

Effective Corporate Governance in Asia

Panelist: Joseph P.H. Fan

Professor of Accountancy and Finance
Deputy Director, Center for
Institutions and Governance
Chinese University of
Hong Kong

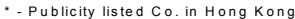
**Prepared for panel discussion at the APEC High Level
Conference on Structural Reform, September 8-9, 2004,
Tokyo**

Outline

- Why some Asian companies failed to produce reliable financial information?
- Auditor, audit committee, and audit supervisory agency
- Self-enforcement: the importance of reputation building in weak institutional environments
- Ultimate solution: institutional reforms

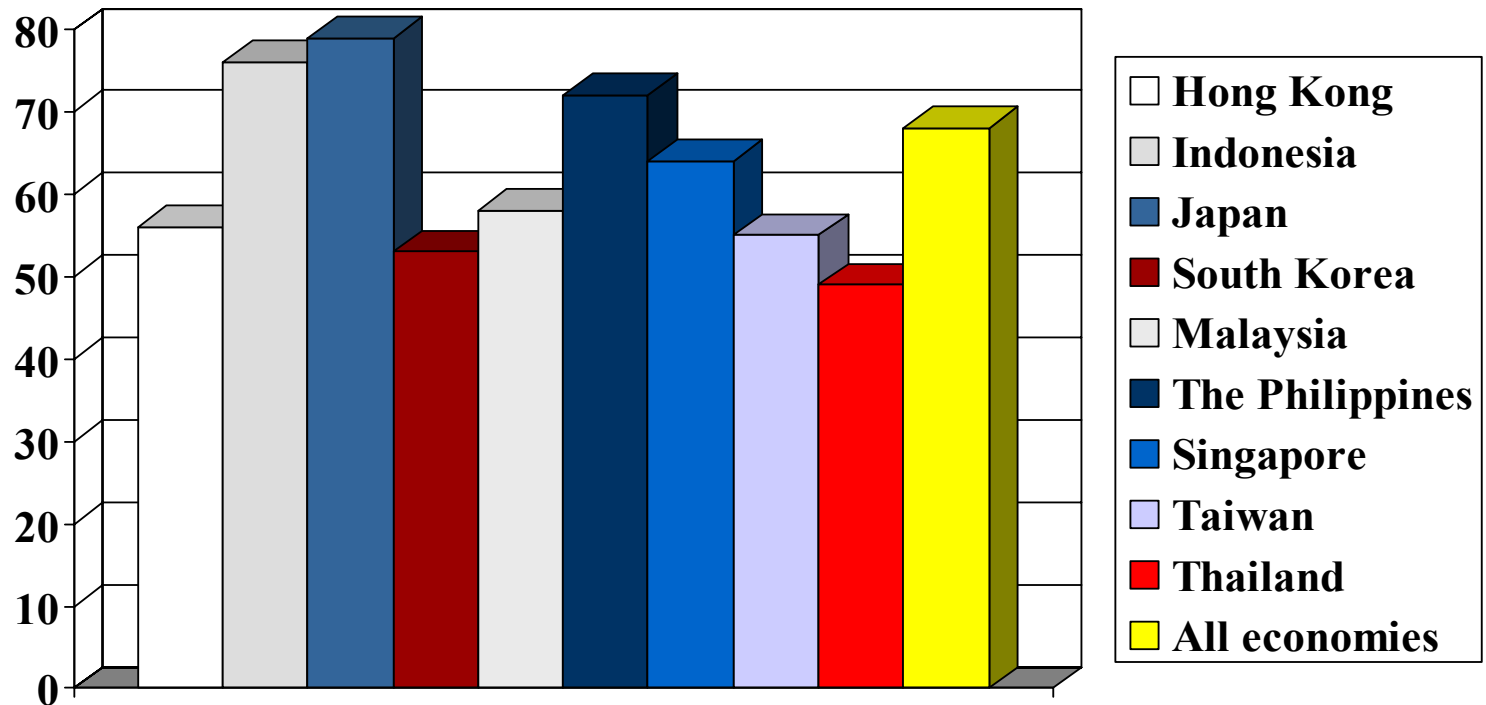
Why some Asian companies failed to produce reliable financial information?

