

Do Investors Really Care About Corporate Governance? Evidence from the Hong Kong Market

Stephen Yan-Leung Cheung

Department of Economics and Finance, City University of Hong Kong

J. Thomas Connelly

Faculty of Commerce and Accountancy, Chulalongkorn University

Piman Limpaphayom

Sasin Graduate Institute of Business Administration of Chulalongkorn University

Lynda Zhou

Department of Economics and Finance, City University of Hong Kong

Abstract

This paper constructs a corporate governance index (CGI) for 168 listed companies. The evidence shows that the companies' market value is positive and significantly associated with their CGI. The effect is robust to the inclusion of control variables. Our results imply that companies with better corporate governance are associated with higher market value in Hong Kong. A significant and positive relationship is further found between the transparency index and market value. Our results also suggest that investors are more concerned with corporate governance practices of China-related companies than for Hong Kong companies.

Keywords: Corporate governance, transparency, Hong Kong.

Corresponding Author: Yan-Leung CHEUNG, Department of Economics and Finance, City University of Hong Kong. Tel: (852)27887960. Fax: (852)27888040. E-mail: efsteven@cityu.edu.hk

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1. Introduction

The financial crisis of 1997-1998 that swept through most of East Asia highlighted the need for corporate governance reform in the region. There have been numerous corporate governance reform initiatives including regional (PECC, 2001) and international (OECD, 2004) efforts. The question is whether good corporate governance practice matters in Asia. The empirical evidence on the relationship between corporate governance practice and firm performance is inconclusive and most prior research has focused on developed markets. This study attempts to address this question in one of the important Asian markets – Hong Kong.

Hong Kong is an international financial centre in Asia which combines an Asian family-controlled business environment, characterized by high family ownership of listed corporations, and an Anglo-Saxon legal and corporate governance system. Hong Kong is a good testing ground to examine whether the Anglo-Saxon legal and corporate governance system works in a market in which the corporate sector is dominated by family ownership (or majority shareholders).

This study has three aims. The first aim is to examine whether investors are concerned with the good corporate governance practice of firms in Hong Kong. In other words, do good corporate governance practices pay? The second aim is to examine which are the determining factors for good corporate governance practices. This addresses the policy issue of which factors concern most investors. The final aim is to examine the corporate governance practice of China-related companies listed in Hong Kong.

The instrument for measuring corporate governance practice in this study is derived from the Revised OECD Principles of Corporate Governance (OECD, 2004) and the Recommended Best Practices (HKEx, 1999). There are 86 questions (including sub-questions) that are classified into five categories---rights of shareholders; equitable treatment of (minority) shareholders; role of stakeholders; disclosure and transparency; and board responsibilities and composition.

The procedure for measuring corporate governance practice used in this study differs from that commonly found in previous work. Instead of awarding one mark for the presence and zero for the absence of an item of information in firms' annual reports and accounts, this study gives credit to the 'amount' of information for each of the criteria under study. We use 2002 data for a sample of 168 companies listed on the Hong Kong stock market. There was a wide disparity in the quality of corporate governance practices in the surveyed companies; overall scores range from 32 to 77 out of 100.

The empirical findings offer compelling evidence that good corporate governance practice matters in Hong Kong. A positive and significant relationship is found between the market-to-book ratio (MTBV) and a corporate governance index (CGI) even after the inclusion of such control variables as performance, risk factors, board characteristics, and ownership structure. When we construct two sub-indices on transparency and non-transparency, a positive and significant relationship is also found between the transparency index and MTBV. We further divide the sample into two groups: China-related companies and local firms. The result shows that investors pay more attention to the corporate governance practice of China-related companies.

The remainder of this paper is organized as follows. Section 2 presents a literature review. Data and methodology are given in Section 3. Section 4 illustrates the results, and Section 5 concludes the paper.

2. Literature Review

Numerous studies have focused on the relationships between corporate governance practice and firm performance with mixed results indicating that good corporate governance practices may not necessarily lead to better firm performance. The divergence of findings may be because it is difficult to measure corporate governance; a detailed review of changes can be found in Patterson (2000). In the U.S., evidence of correlation between a firm's corporate governance attributes and its value is weak (Black, 2001). Some studies use the ownership structure as an indicator of corporate governance while others use various board characteristics such as board size, composition, the quality of directors, board leadership, etc., as proxies for corporate governance. For example, one body of literature has found that concentrated shareholder ownership can lead to more active monitoring, thereby leading to better corporate governance. This active monitoring effectively reduces the probability of management expropriating shareholders' wealth (Weiss and Nikitin; 1998, Hill and Snell; 1998). Bhagat et al. (2000), however, do not find supporting evidence regarding the positive association between ownership concentration and firm performance. Klein (1998) finds no association between firms' committee structures and firm value. Similarly, neither activism of institutional investors (Carleton et al., 1998), nor insider share ownership (Morck et al., 1988) is found to have a significant effect on firm value.

Studies on the association between overall corporate governance practice and firm market value is limited. Gillan et al. (2003) investigate whether MTBV predicts the overall governance of U.S. firms and find no significant results. Black (2001) reports that overall corporate governance behavior affects the market value of Russian firms. Durnev and Kim (2003) focus on the factors that relate to corporate governance in emerging markets, and also address briefly whether governance choices predict firms' market value. They use the Credit Lyonnaise Securities Asia (CLSA) corporate governance index and the S&P disclosure score to measure corporate governance practices for a sample of 859 large firms in 27 countries. There is a limitation to the CLSA index because it includes the subjective judgment of analysts which may cause bias in the data.

Another body of the literature considers board responsibilities and composition as an important determinant of corporate governance. Fama and Jensen (1983) show that the board of directors is regarded as an elementary channel for shareholders to exercise control over senior managers. Various studies on board composition and responsibilities have been carried out. For example, Rosenstein and Wyatt (1990) claim that independent non-executive directors are perceived as a tool for monitoring management behavior. Black et al. (2003) point out that board composition predicts firm value in Korea.

