably against international best practices?[1]	S	L	L	L	L	L	L	L	Y	L	L
3	Do financial reporting practices among small- and medium-sized listed companies compare favourably against international best practices?	M	S	M	M	S	S	S	M	S	S	S
4	Do non-financial reporting standards compare favourably to international standards? (ie, the MD&A, Report of Directors, corporate governance statements, CSR/ESG or sustainability reports, carbon disclosure)	S	L	L	S	L	S	L	S	Y	L	S
5	Do non-financial reporting practices among large listed companies[1] compare favourably to international best practices?[1]	S	L	L	S	L	M	S	S	L	S	S
6	Do non-financial reporting practices among small- and medium-sized listed companies compare favourably to international best practices?	M	S	M	M	S	M	M	M	S	M	M
7	Do large listed companies[1] report their audited annual financial results within two months or 60 days?[1] (Note: Not to be confused with the "annual report", which usually comes out later.)	S	S	Y	S	L	S	M	N	L	S	Y
8	Do small- and medium-sized listed companies report their audited annual results within two months or 60 days?	S	S	Y	S	S	S	N	N	S	S	Y
9	Is quarterly reporting mandatory, is it consolidated and does it provide adequate and credible P&L, cashflow and balance sheet data?	Y	N	S	Y	Y	Y	Y	Y	Y	Y	Y
10	Do securities laws require disclosure of ownership stakes of 5% and above (ie, when an investor becomes a substantial shareholder)?	Y	Y	Y	M	Y	Y	Y	Y	Y	N	Y
11	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	N	Y
12	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	S	M	M	S	M	S	N	L	M	S
13	Does the regulatory regime ensure adequate and timely disclosure of related-party transactions (continuing, small, and large transactions)?	S	L	N	M	S	S	S	N	L	L	S
14	Do securities laws provide a credible deterrent against insider trading and market manipulation?	N	S	N	N	N	M	N	N	S	M	M
15	Are class-action lawsuits permitted and undertaken?	M	N	M	M	N	M	N	N	M	Y	N
16	Is voting by poll mandatory for resolutions at AGMs?	N	Y	N	N	L	N	N	N	M	S	L
17	Is there a national code (or codes) of best practice based on international CG standards?	M	Y	S	M	N	S	L	M	L	S	S
18	Is there a clear and robust definition of "independent director" in the code or listing rules? (ie, one that says independent directors should be independent of both management and the controlling shareholder; which does not make it easy for former employees and former/current professional advisors to become independent directors; and which produces genuinely independent directors)	S	S	S	M	M	S	L	M	S	S	S
19	Must companies disclose the exact remuneration of individual directors and senior executives (top 5) by name (or do they)?	S	Y	L	N	M	N	S	M	L	S	S
20	Are audit committees (or an equivalent) mandatory and implemented?	Y	Y	Y	Y	M	Y	Y	Y	Y	M	Y
21	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
22	Can minority shareholders easily nominate independent directors and are these candidates likely to be elected?	N	N	N	N	N	N	N	N	M	M	N
23	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	N	L	N	L	Y	Y	Y	Y
24	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
25	Do companies release their AGM notices (with detailed agendas and explanatory circulars) at least 28 days before the date of the meeting?	N	L	L	N	S	S	L	Y	S	L	Y

[1] Main index. Continued on the next page

Evaluation of Asian markets on corporate-governance norms (Continued)

II	Enforcement	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	M	N	S	L	M	N	Y	M	S
2	Have their efforts improved tangibly in recent years?	S	Y	Y	M	Y	S	M	S	L	M	Y
3	Are securities regulators seen to treat all companies and individuals equally?	M	S	S	M	S	M	M	N	S	S	M
4	Are the regulatory authorities sufficiently resourced - in terms of funding and skilled staff—to do their job properly?	S	L	S	M	L	S	L	S	L	S	L
5	Does the main statutory regulator (ie, the securities commission) have effective powers of investigation and sanction?	S	L	S	M	L	L	S	M	Y	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)	S	Y	S	S	S	M	S	Y	S	N	S
7	Has it had a successful track record prosecuting cases of insider trading and other market manipulation in recent years?	M	Y	M	N	S	S	N	N	L	S	M
8	Does the stock exchange have effective powers to sanction breaches of its listing rules?	M	M	M	N	S	N	S	M	S	N	M
9	Has it been investing significantly more financial and human resources in investigation and enforcement in recent years?	S	S	M	N	S	N	S	S	S	M	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	L	N	S	M	L	M	L	N	S
11	Do institutional investors (domestic and foreign) exercise their voting rights?	S	Y	S	S	Y	L	S	M	L	S	L
12	Are institutional investors actively voting against resolutions with which they disagree?	S	Y	S	S	Y	S	M	N	S	S	S
13	Do institutional investors (domestic and foreign) often attend annual general meetings?	M	N	M	M	M	M	M	M	M	M	S
14	Do minority shareholders (institutional or retail) often nominate independent directors?	N	M	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	L	M	M	S	S	Y	M	Y	S	Y
16	Are minority shareholder activists willing to launch lawsuits against companies and/or their directors?	N	N	M	N	M	Y	N	N	N	S	N
17	Are minority shareholders adequately protected during takeovers, privatisations, and voluntary delistings?	M	Y	S	S	S	N	L	M	L	S	S
18	Is there an independent commission against corruption (or its equivalent) that is seen to be effective in tackling public- and private-sector corruption?	N	L	M	S	L	M	N	M	Y	S	N
III	**Political and regulatory 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	M	M	N	S	L	S	L	M	S
2	Does the central bank exercise effective regulatory powers over the governance of banks?	L	Y	Y	Y	M	S	Y	Y	Y	M	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; and without fragmentation and disagreement between different financial and economic regulatory authorities)	S	S	M	M	S	S	S	M	L	S	S
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	N	M	N	M	N	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	L	M	S	L	L	S	L	L	S
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	S	N	N	S	N	Y	M	Y	S	M
7	Has the securities commission signed the IOSCO Multilateral Memorandum of Understanding?	Y	Y	Y	M	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?	L	Y	L	M	L	L	Y	L	Y	S	S
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 4-5 years)?	Y	Y	Y	L	Y	Y	Y	L	Y	Y	L
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)	N	N	N	M	M	S	N	N	N	L	N
11	Is the judiciary independent and clean (in relation to company and securities cases)?	N	Y	S	N	L	S	M	M	S	L	M
12	Is the judiciary sufficiently skilled in handling securities cases?	M	Y	M	N	M	S	M	M	Y	M	S
13	Is the media free to report on corporate governance abuses among listed companies?	S	Y	Y	Y	L	L	S	Y	L	L	Y

Continued on the next page

Evaluation of Asian markets on corporate-governance norms (Continued)

IV	IGAAP (or "accounting & auditing")	CH	HK	IN	ID	JP	KR	MY	PH	SG	TW	TH
1	Does the government or the accounting regulator have a policy of following international (IFRS) accounting standards?	Y	Y	S	Y	Y	Y	Y	Y	Y	Y	Y
2	Are local accounting rules in line with international standards?	L	Y	S	L	L	Y	Y	Y	Y	L	L
3	Are accounting policies and practices among large companies* in line with international standards and best practices?[1]	L	Y	L	L	L	L	L	Y	Y	L	L
4	Are accounting policies and practices among small- and medium-sized companies in line with international standards and best practices?	S	S	M	M	S	S	M	S	S	S	S
5	Do the rules require disclosure of consolidated accounts?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
6	Do the rules require detailed segment reporting?	Y	Y	Y	L	L	L	Y	Y	Y	L	Y
7	Is disclosure of audit and non-audit fees paid to the external auditor required, with accompanying commentary?	S	L	Y	N	L	L	S	S	S	L	L
8	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)?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
9	Are local auditing rules in line with international standards?	L	Y	L	L	L	L	Y	Y	Y	Y	Y
10	Are auditing practices among large companies[1] in line with international best practices?[1]	L	L	L	L	S	S	L	L	L	L	L
11	Are auditing practices among small- and medium-sized companies in line with international best practices?	M	S	M	M	S	M	S	S	S	S	S
12	Is the government or the accounting regulator actively implementing new international best practices 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	S	S	L	L	S	Y	L	S
13	Is the government strengthening the regulation of the auditing profession? (eg, by setting up an independent oversight board)	S	M	M	M	S	L	Y	N	Y	L	Y
14	Does the audit regulator exercise effect disciplinary control over the audit profession?	M	M	N	M	M	S	S	M	L	M	S
15	Is the expensing of share-based payments mandatory?	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y
V	**CG culture**	**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.	N	N	N	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.[1]	M	S	S	M	S	M	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.)	N	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	Y	L	L	L	S	S	L	Y	Y	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	M	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	M	S	S	S
8	Do listed companies provide a detailed explanation of their executive and employee remuneration policies?	M	M	M	N	M	N	N	N	S	M	M
9	Is there a trend towards listed companies voluntarily voting by poll at their AGMs and making the results public afterwards?	L	Y	N	N	M	N	N	N	Y	S	Y
10	Has the stock exchange or another organisation developed an open electronic voting platform ("straight through processing") for investors?	S	N	M	N	Y	L	N	N	M	L	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	N	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	M	M	S	M	M	N	M	M	M
13	Have institutional investors set up any corporate governance "focus funds"?	N	N	N	N	L	N	M	N	N	N	N
14	Are retail investors or non-profit organisations engaged in promoting better corporate governance practices?	N	L	L	M	S	Y	Y	M	Y	Y	Y
15	Have retail investors or members of the public formed their own independent (ie, self-funded) shareholder or corporate governance organisations?	N	S	Y	S	L	Y	M	M	L	L	M
16	Is there an institute of directors (or equivalent) actively engaged in director training?	M	Y	M	Y	L	M	Y	Y	L	L	Y
17	Are other professional associations - of accountants, company secretaries, financial analysts and so on - promoting corporate governance training and awareness raising?	L	Y	Y	M	S	M	Y	L	Y	M	Y
18	Are professional associations and academic organisations carrying out original research on local CG practices?	Y	Y	Y	M	L	Y	S	S	Y	Y	L
19	Does the media actively and impartially report on corporate governance reforms and developments?	M	Y	Y	Y	L	L	L	Y	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

Questions in bold carry negative scoring, including 3 0f 7 questions in discipline section

Appendix 3: CLSA CG questionnaire

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).

Two of 7 questions in transparency section have negative scoring

Transparency (18% weight)

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

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)

Three of 7 questions under independence with negative scoring

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 three years ago (2008)?

    B) And at the end of the last year (2011)?