- **Complex organizational and ownership structures**
- Covering up: difficulties of putting investors' interests before family interest
- Relationship-based business dealings, rent seeking, or even corruption
- Prevent predation and expropriation (sometimes by governments) in weak property rights systems
- If these institutional constraints cannot be relieved, it would be difficult to improve corporate transparency even with new accounting standards, laws, and regulations

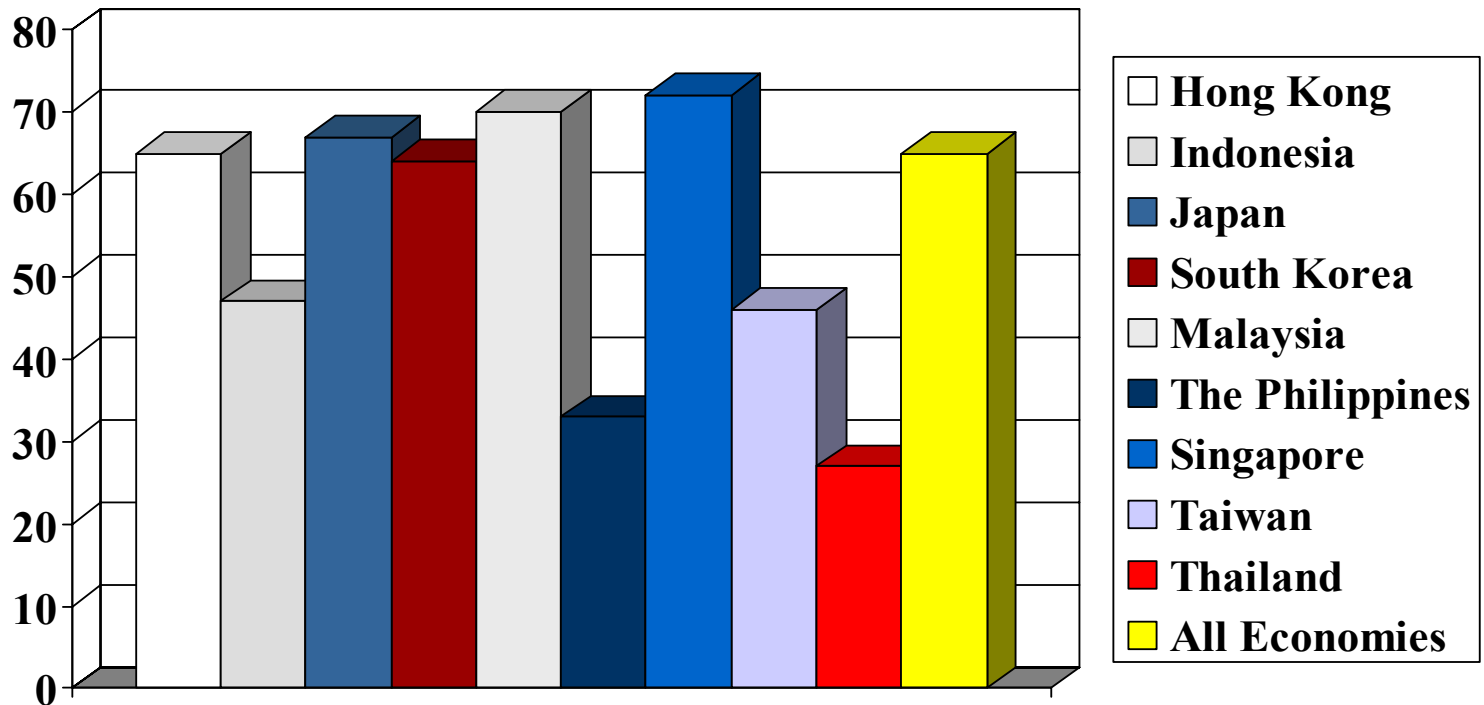


Percentage of listed Asian companies affiliated with business groups

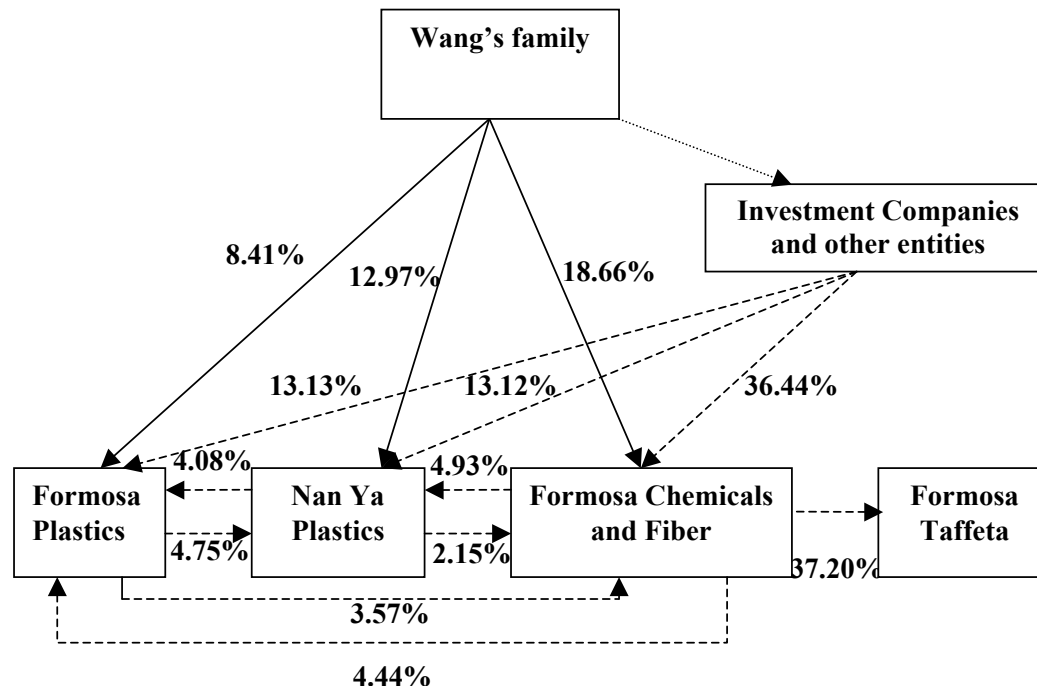
(Source: Claessens, Fan, Lang, 2002)



Percentage of listed companies that are diversified (with multiple segments)



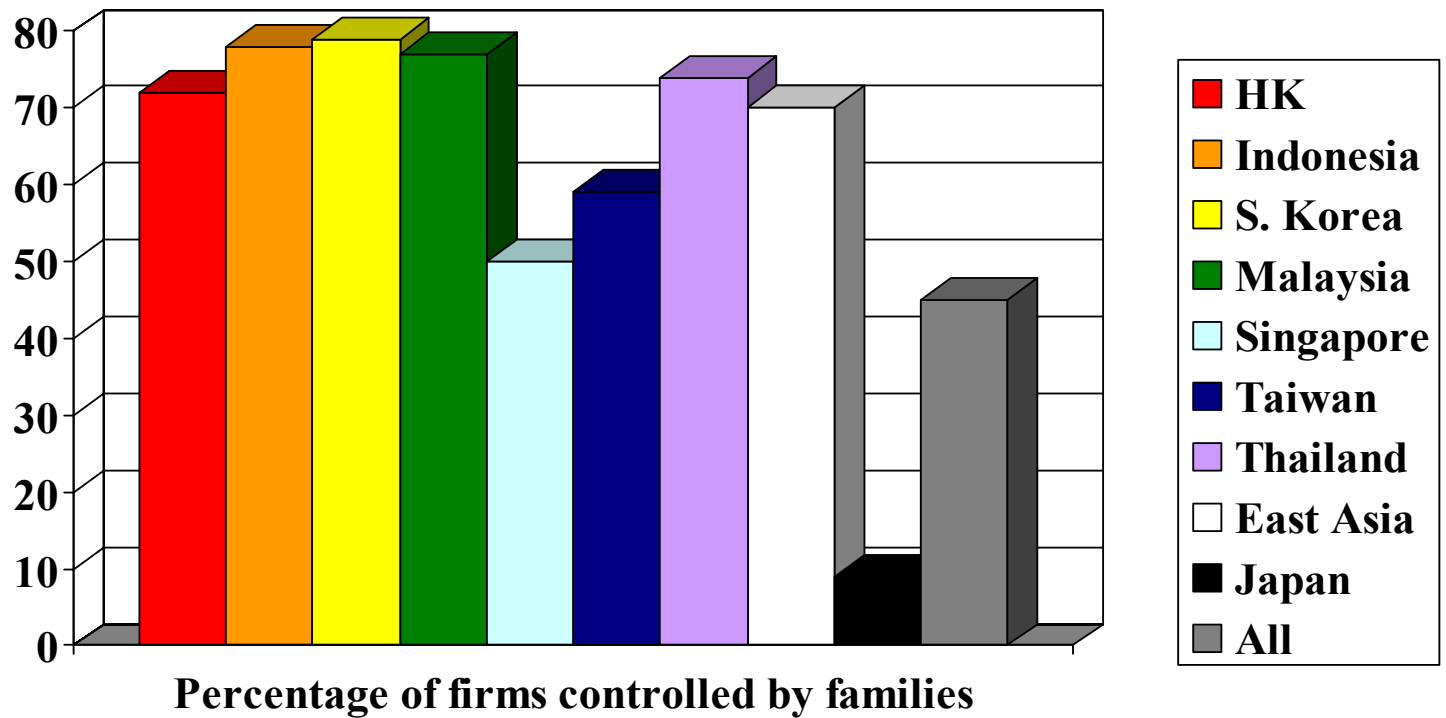
The Formosa Group (Taiwan) of the Wang's Family