3. Data and Methods

Our database consists of the 168 largest companies (see Appendix I) that are constituent stocks of four major indices in the Hong Kong stock market: HSI (Hang

Seng Index), HSHKCI (Hang Seng Hong Kong Composite Index), HSCCI (Hang Seng China Affiliated Corporate Index), and HSCEI (Hang Seng China Enterprise Index). The HSCCI and HSCEI constituent stocks are China-related companies; HSCCI accounts for red-chip companies and HSCEI for H-share companies.¹ Both H-share and red-chip companies are listed in Hong Kong. H-share companies are incorporated in Mainland China and red-chip companies are incorporated in Hong Kong but are controlled (at least 35%) by state-owned (or provincial or municipal) organizations in China. Shleifer and Vishny (1997) show that corporate governance in firms whose controlling shareholder is the state differs from that for firms whose controlling shareholders are private institutions or families. However, there is limited research on the corporate governance practices of H-share or red-chip companies. Our overall sample represents almost 90% of the total capitalization and almost 80% of the Hong Kong market's turnover.

Based on Revised OECD Principles (OECD, 2004) and the Recommended Best Practices (HKEx, 1999), we develop an instrument consisting of 86 questions (including sub-questions). The questions are classified into five categories: rights of shareholders; equitable treatment of (minority) shareholders; role of stakeholders; disclosure and transparency; and board responsibilities and composition.²

The corporate governance practices of listed companies are examined from the public shareholders' perspective, using publicly available information that they use in reaching their investment decisions. Our data sources include annual reports, articles of association, memorandums of association, notices to call shareholders meetings, annual general meeting (AGM) minutes, company websites, analyst reports, and other sources. Each company is assessed by two different raters to ensure consistency.

Companies are rated as good, fair, or poor for each of the 86 questions, and they receive a score of 3, 2, or 1 correspondingly. Each question within a specific survey category carries a weight, as does each category: rights of shareholders (15%); equitable treatment of shareholders (20%); role of stakeholders (5%); disclosure and transparency (30%); and board responsibilities and composition (30%).

The first two categories mainly relate to investor protection, especially for minority shareholders, which is the essence of corporate governance in the Hong Kong market because of the prevalence of family ownership. Therefore, these two categories are assigned a weight of 35%. Information disclosure and board responsibilities are commonly regarded as major topics in governance practice and are weighted equally at 30%. The role of stakeholder category has a limited number of questions and receives a lower weight of 5%. Finally a total corporate governance rating is calculated for each company, and this ranges from zero to 100.³

¹ China-related firms account for 28% of the total number of listed companies in Hong Kong and more than 49% of the total market turnover in 2004.

² A detailed questionnaire can be found in Appendix II.

³ There are debates on the weights assigned to these questions. The weighting scheme used in this study is based on the number of questions in each category. It is difficult to determine which questions are more important and should carry more weight. We repeat our analysis by assigning equal weights to the five categories; the results are similar to those reported in this paper.

Furthermore, we construct another index to assess firms' disclosure performance by including all questions related to transparency. For example, Question A.4 evaluates the quality of annual general meeting (AGM) minutes; Question B.4 asks whether the company provides any rationale for related-party transactions affecting the corporation; Question E.3 assesses the quality of the audit committee report; and Question E.15 examines whether firms disclose how much they pay their independent non-executive directors. Therefore, we include other disclosure-related questions to construct a transparency index. These questions are equally weighted; the index again ranges from 0 to 100. We then combine the non-disclosure-related questions in a non-transparency index, which also ranges from 0 to 100.

Other accounting information and firm performance data are obtained from Datastream and Bloomberg. We download monthly data for 2002, and use geometric averaging to calculate the annual data. All data are processed according to the firm's fiscal date.

4. Results

A. Descriptive Statistics

A major contribution of this study is to construct a corporate governance index for the largest 168 listed companies in Hong Kong. The index ranges from 32.86 to 76.34 on a scale of zero to 100 in ascending order of good corporate governance. The average score is 48.33. Panel A of Table 1 contains some descriptive statistics of CGI and its five sub-indices, which indicate that companies do well in Section B (equitable treatment of shareholders) and Section D (disclosure and transparency) on average, with mean scores of 82.78 and 74.88, respectively. Specifically, there are no incidents of non-compliance or insider trading by company directors or managers in the two years preceding the survey. Most companies also try to make proxy voting easy for their shareholders and send the AGM notice to stockowners well before the meeting date. In terms of disclosure, all companies conduct an annual audit, using qualified external auditors. Companies also offer many channels of information to the general public and investors, such as through their annual reports, company websites, and analyst briefings.

Companies perform well in Section C (role of stakeholders) and Section E (board responsibilities and composition). These sections have mean scores of 69.54 and 60.70, respectively. Well-governed firms are aware of their responsibilities to overall stakeholders. To these ends, many Hong Kong firms recognize their employee obligations and provide long-term incentives for workers through share-option/share-ownership schemes. However, few companies mention their environmental activities. For board responsibilities and composition, all firms issue a board-of-director report. There have been no cases of non-compliance with the Hong Kong Exchange (HKEx) rules during the past two years. However, a significant number of companies do not include the audit committee report in their annual reports.

Firms perform relatively poorly in Section A (rights of shareholders): this section has a mean score of 42.96. Few companies make the minutes of their AGM available to the public. Few companies provide a thorough breakdown of the compensation paid to each board member. Improvement is required in this section.

The results also show that the H-share companies have the lowest CGI scores (mean score = 44.54). The Hang Seng Index constituent stocks perform best (mean score = 52.26), as shown in Panel B of Table 1. The CGI scores grouped by industrial sector are summarized in Panel C of Table 1. Companies in the Finance and Utilities sectors have the highest average scores of 52.86, and companies in the property sector have the lowest average scores of 45.12.

Table 2 shows the descriptive statistics of companies included in our sample. The average firm size is HK\$20,396 million; the return on assets is 4%; the current ratio is 2.05; and the debt-equity ratio is 1.39. On average, the top five shareholders control more than 50% shares of the company. Among these companies, 56 firms have the same person serving as both CEO and board chairman; 134 have an audit committee; 38 have a compensation committee; securities in 91 of them are traded in the US as ADRs; 36 are included in the Morgan Stanley Capital International Index (MSCI) index; and 58 are either H-shares or red chips.

