Guidelines on

CORPORATE GOVERNANCE

for SMEs in Hong Kong

3rd Edition

Organised and Published by

香港董事學會

The Hong Kong Institute of Directors

ABOUT THE PUBLISHER

The Hong Kong Institute of Directors ("HKIoD") is Hong Kong's premier body representing directors to foster the long-term success of companies through advocacy and standards-setting in corporate governance and professional development for directors. A non-profit-distributing organisation with membership consisting of directors from listed and non-listed companies, HKIoD is committed to providing directors with educational programmes and information service and establishing an influential voice in representing directors. With international perspectives and a multi-cultural environment, HKIoD conducts business in biliteracy and trilingualism. Website: http://www.hkiod.com.

Guidelines on Corporate Governance for SMEs in Hong Kong (3rd Edition)

Created and published by The Hong Kong Institute of Directors ("HKIoD") and funded by the SME Development Fund of the Trade and Industry Department of HKSAR Government, this publication is one of the two complementary reference tools for SMEs. While the guidebook, *Guidelines on Corporate Governance for SMEs in Hong Kong*, addresses the "what-to-do" aspects of corporate governance practices, *SME Corporate Governance Toolkit – From Guidelines to Implementation* covers the "how-to-do" steps of implementation. It is recommended that both the Guidelines and the Toolkit are read to facilitate SMEs in the implementation of corporate governance.

Published by
The Hong Kong Institute of Directors Limited
2104 Shanghai Industrial Investment Building, 48 Hennessy Road,
Wan Chai, Hong Kong
Tel: (852) 2889 9986
Fax: (852) 2889 9982
E-mail: executive@hkiod.com
Web-site: www.hkiod.com

First published in Hong Kong 2003
Second Edition 2009
Third Edition 2014
ISBN 978-988-18910-7-5

gratefully acknowledges the following persons and organisations for their support in the development, publication and promotion of the Guidelines

Sponsors

Trade and Industry Department **SME Development Fund**

1st Edition 2003

Created, edited and published by The HKIoD Standards and Ethics Committee.

Authors: Mr Henry Bosch, Prof John Farrar

2nd Edition 2009

Revision Editors: Ms Julia F Charlton, Dr. Alex Lau

3rd Edition 2014

Revision Editors: Ms Julia F Charlton, Dr. Alex Lau

Supporters

Design and Printing

Equity Financial Press Limited

FOREWORD: KEY MESSAGES

SMEs are major employers of the working population of Hong Kong and have contributed much towards our economic prosperity. It is important that SMEs adopt good corporate governance practices in order for them to remain competitive in today's globalized markets. I am glad to see that The Hong Kong Institute of Director is publishing the 3rd edition of the Guidelines on Corporate Governance for SMEs in Hong Kong, which will provide useful materials for local SMEs to achieve that.

Professor K C Chan
Secretary for Financial Services and the Treasury
Financial Services and the Treasury Bureau

****

It is important for Hong Kong's listed companies as well as SMEs to strive to improve their corporate governance standards. Private limited companies make up the significant majority of companies registered with the Companies Registry and, by investing in good corporate governance practices, the companies would be able to enhance their sustainability and bring greater benefits to their shareholders. These Guidelines produced by The Hong Kong Institute of Directors provide a valuable reference, in a very practical and readable manner, to the ways in which corporate governance practices for SMEs may be enhanced.

Ada Chung
Registrar of Companies
Companies Registry

****

SMEs play an essential role in driving innovation and contributing to the growth of our economy. It is therefore important that our market is sound and functions well to facilitate the development and sustainability of SMEs. High standards of corporate governance help instill confidence amongst investors in the market and incentivise entrepreneurs to develop their businesses. Such traits in SMEs assist them in gaining access to finance in the capital markets. We commend The Hong Kong Institute of Directors for updating its guidance which serves as a useful reference for directors of SMEs in the face of an increasingly challenging world.

Carlson Tong
Chairman
Securities and Futures Commission

****

Financial markets can only be successful when investors have faith that companies are operating in the best interest of shareholders. Good corporate governance is one of the foundations of our market, and it's imperative that standards and principles are fully understood. Good corporate governance not only helps SMEs gain trust in the market, it also helps to attract investors. I want to thank The Hong Kong Institute of Directors for its tireless efforts in promoting good corporate governance and for publishing the latest edition of Guidelines on Corporate Governance for SMEs in Hong Kong.

C K Chow
Chairman
Hong Kong Exchanges and Clearing Ltd.

****

PREFACE: FROM THE PUBLISHER

The Hong Kong Institute of Directors is Hong Kong's premier body representing professional directors to foster the long-term success of companies through advocacy and standards-setting in corporate governance and professional development for directors. We represent the interest of directors and are charged with the responsibility to help directors fulfil their fiduciary roles with a focus on best practices in corporate governance.

Through our director professionalism programmes, we aim to enhance the standards of corporate governance in community-wide Hong Kong-listed companies and non-listed companies, including our SMEs. In serving directors of diverse companies, we organise a variety of programmes, including forums specifically for SMEs. To complement these activities, this book of *Guidelines on Corporate Governance for SMEs in Hong Kong* was published.

This book serves as a tool for SME directors in setting strategic directions, business development and internal control – all practical aspects for governing their businesses. The 3rd edition of the book keeps abreast of the regulatory and policy changes to facilitate directors in obtaining up-to-date information on director practices, taking into consideration particularly the New Companies Ordinance (Cap 622) effective commencing 3 March 2014.

We would like to extend our gratitude to:-

- the Trade and Industry Department of the HKSAR Government and the SME Development Fund for supporting and funding the creation of this book;
- the authorities who have provided key messages to the Foreword;
- Ms Julia Charlton and Dr Alex Lau for their service as revision editors of this 3rd edition;
- all those who have helped to publish this 3rd edition; and
- all those who take part in promoting and supporting this book.

Dr Kelvin Wong
Chairman
The Hong Kong Institute of Directors

****

The Hong Kong Institute of Directors is dedicated to the service of directors through organising professional development programmes such as seminars, forums, publications and workshops. The Institute encourages directors to stay up-to-date with regard to corporate governance practices. These guidelines aim to inspire SME directors to address various significant issues with state-of-the-art practices.

Supported and funded by the Trade and Industry Department of the HKSAR Government and the SME Development Fund, the guidelines were developed and first produced in 2003. Since then, the Institute has kept in review legal and regulatory changes and updated the book accordingly. In this 3rd edition of the book, we are mindful of the major legal and regulatory changes that are relevant to directors. In particular, the clarification of directors' duty of care, skill and diligence by the Companies Ordinance (Cap 622) bears profound significance on how directors fulfil their roles. With up-to-date knowledge, this edition is an essential aid for SME directors.