Why some Asian companies failed to produce reliable financial information?

- Complex organizational and ownership structures
- Covering up: difficulties of putting investors' interests before family interest
- Relationship-based business dealings, rent seeking, or even corruption
- Prevent predation and expropriation (sometimes by governments) in weak property rights systems
- If these institutional constraints cannot be relieved, it would be difficult to improve corporate transparency even with new accounting standards, laws, and regulations

Family control



Asia's corporate governance problems are often induced by country level institutional constraints

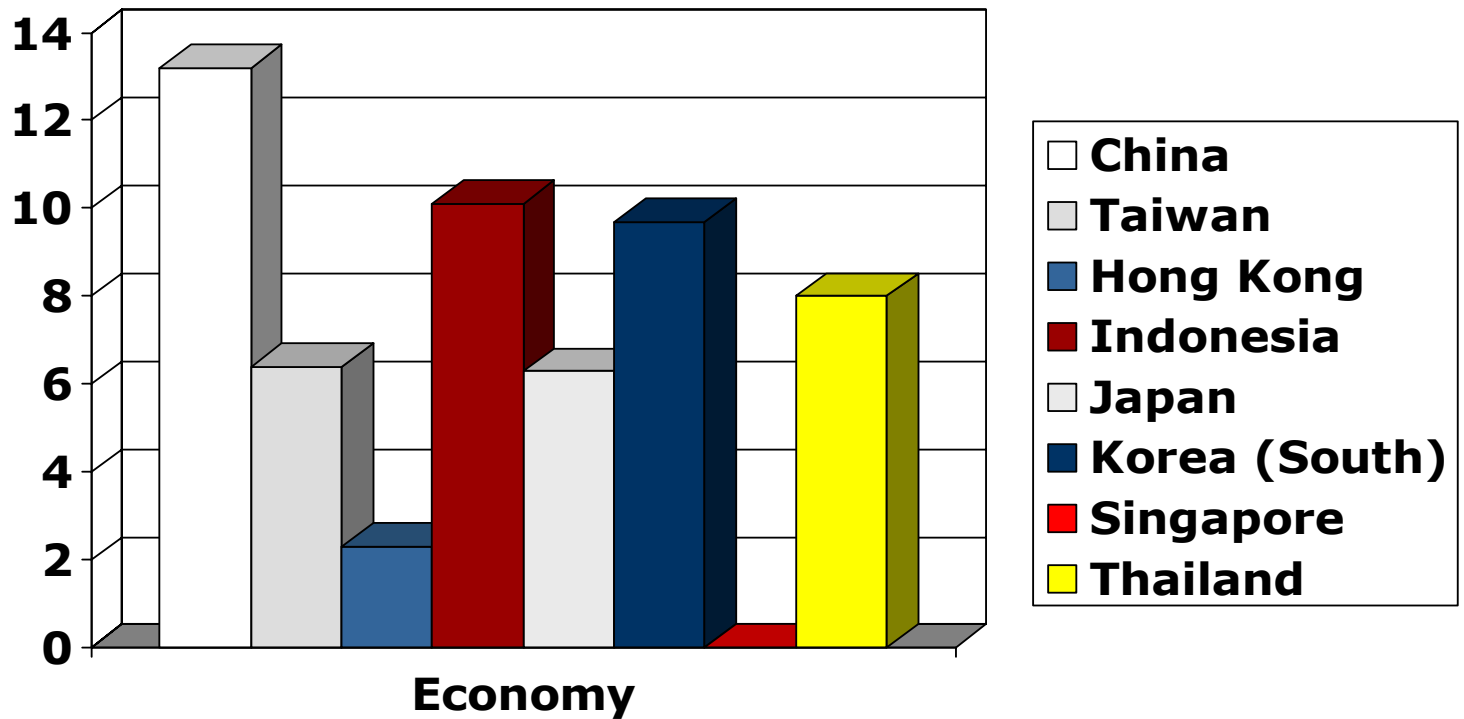
- Weak disciplinary market force
 - Hostile takeovers are rare in Asia
 - In china, state shares are not freely transferable
 - Product markets are heavily regulated in some economies
- Weak laws and public enforcement
 - Significant increase in the quantity of laws, but enforcement is weak
- Corruption and weak public governance in many Asian economies
- These country institutional factors affect the nature of business dealings in Asia and shape corporate governance practices

