

ANALYSIS OF CORPORATE GOVERNANCE
PRACTICES DISCLOSURE IN
2005 ANNUAL REPORT

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Hong Kong Exchanges and Clearing Limited
香港交易及結算所有限公司

EXECUTIVE SUMMARY

- The Stock Exchange (the Exchange) has reviewed the compliance of 621 issuers with the new Code on Corporate Governance Practices (the Code) except for code provision C.2 on internal controls which commenced later than the balance of the Code.
- All of the 621 issuers met the “comply or explain” requirements in their 2005 annual reports in respect of all of the code provisions.
- Large listed issuers complied with more code provisions than smaller listed issuers.
- Eighty-nine per cent of the 621 issuers complied with 41 or more of the 44 code provisions.

BACKGROUND

- The new Code became effective in 2005.
- The Code sets out the principles of good corporate governance, and two levels of recommendations: (a) code provisions; and (b) recommended best practices. Issuers are expected to comply with, but may choose to deviate from, the code provisions. The recommended best practices are for guidance only. The Code provides that issuers must state whether they have complied with the code provisions in their interim reports and annual reports. Issuers are required to explain any deviation.
- The Code was effective – with one exception – for accounting periods commencing on or after 1 January 2005. The exception was in respect of code provision C.2 on internal controls. It became effective for accounting periods commencing on or after 1 July 2005.
- The Exchange has reviewed disclosures made by issuers pursuant to the Code. This is a summary of the scope of its work, its findings and its plans for future work.

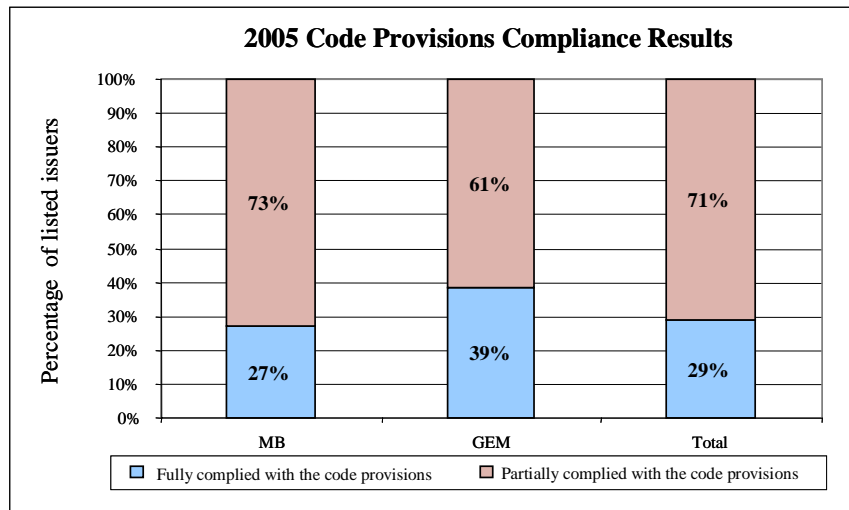
SCOPE OF PROJECT AND FUTURE WORK

- The Exchange reviewed the annual reports of 621 listed issuers (515 Main Board (MB) issuers and 106 Growth Enterprise Market (GEM) issuers). That is, all of the listed issuers with a financial year ended 31 December which had published a 2005 annual report.
- The Exchange analysed issuers’ disclosure in respect of each of the code provisions save for C.2 on internal controls.
- The Exchange intends to undertake a similar review annually and to continue publishing the results. In future years it will expand the scope of the review to all relevant issuers and all code provisions.