B. Regression Results

Does it pay for companies to practise good corporate governance in Hong Kong? To answer this question, we examine the correlation coefficient between CGI and the market value of Hong Kong companies. This study uses the market-to-book ratio as a proxy for a company's market value. Figure 1 shows the relationship between the CGI and market-to-book ratio of Hong Kong companies. We find a positive and statistically significant correlation between good corporate governance practice and the market-to-book ratio. This implies that companies with higher corporate governance scores tend to have higher market-to-book ratios or vice versa. Our results support the conclusion that good corporate governance is positively related to market value. One potential explanation for this finding is that investors are more likely to invest in companies with better information disclosure and more transparency, since they can gain a better understanding of the current operations and future prospects of these companies, which in turn could lead to higher market values.

The endogeneity problem is always a concern for studies on relationship between firm value and corporate governance attributes (Black, 2001). For example, a firm that practices good corporate governance practice is more likely to have a high profit; it can be the high profit that investors value rather than the corporate governance. To avoid misspecification of the equation used to explain how investors value corporate governance, we include a comprehensive set of control variables to mitigate the omitted-variable bias and the possibility that our results are affected by endogeneity.

Our control variables cover performance (asset size, return on asset); risk factors (debt-equity ratio, current ratio); board characteristics and shareholding structure (the numbers of independent non-executive directors and executive directors and the shareholdings of the top five shareholders); and some corporate governance variables (CEO duality, audit committee, compensation committee, H-shares or red chips, ADR stock, MSCI stock). The set of control variables is listed in Table 4 and the correlation coefficients of these variables are also shown in table.

Table 5 displays regression results for CGI with control variables. We exclude the 19 financial institutions in the sample because of their special capital structure. The

results of the full sample are not reported here, but are similar to those of the non-financial institution sample reported in this study. The first column in Table 5 shows the result of regressing MTBV on CGI. The CGI slope coefficient is 0.0330 and is statistically significant at the 5% level. We progressively add control variables from regressions (2) to (5), and obtain the similar result that CGI is positive and significantly associated with MTBV. The coefficient equals 0.0337 and is significant at the 10% level after including all the control variables. This suggests a 10-point increase in the CGI implies a 33.7% increase in MTBV. A worst-to-best change in CGI, from 32.86 to 76.34, implies a 146.53% increase in MTBV.

C. Results of Control Variables

From regressions (2) to (5) in Table 5, consistent results show that several control variables are important in explaining the variation in MTBV.

ROA

It is reasonable to expect that investors' value listed companies based on their profitability. Therefore, the return on assets (ROA) is likely to be associated with MTBV. In this study, we use ROA as an indicator for firm profitability. We find ROA is positively and significantly related to MTBV in all four regression models (coefficient = 2.2866, $t = 2.25$ with all the control variables). This implies that investors value Hong Kong listed companies based on their profitability.

Firm Size

Black et al. (2003) claim that firm size can plausibly affect both a firm's market value and its governance practices. We follow the common practice of using the natural logarithm of total assets to control for firm size. Consistent with prior research (e.g., Lang and Stulz, 1994), the coefficient on $\ln(TA)$ is significantly negative (coefficient = -0.3583, $t = -3.37$ with all the control variables).

Risk Factors

Both capital structure and leverage can affect a firm's MTBV and CGI. We include the current ratio and debt/equity ratio as control variables. The coefficients are not significant.

Board Structure and Shareholding Structure

Both board structure and shareholding structure are important elements of corporate governance practice. This is particularly important in the case of Hong Kong because most Hong Kong listed companies are dominated by a single person or a family group.⁴ Companies with high proportion of executive directors on the board may be an indicator for bad corporate governance practice and may be undervalued by investors. Companies with a dispersed ownership could be an indicator of good corporate governance practice. However, results become insignificant when all control variables are included.

⁴ In Hong Kong, most listed companies tend to be controlled by families. According to a survey of the ownership structure of 553 listed companies in the economy in 1995 and 1996 (Hong Kong Society of Accountants [HKSA] 1997), 53% have one shareholder or one family group of shareholders owning more than half of the entire issued capital. Control by a single shareholder or family group extends to more than 35% of issued capital in 77% of the companies, and more than 25% of issued capital in 88% of the companies.

Other Governance Practice Dummies

CEO duality, audit committee and compensation committee are considered to be the recommended best practice: however these are not mandatory in Hong Kong. Companies with these practices could send a good signal to investors. The result shows that the relationships between these corporate governance variables and the MTBV are not significant, indicating that these variables are not able to explain the variation in MTBV among Hong Kong companies.

Listing on Foreign Exchanges

Whether companies are also traded in the US market is included as one of the control variables. These dually-listed firms may need to comply with more stringent corporate governance rules, which could be valued by investors. The result does not support this view.

MSCI Stock Index

Another control variable is companies' inclusion in the Morgan Stanley Capital International Index, which is a principal international stock index. The index includes 36 major Hong Kong firms. The result shows a significantly positive relationship (coefficient = 1.4939, $t=3.26$ with all control variables) suggesting that the inclusion in the MSCI index is important for investors.

China-related Firms

We also include a dummy variable to separate China-related firms (H-share or red-chip companies) from Hong Kong firms. Investors may have different criteria for these firms because their core business is in China or they are controlled by Chinese state-owned enterprises. The result is, however, not significant.

D. Regression Result for the Transparency Index

We further decompose the CGI into two components: the transparency index and non-transparency index. Table 6 presents the regression results using these two indices as independent variables. Control variables are progressively added from regression (1) to regression (4). Both the transparency index and the non-transparency index are found to be positive and significantly related to MTBV in models 1 and 2. The non-transparency index is not significant in models 3 and 4 with all control variables. The results are similar to those reported in the previous section: ROA has a positive effect on MTBV; large firms tend to be undervalued; and investors value the firm more if it is included in the MSCI index. The results show that a firm's transparency is important in explaining the variation of MTBV among Hong Kong companies.

Comparison between Mainland-related Firms and Local Firms

China-related companies (H-shares and red chips) have a lower average CGI score. An increasing number of China-related companies have been listed in Hong Kong since Hong Kong's return to China in 1997. On the one hand, the high growth rate of the Chinese economy makes Chinese companies attractive to investors. On the other hand, their corporate governance practice is a matter of concern to investors.