Corruption and corporate transparency

- Why corporate transparency in Asia is low, despite new laws and regulations requiring more disclosure?
- Why do Asian investors seldom read financial reports?
- Disclosure of proprietary information can be costly, even investors agree
- Fan and Wong, Journal of Accounting and Economics, 2002

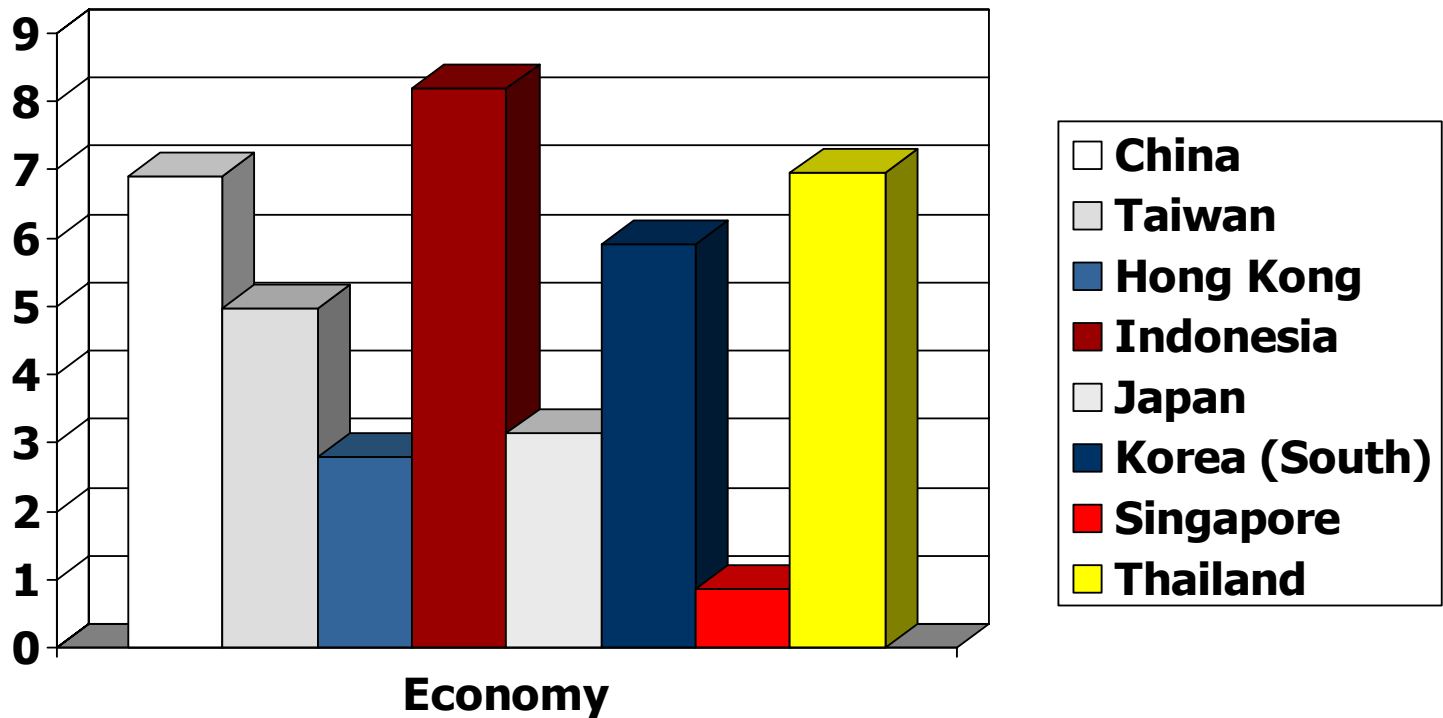
Opacity Premium in Asia

Source: PricewaterhouseCoopers



Corruption in Asian Economies

(Source: Transparency International: mean Corruption Perception Index 1992-2000)