The guidelines include 12 case studies, which are deliberately open-ended with regard to solutions, in order to generate interesting reading and to stimulate opinions. Solutions to the problems posed by the cases are readily available throughout the guidelines.

We are grateful to all those who have helped in the publication of this book. We welcome feedback of comments from readers and users, in order to enable us to enhance our service for directors, stakeholders and the economy of Hong Kong.

Dr Carlye W L Tsui
Chief Executive Officer
The Hong Kong Institute of Directors

****

EVALUATION QUESTIONNAIRE

Thank you for your interest in "Guidelines on Corporate Governance for SMEs in Hong Kong".

In publishing these Guidelines, The Hong Kong Institute of Directors aims to provide SMEs with a tool to lead the strategic planning and management of their businesses, thus strengthening their corporate governance and enhancing their capability to meet the challenges of the competitive world. It will be appreciated if you would kindly take a moment to complete this "Evaluation Questionnaire" and to return it to the Institute by fax or by mail. Thank you very much for your support.

香港董事學會
The Hong Kong Institute of Directors

****

To: The Hong Kong Institute of Directors Fax No: 2889 9982 For Inquiry, Tel No: 2889 9986
2104 Shanghai Industrial Investment Building, 48 Hennessy Road, Wan Chai, Hong Kong

(Please select the appropriate boxes with √ and specify relevant information.)

PART A: Evaluation of Guidelines	Strongly agree	Agree	Neutral	Disagree	Strongly disagree
1. I found the substance of the following chapters useful:					
Chp 1: "The Concept of Corporate Governance and its Importance".	☐	☐	☐	☐	☐
Chp 2: "What Governance Practices do Hong Kong SMEs need?"	☐	☐	☐	☐	☐
Chp 3: "The Special Issues of Family Companies"	☐	☐	☐	☐	☐
Chp 4: "Management Practice Guidelines".	☐	☐	☐	☐	☐
App I: "The Legal Core and Regulatory Background"	☐	☐	☐	☐	☐
App II: "Principles, Protocols and Practice".	☐	☐	☐	☐	☐
2. I found the organisation of contents of the Guidelines appropriate for understanding	☐	☐	☐	☐	☐
3. I found the language of the Guidelines reader friendly	☐	☐	☐	☐	☐
4. I found the Executive Summary including the summary text and charts a handy tool.	☐	☐	☐	☐	☐
5. Other comments on the Guidelines *(Please specify)*:					

PART B: Background Data

1. ☐ My business belongs to the category of SME.

2. My business is: ☐ non-manufacturing business ☐ manufacturing business

3. My business size is as follows:
Number of employees in Hong Kong: ☐ 1-10 ☐ 11-20 ☐ 21-50 ☐ 51-80 ☐ 81-100 ☐ >100
Number of employees elsewhere: ☐ 1-10 ☐ 11-20 ☐ 21-50 ☐ 51-80 ☐ 81-100 ☐ >100
Number of Board Members: ☐ <3 ☐ 3-5 ☐ 6-10 ☐ >10

4. According to the categories described in the Guidelines, my business type is as follows:
☐ Category 1: A small entity owned by a single individual.
☐ Category 2: An entity larger than category 1, employing non-family people.
☐ Category 3: Medium sized company with several shareholders/unincorporated partnership.
☐ Category 4: A large medium private or public company with a substantial number of shareholders and with a representative board.
☐ Category 5: A company listed on the Stock Exchange of Hong Kong.
☐ Others *(Please specify)*: ____________________

5. My business belongs to the following industry/profession:

√	Industry/Profession Type	Code	√	Industry/Profession Type	Code
☐	Academic, Education Services	0100	☐	Legal Services	1300
☐	Accountancy Services	0200	☐	Manufacturing	1400
☐	Architectural, Building, Construction Engineering, Surveying	0300	☐	Marketing, Advertising, Event Management	1500
☐	Arts, Culture, Entertainment	0400	☐	Medical, Healthcare	1600
☐	Banking, Financial Institutions	0500	☐	Property: Developer, Agency, Manager	1700
☐	Business and Management Services	0600	☐	Recreation, Sports	1800
☐	Catering, Hotel, Tourism	0700	☐	Retail	1900
☐	Communications, Publishing	0800	☐	Security, Safety	2000
☐	Statutory, Trade & Professional Bodies	0900	☐	Trading	2100
☐	Human Resources: Search, Training	1000	☐	Transport, Logistics	2200
☐	Insurance	1100	☐	Utilities	2300
☐	Information Technology	1200	☐	Welfare & Social Services	2400
☐	Others *(Please specify):*				9000

6. ☐ My business is related to providing SMEs with advice and counsel.

7. I first came to hear about the Guidelines from:

☐	The Hong Kong Institute of Directors	☐	Other government or related organisations
☐	Trade and Industry Department	☐	Media
☐	Hong Kong Productivity Council	☐	Library
☐	Trade associations/chambers of commerce *(Please specify):*	☐	Other sources *(Please specify):*

Part C: Request for Information

☐ I am interested in the membership and activities of The Hong Kong Institute of Directors. Please send me more information.

Addressing title: Mr/Ms/Mrs/Dr/____________________

Name in Chinese if applicable: ____________________

Name in English: ____________________

Company: ____________________

Position: ____________________

Correspondence address: ____________________

____

Tel No: __________ Fax No: __________ Email: __________

TABLE OF CONTENTS

EXECUTIVE SUMMARY

SMES IN HONG KONG

Small and medium enterprises [SMEs] in Hong Kong are defined as those which employ fewer than 100 people in manufacturing and fewer than 50 in non-manufacturing activity. There are about 310,000 of them and they represent 98% of the total business establishments in the Special Administrative Region. They employ 1.3 million people which is about 48% of total employment outside the government sector. Their prosperity and success is therefore of the greatest importance to the economic well being of Hong Kong and its people.

THE CONCEPT OF CORPORATE GOVERNANCE AND ITS IMPORTANCE

Corporate governance is the system by which companies and other enterprises are controlled. The basic purpose of all commercial enterprises is to preserve and enhance the investments which created them; that is to create wealth, not only in the short term but in perpetuity. Good corporate governance can make a great contribution to success, bad governance makes failure more likely. It is therefore in the interests of all enterprises to consider whether they can improve their system of governance.

All around the developed world a great deal of attention has been paid to corporate governance over the last two decades. Competitive pressures are growing, community expectations are increasing, and the standards required for success are rising. In response, many new techniques have been developed which, if applied appropriately, can be of real practical assistance to individual enterprises and can make a substantial contribution to the health of the economy.

There is no single right way in which companies should be governed but there are fundamental principles which will assist all enterprises to survive and succeed, including:

- Comply with the law.
- Earn the respect of their stakeholders customers, creditors, employees, suppliers and the communities within which they operate.
- Lower the cost of capital by establishing and maintaining a sound reputation.
- Identify and manage the risks facing them.
- Adopt and develop systems which enhance the quality of decision making.