We separate the sample into two sub-samples – China-related and Hong Kong companies – and rerun the regression (with control variables). The MSCI dummy is

not included in the regression model because no China-related companies are included in the MSCI index. The results are presented in Table 7. The CGI score is not statistically significant for local companies. A positive and significant relationship between CGI and MTBV is found for China-related companies (coefficient = 0.0572, $t = 2.40$). This implies that investors value corporate governance more when firms are China-related. Besides overall corporate governance, we find that for China-related companies, firms with more executive directors on the board tend to be undervalued by investors (coefficient = -0.1327, $t = -2.53$). For Hong Kong companies, investors seem to have different criteria, such as firm profitability (coefficient = 4.5531, $t = 2.48$), leverage ratio (coefficient = 0.1882, $t = 3.75$), and the existence of an audit committee (coefficient = 0.5584, $t = 1.69$).

5. Conclusion

This study constructs a CGI to measure the overall corporate governance performance of the 168 largest firms in Hong Kong. Based on Revised OECD Principles of Corporate Governance (OECD, 2004) and the Recommended Best Practices (HKEx, 1999), we develop an instrument to assess firms' corporate governance practice. The instrument consists of five sub-sections, which include shareholders' rights, equitable treatment of shareholders, stakeholders' role, disclosure and transparency, and board responsibilities and composition. A significant and positive relationship is found between CGI and MTBV after taking account of a comprehensive set of control variables. Results show that a worst-to-best change in CGI, from 32.86 to 76.34, implies a 147% increase in MTBV. The transparency-related performance is significant in explaining variations in firm value as well. After comparing the regression results between China-related firms and Hong Kong firms, we find that corporate governance practice matters more for China-related firms.

The major contribution of this study is to construct a corporate governance measure for companies listed in Hong Kong. The result indicates that the market value of Hong Kong listed companies is directly related to their corporate governance indexes. This implies that Hong Kong companies with good corporate governance practices are associated with higher market values. This serves as an important incentive for corporate managers to improve their corporate governance practice. We also find that the average CGI of Hong Kong-based companies is higher than that of China-related companies. The result is reasonable because corporate governance reform in China is a recent phenomenon. More interestingly, investors seem to care more about corporate governance practice among these China-related companies.

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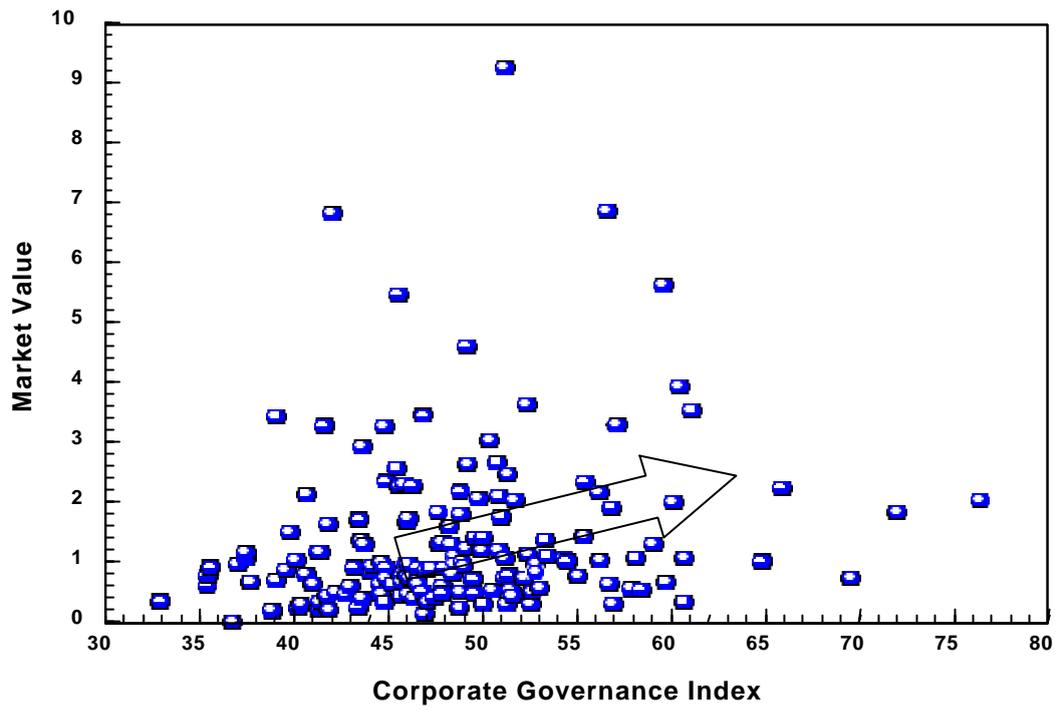


Figure 1: The relationship between the market value and corporate governance index (CGI).The correlation is statistically significant at the 5% level.

Table 1. Descriptive Statistics

Panel A. Descriptive Statistics of CGI and Sub-indices

All the indicis are ranged from 0 to 100

| | Total CGI | Sub-index A | Sub-index B | Sub-index C | Sub-index D | Sub-index E |
|---------------------|--|-------------|-------------|-------------|-------------|-------------|
| Mean | 48.33 | 42.96 | 82.78 | 69.54 | 74.88 | 60.70 |
| Minimum | 32.86 | 27.79 | 63.33 | 41.67 | 64.01 | 41.67 |
| Maximum | 76.34 | 84.49 | 93.33 | 100.00 | 90.33 | 81.67 |
| Standard Deviation | 6.98 | 9.10 | 6.53 | 13.03 | 5.20 | 7.89 |
| No. of Observations | 168 | 168 | 168 | 168 | 168 | 168 |
| Sub-index A | Rights of shareholders | | | | | |
| Sub-index B | Equitable treatment of shareholders | | | | | |
| Sub-index C | Role of stakeholders | | | | | |
| Sub-index D | Disclosure and transparency | | | | | |
| Sub-index E | Board responsibilities and composition | | | | | |