    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 "No";** 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 5 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 the 4 questions in fairness section carries 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: CG questions removed

Questions removed from CLSA's CG questionnaire

Discipline	
Q1)	Do senior management or the controlling shareholders have a meaningful direct stake in the equity of the company? (Ie, not via other listed entities and not via options; a meaningful equity stake would be one of significant absolute value against the estimated net worth of the respective individuals).
Transparency	
Q11A)	In the past 12 months, what is the longest time period between the board meeting to accept results for a period (quarterly/half-year/finals), and the announcement of the results?
Q16)	Does the company have an English-language website where results and other announcements are updated promptly (no later than one business day)?
Q17)	Is it true that the company has not applied for a waiver on disclosure rules for the market?
Independence	
Q20)	Does the company have an executive or management committee that makes most of the executive decisions, which is substantially different from members of the board and not believed to be dominated by major shareholders? (Ie, no more than half are also board members, and major shareholder not perceived as dominating executive decision making).
Q22)	Does the company have a remuneration committee? Is it chaired by a perceived genuine independent director?
Q23)	Does the company have a nominating committee? Is it chaired by a perceived genuine independent director?
Accountability	
Q25)	Does the company have independent, non-executive directors who are nominated by minority shareholders? (Directors nominated by investors or who represent other shareholders apart from the largest controlling shareholder would qualify; otherwise answer "No").
Q28)	Are board members well briefed before board meetings? Are they provided, as far as the analyst can tell, with the necessary information for effective scrutiny of the company, prior to the meeting, in a clear and informative manner? (Answers 35-37 must be based on direct communication with an independent board member. If no access is provided, and no verification of an independent director is provided, answer "No" to each question).
Q29)	Does the audit committee nominate external auditors as disclosed in the annual report (or other publicly available statement)?
Q30)	Does the audit committee supervise internal audit and accounting procedures as far as the analyst can tell?
Q32)	Do companies make publicly available by the next working day the result of the votes taken during the AGM/EGM?
Responsibility	
Q33)	If the board/senior management have made decisions in recent years seen to benefit them at the expense of shareholders (cf Q18 above), has the company been seen as acting effectively against individuals responsible and corrected such behaviour promptly, ie, within six months? (If no such case, answer this question as "Yes").
Q34)	Is it true that there is no controversy or questions over whether the board and/or senior management take measures to safeguard the interests of all and not just the dominant shareholders? (Eg, if EGMs with genuine independent advice for related-party transactions were not held, or independent verification of appropriate pricing for recurrent related-party transactions was not obtained, answer "No").
Q36A)	How many members are on the board?
Q36B)	Is the board small enough to be efficient and effective? (If more than 12, answer "No").
Fairness	
Q41)	Do all equity holders have the right to call General Meetings? (Any classes of shares that disenfranchise their holders would mean a "No" answer).
Q42)	Does the company have cumulative voting for board representation? (Ie, where minority shareholders with say a 20% interest will be able to appoint directors representing one-fifth of the board).
Q43)	Is senior management unquestionably seen as trying to ensure fair value is reflected in the market price of the stock, by guiding market expectations about fundamentals in the right direction through frank discussion on risk/returns, actions like share buybacks and investor meetings, etc?
Q44)	Is it true there have been no questions or perceived controversy over whether the company has issued depositary receipts that benefited primarily major shareholders, nor has the company issued new shares to investors near peak prices, nor have the major shareholders sold shares near peak prices without prior guidance to the market on why shares are seen as fully valued? Also, the company has not issued shares to friendly parties just prior to AGM/EGMs where there are controversial matters being voted on at the shareholder meeting?
Q45)	Does the head of Investor Relations report to either the CEO or a board member?

Source: CLSA Asia-Pacific Markets

Appendix 5: CLSA C&G questionnaire

Leadership

1. Is any individual or committee responsible for the company's environmental controls? (If yes, please provide name of person or head of committee?)

2. Does this person/committee report directly to the board?

Recognition and reaction

3. Is the company aware of any current government regulation that requires it to monitor or reduce emissions? (If yes, please specify.)

4. Has the company quantified annual emissions of CO2/GHG or pollutants such as NO_2, SO_2, etc in either of the past two financial years? (If yes, please include the data in the comments field.)

5. Has the company set voluntary or regulatory-mandated targets for CO_2/GHG emission reductions? (If yes, are targets absolute or a percentage of emissions.)

6. Has the company set targets for reduction of water use? (If yes, are targets absolute or a % reduction.)

7. Has the company set targets for reduction of other waste/pollutants? (If yes, are targets absolute or % reduction.)

8. Has the company ever received a fine for environmental infraction?

9. Does the company recycle waste (including waste water, paper, etc)? (If so, please describe the extent and approach.)

10. Is the company ISO 14000 or similarly accredited?

Disclosure

11. Does the most recent annual report or chairman's statement carry details of environmental impact.

Looking to the future

12. Do any existing R&D projects involve innovative technology to reduce emissions or utilise renewable energy sources?

13. Will any business unit benefit from climate change, environmental cleanup or increased regulation and general acceptance of the need to reduce emissions? (If yes, please specify.)

14. Have any suppliers/vendors/contractors been selected in order to lower the company's indirect emissions footprint? (If yes, please specify.)

Appendix 6: CLSA CSR survey

Policies and objectives

1. Does the company have a social policy/vision that it articulates?
2. Does the company set out its expected behaviours in a code of conduct/business ethics?
3. Is there one person within the company who is responsible for setting goals and objectives related to the social impact of the company and its activities?

Implementation

4. Does the company have anticorruption policies and practices in place?
5. Does the company have health and safety policies which it implements at all its sites and places of work?
6. Have there been any major H&S incidents in the past 3 years?
7. Does the company engage in appropriate sourcing practices to ensure social responsibility in terms of its suppliers?

Results and disclosure

8. Does the most recent Annual Report or Chairman's Statement carry details of Corporate Social Responsibility
9. If a CSR report or statement exists does it disclose performance and gaps?

Appendix 7: Companies with significant CG changes

Companies with CG deterioration of 15ppts or higher since 2010

Company	Code	Change in CG score (ppts)	Rel perf vs MSCI since 2010 (ppts)	Reason
CMB	3968 HK	(15.4)	(23.5)	Growing uncertainties around disclosure of NPLs.
BDO	BDO PM	(16.0)	64.0	Large US$1bn new equity issuance, above what needed for the bank to comply with upcoming Basel 3.
Jiangxi Copper	358 HK	(16.4)	17.7	Late reporting.
United Spirits	UNSP IB	(16.8)	(59.9)	Concerns over gearing of the promoter; issues around diversification, disclosures, gearing, accounting policies.
SouthGobi	1878 HK	(17.3)	(72.9)	Reported latest interim result after 45 days; poor transparency.
China Coal	1898 HK	(17.5)	(36.3)	Late reporting.
Ayala Corp	AC PM	(17.6)	89.4	Treasury shares reissued although the group was underleveraged, no imminent use of proceeds.
Genting Bhd	GENT MK	(17.9)	33.1	Related-party transactions from other vehicles of the Genting group as well as from the controlling family.
Shinsegae	004170 KS	(19.2)	(39.0)	Following a spinoff last year, no longer the main shareholder's major business.
Yanzhou Coal	1171 HK	(19.7)	(23.4)	Did not report annual results within two months after end of the period, reduced number of independent directors.
HK Exchanges	388 HK	(20.1)	(8.4)	Questionable acquisition of LME at an expensive price, without requiring shareholder approval.
Li & Fung	494 HK	(20.6)	(13.9)	Concerns around timing of insider’s sale of shares, poor guidance.
YTL Power	YTLP MK	(21.0)	(16.5)	Diversification into telecommunications, where it has no real industry knowledge.
Cadila	CDH IB	(21.2)	(4.7)	Controversies over recent acquisitions and share swap scheme.
Zhaojin	1818 HK	(21.2)	10.4	Directors' remuneration rose faster than earnings; diversification from gold mining to copper.
Hana Financial	086790 KS	(21.2)	17.7	Reduced outside directors from nine to eight, issues around accounting transparency.
Sina	SINA US	(22.2)	43.0	Controversial investment in 2011, acquiring 19% stake in Mecox Lane, an online apparel retailer for US$66m.
Crompton Greaves	CRG IB	(22.2)	(63.9)	Issues related to diversification, disclosures, gearing, accounting policies and investments in unrelated assets.
Suzlon	SUEL IB	(23.0)	(77.1)	Issues related to diversification, disclosures, gearing, accounting policies and investments in unrelated assets.
Woongjin Coway	021240 KS	(25.5)	(6.2)	Questionable intergroup transaction, deterioration in transparency.
First Gen	FGEN PM	(26.3)	82.6	Controversy over intergroup transactions.
Hon Hai	2317 TT	(29.4)	2.9	Made US$3bn in unknown investments, lack of clarity on investment rationale/strategy.
Chalco	2600 HK	(32.8)	(48.8)	Did not reporting annual results within two months after end of the period, reduced number of independent directors.
Acer	2353 TT	(34.7)	(54.5)	Major recent restructuring, old management dismissed and issues arose over recent investments.
Magang	323 HK	(36.1)	(51.9)	Transparency has deteriorated.
EDC	EDC PM	(38.9)	49.7	Purchase of the hydro power plant from parent raised questions on acquisition price.

Source: CLSA Asia-Pacific Markets

Companies with CG improvement of 15ppts or higher since 2010

Company	Code	Change in CG score (ppts)	Rel perf vs MSCI since 2010 (ppts)	Reason
Synnex	2347 TT	29.6	26.7	Recently elected three independent non-executive directors to the board for the first time.
Ascott Reit	ART SP	23.4	18.9	CG improved on our discipline criteria with the firm disclosing cost of capital and ROA/ROE targets.
HCL Tech	HCLT IB	23.0	9.4	Increased independent directors, introduced diversity to the board composition, more independent directors.
Lenovo	992 HK	22.1	55.8	Multiple restructurings earlier; improvement under the new management team.
JR Central	9022 JP	21.6	(6.4)	Greater clarity on the ¥9tn Maglev project hence higher transparency score.
Everbright Intl	257 HK	21.2	8.8	Established an investor relations department and in the process improved access and disclosure.
CP All	CPALL TB	18.5	160.9	Better disclosure, now provides estimate of cost of equity; increased number of independent directors.
Bajaj Auto	BJAUT IS	18.5	6.8	Demerger of Bajaj Auto affected previous score, but no longer based on past five years' record.
Bursa Malaysia	BURSA MK	18.4	(8.5)	Discloses quarterly results within 45 days, not yet the norm for the rest of the market.
Toray	3402 JP	17.0	40.8	Improved on our discipline criteria, eg, announcing target ROE.

Source: CLSA Asia-Pacific Markets

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Appendix 8: Beware false profits

Recent moves to privatise **Focus Media** as well as the attack on **WCC** put the spotlight back on short-sellers. After all the excited fraud allegations against Chinese small and mid caps last year, the short-sellers behind it have largely faded from headlines. But the attacks continue, and have actually moved on to bigger companies with more legitimate listings.