WHAT GOVERNANCE PRACTICES DO HONG KONG SMEs NEED?

The governance systems likely to be useful to small enterprises are much simpler than those required by larger ones and, in order to clarify what structures and procedures are likely to be of value in particular circumstances, these Guidelines divide the SMEs of Hong Kong into five categories:

1. Small entities owned and operated by single individuals or a few family members.
2. Larger entities employing non-family members, whose owners may include a few family members.
3. Medium sized companies with several shareholders including some outside the family.
4. Large medium private or public companies with a substantial number of shareholders.
5. Companies listed on the stock exchange.

Category 1. While a skilful entrepreneur will probably be able to keep most of the details of his business in his head he will probably benefit from a basic system of credible accounts and internal control, a simple business plan with performance indicators, some form of risk identification and risk management, and a succession plan that will provide for the continuance of the business should the entrepreneur be unable to continue. Some form of regular outside advice is also likely to be beneficial.

Category 2. As enterprises grow in size they usually employ people other than family members and become more complex in other ways. All of the basic governance mechanisms likely to be used by category 1 enterprises will probably be developed further and written policies may be necessary, at least in some areas. In addition, other policies, covering such matters as employment, are likely to be required. The entrepreneur may well benefit from more external advice, particularly in the accounting area, and may well feel the need for some form of board of advisers which is likely to include family members, including probable successors.

Category 3. Once a company has several shareholders it becomes necessary to consider their rights, and it may be important to demonstrate that the company offers attractive investment possibilities. Additional shareholders bring additional responsibilities: Articles of Association, and a representative board of directors, will probably be necessary. The need to satisfy other shareholders means that the accounting and control systems will have to be more reliable, and since in larger companies, planning and risk management will become more important, the relevant systems will be more sophisticated. In these companies the legal obligations of the entrepreneur, and the practical needs of the business, will be more complex and onerous.

Category 4. These companies have a substantial number of shareholders, and as a consequence, there is a separation of ownership from control and the board has a responsibility to act in the interests of the company as a whole. The board must be accountable to the shareholders and it must hold management accountable to it. Not only must all the governance systems needed by category 3 companies be developed to a greater degree of sophistication but additional mechanisms will be required. The composition of the board, its harmony and teamwork, communications with shareholders, the functions of the board and its relationship with management will all take on a greater importance.

Category 5. These companies are listed on the stock exchange and are bound by the listing rules. Inevitably their governance systems will be even more sophisticated than those of category 4 companies.

THE SPECIAL ISSUES OF FAMILY COMPANIES

A high proportion of SMEs in Hong Kong are family companies. They enjoy several substantial advantages, principally:

- Since there is little or no separation of ownership from control, decision making can be streamlined.
- The personal incentives of those involved are usually very strong.
- The loyalty of family workers often increases stability.

But family connections have always had other implications for businesses and rapid technological changes, increasing competitive pressures, social and educational changes, and developments in mainland China have created new challenges and opportunities. As a result family companies face five special issues which lead to less than half of all family companies being carried on by the second generation, and which prudent company controllers need to take into account. They are:

1. Succession.	It is becoming increasingly difficult to find second generation family members who are sufficiently able and well trained, and at the same time willing and sufficiently patient to take over the leadership of the family company at a time that is suitable to the founder. The difficulties in the transfer from the second to the third generation are even greater. Careful planning for succession will prove valuable.
2. Diverging interests.	It is common for family considerations to diverge from company interests, particularly in such areas as the position of incompetent family members. It is prudent to identify possible points of divergence and to deal with them before they become damaging.
3. Non-family executives.	The growing importance of specialist skills requires the recruitment of non-family executives who frequently are reluctant to be subordinate to less competent family members. Well thought out and credible personnel policies are important.
4. Narrow perspectives.	In a fast changing competitive environment it is valuable to introduce broad perspectives into the company decision making which sometimes test the flexibility of family entrepreneurs.
5. Shortage of capital.	Family companies frequently find it difficult to provide sufficient capital to take advantage of technical innovations without diluting family control. Careful financial planning is vital.

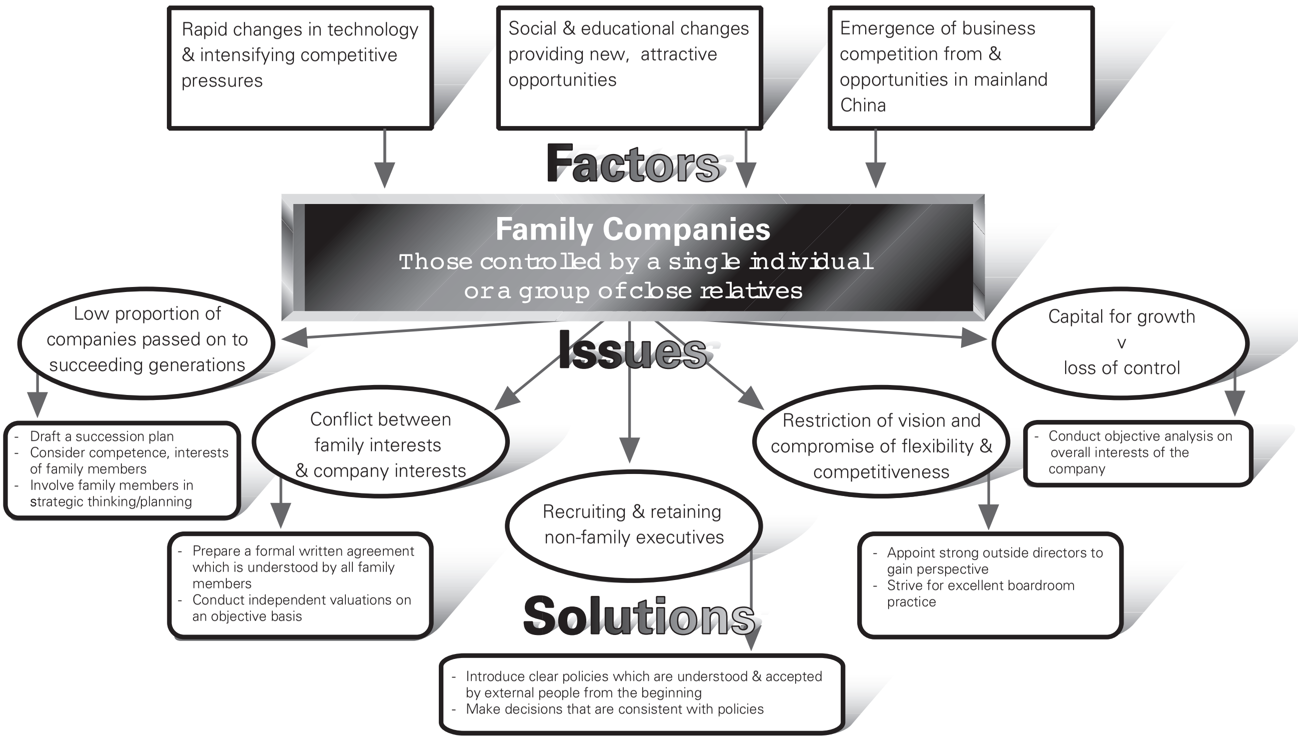
Prudent and early consideration of the appropriate governance structures and mechanisms will contribute substantially to the satisfactory resolution of these issues.