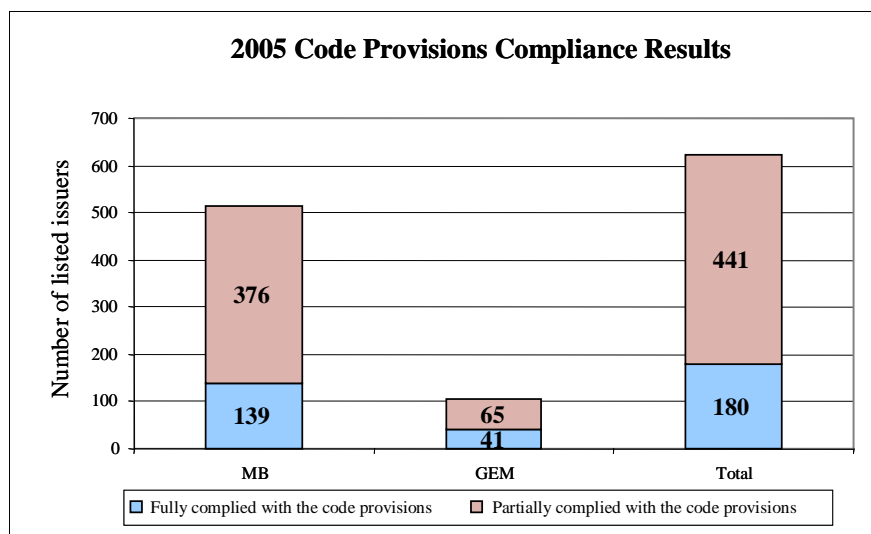
FINDINGS¹

Overall Compliance

- ALL of the 621 issuers either:
 - a) indicated in their annual reports that they had complied with the code provisions; or
 - b) explained their deviation from one or more code provisions.



- Twenty-nine per cent of issuers stated they had complied with the code provisions for the whole accounting period (ie January to December 2005).

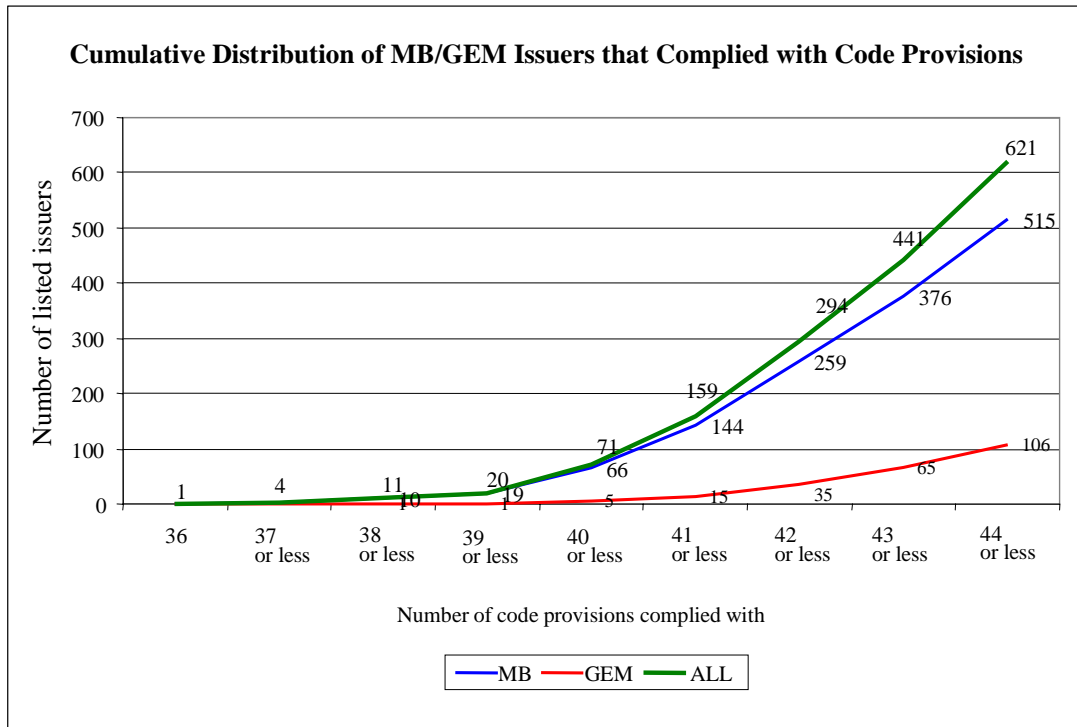


- Compliance of GEM issuers was slightly higher than for MB issuers (39 per cent for GEM vs 27 per cent for MB).