Stocks were slammed by Muddy Waters allegations

Before last summer, few investors would have been able to pick Chinese forestry company **Sino-Forest** out of a line-up. One year on, and it looks as if a police line-up is exactly where some senior management could end up. The catalyst for this change was short-seller Muddy Waters, headed by Carson Block. Sino-Forest's shares dropped 74% in Toronto trading after he wrote in Jun-11 that the company had overstated its timber assets in China, supporting the allegations with detailed claims. Shares have subsequently been delisted as the company's attempts to clear its name mostly failed

Sino-Forest precipitated a witch hunt

Sino-Forest precipitated a witch hunt for Chinese stocks listed in the USA, with the faintest whiff of impropriety (or rumours of an upcoming Muddy Waters report) leading to sharp declines. Clearly, there have been some babies with the bath water, and Muddy Waters lost some of its shine, with its (thus far) failed attacks on Spreadtrum and **Focus Media**. However, Block and his ilk have helped put shonky corporate governance among Chinese listed companies - especially backdoor listings in the US - on investor agendas, which is undeniably good.

Short-list of prominent Chinese short-seller attacks (HK shift underway)

Company	Code	Short-seller started coverage
American Superconductor	AMSC US	11 Jun 08
Orient Paper	ONP US	28 Jun 10
China Biotics	CHBT US	30 Aug 10
Rino International	RINO US	10 Nov 10
China MediaExpress	CCME US	03 Feb 11
Longtop Financial Tech	LFT US	26 Apr 11
Sino-Forest	(delisted)	02 Jun 11
Spreadtrum	SPRD US	28 Jun 11
Chaoda Modern	**682 HK**	**26 Sep 11**
Qihoo 360[1]	QIHU US	01 Nov 11
Focus Media	FMCN US	21 Nov 11
Winsway	**1733 HK**	**19 Jan 12**
Shougang Fushan	**639 HK**	**10 Apr 12**
Huabao	**336 HK**	**24 Apr 12**
Evergrande	**3333 HK**	**20 Jun 12**
Qihoo 360[1]	QIHU US	02 Jul 12
New Oriental Edu	EDU US	18 Jul 12
West China Cement	**2233 HK**	**07 Aug 12**

[1] Qihoo 360 has been attacked by two short-sellers at different times. Source: CLSA Asia-Pacific Markets

A successful hit on a large target

False prophets?

Sino-Forest was not Muddy Waters' (MW) first target and the short-seller was not the first to write detailed reports about stocks it had already shorted. But the successful hit on such a large target (Sino-Forest market cap was US$4.2bn before the report) spawned a host of copycats and increased the influence of firms already employing the same business model.

Some prominent short-sellers and their targets

Firm	Hits	Misses	Current bids	Position?	Website
Muddy Waters	Sino-Forest, China MediaExpress Holdings, Rino International Corp	Spreatrum, Focus Media (?)	Orient, New Oriental Edu	Y	http://www.muddywatersresearch.com/
Anonymous Analytics	Chaoda		Huabao, Qihoo 360	N	http://www.anonanalytics.com/
Citron	Longtop Financial, China-Biotics, Xinhua Financial Media		Evergrande, Qihoo 360	Y	http://www.citronresearch.com/
Geoinvesting	Sino Clean Energy (SCEI)				http://geoinvesting.com/
Manuel Asensio	Diana Corporation, Winstar Communications	PolyMedica Corp		Y	http://www.asensio.com/
Jon R. Carnes (Alfred Little)	Sino Clean Energy (SCEI)			Y	http://labemp.wordpress.com/
Veritas	UB Holdings Ltd./Kingfisher Airlines Ltd.			N	http://www.veritascorp.com/home/
Glaucus Research			Fushan, West China Cement	Y	http://glaucusresearch.com/
Jonestown Research			Winsway	Y	http://invest-door.com/

Note: This list is far from complete. We have another seven names, and are surely missing many more. Source: CLSA Asia-Pacific Markets

Most of the early targets were smallish private Chinese companies that listed in the USA by buying shell companies through reverse mergers. Subsequent targets have gotten larger and have gone through proper listings in either the USA or Hong Kong. Thus, even as short-sellers have faded somewhat from the media spotlight, their potential impact has increased.

Collectively, they have forced the SEC to tighten oversight on backdoor listings. Detractors would argue that they have starved good Chinese companies of capital by initiating a witch hunt that has made equity financing all but impossible.

Slipping in through the back door

Why China?

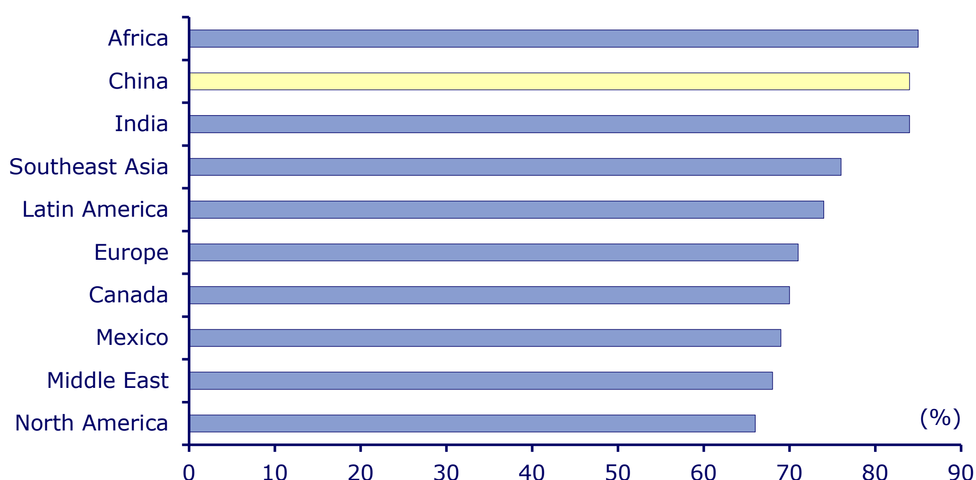
Before going through the different short-sellers individually, the most obvious shared trait is a taste for Chinese companies. Early on, the attraction in targeting reverse merger listings would have been quite clear. By slipping in through the back door, companies could easily escape most of the oversight required for traditional listings. Chinese companies, with the help of a few smallish investment banks, auditors and lawyers in the USA took full advantage of these loopholes.

Beyond that, as short-seller Anonymous Analytics (AA) writes: 'We started with China not because Chinese companies are engaged in more fraud than Western companies, but because they are less apt at covering their tracks. China is new to capitalism, and Chinese managers are new to stealing money from the capital markets.'

AA goes on to say that '. . . exposing Chinese frauds has become cliché, if not outright boring.' In this, it suggests what other short-sellers have implied and, in some cases, overtly stated: It will move on to focus more on Western companies, just not yet. In any case, there should still be plenty of fraud to root out in China. According to a 2011 joint Kroll-EIU report, some 84% of respondents doing business in China were victims of fraud. China pipped India for Asia's top spot, but still fell short of Africa.

Some 84% of respondents doing business in China were victims of fraud last year

Share of respondents who have been victims of fraud in past 12 months



Source: Kroll-EIU Global Fraud Report

Score card

Bigger targets are proving much better at defending themselves from the short-sellers, and there have not been any home-runs yet in 2012. Below we look at five active short-sellers, including their hits and misses, as well as the auditors at the targeted companies.

Quote: 'TRE's capital raising is a multibillion dollar Ponzi scheme, and accompanied by substantial theft.'

Muddy Waters (Short-seller, not blues legend)

Carson Block's firm Muddy Waters is the most visible of the short-sellers thanks to its very successful take-down of **Sino-Forest** in 2011. Though there had been earlier successes from both Muddy Waters and others, Sino-Forest's size (over US$4bn market cap) and position in major institutional investors' portfolios set it apart. MW's three big attacks since Sino-Forest have been less successful. Chinese chip designer **Spreadtrum** is up 29% since MW started its attack, while **Focus Media** is flat, bouncing back after an initial sell-down. It is too early to call **New Oriental Education**, which is under investigation from the SEC for its Variable Interest Entity (VIE) structure.

Muddy Waters: Strong start; struggling of late

Company	Code	Auditor	Started coverage	Price at start (lcl ccy)	Last price (lcl ccy)	Date	Percentage change (%)	
Orient Paper	ONP US	BDO	28 Jun 10	8.33	2.12	13 Aug 12	(74.5)	
Rino International	RINO US	Frazer Frost	10 Nov 10	6.07	3.54	20 Dec 10	(41.7)	Delisted 12/20
China MediaExpress	CCME US	Deloitte	03 Feb 11	11.09	2.09	16 Dec 11	(81.2)	Delisted 12/16
Sino-Forest	TRE CH	Ernst & Young	02 Jun 11	14.46	5.10	26 Aug 11	(64.7)	Delisted 5/29/12
Spreadtrum	SPRD US	PWC	28 Jun 11	13.80	17.80	13 Aug 12	29.0	
Focus Media	FMCN US	Deloitte	21 Nov 11	25.50	25.45	13 Aug 12	(0.2)	
New Oriental Education	EDU US	Deloitte	18 Jul 12	14.62	13.40	13 Aug 12	(8.3)	

Source: Bloomberg, CLSA Asia-Pacific Markets

Citron on China Biotics: 'Amazing that a company that is not at all shy in its use of PR's had this explosive store growth without one: ribbon cutting, new store PR, or notice of opening.'

Citron

According to its website, US-based Citron has been publishing columns for over 10 years, with over 150 reports. It is headed by Andrew Left. For China-focused investors, **Longtop** has been its biggest mark. We look at this in more detail below. It is too early to say how the two most prominent subsequent attacks on Chinese companies - **Qihoo 360** and **Evergrande** (more details below), will turn out.

Citron: Some home runs followed by base hits

Company	Code	Auditor	Started coverage	Price at start (lcl ccy)	Last price (lcl ccy)	Date	Percentage change (%)	
American Superconductor	AMSC US	PWC	11 Jun 08	45.00	4.14	13 Aug 12	(90.8)	
China Biotics	CHBT US	BDO	30 Aug 10	14.00	1.00	14 Sep 11	(92.9)	Delisted
Longtop Financial Tech	LFT US	Deloitte	26 Apr 11	25.00	0.26	14 Sep 11	(99.0)	Delisted
Qihoo 360[1]	QIHU US	Deloitte	01 Nov 11	21.02	17.11	13 Aug 12	(18.6)	
Evergrande	3333 HK	PWC	20 Jun 12	4.48	3.43	13 Aug 12	(23.4)	

[1] Also under attack by Anonymous Analytics a few months later. Source: Bloomberg, CLSA Asia-Pacific Markets

AA on Chaoda: 'We suspect management has made it a policy to grossly inflate capex costs as a cover to transfer money out of Chaoda.'

Anonymous Analytics

Last September, the Anonymous group of hackers ("hacktivists") shifted its attentions from web freedom, supporting Wikileaks founder Julian Assange and tracking down child pornographers, among other things, to start writing about corporate fraud. Their first attack, on vegetable grower **Chaoda** was a spectacular success; the company was suspended the same day they issued their report and remains so.

Their next call on flavour-maker **Huabao** has been hit and miss. The company's share price has bounced around at a similar level after being accused of hiding costs and not disclosing related-party transactions. According to *Hurun Report*, though, CEO Zhu Linyao sold US$549m in stock and assets in 2011, second highest in China. This summer, AA joined Citron, attacking online portal **Qihoo 360**, but focusing explicitly on the details around traffic measurements, which they accuse QIHU of lying about.