Panel B. CGI by Listig Group

All the indicis are ranged from 0 to 100

| | Total CGI | HSI | HSHKCI | HSCCI | HSCEI |
|---------------------|--|-------|--------|-------|-------|
| Mean | 48.33 | 52.26 | 49.23 | 49.00 | 44.54 |
| Minimum | 32.86 | 35.52 | 35.52 | 40.56 | 32.86 |
| Maximum | 76.34 | 76.34 | 76.34 | 65.83 | 59.01 |
| Standard Deviation | 6.98 | 9.15 | 7.07 | 5.68 | 6.59 |
| No. of Observations | 168 | 33 | 110 | 27 | 31 |
| HSI | Hang Seng Index | | | | |
| HSHKCI | Hang Seng Hong Kong Composite Index | | | | |
| HSCCI | Hang Seng China Affiliated Corporate Index | | | | |
| HSCEI | Hang Seng China Enterprise Index | | | | |

Panel C. CGI by Industry Sector

All the indicis are ranged from 0 to 100

| | Total CGI | Industrial | Properties | Finance | Utilities | Consolidated Enterprises | Hotel & Miscellaneous |
|---------------------|-----------|------------|------------|---------|-----------|-----------------------------|--------------------------|
| Mean | 48.33 | 46.39 | 45.12 | 52.68 | 51.68 | 49.66 | 49.32 |
| Minimum | 32.86 | 32.86 | 35.52 | 40.32 | 36.95 | 35.34 | 39.53 |
| Maximum | 76.34 | 61.05 | 56.87 | 71.96 | 76.34 | 65.83 | 60.65 |
| Standard Deviation | 6.98 | 5.41 | 5.97 | 7.54 | 13.86 | 5.89 | 10.64 |
| No. of Observations | 168 | 62 | 21 | 19 | 9 | 54 | 3 |

Table 2. The Characteristics of Our Sample Companies

| | | All | HSI | HSHKCI | HSCCI | HSCEI |
|--|---------------------------|-----------|------------|-----------|-----------|----------|
| Market Value | | | | | | |
| (in million HK\$) | Mean | 20,395.87 | 88,227.87 | 27,870.77 | 25,754.78 | 3,920.87 |
| | S.D. | 76,356.70 | 156,370.02 | 90,962.89 | 80,826.03 | 5,899.57 |
| ROA | | | | | | |
| | Mean | 0.04 | 0.07 | 0.04 | 0.05 | 0.05 |
| | S.D. | 0.10 | 0.07 | 0.12 | 0.10 | 0.04 |
| Ln(TA) | | | | | | |
| | Mean | 16.18 | 17.88 | 16.16 | 16.04 | 16.63 |
| | S.D. | 1.66 | 1.58 | 1.85 | 1.26 | 1.19 |
| Current | | | | | | |
| | Mean | 2.05 | 1.61 | 2.11 | 1.89 | 2.03 |
| | S.D. | 1.68 | 0.95 | 1.47 | 1.06 | 2.39 |
| D/E | | | | | | |
| | Mean | 1.39 | 1.92 | 1.61 | 0.98 | 0.79 |
| | S.D. | 2.23 | 3.59 | 2.61 | 0.69 | 0.79 |
| No. of firms with the committee | | | | | | |
| | Dummy CEO & Chairman | 56.00 | 13.00 | 43.00 | 8.00 | 8.00 |
| | Dummy Audit committee | 134.00 | 30.00 | 99.00 | 24.00 | 17.00 |
| | Dummy Compensation | 38.00 | 12.00 | 30.00 | 4.00 | 8.00 |
| | Dummy ADR | 91.00 | 28.00 | 63.00 | 11.00 | 22.00 |
| | Dummy MSCI | 36.00 | 22.00 | 36.00 | - | - |
| | Dummy H Share & Red Chips | 58.00 | 6.00 | 6.00 | 27.00 | 31.00 |

Table 3. Variables Definitions

This table provides a brief description of the variables used in the paper. Accounting data and firm performance information are downloaded from DataStream and Bloomberg. Refer to the firm performance variables, we take geometric average of monthly data based on firms' fiscal date; for accounting variables, we use annual data on firms' fiscal year.

| Variables | Description |
|---------------------------|---|
| CGI | Corporate Governance Index constructed based on OECD principles. |
| TINDEX | Transparency Index constructed based on all disclosure related questions in the survey. |
| NONTINDEX | Non-transparency Index constructed based on non-disclosure related questions. |
| MTBV | Defined as market value of common stock/ book value of common stock. We drop 2 firms with negative book value of common stock |
| ROA | Return on Asset |
| Ln(TA) | Natural Log of Total Asset |
| Current | Current Ratio |
| D/E | Debt to Equity Ratio |
| BOUT | Number of out-sider directors in the board (Including independent non-executive directors, non-executive directors and honorable directors) |
| BEXC | Number of Executive Directors in the board |
| Top5 | Percentage of total outstanding shares held by five largest shareholders |
| Dummy CEO& Chairman | Whether CEO of the firm and Chairman of the board is the same person. 1 is yes, 0 is no. |
| Dummy Audit Committee | Whether the firm has Audit Committee. 1 is yes, 0 is no. |
| Dummy Compensation | Whether the firm has Compensation Committee. 1 is yes, 0 is no. |
| Dummy H Share / Red Chips | Whether the firm belongs to H Share / Red Chips. 1 is yes, 0 is no. |
| Dummy ADR | Whether the firm is available for American Depository Receipts (ADRs) trading. 1 is yes, 0 is no. |
| Dummy MSCI | Whether the firm is in Morgan Stanley Capital International Index. 1 is yes, 0 is no. |

Table 4. Correlation Matrix of All Variables

This table provides correlation coefficients between dependent variables, independent variables and control variables
 Statistically significant correlations (at 5% level or better) are shown in bold.