Remarks: Issuers having “partially complied with the code provisions” means that the issuer disclosed that they had complied with only some of the code provisions (whilst deviating from others) and/or they had complied with all of the code provisions but not for the whole year (eg some issuers disclosed that they had initially not complied with one or more code provisions but during the year had changed their arrangements such that they became fully compliant).

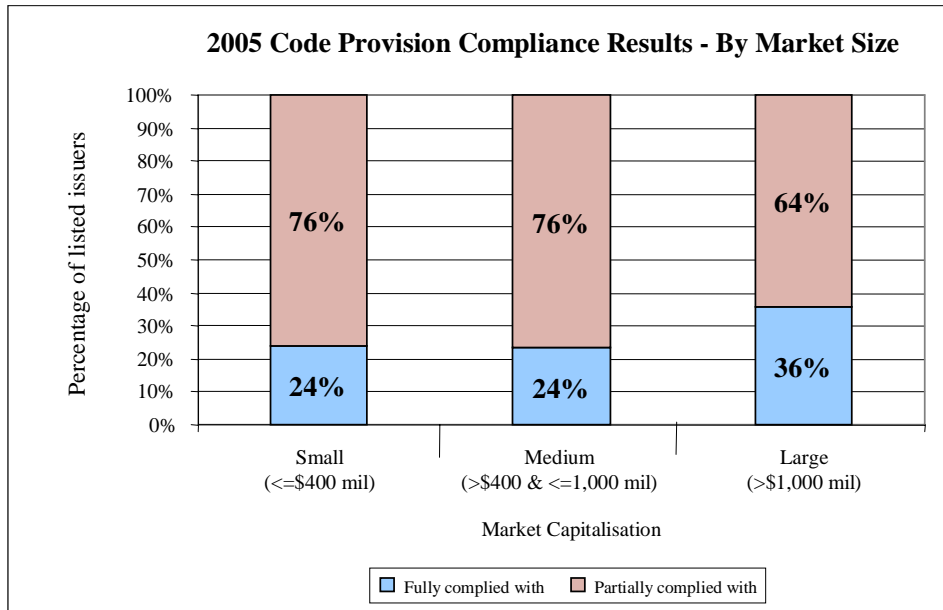
¹ References to \$ are to Hong Kong dollars. Percentages are approximate; they are generally rounded to the nearest full percentage.

- About 89 per cent of listed issuers (550 out of 621) stated that they had fully complied with 41 or more of the 44 code provisions.
- The line graph illustrates issuers' compliance levels in more detail. The same information is provided in the following table.