Anonymous Analytics: Living off its Chaoda laurels

Company	Code	Auditor	Started coverage	Price at start (lcl ccy)	Last price (lcl ccy)	Date	Percentage change (%)	
Chaoda	682 HK	Grant Thornton	26 Sep 11	1.10	1.10		-	Suspended same day as coverage began
Huabao	336 HK	PWC	24 Apr 12	3.98	3.87	13 Aug 12	(2.8)	
Qihoo 360[1]	QIHU US	Deloitte	02 Jul 12	17.29	17.11	13 Aug 12	(1.0)	

[1] Following the Citron report by a few months. Source: Bloomberg, CLSA Asia-Pacific Markets

Glaucus: 'We sent an investigator to . . . address from the SAIC filings; only to find this purported multi-millionaire's registered residential address is the affiliated dormitory of a water treatment plant!'

Glaucus

California-based Glaucus Research, led by Matt Wiechert (formerly Roth Capital), has attacked a number of small US-listed Chinese firms since the start of 2011. In 2012, they have turned to Hong Kong, publishing research reports on two larger Hong Kong-listed firms: **Fushan** and **West China Cement**. In an interview, Wiechert indicated that he liked to focus on commodity businesses because their assets are hard to value for auditors, regulators and investors.

Glaucus: Private Chinese resource companies in the crosshairs

Company	Code	Auditor	Started coverage	Price at start (HK$)	Last price (HK$)	Date	Percentage change (%)
Fushan	639 HK	BDO	10 Apr 12	2.66	2.19	13 Aug 12	(17.7)
West China Cement	2233 HK	Deloitte (Previous PWC)	07 Aug 12	1.33	1.2	13 Aug 12	(9.8)

Source: Bloomberg, CLSA Asia-Pacific Markets

Jonestown on Winsway: 'A delivery man with a hidden camera was sent to the Winsway office at Cheung Kong centre . . .'

Jonestown Research

We could not find much about this US-based company, whose name and slogan 'Urging investors not to drink the Kool-Aid' is an obvious, and cleverly ghoulish, reference to the Jonestown massacre of 1978. Its sole public attack is on coal processor **Winsway**. The company is down -47% since Jonestown's initial report, but it also managed to entice **Chalco** into taking a 34% stake in April.

Jonestown

Company	Code	Auditor	Started coverage	Price at start (HK$)	Last price (HK$)	Date	Percentage change (%)
Winsway	1733 HK	KPMG	19 Jan 12	2.1	1.11	13 Aug 12	(47.1)

Source: Bloomberg, CLSA Asia-Pacific Markets

Given the sheer volume of fraud cases against Chinese companies . . .

Anatomy of a short-seller attack

Given the sheer volume of fraud cases against Chinese companies, they tend to bleed together. Before looking into the details and alleged red flags, we look at the immediate share-price impact. Not surprisingly, the first trading day after the report is released, the stocks fall: anywhere from -2% to -64%, with a grouping in the high single-digit/low double-digit drop. After that, most stocks bounce either the next day or within the next two weeks, by an average of 11%. A few stocks end the subsequent month higher than they were before the reports were issued; most don't.

. . . they tend to bleed together

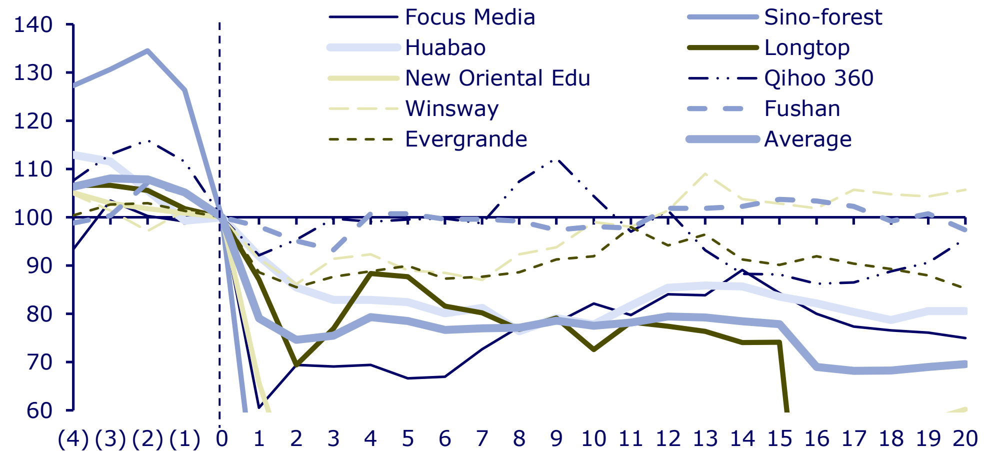
Short-term impact of short-seller reports (on guilty and innocent alike)

(%)	One-day fall	Next day	Next month high (rel to first day)	Next month high (rel to day before report)
Evergrande	(11)	(4)	11	(2)
Focus Media	(39)	15	47	(11)
Fushan	(2)	(3)	6	4
Huabao	(8)	(7)	(7)	(7)
Longtop	(13)	(20)	1	(12)
New Oriental Edu	(34)	(35)	(5)	(37)
Qihoo 360	(8)	4	22	12
Sino-forest	(64)	17	3	(57)
Winsway	(9)	(6)	20	10
Average	(21)	(4)	11	(11)

Source: CLSA Asia-Pacific Markets

Volumes jump on average 10x following the reports

Short-term impact of short-seller reports



Note: Sino-forest report released mid-day the day before. Source: Bloomberg, CLSA Asia-Pacific Markets

The Sino-Forest report was released during trading hours on day -1; some trades transacted that day. Big jump was the next day. Huabao's volume suspiciously quadrupled day-on-day four days before the Anonymous Analytics report.

In the appendix, we summarise 33 fraud cases against Chinese companies since the start of 2011, including both those that have been proven guilty and those that the market seems to have judged innocent.

Commodities (soft and hard) clearly stand out

Sectors: It is a broad range of companies, but commodities (soft and hard) clearly stand out, with 11 of the 33 cases. More than anything, this reflects the difficulties in valuing commodity assets - whether forests or mines.

Red flags: Auditor resignations; CEO/CFO resignation; related-party transactions; negative cashflow; receivables rising faster than revenue; sudden shift in revenue per employee; and, that old staple, unusually high margins.

CLSA coverage: Most of these companies fly well under most institutional investors' radar screens, as well as CLSA's. The exceptions:

- **Focus Media** - James Lee has written extensively about the Muddy Water allegations and management's defence. His first detailed note here: *Rushing to judgment*.
- **Evergrande** - Nicole Wong sees plenty of risk at Evergrande, but does not buy into Citron's accusations that it is overstating its balance sheet. Read *Targeted*.
- **Fushan** (639 HK) - Andrew Driscoll acknowledges well-known CG risks for Fushan but believes managements explanations in reply to the short-seller allegations generally make sense. Read *Short seller alert*.

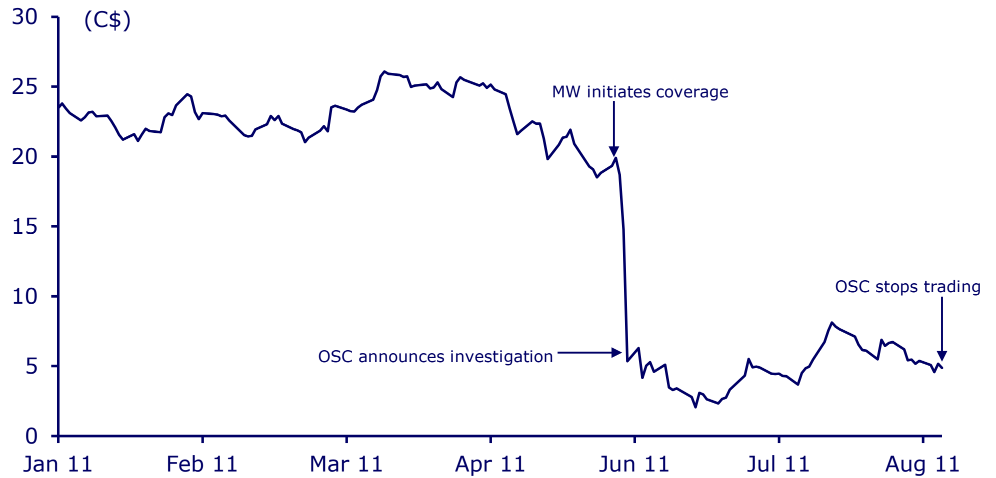
Two successful short-seller hits

Case studies

In the appendix, we look at two successful short-seller hits (Sino-Forest and Longtop), one that looks like a miss as of now (Focus Media) and one where the jury is still out (Huabao).

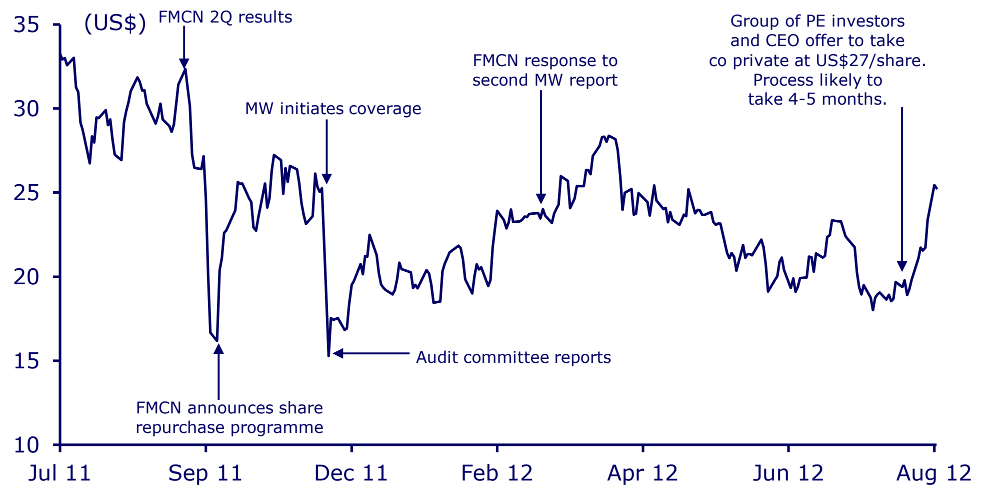
The charts that put Muddy Waters and short-sellers on the map . . .

Sino-Forest's share-price performance



. . . and chart of a successful management defence

Focus Media's share-price performance



Source: Bloomberg, CLSA Asia-Pacific Markets

Red flags and Moody's blues

Where there's fire, there's smoke

Where there's fire, there's smoke. Of course, no simple accounting or governance screen will catch out cases of corporate fraud. But it helps to narrow the list of companies whose accounts need to be combed, and that need to be visited. We have tweaked the screens that ratings provider Moody's used in last summer's imperfect but prescient red flags report to uncover accounting and governance risk. Two consumer plays, Dongxiang and Gome; Rusal; and, improbably, HHI and Wharf stood out, along with a number of SOEs that are, presumably, protected.