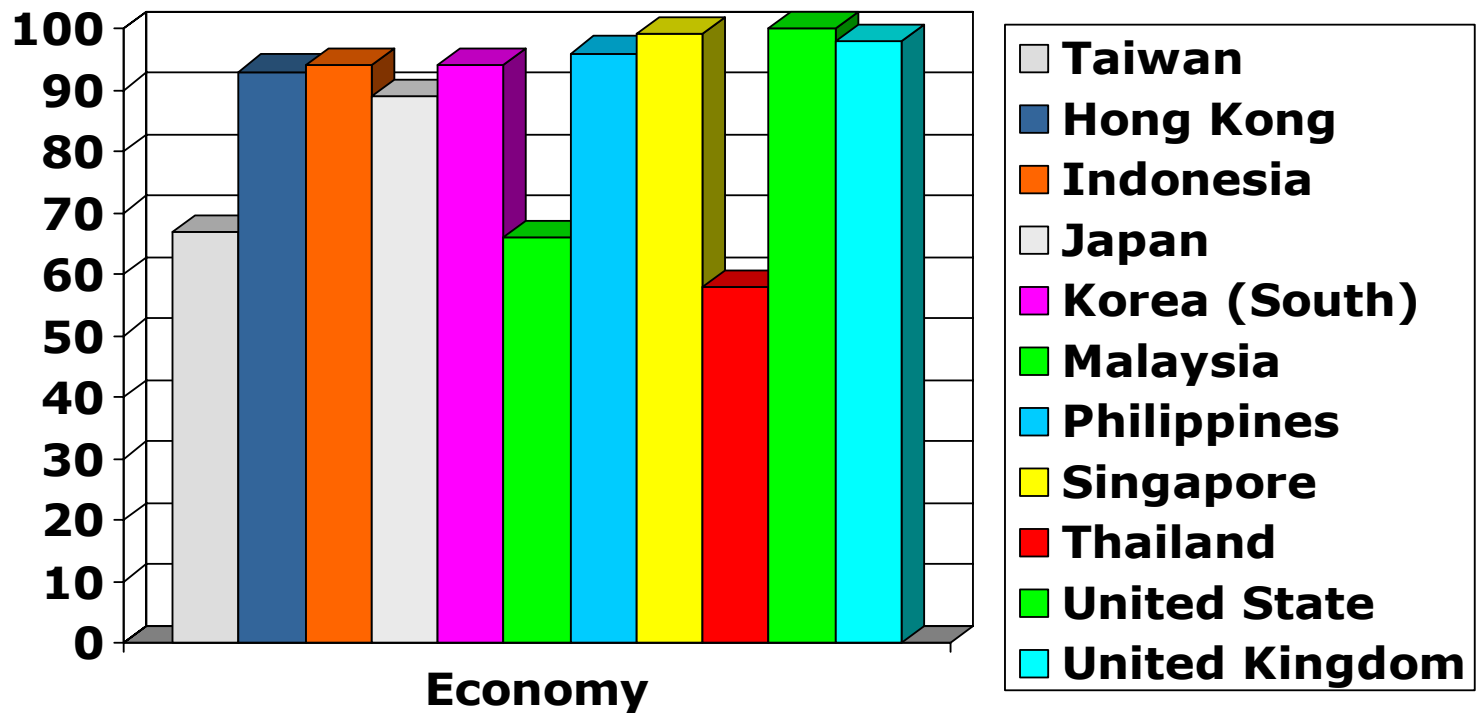


Corporate governance roles of external auditors in Asia

- Important

- Academic research (Fan and Wong, Journal of Accounting Research) has found that high quality auditors improve the credibility of accounting information to investors and help strengthening corporate governance in East Asia

Market Share of Big-Five and Big-Five Affiliated Auditors in Asia, US, and UK



Auditor oversight agency and audit committee

- Audit oversight body
 - Agree that creating an audit oversight body is important.
 - Does the agency have strong disciplinary power?
 - Will Asian governments and courts respect and help enforce the disciplinary actions recommended by the audit overseeing agency?
 - It may be unrealistic to rely on auditors as gatekeepers
- Will an audit committee help in Asia?
 - Yes if one can bypass institutional constraints

Boards of directors are weak in governance: the case of China

(Chen, Fan, Wong, 2004)

Board size	9.22 (range 5 to 19)
Manager directors	34%
Largest shareholder	53%
Minority shareholders	0%
Politicians	32%
<i>Central govt</i>	4%
<i>Local govt</i>	19%
<i>Others</i>	9%

Boards of directors are weak in governance: the case of China

(Chen, Fan, Wong, 2004)