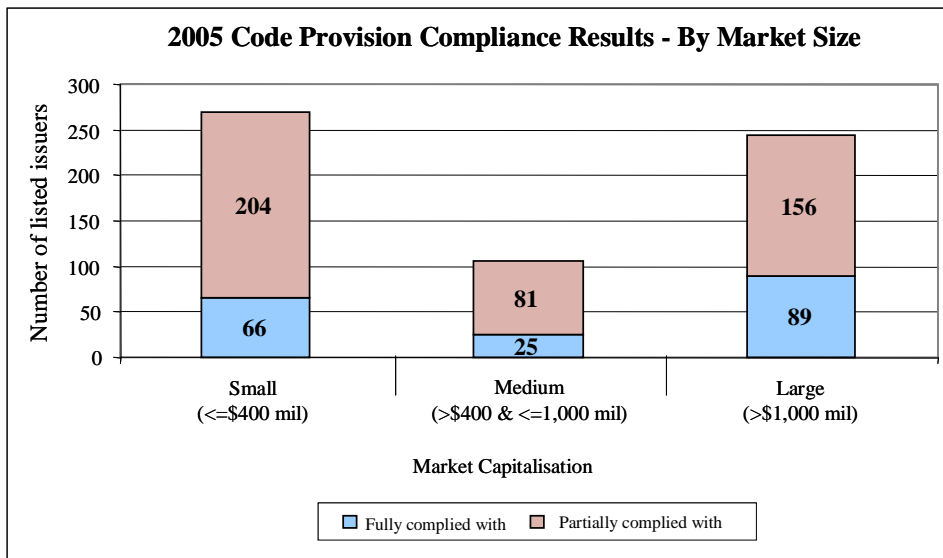


Number of code provisions complied with	MB issuers	GEM issuers	Total
36	1	0	1
37	3	0	3
38	6	1	7
39	9	0	9
40	47	4	51
41	78	10	88
42	115	20	135
43	117	30	147
44	139	41	180
Total	515	106	621

Overview of Compliance by Market Size



- The size of listed issuers appears to be a significant driver of corporate governance practice. (This is consistent with the findings in other jurisdictions.)



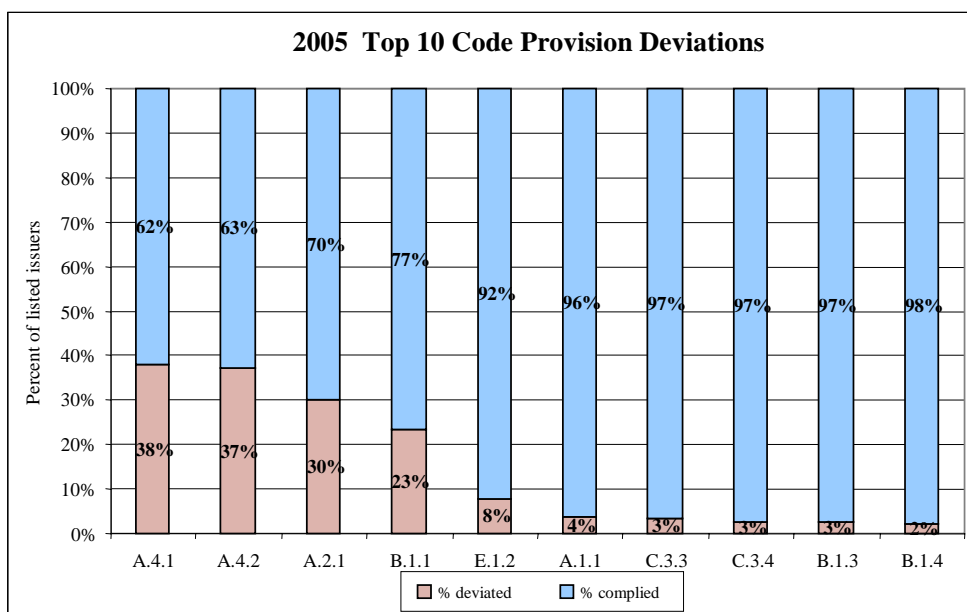
- As these graphs illustrate, large listed issuers complied with more code provisions than small and medium-sized listed issuers.

Overview of Compliance by Code Provision

	Code provisions	% compliance (by the 621 listed issuers)
1	A.1.2	100%
2	A.1.4	100%
3	A.1.5	100%
4	A.1.6	100%
5	A.1.8	100%
6	A.2.3	100%
7	A.3.1	100%
8	A.5.1	100%
9	A.5.2	100%
10	A.5.3	100%
11	A.6.2	100%
12	A.6.3	100%
13	B.1.5	100%
14	C.1.1	100%
15	C.1.2	100%
16	C.1.3	100%
17	C.3.2	100%
18	C.3.5	100%
19	C.3.6	100%
20	D.2.2	100%
21	A.1.7	99.8%
22	A.2.2	99.8%
23	D.2.1	99.8%
24	E.2.2	99.8%
25	E.2.3	99.8%
26	B.1.2	99.7%
27	C.3.1	99.7%
28	D.1.1	99.7%
29	E.1.1	99.7%
30	A.6.1	99.4%
31	D.1.2	98.7%
32	E.2.1	98.6%
33	A.1.3	98.4%
34	A.5.4	97.7%
35	B.1.4	97.6%
36	B.1.3	97.3%
37	C.3.4	97.3%
38	C.3.3	96.6%
39	A.1.1	96.1%
40	E.1.2	92.3%
41	B.1.1	76.7%
42	A.2.1	69.7%
43	A.4.2	62.6%
44	A.4.1	62%