INTEGRATING MANAGEMENT PRACTICES WITH GOVERNANCE

The main focus of good corporate governance is on company boards and the controllers of smaller enterprises, because they alone can take the major decisions. But, in all but the smallest enterprises, once the main structures and policies have been put in place much detail must be added by those responsible for day-to-day management. Thus management practice has to be integrated with good governance.

There is no single simple system for governing well. Companies and other enterprises vary so much in size, ownership structure, complexity, traditions and the personalities involved that the principles of good governance have to be adapted to particular circumstances. This may take a great deal of thought and the purpose of these guidelines is to assist entrepreneurs and directors in selecting and developing the most appropriate systems for their organisations. If that is done well both the individual enterprises and the economy of Hong Kong will be strengthened.

Special Issues Facing Family Companies



What Governance Practices Hong Kong SMEs Need

SMEs

Category 1	Category 2	Category 3	Category 4	Category 5
Owned by a single individual who may be assisted by family members	Of growing size which employ people other than close relatives	With several shareholders or partners, whether members of the family	With a substantial number of shareholders	Listed on the Stock Exchange
Credible accounts & a system of internal control	Formal accounting systems	Systems of internal control to support annual accounts	Processes & practices for category 3 in place	Processes & practices for category 4 in place
A simple, written business or strategic plan	A detailed, 3-5 year business plan & annual review	Clear objectives and plans	A sophisticated system to ensure ongoing prosperity	Listing rules & Code of Best Practice of SEHK
A simple set of performance indicators	A number of performance indicators	A system of performance indicators	Adherence strictly to the principle of accountability	
Analysis of the risks & relevant basic policies	Risk identification & risk management	A system to manage risks	Establishing a track record of good governance before applying to list	

- External professional advice
- One or more part-time advisers
- Some form of succession plan

- A succession plan involving formal family agreement
- Simple policies on remuneration & HR issues
- Simple policies to guide decision making e.g. in purchasing & sales
- A system displaying the company's financial situation to all concerned
- External advice from professional accounting firms
- A simple board of advisers
- Appoint a Governing Director for the board

- An extensive network of policies & reporting systems
- A written Articles of Association
- An accountable board of directors
- A system to delegate authority from the board
- A mechanism to ensure due performance by the board
- A system for setting goals and strategies for the company by board and management
- Written job descriptions for employed managers/executives
- Board to act in the interests of the company as a whole

- Delegating power to the board to manage the company
- A mechanism permitting shares to be bought & sold
- Guidelines for board composition & its operations
- Board committees
- Board harmony and teamwork
- Monitoring & helping management

Management Practice Guidelines

CHAPTER 1

THE CONCEPT OF CORPORATE GOVERNANCE AND ITS IMPORTANCE

1.1 BACKGROUND

1.1.1 Business enterprise is the lifeblood of Hong Kong and small and medium enterprises (SMEs) are a dynamic part of the economy. In the past decades labour intensive manufacturing has been relocated to Southern China and Hong Kong is now dominated by service industries which are less labour intensive. The past history of Hong Kong has shown the viability of Chinese family businesses but the recent trend is towards more personal ventures than family business. The emphasis is shifting to preservation of personal wealth rather than dynastic succession. Growth enterprises, particularly emerging ones with good business ideas and potential, often do not fulfil the profitability/track record requirements of the Main Board of the Stock Exchange of Hong Kong ("Main Board"). For them the Growth Enterprise Market of the Stock Exchange of Hong Kong ("GEM") has been designed to bridge this gap.

1.1.2 According to the Survey carried out for these Guidelines the majority of Hong Kong SMEs are sole traders, partnerships, family companies and private companies. These are typically small business units with 10 or less staff and highly centralised management with the decision making vested in a few individuals. Perception and knowledge of governance issues tend to be at a most basic level but corporate governance systems become more sophisticated as firms grow in size and their operations become more complex.

1.2 FUNDAMENTAL CONSIDERATIONS

1.2.1 In designing appropriate corporate governance for Hong Kong it is important to consider international trends but at the same time to guard against impractical and costly reforms. The corporate system in Hong Kong follows the UK rather than the US model and concentrates on a combination of legal and self regulation. In any event, to date, both the US and UK models are designed for listed public companies, not SMEs.

1.2.2 Corporate governance is about control and accountability. The UK Cadbury Report on the *Financial Aspect of Corporate Governance* (1992) defined corporate governance as "the system by which companies are directed and controlled".

1.2.3 Corporate governance is also about the advancement of shareholder wealth through greater efficiency resulting from the accountability of management and the board to shareholders and creditors. Good, performance driven, governance thus supports wealth creation, which in turn drives more investment and employment. The key is to ensure that the corporate governance agenda is focused on improving performance and not just bogged down in conformity and compliance.

1.2.4 Fundamental corporate governance, as it stands currently in Hong Kong, consists of a core of legal rules which are contained in the Companies Ordinance. These deal mainly with the board of directors and meetings of shareholders and duties and remedies. Hong Kong company law was overhauled by the adoption of a new Companies Ordinance (the "New Companies Ordinance") in 2012. The New Companies Ordinance (Cap 622) replaces the Companies Ordinance (Cap 32) (the "Old Companies Ordinance"), except for certain provisions relating to winding-up and insolvency and the public offer/prospectus regime for offers of shares and debentures (these will remain in the Old Companies Ordinance, which has been renamed Companies (Winding up and Miscellaneous Provisions) Ordinance). The New Companies Ordinance came into force on 3 March 2014. Listed Companies are regulated by the Securities and Futures Commission and the Stock Exchange of Hong Kong. In addition there is a growing system of self regulation promoted by professional bodies such as The Hong Kong Institute of Directors and the Hong Kong Institute of Certified Public Accountants to supplement the letter of the law and regulations. Finally, there are of course business ethics.

1.2.5 Corporate governance as its name suggests, is primarily designed for companies. Indeed in the past, corporate governance codes have been drafted with listed public companies in mind. However, these guidelines, while drafted with companies in mind, contain provisions which will be helpful to those SME businesses which are not incorporated. We also deal separately with specific issues concerning sole traders and partnerships.