The big warning signs would come as no surprise: margins well-above-industry norms and rapid asset acquisitions after listing. Related-party transactions are also a cause for concern. That said, as one Big-4 forensic accountant told CLSA: 'Related-party transactions that you see aren't a problem; it's the ones that are not disclosed.' To this end, further scrutiny of shell companies and physical checks on suppliers and customers are key.

Colum Bancroft, head of forensic accounting for Greater China at global risk-consultant Kroll, breaks down the following red flags:

- Company culture without accountability
- Change in auditor
- Delay in publication of financial results
- Frequent change in senior management
- M&A transactions unrelated to core business
- Company with high levels of debt
- High number of related parties

Watching for red flags

	Method	Red flag
Inflate revenue	Fictitious sales; underestimating sales returns; changing timing of sales; increasing sales by transacting with related parties	Increase in debtor days; unusual fluctuations towards reporting period end; subsequent increase in bad debt provision/credit notes; strong growth when competitors are experiencing weak sales; hidden related party relationships; increase in profits but negative cashflow
Minimising expenses	Expenses not matching the period when revenue is recognised; not recording expenses; changing the rate of depreciation	Unusual fluctuations from prior year; increase in profits but negative cashflow
Manipulating depreciation charges	Changing the rate of depreciation	Accounting policies should disclose
Capitalising expenses	Not treating cost as the expense on the P&L, but capitalising on the balance sheet (ex. R&D)	Increase in capex; increase in fixed assets, possibly including increased development costs
Inventory manipulation	Inflating inventory valuation; different inventory inputs: direct costs, labour, overhead, fully finished, partly finished; change in inventory = change in profit	Inventory trend analysis versus sales; significant variations from prior years; increase in profits but negative cashflow
Off-balance-sheet items	Hide liabilities off the balance sheet; hide liabilities in unconsolidated associated companies; subsidiaries versus associates; subsidiaries included in income, associates only on balance sheet	Careful reading of accounting policies and notes reveals inconsistencies; review group structure
Mark-to-market (fair value) accounting	Value financial assets at their market value	Companies adapting mark-to-market accounting for non-financial assets without an efficient and transparent mechanism; review detailed disclosures

Source: Kroll, CLSA Asia-Pacific Markets

Twenty questions in five categories

Revisiting Moody's red flags

Ratings agency Moody's made a splash last July with a report tallying red flags at 61 Chinese companies, without making any changes to its official ratings. Moody's considers 20 questions in five categories: governance; risky or opaque business models; fast-growing businesses; quality of earnings or cashflow; and concerns over auditors and quality of financial statements.

Six companies were highlighted for posting an especially large number of red flags. As we commented at the time, there were no particular surprises in the names. However, subsequent developments in stocks named (and a few un-named) suggest it is worth looking back at the Moody's report and methodology.

Of the six companies (below): one was already suspended (China Forestry), two are under attack by short-sellers (West China Cement and Winsway) and two have had their bond ratings reduced (Hidili) or pulled (LDK Solar). China Lumena, which mines and refines thernadyte (used primarily in detergents), has not been hit by anything in particular, but the stock is down around 55% and inventory levels grew 7x in FY11.

Three companies Moody's looked at that did not quite make the red-flag leader board

Three companies Moody's looked at that did not quite make the red-flag leader board: Sino-Forest, Chaoda and Evergrande. Sino-Forest has been delisted, Chaoda was suspended in September and property developer Evergrande is under attack from short-sellers.

Revisiting Moody's red flags in China (July 2011)

Company	West China Cement	China Forestry	Winsway	Lumena	LDK	Hidili	Sino-Forest	Evergrande	Chaoda
Code	2233 HK	930 HK	1733 HK	67 HK	LDK US	1393 HK	-	3333 HK	682 HK
Total red flags	12	12	11	10	9	9	7	7	6
Comments	Under attack	Was already suspended	Under attack	FY11 AR +78%; Inv +7.3x	Bond rating suspended in Aug 11; ward of state	Rating to B2 from B1 in May 12	Delisted	Under attack	Suspended
Weakness in corporate governance	$	$	$	$	$			$	
Riskier or more opaque business models		$		$	$	$			
Fast growing business strategies	$		$	$		$	$	$	
Poorer quality of earnings or cashflow	$	$	$	$	$	$	$		$
Concerns over auditors and quality of financial statements	$								

Source: Moody's, CLSA Asia-Pacific Markets

We look back at the Moody's methodology and rebuild a simple screen

Looking for the next targets

In all, six of the nine names above either were or are under attack by short-sellers. This suggests that either the short-sellers really took Moody's report to heart, or that they are running similar screens. We would bet on the latter. With that in mind, we look back at the Moody's methodology and rebuild a simple screen to see who might be on the short-list of next targets for short-sellers.

Weakness in corporate governance

For CG, Moody's focuses on a handful of relatively simple, objective metrics around: Family control, management changes, related-party transactions and major shareholders' outside businesses. This provides a lot less granularity, of course, than the 46 (becoming 30) question CG template that CLSA has been revising for 11 years.

Closest proxy, based on our scoring, would be the rankings for responsibility

The closest proxy, based on our scoring, would be the rankings for responsibility, one of six (becoming five) sub-sections in our core CG scoring. We also look at an easily compiled list of major shareholders' stakes in the listed companies.

Riskier or more opaque business models

For Moody's, this section again captures related-party transactions and complicated group structures. It also captures the most commonly cited red flag for fraud, whether from forensic accountants, short-sellers or private investigators: Unusually high margins.

Of course, this has to be taken in context. For example, it is not uncommon for wind operators to achieve Ebitda margins over 80%, a number that would be suspect from an unbranded manufacturer. In addition to looking at companies with Ebitda margins over 40%, we look at companies with average 2008-11 Ebitda margins of at least 5% over their sector average. Again, the best companies in the sector should be able to achieve superior margins on a consistent basis. But this is rare enough to easily screen out the sector leaders.

Fast-growing business strategies

The focus here is on revenue or asset growth

The focus here is on revenue or asset growth. However, we believe that is a bit misleading, as it would show up too many smaller companies that simply happen to still be in a rapid growth phase. We can also look at negative free cashflow against positive operating cashflow, suggesting that a company has capacity to support internal growth but is expanding more quickly than that allows. Clearly, this isn't always a bad thing but in plenty of cases it can be.

Poorer quality of earnings or cashflow

Deviation between cashflow and P&L earnings is another of the most often cited red flags, as is dramatic growth in working capital (accounts receivable days or inventory days). These are relatively easy to screen for, if not always so easy to contextualize.

We checked for sector anomalies in working capital as a percentage of sales

In addition to looking at accounts receivable (A/R) day increases, we checked for sector anomalies in working capital as a percentage of sales. For more detailed work, it clearly makes sense to pick out companies with A/R day or working capital/sales increases when the company is experiencing sales growth against general sector declines.

We also look at diminishing returns on assets by singling out declines in sales per capital employed.

Concerns over auditors and quality of financial statements

CLSA's CG survey covers auditors and the audit committee in the independence subsection. Specifically, we have focused on the independence and qualifications of the audit committee. Impressive titles on the audit committees of both Olympus and Satyam were not enough to prevent the massive frauds at those companies; financial backgrounds are essential.

Looking at more widely available information, it is easy enough to see auditor changes, though it is usually too late to sell/short a stock if the auditor has already resigned. And, despite the continuing issues at the Big-4 audit firms, use of a smaller local name would merit a flag. For both auditor switches and use of smaller auditing firms, the usual explanation is 'fees.'

A much bigger red flag

Another much bigger red flag would be the issuance of "qualified" accounts, though this somehow passed mostly unnoticed at Olympus. We did screen CLSA's HK/China coverage for qualified accounts. There were none.

Auditing the auditors (from our short-list of short-seller attacks)

(No.)	Co's on short-seller short-list	Co's on short-seller short-list delisted
Deloitte	**7**	**2**
PWC	4	-
BDO	3	1
KPMG	1	-
Ernst & Young	1	1
Other	**2**	**2**

Source: Bloomberg, CLSA Asia-Pacific Markets

A look at the auditors

In Hong Kong, shareholder activist David Webb has compiled the performance of auditors to local listings here. PWC's clients have done the best by investors, returning an 1% Cagr, versus -4% for KPMG, -7% for Deloitte and -8% for Ernst & Young. Companies' audited by BDO, the biggest local firm, fared much worse at a -19% Cagr. Performance of companies audited by other smaller names is mixed.

In the USA, the SEC has been after small, slipshod auditors for Chinese reverse listings at least as early as December 2010, when it fined and put Moore Stephens (http://www.sec.gov/litigation/admin/2010/33-9166.pdf) on watch.

Balance-sheet risks

We add a segment on balance-sheet risk

In addition to the categories that Moody's considered in its report, we add a segment on balance-sheet risk, covering net gearing and interest coverage. We also look at goodwill as a share of total equity here. It could recognise a number of false positives on companies that have just gone through significant acquisitions, but it is always a classic hiding place for bad assets/losses on the balance sheet.

Altman-Z score is also helpful

An Altman-Z score is also helpful to judge bankruptcy risk that we use when looking at (US-listed) solar companies, but not available as an easy Bloomberg screen for HK-listed companies.

Ultimately, we screen for 14 fields:

Corporate governance

- Responsibility (bottom quartile)
- Major holder >30%

Risky business

- 2008-11 average Ebitda margin >5ppts >sector average

Rapid growth

- Negative FCF >50% of OCF

Poorer quality of earnings or cashflow

- OCF/net income <1
- Sales/capital employed -40% YoY
- A/R up >20% YoY
- 2008-11 working capital/sales delivered >20% Cagr

Auditors or financial statements
- ❑ Non big-4 auditor
- ❑ Independence (bottom quartile)
- ❑ Qualified accounts (Check showed none among our HK/China coverage)

Balance sheet risks
- ❑ Net debt/equity >75%
- ❑ Interest coverage <2
- ❑ Goodwill/equity >20%

Our findings

After stripping out financial companies, for which the metrics don't make sense, 56 of 161 HK/China companies under CLSA coverage fall foul on four or more fields. We list the 23 companies that scored five or more hits in the appendix. Looking at the high scores, a few points struck us.

Coverage bias
First, there is naturally a large positive bias in the sample group. Analysts naturally weed out the smaller, dodgier companies from their coverage lists. Notably, most of the stocks attacked by short-sellers are not/were not under coverage. The exceptions, like Focus Media, have successfully defended their positions.

High positives, but for good reason

Major holders
The rationale of screening for companies in which the major shareholder has >30% stake is to highlight companies where, if push comes to shove, minority stakeholders' rights could more easily get shunted aside. Of course, that does not mean that they *will* get shunted aside. One would hope not: 127 of the 161 companies we screened turned up positive for this. The positive answers basically come from two groups.