Directors from unaffiliated firms

(“expert” directors) 18%

Professionals 5%

Academics 14%

Woman directors 5%

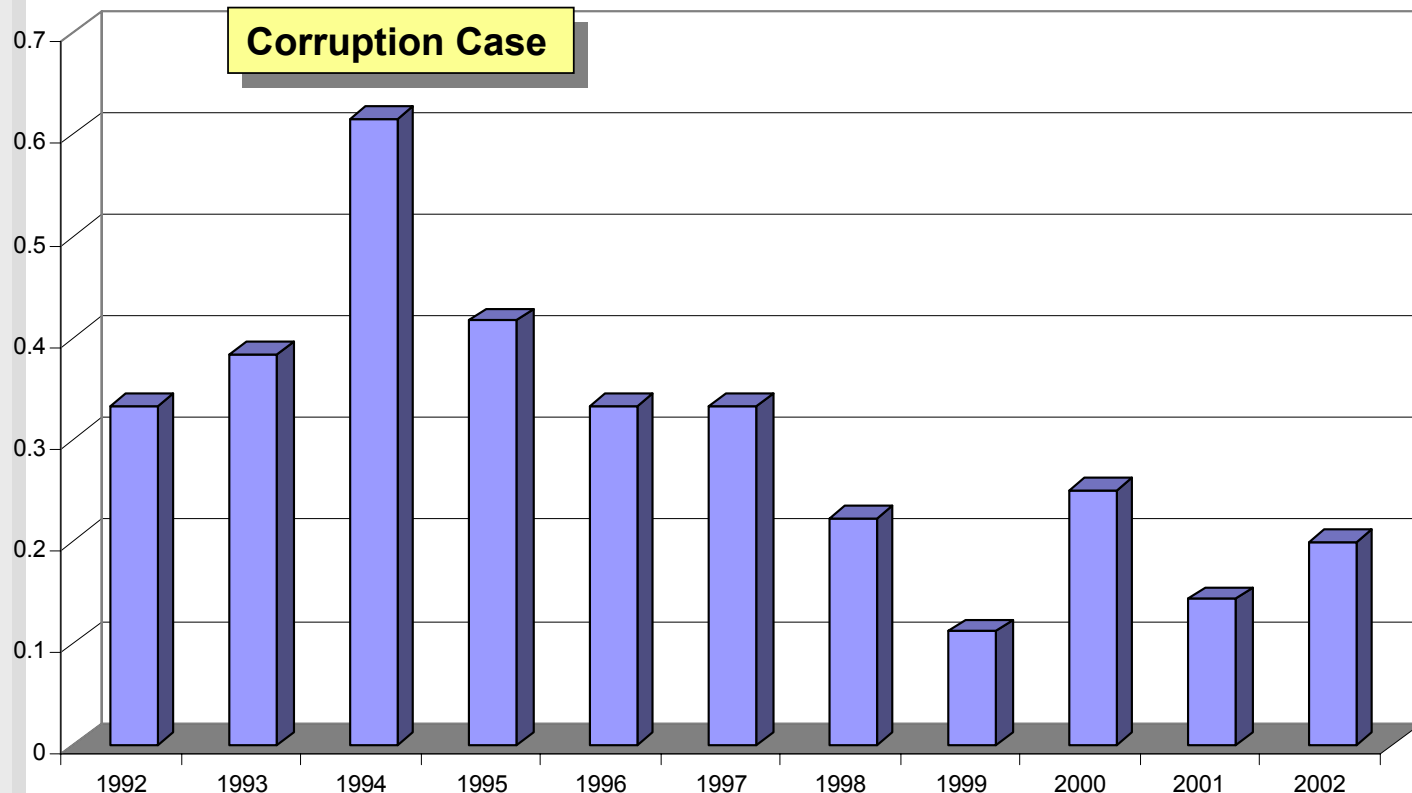
Age 47

Education *Between Junior college
and university*

Corruption and board professionalism

Shougang Group in China

Percentage of Directors that Are Professionals –



Corporate governance in weak institutional environments: what work?

- **Reputation building**, in my view, is the most important self-enforcing mechanism of corporate governance
 - Reputation of profitability
 - Reputation of accountability
 - The two do not always go hand in hand

How do Asia's public corporations build reputation?

- Repeated transactions that show good results and reliability
- Bonding (borrowing someone else's reputation)
 - Foreign partners in joint ventures or strategic alliance
 - Foreign listings
 - Information intermediaries, such as rating agencies, financial analysts, and external auditors

Reputation ratings

Corporate Reputation Rating

<http://www.ratingresearch.com/>

Corporate Reputation Ratings: Banking Industry Rating release date: 3 March 2003

For a brief description of each rating, position mouse pointer over the rating code.

Firm	RSR*
Fifth Third Bancorp (FITB)	AA
Northern Trust Corporation (NTRS)	AA
BB&T Corp. (BBT)	A
State Street Corporation (STT)	A
SunTrust Banks, Inc. (STI)	A
Wachovia Corporation (WB)	A
Washington Mutual, Inc. (WM)	A
Wells Fargo & Company (WFC)	A
Bank of America Corporation (BAC)	BBB