1.3 SMALL AND MEDIUM ENTERPRISES IN HONG KONG

1.3.1 The Hong Kong SAR Government generally defines small and medium enterprise (SME) as any manufacturing business which employs fewer than 100 persons in Hong Kong or any non-manufacturing business which employs fewer than 50 persons in Hong Kong. This covers a variety of types of business; sole traders, partnerships, listed and unlisted, family and closely held companies. Listed companies are subject to more rules including the SEHK Listing Rules for the Main Board or GEM and the systems of corporate governance mandated by them.

1.3.2 SMEs numbered about 310,000 as at December 2013. They are 98% of the total business establishments and provide jobs for about 1.3 million people which is about 48% of total employment (excluding the civil service). A majority are in the import/export business, followed by wholesale and retail traders, restaurants and hotels. It has been thought necessary to develop these guidelines for all SMEs to ensure that all significant businesses in Hong Kong aim towards a standard of corporate governance unprecedented in other countries. SMEs are a significant source of economic growth in Hong Kong and it is important that they too share the good reputation of bigger businesses in Hong Kong.

1.3.3 SMEs in Hong Kong currently face new challenges from fast changing market conditions and globalisation. They need to attract equity and debt finance. Many seek greater opportunities in Mainland China and need more sophisticated business structures. The SME Development Fund, a fund which has been established by the Government of the Hong Kong Special Administrative Region and administered by the Trade and Industry Department to provide financial support to projects which will enhance the competitiveness of Hong Kong's SMEs, has therefore provided the funding for the drafting of these Guidelines. The aim of the Guidelines is to provide basic guidance for SMEs to assist them in achieving structures which will facilitate and enhance growth and profitability.

1.3.4 In the majority of SMEs, ownership and control are in the hands of a single individual and issues of accountability normally do not arise unless the business becomes insolvent or acts in breach of the general law. However, even in such cases, appropriate systems and practices will increase the probability of further success. SMEs which are family companies have their own structural complications which are discussed in Chapter 3.

1.4 THE ECONOMIC IMPORTANCE OF GOOD GOVERNANCE

1.4.1 The importance of supplementing law by a good system of self regulation has been recognised in Hong Kong for some time and Hong Kong has been recognised as having one of the best systems in South East Asia for public listed companies. The OECD and World Bank have stressed the importance of good corporate governance for the following reasons:

(a) There is the link between corporate governance and investment and economic growth. It is not only the quantity of investment which matters. It is how efficiently this is allocated and monitored. Corporate governance has a crucial impact on all three.

(b) The legal component influences how we mobilize capital by defining property rights and guaranteeing credible information.

(c) Corporate governance as a whole is seen as a constituent element of equity risk. Bad corporate governance signals misuse of information and a high probability of expropriation of shareholder value.

1.4.2 A McKinsey & Co study of July 2002 Global Investor Opinion Survey showed the average premiums that the overwhelming majority of investors will be willing to pay for companies with good corporate governance. These averaged 12-14% in North America and Western Europe and 20-25% in Asia. More than 60% of investors state that governance considerations might lead them to avoid companies with poor governance and a third would avoid countries with that reputation. Surveys done by Wiltshire Associates of the USA in the companies targeted by Californian Public Employees Retirement Fund (CalPERS) for poor governance showed that they subsequently improved their performance considerably. More recently, a report by CLSA (Credit Lyonnais Securities Asia) on Emerging Markets around the world indicates that in many markets, companies with good corporate governance have outperformed their indices in recent years and move to valuation premia. The research shows that companies with governance are also those with high ROEs (return on equity) and the largest value creators on an EVA (Economic Value Added) analysis. Governance issues in the survey included: management discipline, transparency, independence, accountability responsibility, fairness and social responsibility.

1.4.3 The market can only make the best decisions regarding allocation of capital if there is proper disclosure. Effective monitoring depends on sound procedures, clear lines of authority and incentive schemes. Globalisation affects this because of the

- Growing importance of the private sector.
- Growing international institutional investment.
- Growing international interdependence through technology.
- Changing patterns of competition.

1.5 CORPORATE CULTURE AND BUSINESS TRADITIONS

1.5.1 Hong Kong inherited the British model and the Companies Ordinance has been strongly influenced by the UK model but increasingly Hong Kong as an international financial centre, pays attention to other international influences.

1.5.2 As the system of law fosters business entrepreneurism with modest restraints, a strong element in the corporate system of Hong Kong in the past has been the prosperity of the Chinese family business. It is important that such entrepreneurism continues and is not enmeshed in unnecessary regulation. Good governance is best when it is adopted voluntarily. An established track record of good governance will ultimately pay off.

1.6 INTERNATIONAL DEVELOPMENTS

1.6.1 In the past, corporate governance has been regarded as part of the social governance of a particular society. Hong Kong inherited the UK model which was then adapted to the needs and interests of Hong Kong business. Other major systems are the US model which combines considerable freedom of transactions in its Business Corporations legislation while enforcing a tough system of securities regulation for listed corporations; the German model with its two tier board system, considerable bank involvement and more emphasis on debt capital; and the Japanese model which is based substantially on the Keiretsu system of interlocking companies as satellites around a main bank.

1.6.2 With the growth of a market economy in the PRC, a diminishing proportion of China's economy is dominated by State capital and public ownership. Since the early 1990s there has been an increase in globalisation and as part of this, there has been increasing stress on improving corporate governance. The South East Asian Financial Crisis pointed to defects in governance in the region. Hong Kong was given a good rating but was still prejudiced by the effects of the Crisis in the region.

1.6.3 In 1998 the OECD prepared a report on corporate governance based on the work of an international committee. This identified certain fundamental parameters, namely:

- The maximisation of shareholder value.
- Increased transparency and independent oversight of management by boards.
- Voluntary adaptation and evolution of good practice in an environment of globally understood minimum standards.
- The possibility of universal minimum standards in areas such as accounts.

1.6.4 The OECD Principles were adopted in 1999 and updated in 2004 and have been taken up as a useful international benchmark by many countries. They have also been endorsed by the IMF and World Bank. They have been followed by Regional Round Table meetings and Hong Kong has participated in these meetings. The OECD Principles have been used by the China Securities Regulatory Commission of the PRC in drafting its Principles for Listed Companies.

1.6.5 Corporate governance systems set out rules aiming at:

- Defining governance roles and
- Improving the governance process.

The first deals with matters such as the role of a board of directors and its relationship to the general meeting and shareholders and management; the role of the chair and individual directors including the CEO. It also deals with board meetings, board committees and general meetings and relates to best practice which supplements the legal requirements.

Improving the governance process deals with determining appropriate responsibilities for strategy; delegation; monitoring, compliance and risk management.