First, **state-owned enterprises** (SOEs): The SOEs' parent companies almost universally hold onto majority stakes of their off-shoots. On one hand, that means that the listcos will answer to the group, and ultimately the central government (through the State-owned Assets Supervision and Administration Commission), rather than minority investors. However, SOEs have been notably absent from the list of short-seller attacks. Any of the SOEs that were allowed to list on foreign exchanges were deemed by Beijing as being too important to fail. And, in any case, risk of no promotion and, potentially, execution is usually (though not always) effective in preventing outright fraud.

For **private enterprises**, one could argue that it is a good sign that the founding entrepreneur (usually) is still fully invested and involved. This makes sense, but it also becomes that much more important that shareholders are confident their interests are aligned with those of the major holder. In our full CG questionnaire, we dig deeper on the individual shareholder to see whether the listco is his/her main investment and whether she/he is known to be heavily indebted personally (and thus a possible forced seller).

All of the power utilities got hit on the 75% net gearing flag

Balance sheet, cashflow and business models
All of the power utilities got hit on the 75% net gearing flag. We could have raised that threshold to 200%, and still most of them would get hit. That does not mean they will struggle to get financing, but it certainly puts earnings at risk as input costs and rates shift. Property and, more generally, infrastructure companies also got hit by negative free cashflow and working capital metrics during the development stage of projects.

Trailing data

It is a truism that sell-side analyst earnings revisions are a lagging indicator for company/stock performance. For the screens, we simply use trailing data. This would remove some forecasting biases, but it punishes companies that simply had a rough year in 2011, while not capturing those that are struggling now (ie, solar), or rewarding those companies that are turning around in 2012.

Margin outperformance

Roughly a quarter of firms screened showed superior margin performance over three years. Many of these simply reflect one of two legitimate reasons: they are superior operators; better companies, of course, should earn better margins; and the peer group is too diverse. For example, as wind pure-plays, Huaneng Renewables and Datang Renewables naturally achieve much wider margins than the broader group of Chinese generation companies.

Company specifics

Realistically, SOEs are not going to be allowed to fail

In the table below, SOEs are in bold. Realistically, they are not going to be allowed to fail. Beyond that, and the general caveats, each company is unique.

- **Rusal (486 HK)** has never been a favourite for corporate governance advocates. However, it is perhaps unfairly penalised on the funding screens as against their US$11bn of debt there is ~US$9bn investment they have (25% interest in Norilsk Nickel), meaning if we looked at net debt including listed investments, the gearing and coverage ratios fall substantially.
- Likewise, it seems unlikely that short-sellers are about to take down either the 126-year-old property behemoth **Wharf** (4 HK), or **HHI** (737 HK), the highway unit of property and infrastructure giant Hopewell Holdings.
- That leaves consumer electronics retailer **Gome** (493 HK) and sportswear company **Dongxiang** (3818 HK). Both consumer companies were hit by rising A/R (1-year basis) and working capital (2-year basis), while Gome tripped the Goodwill trigger.

Top hits - SOEs in bold

Company	Code	Sector	Hits	Re	Ind	Hol	Mar	Cap eff	OCF	FCF	A/R	Work cap	Good will	Gear	Int cov	Aud	Rec
Rusal	486 HK	Materials	6	1	1	1	0	0	1	0	0	0	0	1	1		U-PF
Wharf	4 HK	Property	6		1	1	1	0	1	1	0	1	0	0	0		U-PF
Dongxiang	3818 HK	Consumer	5			1	1	0	1	0	1	1	0	0	0		U-PF
Gome	493 HK	Consumer	5	1		1	0	0	0	0	1	1	1	0	0		U-PF
Chalco	**2600 HK**	**Materials**	**5**	**1**		**1**	**0**	**0**	**0**	**1**	**0**	**0**	**0**	**1**	**1**		**SELL**
Jiangxi Copper	**358 HK**	**Materials**	**5**	**1**	**1**	**1**	**0**	**0**	**1**	**0**	**1**	**0**	**0**	**0**	**0**		**U-PF**
Datang Ren	**1798 HK**	**Power**	**5**			**1**	**1**	**0**	**0**	**1**	**0**	**0**	**0**	**1**	**1**		**U-PF**
Huaneng Power	**902 HK**	**Power**	**5**			**1**	**0**	**0**	**0**	**1**	**0**	**0**	**1**	**1**	**1**		**U-PF**
HN Ren	**958 HK**	**Power**	**5**			**1**	**1**	**0**	**0**	**1**	**1**	**0**	**0**	**1**	**0**		**U-PF**
HHI	737 HK	Infrastructure	5			1	1	0	0	1	1	1	0	0	0		U-PF

Note: **Re**: Responsibility; **Ind**: Independence; **Hol**: Major holder >30%; **Mar**: 08-11 avg Ebitda margin >5 ppt >sector avg; **Cap eff**: Sales/Capital employed -40% YoY; **OCF**: Op Cashflow/net income <1; **FCF**: Negative FCF >50% of OCF; **A/R**: A/R up >20% YoY; **Work cap**: 08-11 working capital/sales up >20%; **Goodwill**: Goodwill/Equity >20%; **Gear**: Net debt/equity > 75%; **Int cov**: Int coverage <2; **Aud**: Non big-4 auditor. Source: CLSA Asia-Pacific Markets, Bloomberg

Chinese frauds and short-seller attacks (guilty and innocent alike)

Company	Code	Summary	Comments	Short-seller	Alleged red flags
Chaoda	682 HK	Anonymous Analytics accused the Chinese vegetable producer of falsified financial statements, and funnelling >US$400m out of the company through related-party transactions/fake capex. Was already under investigation in HK and had been hit by a *Next* magazine expose.	Suspended	Anon Analytics (AA)	Auditor resigned, related-party transactions
China Biotics	CHBT US	Auditing firm found irregularities 'likely constituting illegal acts'			
China Green Agriculture	CGA US	SEC investigated			
China Integrated Energy	CBEH US	Accused of falsely reporting sales for biodiesels, delisted by Nasdaq			
China MediaExpress	CCME US	Vastly overstated network of digital displays they operated			
China Natural Gas	CHNG US	Chairman charged with fraud for improper loans totalling US$14.3m, delisted			
China Redstone	CGPI US	Discovered by independent researchers to be misstating assets, delisted by the SEC			
China Shenghuo Pharmaceutical	CKUN US	SEC found going concern to be of concern, company decided to delist			
China Sky One Medical	CSKI US	Rosen Law firm filed class action lawsuit on behalf of investors, delisted 3/12			
Duoyuan Global Water	DGW US	Halted trading on shares after 4 of 6 independent directors resigned, NYSE unsatisfied w/cooperation, failed to file financial report in a timely manner with the SEC, delisted	Independent directors matter.		
Duoyuan Printing	DYP US	Prompted by a failure to file a financial report with the SEC and inability to hire another auditor after Deloitte resigned, delisted			
Evergrande	3333 HK	Citron accused the property developer of misrepresenting its balance sheet through inflated asset prices, off-balance-sheet financing, overstating A/R and more.	Nicole Wong believes Citron's overstating its case, but Evergrande is getting burned nonetheless by overly ambitious expansion.	Citron	CEO's mail order degree;
Focus Media	FMCN US	The advertising company came under attack from Muddy Waters, who claimed that they overstated the number of displays, and made dodgy acquisitions subsequently written off. Focus Media's refusals were immediate and have been strong and consistent. Ongoing.	James Lee of Credit Agricole Securities (USA) stands by management in their defence. After an initial selloff, so do shareholders.	Muddy Waters	
Fushan	639 HK	Glaucus accused the coal miner of misrepresenting its acquisition costs, suspicious board changes and unbelievably high operating margins, among other things.	The company came out to pretty convincingly refute all accusations. Continues to suffer from some CG discount, says CLSA commodities head Andrew Driscoll.	Glaucus	Abnormally high gross margins; related-party transactions; small auditor
Hontex International	946 HK	Disclosed misleading information in their prospectus, forced to repay HK$1bn to investors			
Huabao	336 HK	Anonymous analytics accused the flavour-maker of hiding costs and assets and overpaying for related-party transactions. The company has consistently defended its position.		Anonymous Analytics	Inflated margins, related party transactions
Longtop Financial	LGFTY US	Hid large costs off balance sheet, faked financial statements	Most employees employed through a third party, undeclared related parties. Longtop's defence was basically 'those are China/US differences'	Citron	Extremely high margins; revenue per employee rocketed

Continued on the next page

Chinese frauds and short-seller attacks (guilty and innocent alike) (continued)

Company	Code	Summary	Comments	Short-seller	Alleged red flags
New Oriental Education	EDU US	Muddy Waters accused this educational co of overstating revenue by consolidating franchise store revenue (while denying it has franchisees).	Company facing a rash of investor lawsuits, and SEC investigation (over VIE structure)	Muddy Waters	Abnormally high gross margins (OP margin, possibly not)
Orient Paper	ONP US	Accused of misstating assets, unstated related party transactions		Muddy Waters	
Puda Coal	PUDA US	Two executives allegedly stole and sold the company's assets before they raised more than US$00m from public investors			
Qihoo 360	QIHU US	Chinese mobile security and online advertising co accused by Anonymous Analytics of exaggerating site traffic. The company vehemently denies, indicating that the data anonymous used is sketchy (unreleased). Investment by their audit committee head in suspended Boshiwa also troubling.		Citron and Anonymous Analytics	
Real Gold Mining Ltd.	246 HK	Deloitte resigned as auditor when company failed to disclose "material" information, shares suspended			
RINO International	RINO US	Muddy Waters issued report saying they falsified documents, did not enter into two major contracts for which sales were reported.	Short-seller	Muddy Waters	
Sino Clean Energy	SCEI US	Allegations of fraud by prominent short sellers, Nasdaq suspends shares 5/12	Short-seller said activity at the plant did not match company's claims; audit committee corrupt.	Alfred Little	SCEI filed its 10-K late two years in a row (2010 & 2011). They also reported massive growth in 2010 (131% revenue) that looked suspicious
Sino-Forest	TRE CN	Sino held "undisclosed control" over the network of third parties through which it conducted purchase and sale transactions.	Undeclared, related-party transactions	Muddy Waters	16 years of negative cashflow; sharply rising debts; receivables rising significantly faster than revenue
Spreadtrum	SPRD	MW accused the Chinese chip designer of fraudulent reporting.	Stock initially fell 34%, but has bounced back.	Muddy Waters	CEO/CFO resignations
Universal Travel Group	UTG US	Accounting firm resigned, SEC became concerned, and UTA wasn't able to respond quickly enough, delisted			
West China Cement	2233 HK	Accused of fraud by Glaucus. 4 auditors since 2009; unusually high margins; related-party transactions	CLSA's Richard Huang believes Glaucus is overstating its case, but does raise some valid points	Glaucus	High margins
Winsway Coking Coal	1733 HK	Accused of misstating assets, unstated related-party transactions		Jonestown	Inventory, sales mismatch
Xinhua Finance	XFML US	Management indicted for illegal transactions			
Yurun Foods	1068 HK	Rumours that MW was targeting it, but never happened			
ZST Digital Networks	ZSTN US	Hedge fund manager put out report saying sales unrealistic based on market share, auditor resigned, the company announced that they would be unable to file its 10-K and delisted			