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 | 13 | 14 | 15 |
|-------------|---------------|---------------|---------------|--------|---------------|---------------|---------------|---------------|---------------|--------|--------|---------------|--------|--------|-------|
| 1 Total CGI | 1.000 | | | | | | | | | | | | | | |
| 2 mtbv | 0.131 | 1.000 | | | | | | | | | | | | | |
| 3 ln(TA) | 0.196 | -0.282 | 1.000 | | | | | | | | | | | | |
| 4 roa | 0.084 | 0.305 | -0.056 | 1.000 | | | | | | | | | | | |
| 5 current | -0.062 | 0.131 | -0.386 | 0.139 | 1.000 | | | | | | | | | | |
| 6 bexc | -0.151 | -0.248 | 0.258 | 0.020 | -0.180 | 1.000 | | | | | | | | | |
| 7 bout | 0.355 | 0.043 | 0.460 | 0.027 | -0.067 | -0.190 | 1.000 | | | | | | | | |
| 8 top_5 | -0.116 | -0.093 | 0.097 | 0.005 | -0.154 | 0.067 | -0.190 | 1.000 | | | | | | | |
| 9 dummya | 0.370 | 0.040 | 0.025 | -0.056 | 0.082 | -0.004 | 0.147 | -0.118 | 1.000 | | | | | | |
| 10 dummyc | 0.556 | 0.135 | 0.203 | 0.138 | -0.091 | -0.203 | 0.186 | -0.096 | 0.272 | 1.000 | | | | | |
| 11 dummycc | -0.037 | 0.079 | -0.048 | 0.016 | -0.025 | -0.130 | -0.102 | -0.016 | -0.052 | 0.040 | 1.000 | | | | |
| 12 dummysc | 0.227 | 0.169 | 0.392 | 0.088 | -0.088 | -0.072 | 0.402 | -0.321 | 0.010 | 0.134 | 0.062 | 1.000 | | | |
| 13 dummyADR | 0.107 | -0.096 | 0.436 | 0.045 | -0.130 | 0.025 | 0.314 | 0.002 | -0.017 | 0.126 | 0.068 | 0.247 | 1.000 | | |
| 14 dummyhr | -0.179 | -0.127 | 0.078 | 0.073 | -0.043 | 0.255 | -0.205 | 0.291 | -0.164 | -0.033 | -0.089 | -0.379 | 0.040 | 1.000 | |
| 15 D/E | 0.085 | 0.302 | 0.245 | -0.037 | -0.025 | -0.030 | 0.212 | 0.078 | 0.014 | 0.142 | -0.150 | 0.066 | -0.026 | -0.049 | 1.000 |

Table 5. OLS Results for CGI with Control Variables

The regression model has the market to book value (MTBV) of all companies as the dependent variable. The independent variables are corporate governance index (CGI), return on asset (ROA), natural log of total asset (Ln(TA)), current ratio (Current), debt-equity ratio (D/E), number of out-side directors in the board (BOUT), number of executive directors in the board (BEXC), percentage of total outstanding shares held by five largest shareholders (Top5) and other dummy variables.

T-statistics, based on White's Heteroskedasticity-Consistent Standard Errors & Covariance, are reported in parentheses.

* represents significance level at 10% (two-tailed test), ** represents significance level at 5% (two-tailed test),

*** represents significance level at 1% (two-tailed test).

| | MTBV | | | | |
|---------------------------|--------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | (1) | (2) | (3) | (4) | (5) |
| CGI | 0.0330** (1.98) | 0.0428** (2.51) | 0.0475*** (2.86) | 0.0356** (2.47) | 0.0337** (1.98) |
| ROA | | 2.5282** (2.45) | 3.0430*** (2.67) | 3.0431*** (2.67) | 2.2866** (2.25) |
| Ln(TA) | | -0.3081*** (-4.90) | -0.2043** (-2.56) | -0.2209** (-2.45) | -0.3583*** (-3.37) |
| Current | | -0.042 (-0.79) | -0.0317 (-0.71) | -0.0209 (-0.47) | 0.0098 (0.23) |
| D/E | | -0.0441 (-0.44) | -0.0190 (-0.18) | 0.0347 (0.32) | 0.1423 (1.22) |
| BOUT | | | -0.0249 (-0.51) | -0.0070 (-0.13) | -0.0193 (-0.38) |
| BEXC | | | -0.1089*** (-2.97) | -0.0941** (-2.31) | -0.0622 (-1.39) |
| Top5 | | | -0.0128*** (-2.85) | -0.0126*** (-2.70) | -0.0011 (-0.17) |
| Dummy CEO & Chairman | | | | 0.1837 (0.80) | 0.1738 (0.85) |
| Dummy Audit committee | | | | 0.1353 (0.73) | 0.2321 (1.31) |
| Dummy Compensation | | | | 0.2794 (0.81) | 0.3000 (0.90) |
| Dummy ADR | | | | | -0.1421 (-0.61) |
| Dummy MSCI | | | | | 1.4939*** (3.26) |
| Dummy H Share & Red Chips | | | | | 0.3374 (1.65) |
| Adjusted R-squared | 0.0258 | 0.1867 | 0.2653 | 0.2589 | 0.3816 |
| F-Stat | 4.87** | 6.60*** | 6.37*** | 4.78*** | 6.24*** |

Table 6. OLS Results for Transparency Index with Control Variables

The regression model has the market to book value (MTBV) of all companies as the dependent variable. The independent variables are transparency index (TINDEX), non-transparency index (NONTINDEX), return on asset (ROA), natural log of total asset (Ln(TA)), current ratio (Current), debt-equity ratio (D/E), number of out-side directors in the board (BOUT), number of executive directors in the board (BEXC), percentage of total outstanding shares held by five largest shareholders (Top5) and other dummy variables.

T-statistics, based on White's Heteroskedasticity-Consistent Standard Errors & Covariance, are reported in parentheses.

* represents significance level at 10% (two-tailed test), ** represents significance level at 5% (two-tailed test),