1.6.6 Many of the developments in international corporate governance have been made in connection with listed public companies. Only a small proportion of SMEs in Hong Kong fall into this category. For this reason some of the principles and procedures recommended for such companies have little or no relevance to many SMEs in Hong Kong. It is important, therefore, to discern those principles and procedures which are of relevance and which can be adapted to the needs of SMEs. We shall deal specifically with that question in Chapter 2.

CHAPTER 2

WHAT GOVERNANCE PRACTICES DO HONG KONG SMES NEED?

2.1 THE NEED FOR GOOD GOVERNANCE

2.1.1 Corporate Governance, as we saw in Chapter 1, is the system by which companies and like organisations are controlled and made accountable. All companies, even those owned and operated by a single entrepreneur are controlled and governed somehow; some well and some poorly.

2.1.2 The basic purpose of all commercial companies is to preserve and enhance the investment which created them, not just in the short term but in perpetuity. Good governance practices can increase the chances of wealth creation in the short term, but they can make a much greater difference in the longer term, partly through creating confidence in those on whom the company depends.

2.1.3 The fundamental reason for seeking to improve the governance of companies is to help them preserve and enhance their investment, to create wealth more efficiently – in the long term as well as the short. In all cases better governance helps companies achieve their chosen objectives more effectively, and at lower cost, and it also reduces the risk of insolvency and other disasters which can prevent them from achieving their objectives. Structures and practices that help companies to be successful in the short term are complex enough, but longer term success and the avoidance of disaster involves additional considerations. In addition the support, or at least the acceptance, of the company's stakeholders [usually customers, creditors, suppliers, employees and the community within which the company operates] must be maintained, and as the company grows, more has to be done in this area.

2.1.4 In most SMEs, ownership and control are in the hands of a single individual and issues of accountability do not arise. In such companies the intuition and experience of a brilliant entrepreneur can go a long way to create wealth and control risks, but in all companies the use of appropriate systems and practices will increase the probability of success. Indeed, family companies have their own special problems, mainly associated with succession and the mixture of family and business roles, which can lead to disaster if they are not well managed. [See Chapter 3]

2.1.5 In those companies in which ownership is separated from control, effective accountability is essential to good corporate governance. Shareholders delegate most of the powers of ownership to the boards they elect, and the boards appoint managements and delegate some powers to them. Since some managements and boards tend to neglect their responsibilities, by acting in their own interests or by failing to fulfill their duty of care, governance mechanisms which enhance accountability become important. This issue becomes central for listed companies and it is now recognised, not only that most shareholders will pay a substantial premium for the shares of well governed companies, but that the credibility of all companies listed on a given stock market depends, in part, on the standards of governance maintained.

2.1.6 This is of particular importance to Hong Kong which must compete with powerful neighbours. The availability of foreign capital, its price, and the readiness of foreign counterparties to enter into commercial relationships depend, to a considerable extent on trust and a reputation for good corporate governance will go a long way to strengthening the Region's economic position and to making Hong Kong a more attractive place to do business. While this is principally a matter for the larger listed companies, a reputation for good governance among the SMEs is also important.

2.1.7 As companies expand and become more complex, good governance becomes more difficult and more important. Larger companies usually have a larger set of stakeholders, and they employ more managers and executives to whom they delegate authority. Managing these relationships requires systems and policies. As soon as ownership is divided and other shareholders appear, issues of accountability emerge, until in large listed companies with a fragmented shareholding, they become dominant.

The Response

2.1.8 For many decades and in many countries, companies have been developing and improving the systems and practices of good governance. Most of the advances have been made in large listed companies where substantial resources have been committed to the task, where the abuse of power has been more obvious, and where collapses have had more serious consequences. Some of the sophisticated systems which have been developed are not appropriate for most SMEs, but many practices developed in large companies have been found valuable even in smaller companies, though often in a simplified form. Larger and more complex SMEs usually find that their performance is enhanced by adopting more of the sophisticated governance practices worked out in the large listed companies.

2.1.9 There are substantial differences in the ways in which companies are governed and it is important to recognise that there is no single approach. No simple blueprint applies to all situations, and differences in firm size, ownership structure, complexity, traditions and the personalities involved can, and should, make a great deal of difference to the way companies are governed. Nevertheless there are important underlying principles of proven worth which are likely to increase the chances of survival and success.

2.1.10 The most fundamental are that all companies must:

(a) Comply with the law.

(b) Earn the respect, or at least the tolerance, of their stakeholders – customers, creditors, employees, suppliers, and the communities within which they operate.

(c) Lower the cost of capital by establishing and maintaining a sound reputation.

(d) Identify and manage the risks facing them.

(e) Adopt and develop systems which enhance the quality of decision making.

2.1.11 Many practices have been developed which will assist toward these ends. It is for each company to review what has been developed elsewhere and to ask "does this apply to us?" To provide guidance on which practices are likely to be appropriate to a particular company it is helpful to divide them into five categories.

PRINCIPAL CHARACTERISTICS	
CATEGORY 1	Small entities owned by single individuals. Operations may involve a few family members.
CATEGORY 2	Larger entities employing non-family people. Owners may include a few family members or outsiders.
CATEGORY 3	Medium sized companies with several shareholders, or unincorporated partnerships.
CATEGORY 4	Large medium private or public companies with a substantial number of shareholders and with representative boards.
CATEGORY 5	Companies listed on the Stock Exchange of Hong Kong ("SEHK").

2.2 CATEGORY 1: Small entities owned by single individuals. Operations may involve a few family members.

2.2.1 The smallest enterprises are owned and managed by a single individual who, in some cases, is assisted by a small number of family members; most enterprises in Hong Kong are of this type. Some are registered as companies but many are operated as sole traders without the benefit of limited liability. In such enterprises the owner has no need to consider other shareholders or non-family employees, but will certainly have to satisfy customers, maintain the confidence of suppliers and possibly creditors, and will have to establish a sound reputation in the community in which the enterprise operates. Unless the entrepreneur is able to provide all the necessary capital for expansion the most pressing problems may be ensuring that the company creates and sustains credibility in the eyes of its bankers or other lenders. However successful the entrepreneur is, he must face the possibility that he may become temporarily or permanently incapacitated, and if the business is to survive and be carried on by other family members there must be sufficient records and documentation to allow them to understand it. If the founder wishes to sell the business at any stage its value will depend on what a purchaser can earn from it, and good systems and documentation will make a great difference.

2.2.2 For these purposes the following systems and practices will be important for governing the company well, and will constitute a minimum standard of good governance:

(a) Credible accounts and a simple system of internal control which enable the entrepreneur to know what is really going on in the business, and also enable the lenders to accept them as reliable. Similar to large companies, it is equally important for small companies to keep accurate and up to date records of revenue, expenditures, debtors and creditors, and as companies grow and become more complex, these categories will be sub-divided and additional measures will be found to be useful. Record keeping is likely to develop from a simple hand written ledger to quite sophisticated computer programmes. Such accounts may be important for taxation purposes. Their preparation will frequently require the part time assistance of a professional accountant who is able to advise on record keeping and presentation.