- Twenty (45 per cent) of the 44 code provisions (excluding C.2 on internal controls) were fully complied with by the 621 listed issuers reviewed. These code provisions were: A.1.2; A.1.4; A.1.5; A.1.6; A.1.8; A.2.3; A.3.1; A.5.1; A.5.2; A.5.3; A.6.2; A.6.3; B.1.5; C.1.1; C.1.2; C.1.3; C.3.2; C.3.5; C.3.6; D.2.2.
- The code provisions most commonly deviated from were as follows:
 - a) Code provision A.4.1 (dealing with non-executive directors, or NEDs, being appointed for a specific term, subject to re-election);
 - b) Code provision A.4.2 (dealing with directors appointed to fill a casual vacancy being subject to election by shareholders at the first general meeting after their appointment and every director being subject to retirement by rotation at least once every three years);
 - c) Code provision A.2.1 (dealing with separation of the roles of chairman and chief executive officer, or CEO);
 - d) Code provision B.1.1 (dealing with establishing a remuneration committee with a majority of independent non-executive directors, or INEDs); and
 - e) Code provision E.1.2 (dealing with attendance and questioning of the chairman of the board and chairmen of various committees at the annual general meeting, or AGM).

These deviations are considered further below.



- As set out in the chart above, the most common deviations were from code provisions A.4.1, A.4.2 and A.2.1. More than 30 per cent of the relevant issuers deviated from each of these code provisions.
- Common reasons for deviation are set out below.

Detailed Analysis of Top Five Deviations

Code Provision A.4.1

Status of compliance	Number of listed issuers	% of listed issuers
Decided not to follow the code provision	146	62%
Rectified the deviation during the year	45	19%
Propose to rectify the deviation	44	19%
Total	235	100%

- As the table shows, only 38 per cent of the listed issuers that disclosed they had deviated from code provision A.4.1 rectified, or proposed to rectify, the deviation.
- The vast majority of the large number of issuers that apparently do not intend to follow the code provision said that whilst their NEDs are not appointed for a specific term, they are subject to retirement by rotation each AGM.
- However, a significant number of these issuers also disclosed that their chairman and managing director are excluded from retirement by rotation. It was asserted that the leadership of the chairman and managing director are essential for the stability of the board and the business, and there should be orderly succession arrangements.

Code Provision A.4.2

Status of compliance	Number of listed issuers	% of listed issuers
Decided not to follow the code provision	58	25%
Rectified the deviation during the year	48	21%
Propose to rectify the deviation	126	54%
Total	232	100%

- There are two limbs to code provision A.4.2:
 - All directors appointed to fill a casual vacancy should be subject to election by shareholders at the first general meeting (GM) after their appointment; and
 - Every director should be subject to retirement by rotation at least once every three years.
- Some issuers deviated from only one limb; others deviated from both limbs.
- A significant number of issuers that disclosed they had deviated from code provision A.4.2 said that the deviation was – in part at least – due to their policy that directors appointed to fill a casual vacancy would be subject to re-election by shareholders at the first AGM after appointment, rather than the first GM.
- Even more common, however, was deviation as a result of either or both:
 - The issuer's chairman and managing director not being subject to retirement by rotation; and /or
 - The issuer's arrangements for retirement by rotation (generally said to be set out in the issuer's constitutional documents) providing for one-third of the directors for the time being or, if their number is not three or a multiple of three, then the number nearest to one-third to retire from office each year.

- Fifty-four per cent of listed issuers that deviated from code provision A.4.2 proposed to rectify the deviation. We have sample checked 10 of those issuers and confirmed that all passed a resolution in their subsequent AGM to amend their Articles of Association or bye-laws so as to comply with the Code.