Source: CLSA Asia-Pacific Markets

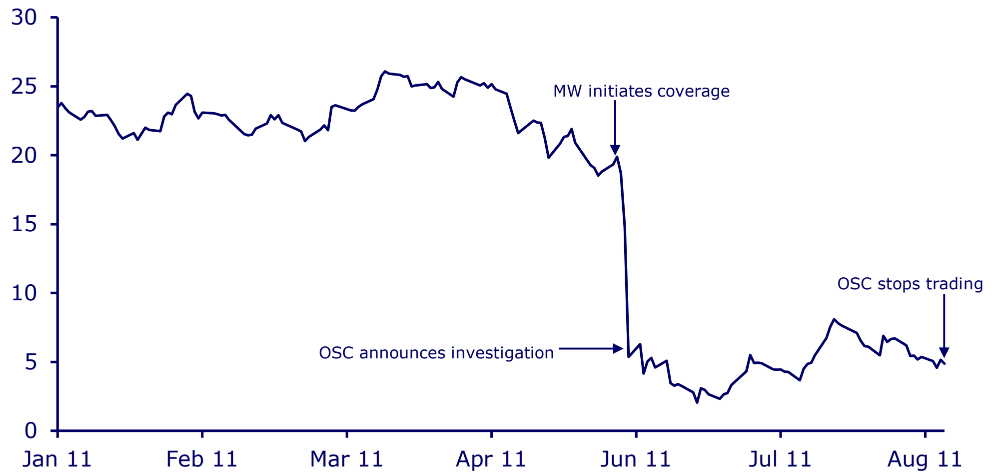
The chart that put Muddy Waters and short-sellers on the map

Case studies

Sino-Forest

Sino-Forest is a commercial forest plantation operator in China. Its business involved owning and managing a plantation of trees, from which it sold timber and wood logs and manufacturing engineered-wood products.

Sino-forest - Clean hit



Source: Bloomberg, CLSA Asia-Pacific Markets

'A multibillion dollar Ponzi scheme . . . accompanied by substantial theft'

Allegations

Muddy Waters alleged that TRE had overstated its assets by roughly US$900m. Further, it relied upon a complex structure in which it passes the majority of its revenue through "authorised intermediaries," which supposedly paid TRE's taxes. MW called TRE's capital-raising 'a multibillion dollar Ponzi scheme . . . accompanied by substantial theft'.

Reaction

Sino-Forest's reaction was slow in coming. As far as we can tell, it made no substantial refutations until over a week after MW's report. Its first real response was during its 1Q earnings call on 13 June, which did little to calm investors. The OSC had already announced its investigation. TRE's final reaction was to file suit for defamation against MW at the end of March, six months after its shares stopped trading, citing 'inflammatory language' as MW's main offence.

Red flags

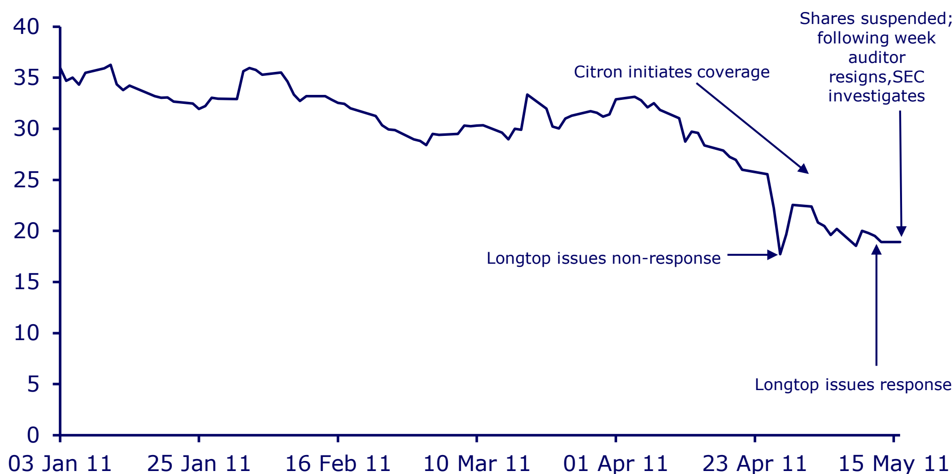
- 16 years of negative cashflow
- Sharply rising debts
- Receivables rising significantly faster than revenue

Longtop Financial

Longtop Financial Technologies provides a range of software solutions and services to financial institutions in China, such as the development/licensing/support of software solutions, providing maintenance of for the systems implemented, system integration services, etc. The company classified them in four different categories: channel, business, management and business intelligence.

Dead man's bluff

Longtop - Off the exchange



Source: Bloomberg, CLSA Asia-Pacific Markets

Allegations

Incredibly wide margins

Citron alleged that Longtop had been faking every one of its financial statements since its initial public offering. Citron pointed to Longtop's incredibly wide margins, significantly higher than any of its peers.

Citron also pointed to Longtop's unconventional employee structure, which did not directly employ over three-fourths of its staff (employed by supposed third-party HR staffing companies [former Xiamen Longtop Human Resources Services instead) as recently as 31 March 2010 and allowed Longtop to move most of its cost structure off-balance sheet. Citron believed that the two companies were related parties and thus an arrangement like this was illegal.

Overpayment for assets, and opaque disclosures

Another allegation was the deliberate overpayment for assets and opaque disclosures for the transactions. Citron also accused top management of previous fraud. In 1996 while working at a different company, it set up a company and poached employees, tricked clients into signing contracts for this other company, among other things. Citron further accused the founder and chairman's gifting of 70% of his stock holdings over four years to employees and friends of having unknowable, nefarious intentions.

Reaction

Longtop denied all the accusations put forth in Citron's (and other seller's) reports. It responded to each allegation, citing accounting and legal differences between the USA and China for every one of them. It denied being a related party to Xiamen Longtop Human Resources Services and claimed that its payments towards the employees provided by Xiamen Longtop Human Resources Services could be found in Chinese filings. As for acquisitions, Longtop claimed US and PRC GAAP differences most likely led others to review different documents (cash basis versus accrual basis). It also

Longtop denied all the accusations put forth in Citron's (and other seller's) reports

indicated that once an acquisition has been made, it dumped employees and business from the acquisition into its current business, in order to 'promote the Longtop brand rather than the acquired company's brand'. No mention was made of management's history.

Red flags

- ❑ Gross margin higher than peers

We hosted Colum Bancroft, the head of forensic accounting for Kroll, in May 2012. Using Longtop as a case study, he highlighted the following points.

- ❑ Suspicious margin jump from 2008-09.
- ❑ After a big jump from 2007-08, revenue per employee did not change significantly despite such rapid expansion. Majority of employees contracted through an "unrelated party" Xiamen Longtop Human Resource Services.

(Go to www.clsa.com for a video replay of Bancroft's presentation.)

Longtop financials

(US$'000)	Mar 10	Mar 09	Mar 08	Mar 07
Revenue	169,057	106,296	65,916	5,799
Net profit	59,091	43,472	2,927	768
Net margin (%)	35	41	4	13
No. of employees	4,258	2,602	1,659	790
Revenue per employee	40	41	40	7

Source: Bloomberg, Kroll

Focus Media

Multiplatform digital media company

Focus Media (FM) is a multiplatform digital media company. It owns and operates a number of different advertising networks including LCD displays, poster frames, in-store ads, movie theatres ads and outside billboards throughout China in commercial and residential locations. The LCD display network consists of digital screens in residential, commercial and public buildings, such as malls, hotels and lobbies of apartment buildings. The poster frame network is composed of flat-panel digital poster frames placed in elevators and other public areas of commercial or residential buildings. The in-store network is made up of flat-panel digital displays placed in specific product areas inside stores. The outdoor billboard network is operated by subsidiaries (Hua Kuang, Shanghai OOH) and is composed of traditional billboards. (Note: James Lee of Credit Agricole Securities (USA) covers Focus Media. He has written extensively about the Muddy Waters allegations and management's well-argued defence.)

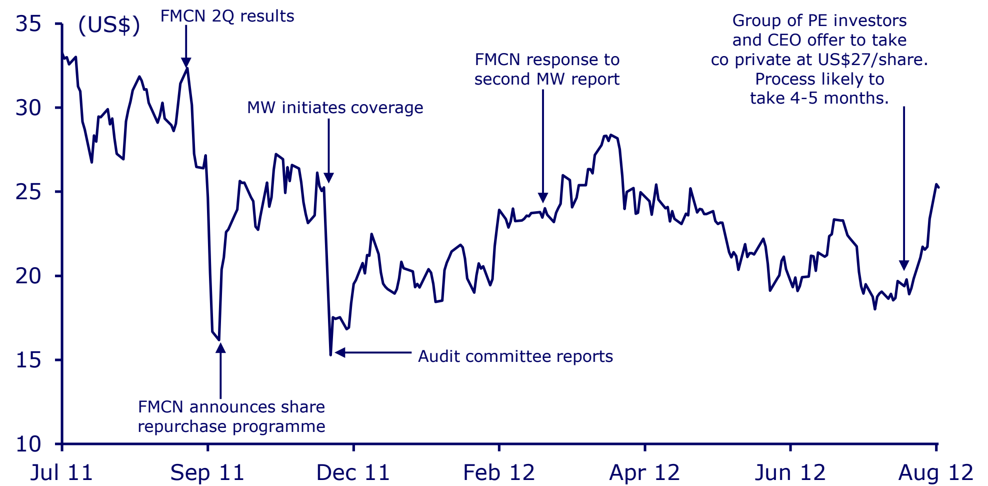
Allegations

Allegedly overstated the number of LCD displays within its network

Muddy Waters alleged that FM had overstated the number of LCD displays within its network by 50% and deliberately overpaid for acquisitions, having written down US$1.1bn out of US$1.6bn in acquisitions since 2005; 21 of these were written down to zero and then given away with no consideration, MW says unjustifiably. MW further charged that insiders used FM as their counterparty in trading in and out of FM subsidiary Allyes, with several individuals earning a total of at least US$70.1m, while shareholders lost US$159.6m.

Advantage: Management

Focus Media - Advantage, company



Source: Bloomberg, CLSA Asia-Pacific Markets

Reaction

FMCN reacted immediately to the allegations

FM reacted immediately to the allegations, holding a conference call the evening the report came out and stating definitively that MW misunderstood the nature of its LCD network, counting certain types of devices as part of the picture frame network rather than the LCD network. It chalked the second accusation up to bad business decisions. It countered the Allyes accusation with the explanation that the business took an impairment, after which top management at FM put forward its own capital as a show of confidence to the Allyes management. After a new valuation by an independent third-party valuation, management earned large gains.