(b) A simple, written business or strategic plan which defines the company's objectives and the chosen route for reaching them. Good plans usually include an analysis of the company's strengths and weaknesses, and the opportunities and threats which it faces [a SWOT analysis]. A good plan may make use of any industry statistics or inter-firm comparisons which are available, and prudent entrepreneurs will check what sources of relevant government information are available. Such a plan will assist the entrepreneur to improve business decisions, and a coherent and logical plan will contribute to the company's credibility in the eyes of lenders. The effort of putting the plan down in writing and reviewing it each year will probably be well worth the while, even for very small enterprises.

CASE STUDY 1: Bank Loan

An entrepreneur started a street stall with his personal savings and through good personal relations with his customers and a canny knack of buying the right products at the right time, built his business rapidly. He realised that his success could be repeated in several other local areas but he lacked the capital necessary to buy equipment and stock. His family was unable to lend him enough to expand and he turned to his bank for a loan. The bank manager was sympathetic but wanted reassurance about interest and repayments. He asked for a written plan which set out how the money was to be used and how much would be earned from it. The stallholder had always relied on his instincts and had never produced a plan, let alone a written one, but when he came to set out his thoughts he was surprised to find that several new ideas came to mind. He talked the plan through with his brother who pointed out several risks which he was able to take into account. The bank manager was also helpful and told him several stories about the steps other entrepreneurs had taken on the way to success. By the time the loan had been obtained the stallholder felt that the plan was worth almost as much as the loan.

(c) A simple set of performance indicators, including a budget and a system for monitoring debtors and creditors, will also be valuable; it will enable the entrepreneur to monitor whether the company is performing in accordance with the plan.

(d) A simple analysis of the risks facing the company and basic policies for managing them will assist the entrepreneur to avoid disaster. All enterprises face a considerable number of risks which can change from time to time, and it is well worth the while considering them and working out what steps can be taken to reduce the chance of them occurring and the consequences if they do occur.

(e) One of the most significant risks is that of infringing the law in such areas as consumer protection and environmental protection. A well governed enterprise will be aware of the laws with which it must comply and will adopt appropriate compliance policies; this may require external professional advice. Compliance with the law and conformance with community standards will help protect the company's reputation and the respect in which the company is held in the community in which it operates.

2.2.3 Those enterprises which are registered as sole proprietorships need not have their accounts audited, but those registered as limited companies must submit audited financial statements.

2.2.4 A single entrepreneur is not required to have a board of directors, and it is unlikely that he would find it economic to establish one, but in order to help the entrepreneur think outside the square, and to take advantage of a number of perspectives, the involvement of one or more friendly part time advisers, such as the company accountant, would probably be valuable. Scheduled meetings between the entrepreneur and his adviser[s] would create a framework which will focus attention on objectives and longer term issues and is likely to make a constructive contribution to the quality of decision making.

2.2.5 Some form of succession plan will also be important. It should make provision for the continuance of the business if the entrepreneur dies, becomes unable to manage the business, or wishes to retire. [See Chapter 3]

2.3 CATEGORY 2: Larger entities employing non-family people. Owners may include a few family members or outsiders.

2.3.1 As enterprises grow in size, they will employ people other than close relatives, some of whom are likely to be strangers in the first place. The pattern of ownership may also change with the entrepreneur bringing one or more family members into the business, perhaps as designated successors with recognised rights. Some may contribute additional capital. Some enterprises in category 2 are partnerships whose partners are exposed to unlimited liability, and many are incorporated as companies.

2.3.2 Such enterprises will find value in all of the systems and practices used by those in category 1 but will have to develop them in greater detail:

(a) The larger size of category 2 enterprises makes the accounting and internal control process more complex and more important. The entrepreneur may no longer be able to watch over all the operations and may need formal systems to check on activities he cannot supervise directly.

(b) The business plan is also more likely to be more detailed and it may need to span a longer time horizon, perhaps three, or even five, years. It will also be more important to review it annually.

(c) Larger and more complex companies need more performance indicators and the process of collecting the relevant data and presenting it in a usable form will require closer attention. Both financial and non-financial performance indicators will be found to be valuable. The most important financial indicator is the budget, and cash flow statements, balance sheets, and regular reports on the level of debtors and inventories will also be helpful. Non-financial performance indicators can give early warning of developing problems and usually cover relationships with the company's principal stakeholders; they may deal with customer satisfaction, staff morale, productivity etc.

(d) Because larger companies will probably engage in a wider range of activities, the number and variety of the risks they face will be greater. A risk is the chance of something happening which will prevent the company from achieving its objectives. Risk identification and risk management will therefore assume greater importance. A formal process of evaluating the risks facing the organisation may be worth the while. It is best to evaluate risks according to the likelihood of occurrence and the consequences if they do occur. This can be done quite simply by making a list of all the risks faced by the company and giving them two scores, on the following basis:

Likelihood of occurrence
5 almost certain
4 likely
3 moderate
2 unlikely
1 rare

Consequences of occurrence
5 catastrophic
4 major
3 moderate
2 minor
1 insignificant

When the scores are multiplied together any risk which has a combined score of 15 or more probably requires a specific policy to deal with it.

(e) Written policies for managing the most serious of the risks are likely to help avoid disaster.

(f) If several family members are taking an active role in the company, the succession plan will assume far greater importance and will have to be understood and agreed by the up-coming generation. It may well involve a formal family agreement with recognised shareholdings and an external valuation of the company.

(g) Whether the founder intends to pass the business to his heirs, or to sell it to an outsider, controls systems and records that will allow new managers to understand the business and continue its prosperity are essential.

CASE STUDY 2: Founder's Retirement I

Six members of the family had joined the founder in the business, and three of them had worked in it for over thirty years. When times were favourable for the company they received good salaries, but there had been several periods when the going got tough and the family members had sacrificed a large part of their remuneration for the good of the business. It had always been understood that when the time was ripe the founder would retire on a pension and the remaining family members, who constituted an informal board, would carry on with the business and inherit equal shares in the ownership of the business – but no formal legal agreement had ever been put in place.

After a period of very successful trading the founder received a very attractive offer for the company and decided to sell. He reasoned that the sale price would allow him to take a very attractive pension, and he argued that the rest of the family would also be well provided for. The other family members were furious and pointed to their long service and the sacrifices they had made for the company, but they had no legal rights and their efforts to persuade the founder failed. The company was sold and the other members of the family left the business feeling bitter at what they saw as betrayal.