Code Provision A.2.1

Status of compliance	Number of listed issuers	% of listed issuers
Decided not to follow the code provision (see note below)	146	78%
Rectified the deviation during the year	27	14%
Propose to rectify the deviation	15	8%
Total	188	100%

Note:

Reasons given by listed issuers for their decision not to follow code provision A.2.1	Number of listed issuers	% of listed issuers
Same person provides the Group with strong and consistent leadership, allows for more effective planning/formulation and execution/ implementation of long-term business strategies	58	39%
Contributions are made by all executive directors/INEDs, who bring different experience and expertise and who meet regularly to discuss issue affecting the issuer's operations	26	18%
The Board has confidence in the person who acts as CEO and chairman, eg because the person is knowledgeable, well known and/or has a good understanding of the operations of the issuer	20	14%
Due to the size of the Group, the scope and/or nature of its business and/or a practical necessity arising from the corporate operating structure	20	14%
The responsibilities of the chairman and CEO are clear and distinct and therefore need not be set out in writing	3	2%
The issuer considers that its structure is sufficiently consistent with the Code and the deviation has no materially adverse impact on its corporate governance structure	1	1%
More than one of the above	18	12%
Total	146	100%

Remarks: Three listed issuers stated that they had deviated from A.2.1 on the basis that they did not at that time have one officer with the title of CEO; instead the CEO duties were undertaken by more than one individual. Code provision A.2.1 provides that "The roles of chairman and chief executive officer should be separated and should not be performed by the same individual. The division of responsibilities between the chairman and chief executive officer should be clearly established and set out in writing." Consequently, the Exchange considers that these issuers have in fact complied with the code provision. Figures are adjusted accordingly.

- Seventy-eight per cent of the listed issuers that deviated from code provision A.2.1 disclosed that they had made a considered decision to do so.
- More than thirty-nine per cent of those issuers stated that they had decided against compliance with the code provision because having the same person as CEO and chairman provided strong and consistent leadership for effective planning and implementation of business strategies.
- A few issuers contended that having the same person as CEO and chairman did not compromise accountability or independent decision-making because: (a) their independent directors have free and direct access to the issuer’s management, internal audit division, external auditors and independent professional advice, as necessary; and (b) their audit committee is comprised exclusively of INEDs.

Code Provision B.1.1

Status of compliance	Number of listed issuers	% of listed issuers
Decided not to follow the code provision	12	8%
Rectified the deviation during the year	125	86%
Propose to rectify the deviation	8	6%
Total	145	100%

- As the table shows, 86 per cent of the listed issuers that disclosed they had deviated from code provision B.1.1 had rectified the deviation by year-end.
- The few issuers that did not rectify (or propose to rectify) their deviation cited reasons including that the small size of the issuer and/or its board did not warrant use of resources (including additional cost) to establish a remuneration committee.

Code Provision E.1.2

Reasons given by listed issuers on their decision not to follow the code provision E.1.2	Number of listed issuers	% of listed issuers
Business engagement/other commitment	32	67%
Out of office/bad health/personal reason	9	19%
No disclosure on reason of absence but appointment of executive director to chair meeting	3	6%
No disclosure on reason of absence and ambiguous explanation e.g.: “Appropriate arrangements have been made accordingly before the holding of AGM” or “opinion of INED had been expressed and endorsed in the letters from independent board committees, which were included in circular”	2	4%
No reason given	2	4%
Total	48	100%

Parties not attending the AGM	Number of listed issuers	% of listed issuers
Chairman of the Board	42	88%
Chairman or member of any committee	2	4%
Chairman of the Board and chairman or member of audit committee	3	6%
Chairman of the Board and chairman or member of audit and remuneration and nomination committee	1	2%
Total	48	100%

- Forty-eight listed issuers deviated from code provision E.1.2. None of those issuers disclosed a proposal to rectify the deviation.
- As the table shows, the majority of issuers that deviated from code provision E.1.2 claimed the chairman was kept from the AGM because of business engagements or other commitments.