Alleged red flags

Muddy Waters stated that its principal red flag was FM's acquisition history, over which the amount of writedowns it took accumulated to greater than one-third of FM's enterprise value (as of 21 November 2011). MW also stated that US$902.3m of these were of goodwill. Red flag = deliberate overpayment.

Huabao

Huabao International is an investment holding company, mainly engaged in the production, distribution and sale of flavours and fragrances and reconstituted tobacco leaves in China. Those are its three segments, all three of which it has R&D, production and sale divisions in.

Allegations

A 'pump and dump scheme'

AA called Huabao a 'pump and dump scheme with the primary objective of enriching its chairwoman, Chu Lam-yiu and her proxies at the expense of shareholders'. It alleged that Huabao's margins and revenue growth, and R&D expenses are impossibly high and low respectively, with gross margins 30-40% wider than industry averages. AA claimed that Huabao attempted to conceal its operations by disclosing less in financial reporting and hiding one of its facilities using Photoshop. It further accused Huabao of large dividends to draw attention away from its operations and said that there are large discrepancies between the company's Hong Kong and mainland filings. AA also alleged that Deloitte resigned in 2006 as Huabao's auditor because of these practices.

The jury is still out

Huabao (336 HK) - Not so clear

Source: Bloomberg, CLSA Asia-Pacific Markets

Huabao summarily denied the accusations

Reaction

Huabao summarily denied the accusations. It claimed Deloitte resigned because of a disagreement concerning audit fees. Concerning discrepancies between Chinese and HK documents, it claimed it never authorised anyone outside the firm to view SAIC documents, and even if it did there should be no unaccounted for differences; those that may exist owe themselves to accounting methods and in a statement detailed them.
(http://huabao.todayir.com/attachment/2012050406170100142270_en.pdf)

Red flags

- ❑ Unusually high margins

Margin comparison

Company	Code	Gross margin (%)	Ebitda margin (%)	Operating margin (%)
Average		37.8	15.7	12.2
Huabao International	336 HK	72.0	66.4	63.7
Ezaki Glico	2206 JP	42.5	5.5	1.6
CJ Corp	001040 KS	34.5	12.2	6.7
Kewpie Corp	2809 JP	24.1	7.1	4.3
Kikkoman Corp	2801 JP	40.4	10.7	6.3
Morinaga Milk Industry	2264 JP	30.9	5.3	2.3
CHR Hansen	CHR DC	48.6	31.8	25
China Mengniu Dairy	2319 HK	25.7	6.9	4.6
Premier Foods	PFD LN	28.2	12.3	6.6
Inner Mongolia Yili Indus A	600887 CH	28.5	5.8	3.9
Tiger Brands	TBS SJ		17.8	15.9
McCormick & Co-Non VTG shrs	MKC US	40.5	17.3	14.6
Kerry Group A	KYG ID	40.8	10.8	8.9

Source: Bloomberg, Anonymous Analytics

Full list of top red flag hits (1 = negative score)

Company	Code	Sector	Hits	Re	Ind	Hol	Mar	Cap eff	OCF	FCF	A/R	Work cap	Good will	Gear	Int cov	Aud	Rec
China Power[1]	2380 HK	Power	6	1	1	1	0	0	0	1	0	0	0	1	1		BUY
Shanghai Ind[1]	363 HK	Conglomerates	6	1	1	1	1	0	1	0	0	1	0	0	0		O-PF
Wharf	4 HK	Property	6		1	1	1	0	1	1	0	1	0	0	0		U-PF
Rusal	486 HK	Materials	6	1	1	1	0	0	1	0	0	0	0	1	1		U-PF
Conch[1]	914 HK	Materials	6	1	1	1	1	0	1	1	0	0	0	0	0		O-PF
CNBM[1]	3323 HK	Materials	6	1	1	1	0	0	0	1	0	0	0	1	0	1	BUY
HHI	737 HK	Infrastructure	5			1	1	0	0	1	1	1	0	0	0		U-PF
HN Renewables[1]	958 HK	Power	5			1	1	0	0	1	1	0	0	1	0		U-PF
Datang Ren[1]	1798 HK	Power	5			1	1	0	0	1	0	0	0	1	1		U-PF
CR Power[1]	836 HK	Power	5		1	1	0	0	0	1	0	0	1	1	0		BUY
Longyuan Power[1]	916 HK	Power	5	1	1	1	0	0	0	1	0	0	0	1	0		BUY
GAC[1]	2238 HK	Autos	5			1	0	1	1	0	1	1	0	0	0		BUY
COSL[1]	2883 HK	Petro/chems	5	1	1	1	1	0	0	0	0	0	0	1	0		O-PF
ASM Pacific	522 HK	Technology	5	1	1	1	1	0	1	0	0	0	0	0	0		BUY
Magang	323 HK	Materials	5	1		1	0	0	1	1	1	0	0	0	0		BUY
Shougang Fushan	639 HK	Materials	5	1	1	0	1	0	0	0	1	0	0	0	0	1	BUY
Dongfang[1]	1072 HK	Power	5		1	1	0	1	1	0	0	0	0	0	0	1	SELL
Shougang Intl[1]	697 HK	Materials	5			1	0	0	0	1	1	0	0	1	1		BUY
Dongxiang	3818 HK	Consumer	5			1	1	0	1	0	1	1	0	0	0		U-PF
Jiangxi Copper[1]	358 HK	Materials	5	1	1	1	0	0	1	0	1	0	0	0	0		U-PF
Chalco[1]	2600 HK	Materials	5	1		1	0	0	0	1	0	0	0	1	1		SELL
Huaneng Power[1]	902 HK	Power	5			1	0	0	0	1	0	0	1	1	1		U-PF
Gome	493 HK	Consumer	5	1		1	0	0	0	0	1	1	1	0	0		U-PF

Note: **Re**: Responsibility; **Ind**: Independence; **Hol**: Major holder >30%; **Mar**: 08-11 avg Ebitda margin >5ppts >sector avg; **Cap eff**: Sales/capital employed -40% YoY; **OCF**: Op cashflow/net income <1; **FCF**: Negative FCF >50% of OCF; **A/R**: A/R up >20% YoY; **Work cap**: 08-11 working capital/sales up >20%; **Goodwill**: Goodwill/equity >20%; **Gear**: Net debt/equity >75%; **Int cov**: Int coverage <2; **Aud**: Non-big-4 auditor. [1] SOEs. Source: Bloomberg, CLSA Asia-Pacific Markets

Companies mentioned

Chaoda Modern (N-R)

China Biotics (N-R)

China Lumena (N-R)

China MediaExpress (N-R)

Dongxiang (3818 - HK$0.77 - UNDERPERFORM)

Evergrande (3333 - HK$3.29 - UNDERPERFORM)

Focus Media (FMCN - US$24.88 - BUY)

Gome (493 - HK$0.72 - UNDERPERFORM)

HHI (737 - HK$3.88 - UNDERPERFORM)

Huabao (N-R)

LDK Solar (N-R)

Longtop (N-R)

New Oriental Edu (N-R)

Qihoo 360 (N-R)

Rusal (486 - HK$4.35 - UNDERPERFORM)

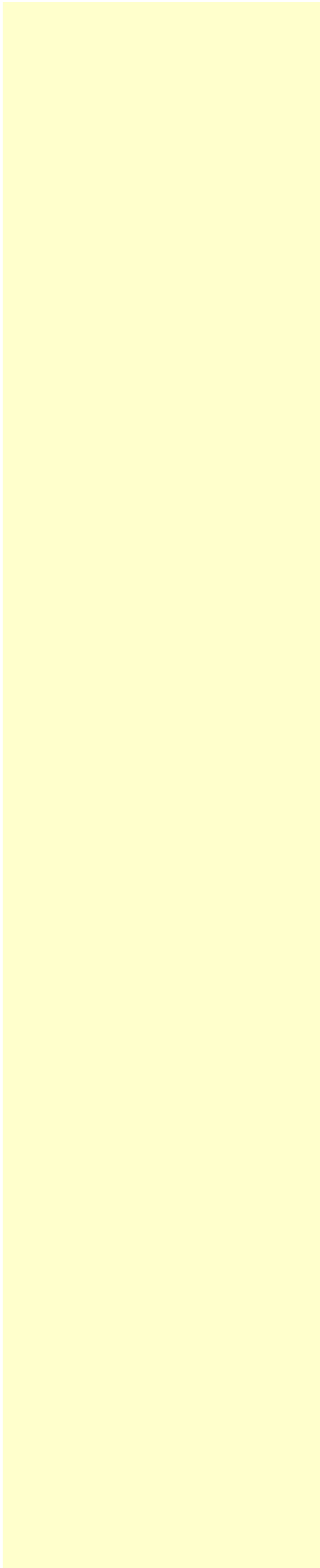
Shougang Fushan (639 - HK$2.11 - BUY)

Spreadtrum (N-R)

WCC (N-R)

Wharf (4 - HK$49.25 - OUTPERFORM)

Winsway (N-R)



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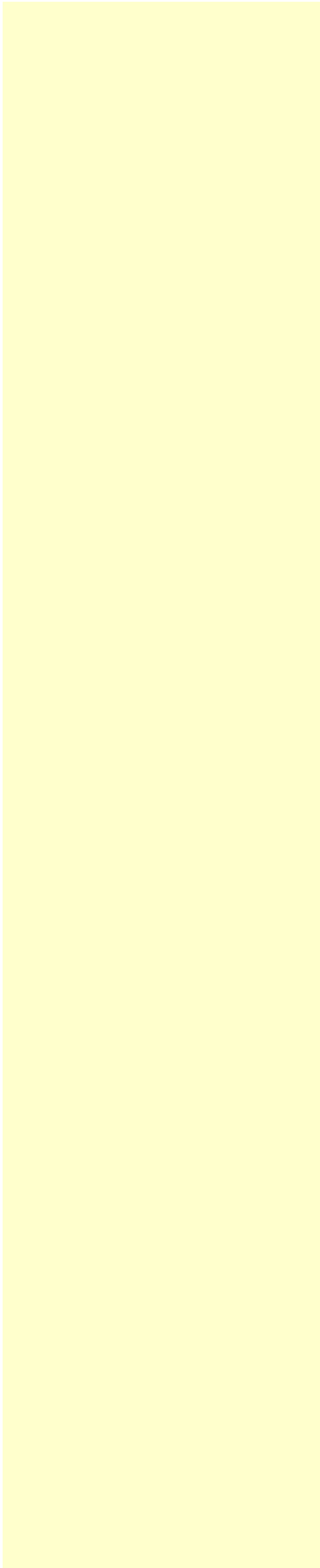

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Key to CLSA/Credit Agricole Securities investment rankings: **BUY**: Total return expected to exceed market return AND provide 20% or greater absolute return; **O-PF**: Total return expected to be greater than market return but less than 20% absolute return; **U-PF**: Total return expected to be less than market return but expected to provide a positive absolute return; **SELL**: Total return expected to be less than market return AND to provide a negative absolute return. For relative performance, we benchmark the 12-month total return (including dividends) for the stock against the 12-month forecast return (including dividends) for the local market where the stock is traded.

14/06/2012