

# Hong Kong

# Capital Markets Update

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## HKEx Analysis of Corporate Governance Practice Disclosure in 2014 Annual Reports

On 27 November 2015, The Stock Exchange of Hong Kong Limited (the "Exchange") published a report entitled "[Analysis of Corporate Governance Practice Disclosure in 2014 Annual Reports](#)" (the "Report") as a result of its' review of issuers' compliance with the Corporate Governance Code and Corporate Governance Report (the "Code"), which involved analysing the disclosures made by 1,237 issuers in their 2014 annual reports (the "2014 Review").

### Key findings:

#### 1. Issuers continued to demonstrate a high degree of compliance with Code Provisions ("CPs")

The 2014 Review revealed that 35% of the issuers reported full compliance with all CPs (i.e. subject to 'comply or explain') and 98% of issuers complied with 70 or more CPs out of 75. Please refer to the next section for details of the 5 CPs with the lowest compliance rates.

#### 2. Issuers with a larger market capitalisation achieved an overall higher compliance rate than those with a smaller market capitalisation

Issuers are categorised into three different groups according to the market capitalisation for further analysis and it was noted that the percentage of full compliance with CPs for large-cap (>\$4.2 billion), mid-cap (>\$0.7 & ≤4.2 billion) and smaller-cap (≤\$0.7 billion) issuers were 38.1%, 36.2% and 28.6%, respectively. The relatively lower full compliance rate by smaller-cap issuers is an indicative of resource constraints faced by these issuers.

#### 3. Overall compliance rate was higher for Hang Seng Index ("HSI") companies

The Exchange also analysed the overall compliance rates of issuers by comparing the compliance rates of HSI companies and non-HSI companies and noted that the overall compliance rate of HSI companies was higher than that of non-HSI companies.

#### 4. Disclosures of policy on board diversity in the Corporate Governance Report

Notwithstanding 99% of the issuers reported they have complied with the CP on board diversity, the Exchange noted a few omissions of the required disclosures further to their sample examinations of the actual disclosures by issuers. The Exchange indicated they will continue to monitor the reporting by issuers in this regard.



## Our Recommendations

Issuers are recommended to review their own CPs compliance status and take appropriate actions to rectify deviations, if any. Some deviations from the CPs is permissible, so long as the reasons for doing so are clearly explained and the underlying principle is met.

Issuers are also recommended to assess the impact of the upgrades of certain current recommended best practices (RBPs) on internal controls to CPs effective the accounting periods beginning on or after 1 January 2016. Summary of the key amendments can be referred to in the appendix. In particular, issuers should have an internal audit function or otherwise should review the need for one on an annual basis and should disclose the reasons for the absence of such a function in their corporate governance report. The Exchange clarified that outsourcing of the internal audit function to competent persons do not constitute a deviation from the CP.

**The Five CPs with the lowest compliance rates**

<b>A.2.1</b>	Separation of the roles of chairman and chief executive	The roles of chairman and chief executive should be separated and should not be performed by the same individual. The division of responsibilities between the chairman and chief executive should be clearly established and set out in writing.
<b>A.6.7</b>	Non-executive directors' attendance at general meetings	Independent non-executive directors and other non-executive directors, as equal board members, should give the board and any committees on which they serve the benefit of their skills, expertise and varied backgrounds and qualifications through regular attendance and active participation. They should also attend general meetings and develop a balanced understanding of the views of shareholders.
<b>A.4.1</b>	Non-executive directors being appointed for a specific term, subject to re-election	Non-executive directors should be appointed for a specific term, subject to re-election.
<b>E.1.2</b>	Chairman's attendance at annual general meeting ("AGM")	The chairman of the board should attend the annual general meeting. He should also invite the chairmen of the audit, remuneration, nomination and any other committees (as appropriate) to attend. In their absence, he should invite another member of the committee or failing this his duly appointed delegate, to attend. These persons should be available to answer questions at the annual general meeting. The chairman of the independent board committee (if any) should also be available to answer questions at any general meeting to approve a connected transaction or any other transaction that requires independent shareholders' approval.
<b>A.5.1</b>	Establishment of a nomination committee which is chaired by the chairman of the board or an independent non-executive director	Issuers should establish a nomination committee which is chaired by the chairman of the board or an independent non-executive director and comprises a majority of independent non-executive directors.

The Exchange reminded shareholders and market practitioners that deviations from CPs are acceptable where an issuer considers the adoption of an alternative to a CP is more suitable in light of its own situation and disclose the reasons for departures in its corporate governance report.

The Exchange further noted that while issuers have disclosed the reasons for departures from the CPs, there is room for improvement in disclosing the reasons for departures. In particular, issuers should avoid using vague and repeated "boilerplate" style of explanations. Issuers are expected to explain in their reports the reasons for the departures based on their own circumstances, whether the departures are temporary and what would be/have been done to rectify the deviation.

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If you have any questions about the matters discussed in this publication, please feel free to contact Paul Lau or Katharine Wong of our Capital Markets Advisory Group.

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## Summary of key amendments to the Code effective for accounting periods beginning on or after 1 January 2016

### I. Risk management and internal control

- Risk management is incorporated into the Code where appropriate.

### II. Responsibilities of the board and management

- The roles and responsibilities of the board and management are clarified.
- The board is responsible for "determining" as well as evaluating the risks it is willing to take to achieve the issuer's objectives and to ensure the establishment and maintenance of effective risk management and internal control systems.
- The management is responsible for designing, implementing and monitoring the risk management and internal control systems. The management should also provide "confirmation" to the board on the effectiveness of the systems.

### III. Annual review and disclosure in Corporate Governance Report

- Upgrade to a CP the existing recommended best practice (RBP) which sets out the matters that the board's annual review should consider. Matters to consider by the board include the listed issuer's ability to respond to changes in its business and external environment; the scope and quality of management's ongoing monitoring of risk and the internal control system; the extent and frequency of communication of monitoring results to the board; significant control failures or weaknesses that have been identified during the period; and the effectiveness of the listed issuer's processes for financial reporting.
- Upgrade to a CP the existing RBP regarding disclosure of the issuers' process used to identify, evaluate and manage significant risks; review the effectiveness of the risk management and internal control systems; and resolve material internal control defects in the CGR.
- Amend an existing CP to require the board to oversee the listed issuer's management and internal controls systems on an ongoing basis, so that such on-going responsibility is not discharged by an one-off annual review.

### IV. Internal audit

- Upgrade of the existing RBP to a CP and amend it to state that listed issuers should have an internal audit function. If the listed issuer does not have an internal audit function, the listed issuer should review the need for one on an annual basis and disclose the reasons for the absence of such function in the CGR.
- Amend the existing CP to extend the board's annual review to ensure the adequacy of resources, staff qualifications and experience, training programmes and budget of the listed issuer's internal audit function, in addition to its accounting and financial reporting function.

### V. Audit committee's role

- Under the current provisions of the Code, the audit committee is responsible for the review of the listed issuer's financial information and the oversight of the listed issuer's financial reporting system and internal control procedures. Under the revised Code, the audit committee's responsibilities are extended to incorporate risk management responsibilities.