Bank of New York Co. (BK)	BBB
Citigroup Inc. (C)	BBB
Comerica Incorporated (CMA)	BBB
National City Corporation (NCC)	BBB
Regions Financial Corp. (RF)	BBB
SouthTrust Corporation (SOTR)	BBB
Bank One Corporation (ONE)	BB
FleetBoston Financial Corporation (FBF)	BB
JP Morgan Chase & Co. (JPM)	BB
KeyCorp (KEY)	BB
PNC Financial Services Group Inc. (PNC)	BB
U.S. Bancorp (USB)	BB

- 
-
- Where else do we find reputation at work?

The CEO that holds a bible – does it work?

- He is the CEO of a listed micro-electronic company in Taiwan
- He always holds a bible in front of media and prays before company meetings
- He was recently married to a daughter of Mr. Wang Young-Ching, the chairman of Formosa Group, and the “god of management” in Taiwan
- His company has been involved in various law suits involving stealing trade secrets from competitors. He and his wife are prosecuted by the Taiwan court for 4 years in prison and monetary penalties
- Borrowing the reputation from the two gods, will he and his company prevail?



Conclusions

- **Sustainable growth** of corporations and economy as a whole is the ultimate reward of effective corporate governance
- **Reputation** is the most important corporate governance mechanism in Asia that all corporations should seek to establish with their stakeholders
- But there is a limitation of the self-enforcing solution. The ultimate solution is **institutional reform** that improve public governance and law enforcement