*** represents significance level at 1% (two-tailed test).

| | MTBV | | | |
|---------------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | (1) | (2) | (3) | (4) |
| TINDEX | 0.0371** (2.32) | 0.0414** (2.45) | 0.0373** (2.56) | 0.0388*** (2.80) |
| NONTINDEX | 0.0179* (1.81) | 0.0202** (2.19) | 0.0136 (1.47) | 0.0108 (0.89) |
| ROA | 2.3482** (2.30) | 2.8850*** (2.63) | 2.8973*** (2.63) | 2.1137** (2.15) |
| Ln(TA) | -0.3414*** (-4.85) | -0.2419*** (-2.72) | -0.2540** (-2.60) | -0.3850*** (-3.60) |
| Current | -0.0575 (-1.05) | -0.0496 (-1.08) | -0.0416 (-0.92) | -0.0108 (-0.25) |
| D/E | -0.0589 (-0.58) | -0.0319 (-0.29) | 0.0164 (0.15) | 0.1205 (1.08) |
| BOUT | | -0.0277 (-0.56) | -0.0106 (-0.19) | -0.0267 (-0.54) |
| BEXC | | -0.1046*** (-2.87) | -0.0902** (-2.23) | -0.0558 (-1.27) |
| Top5 | | -0.0140*** (-3.10) | -0.0138*** (-2.94) | -0.0017 (-0.27) |
| Dummy CEO & Chairman | | | 0.2084 (0.91) | 0.1935 (0.95) |
| Dummy Audit committee | | | 0.1642 (0.88) | 0.2637 (1.51) |
| Dummy Compensation | | | 0.1997 (0.59) | 0.2254 (0.68) |
| Dummy ADR | | | | -0.1382 (-0.61) |
| Dummy MSCI | | | | 1.4847*** (3.30) |
| Dummy H Share & Red Chips | | | | 0.2346 (1.14) |
| Adjusted R-squared | 0.1896 | 0.2734 | 0.2661 | 0.3943 |
| F-Stat | 5.76*** | 5.97*** | 4.60*** | 6.16*** |

Table 7. Comparison of OLS Results between Mainland-related Firms and Local Firms

The regression model has the market to book value (MTBV) of all companies as the dependent variable. The independent variables are corporate governance index (CGI), return on asset (ROA), natural log of total asset (Ln(TA)), current ratio (Current), debt-equity ratio (D/E), number of out-side directors in the board (BOUT), number of executive directors in the board (BEXC), percentage of total outstanding shares held by five largest shareholders (Top5) and other dummy variables. We separate the regression on China-related Firms and Hong Kong local firms.

T-statistics, based on White's Heteroskedasticity-Consistent Standard Errors & Covariance, are reported in parentheses.

* represents significance level at 10% (two-tailed test), ** represents significance level at 5% (two-tailed test),

*** represents significance level at 1% (two-tailed test).

| | MTBV | |
|-----------------------|----------------------|---------------------|
| | China-related Firms | Local Firms |
| CGI | 0.0572** (2.40) | 0.0273 (0.99) |
| ROA | 1.1930 (0.33) | 4.5531** (2.48) |
| Ln(TA) | -0.0318 (-0.45) | 0.0662 (0.53) |
| Current | 0.0704 (1.36) | 0.1208 (1.25) |
| D/E | 0.1192 (1.12) | 0.1882*** (3.75) |
| BOUT | -0.0309 (-0.84) | -0.0601 (-0.55) |
| BEXC | -0.1327** (-2.53) | -0.1401 (-1.21) |
| Top5 | -0.0051 (-1.15) | -0.0111 (-1.31) |
| Dummy CEO & Chairman | 0.1984 (0.88) | 0.1391 (0.3) |
| Dummy Audit committee | -0.0322 (-0.18) | 0.5584* (1.69) |
| Dummy Compensation | 0.0791 (0.33) | 0.3003 (0.48) |
| Dummy ADR | -0.1142 (-0.60) | -0.5526 (-1.36) |
| Adjusted R-squared | 0.3057 | 0.3015 |
| F-Stat | 2.60** | 4.13*** |

Appendix I --- List of Sample Firms

Allied Group (373)

Allied Ppt (HK) (56)

CKI Holdings (1038)

CLP Holdings (2)

HK&S Hotels (45)

HKEx (388)

| | | |
|------------------------|------------------------|-----------------------|
| Angang Newsteel (347) | CNAC (1110) | HKR Int'l (480) |
| Anhui Conch (914) | CNOOC (883) | Hopewell Hold (54) |
| Anhui Expressway (995) | CNPC (Hong Kong) (135) | HSBC Holdings (5) |
| Artel Group (931) | COFCO Intl (506) | Huadian Power (1071) |
| Asia Satellite (1135) | COSCO Intl Hold (517) | Huaneng Power (902) |
| ASM Pacific (522) | COSCO Pacific (1199) | Hung Hing Print (450) |
| Bank of E Asia (23) | Culturecom Hold (343) | Hutch Harb Ring (715) |
| Beijing Airport (694) | Dah Sing (440) | Hutchison (13) |
| Beijing Ent (392) | Datang Power (991) | Hysan Dev (14) |
| Beijing N Star (588) | Denway Motors (203) | i-Cable Comm (1097) |
| Beijing Yanhua (325) | Digital China (861) | ICBC (Asia) (349) |
| BOC Hong Kong (2388) | Dream Int'l (1126) | IDT Int'l (167) |
| Brilliance Chi (1114) | E&E Int'l (33) | Interchina Hold (202) |
| BYD Company (1211) | Eganagoldpfeil (48) | Intl Bk of Asia (636) |
| Cafe De Coral H (341) | Esprit Holdings (330) | JCG Holdings (626) |
| Cathay Pac Air (293) | First Pacific (142) | Jiangsu Express (177) |
| Chalco (2600) | Fong's Ind (641) | Jiangxi Copper (358) |
| Cheung Kong (1) | Forefront Int'l (885) | Johnson Elec H (179) |
| China Aerospace (31) | Founder Hold (418) | K M Bus Hold (62) |
| China East Air (670) | Fountain Set (420) | K. Wah Int'l (173) |
| China EB Ltd (165) | Giordano Int'l (709) | Kerry Ppt (683) |
| China Insurance (966) | Glorious Sun (393) | Kingmaker (1170) |
| China Mer Hold (144) | Great Eagle H (41) | LCH Bank (1111) |
| China Mobile (941) | Guangdong Inv (270) | Lenovo Group (992) |
| China Oilfield (2883) | Guangnan (Hold) (1203) | Lerado Group (1225) |
| China Overseas (688) | Guangshen Rail (525) | Li & Fung (494) |
| China Pharma (1093) | Guangzhou Inv (123) | Linmark Group (915) |
| China Res Land (1109) | Guoco Group (53) | Lippo China Res (156) |
| China Res Logic (1193) | GZI Transport (1052) | Maanshan Iron (323) |
| China Resources (291) | HAECO (44) | Moulin Int'l (389) |
| China Ship Dev (1138) | Hang Lung Group (10) | MTR Corporation (66) |
| China South Air (1055) | Hang Lung Ppt (101) | New Asia Realty (49) |
| China Telecom (728) | Hang Seng Bank (11) | New World Dev (17) |
| China Travel HK (308) | Henderson Inv (97) | Next Media (282) |
| China Unicom (762) | Henderson Land (12) | Ngai Lik Ind (332) |
| Chinese Est H (127) | HK & China Gas (3) | Oriental Press (18) |
| CIFH (183) | HK Chinese Ltd (655) | Pac Centry Ins (65) |
| Citic Pacific (267) | HK Electric (6) | PCCW (8) |
| PetroChina (857) | Singamas Cont (716) | Truly Int'l (732) |
| Qingling Motors (1122) | Sino Land (83) | Tsingtao Brew (168) |
| QPL Int'l (243) | Sino-I Tech (250) | TVB (511) |
| RoadShow (888) | Sinopec Corp (386) | Varitronix Intl (710) |

| | | |
|------------------------|-----------------------|------------------------|
| SaSa Int'l (178) | Sinopec Kantons (934) | Vitasoy Int'l (345) |
| SCMP Group (583) | Smartone Tele (315) | Vtech Holdings (303) |
| Shanghai Ind H (363) | SW Kingsway (188) | Wharf Holdings (4) |
| Shanghai Pechem (338) | Swire Pacific A (19) | Wheelock (20) |
| Shangri-la Asia (69) | Swire Pacific B (87) | Wing Hang Bank (302) |
| Shenzhen Express (548) | TCC Int'l Hold (1136) | Wing Lung Bank (96) |
| Shenzhen Int'l (152) | TCL Int'l Hold (1070) | Wong's Int'l (99) |
| Shenzhen Invest (604) | Techtronic Ind (669) | Yanzhou Coal (1171) |
| SHK Ppt (16) | Texwinca Hold (321) | Yizheng Chem (1033) |
| Shui On Cons (983) | Tianjin Dev (882) | Yue Yuen Ind (551) |
| Shun Tak Hold (242) | TPV Technology (903) | Zhejiang Express (576) |
| Silver Grant (171) | Travelsky Tech (696) | Zhenhai Refin (1128) |

Appendix II – Survey Questionnaire

Question Number

Survey Question

Section A -- Rights of Shareholders

- A.1 Does the company offer other ownership rights beyond voting (such as share repurchases or dividends)?
- A.2 Is the decision on the remuneration of board members or executives approved by the shareholders annually?
- A.3 How is the remuneration of the board presented?
- A.4 Assess the content and quality of the notice to call the shareholders meeting (such as appointments of directors, auditors).
- A.5 Did the Chairman of the Board attend last AGM?
- A.6 Did the CEO/Managing Director attend last AGM, including a list of board attendance?
- A.7 Do AGM minutes record that there was an opportunity for shareholders to ask questions/ raise issues in the past one year?
- A.8 Does the company have anti-takeover defenses such as board ownership, cross- or pyramid shareholding?

Section B -- Equitable Treatment of Shareholders

- B.1 Does the company offer one-share, one-vote?
- B.2 Is there any mechanism to allow minority shareholders to influence board composition?
- B.3 Have there been any cases of insider trading involving company directors and management in the past two years?
- B.4 Does the company provide rationales/explanations for related-party transactions affecting the corporation?
- B.5 Is the company a part of an economic group where the parent/controlling shareholder also controls key suppliers, customers, and/or similar businesses?
- B.6 Has there been any non-compliance case regarding related-party transactions in the past two years?
- B.7 Does the company facilitate voting by proxy?
- B.8 Does the notice to shareholders specify the documents and/or notarization required to give proxy?
- B.9 How many days in advance does the company send out the notice of general shareholder meetings?

Section C -- The Role of Stakeholders in Corporate Governance

- C.1 Does the company explicitly mention the safety and welfare of its employees?
- C.2 Does the company explicitly mention the role of key stakeholders such as customers or the community at large (or creditors or suppliers)?
- C.3 Does the company explicitly mention environmental issues in its public communications?
- C.4 Does the company provide an ESOP (employee share option program), or other long-term employee incentive plan linked to shareholder value creation, to employees?

Section D -- Disclosure and Transparency

- D.1 Does the company have a transparent ownership structure?
- D.2 Does the company have a dispersed ownership structure?
- D.3 Is the company's actual ownership structure obscured by cross-shareholdings?
- D.4 Assess the quality of the annual report (financial performance, board members and compensation, etc.).
- D.5 Is there any statement requesting the directors to report their transactions of company stock?
- D.6 Does the company use an internationally recognized accounting standard?
- D.7 Does the company have an internal audit operation established as a separate unit in the company?
- D.8 Does the company perform an annual audit using independent and reputable auditors?
- D.9 Are there any accounting qualifications in the audited financial statements apart from the qualification on Uncertainty of Situation?
- D.10 Does the company offer multiple channels of access to information? (annual report, website, press and analyst briefings)?
- D.11 Is the financial report disclosed in a timely manner?
- D.12 Does the company have a website, disclosing up-to-date information?

Section E -- Responsibilities of the Board

**Question
Number**

Survey Question

- E1.1 Does the company have its own written corporate governance rules?
- E1.2 Does the board of directors provide a code of ethics or statement of business conduct for all directors and employees?
- E1.3 Does the company have a corporate vision/mission?
- E.2 Does the regulatory agency have any evidence of the firm's non-compliance with rules and regulations over the last three years?
- E.3 Assess the quality and content of the Audit Committee Report in the annual report.
- E.4 Have board members participated in the Hong Kong Institute of Directors (or equivalent) training on corporate governance?
- E.5 How many board meetings are held per year?
- E.6 Is the chairman an independent director? Is the chairman also the CEO?
- E.7 Does the company have an option scheme which incentivizes top management?
- E.8 Does the board appoint independent committees with independent members to carry out various critical responsibilities such as: audit, compensation and director nomination?
- E.9 What is the size of the board?
- E.10 How many board members are non-executive directors?
- E.11 Does company state in its annual report the definition of 'independence'?
- E.12 Among directors, how many are independent directors?
- E.13 Does the company provide contact details for a specific investor relations person?
- E.14 Does the company have a board of directors report?
- E.15 Does the company disclose how much they paid the independent non-executive directors?
- E.16 Do the company provide training to directors (including executive and nonexecutive directors)?