2.3.3 In addition to the governance practices relevant to category 1 enterprises, the following will be found valuable:

(a) Simple policies covering remuneration and other human relations issues such as incentives, discipline and dismissal. If these are, and are seen to be, fair to all, they will help the company attract good employees and maintain the loyalty and enthusiasm of those who are employed.

(b) Since these enterprises are likely to be larger and more complex, some decisions will have to be made by managers or executives other than the entrepreneur and simple policies to guide decision making will be necessary so that the company is perceived to be consistent and reliable. Policies covering purchasing and sales are likely to be particularly relevant, but careful regard to all issues which could affect the company's success and reputation will also be important.

(c) If family members have been brought in to take positions of responsibility in the company, consideration should be given to securing their continued loyalty, and making them feel fairly treated, by making them part owners of the business and including them on the board. If the owner dies, or becomes unable to continue to manage the business, such an arrangement will also help to secure the future of the company.

(d) If capital has been contributed by anyone other than the original entrepreneur, a system must be introduced which allows all concerned to understand the company's financial situation and feel comfortable that they are being treated fairly. Since borrowings are likely to be larger than in the case of category 1 enterprises, relations with the bank, or other suppliers of loan capital will probably require greater care and more formal governance procedures and mechanisms are likely to be required.

2.3.4 Many category 2 enterprises seek assistance from external accounting firms and have their accounts audited. All limited companies are required to produce audited financial statements, and larger partnerships and sole proprietorships are likely to find it in their interests to seek an audit opinion. Valuable external advice can be obtained from professional accounting firms and the entrepreneur is likely to find it valuable to be able to take advice on a wider range of issues.

2.3.5 Since any investors, other than the founder, are likely to be few in number and able to exert influence directly, there is no need for a representative accountable board, but a simple board structure, perhaps constituted as a board of advisers, may be valuable.

2.3.6 Boards of advisers can be appointed by those who control enterprises and asked to provide advice on selected matters. In some cases an entrepreneur may offer his chosen advisers a formal contract, but more often appointments will be made on the basis of an oral agreement. Since the members of a board of advisers are not able to control management, or ultimately remove the CEO, they should not put themselves in a position in which they can be held accountable for the company's performance. It is therefore important that they should be given specific terms of reference in relevant documentation, such as a company's Articles of Association to make it clear that legally the members of the board are advisers and not legally directors. In some circumstances it may be appropriate for a governing director to be appointed with clearly designated powers. The entrepreneur is then able to refer chosen matters to the board for consideration, but is not obliged to follow their advice.

2.3.7 The establishment of such a board of advisers offers benefits to the entrepreneur:

(a) The establishment of a framework of board meetings, which involves the setting of agendas, the preparation of board papers, the recording of minutes, and the need to explain developments, opportunities and threats, creates a discipline which causes the entrepreneur to lift his eyes from day-to-day events and pressures and to focus on longer term objectives and more strategic issues.

(b) Effective members of the board of advisers ask tough questions that management might not ask itself, and thus they provide a perspective which enhances judgement and decision making by causing the entrepreneur to consider more deeply and to think outside the square.

CASE STUDY 3: Entrepreneur's New Director

An entrepreneur who had built a printing business employing forty people found that the volume of business and the growing complexity of the company were causing him to focus on the day-to-day pressures of running the company, and that some of his decisions were becoming inconsistent. He decided to appoint his accountant as a director and to hold regular meetings with him. In order to make the meetings effective he produced agendas, a few papers on important matters and appointed a part-time company secretary to take minutes of the meetings. The new director asked many questions about the operations of the company, and about why major decisions had been taken or were being proposed. The entrepreneur found that he was being forced to think through the issues in a more deliberate way than he had done previously, he checked his facts more carefully and the process of explaining the business led him to a deeper understanding of it. He found that cost benefit analyses and SWOT [strengths, weaknesses, opportunities and threats] analyses were valuable tools. After a year he was asked whether the appointment of the new director was worth the while. "It was the best decision I ever made" he replied. "I am looking for a second director who comes with a different set of experiences."

2.4 CATEGORY 3: Medium sized companies with several shareholders, or unincorporated partnerships.

2.4.1 Limited companies which have several shareholders, whether members of the family or not, have moved into category 3. Many will be family companies in which second or third generation family members have been granted legal rights. Some companies may have non-family investors, and this category also includes some larger unincorporated partnerships. Some of the companies in this category may be seeking, or have sought, the investment and assistance of venture capitalists and, as a consequence, have accepted additional disciplines over their operations. In any event the additional shareholders bring additional responsibilities: once the entrepreneur is no longer the sole owner, he will no longer be able to do as he pleases with his company; the law requires him to act in the interests of the company, which for most practical purposes means the longer term interests of the shareholders as a whole.

2.4.2 Category 3 companies will probably be larger than the enterprises in categories 1 and 2, and will have more employees, some of whom are likely to have executive responsibilities. These companies are more likely to be medium than small companies.

CASE STUDY 4: Founder's Retirement II

A family business which had been established for over forty years had grown considerably and employed eighty people, including a professional accountant and a highly qualified IT specialist. The four children of the founder's family had all worked outside the firm for a number of years to gain experience, and had then taken various positions in it. On his sixty-fifth birthday the founder called a family conference and announced that he had given consideration to his eventual retirement and, as an initial step, each of his children were to be given 10% of the shares in the company, and that the family members would constitute a board which would meet each month to discuss the company's objectives and its progress towards them.

Two issues quickly led to considerable friction and threatened to disrupt the business: the eldest son, who held the most senior position, and thought that he contributed most to the company, felt that equal treatment for his siblings who contributed less was unfair; and the accountant, who had been the founder's principal confidant and adviser for many years resented being excluded from the board. The founder wondered whether he had made the right decision but decided to wait to see if things would settle down.

2.4.3 Category 3 companies will need all the governance systems and practices outlined for category 1 and 2 enterprises and will need to develop them more fully. In particular they will need:

(a) Systems of internal control which are robust enough to support annual accounts which are sufficiently reliable to maintain the confidence of investors, and which are capable of helping management to make good decisions.

(b) Objectives and plans which are sufficiently clear and consistent to win and maintain the confidence of investors as well as lenders.

(c) An understanding of the risks facing the business, and a system for managing the most important of them, which enables the company to avoid erratic performance.

(d) Arrangements for establishing an extensive network of policies, such as those relating to compliance with the law, the employment of non-family members, and reporting systems, which allow the CEO to be satisfied that the policies are up to date and are being implemented thoroughly. Most of these will deal with the management of the risks that the company has identified [see para 2.3.2]. It is good practice for management to formulate, and the board to ratify, a policy to manage each major risk, and for these to be recorded in writing and to be retained in a loose leaf manual so that they can be reviewed whenever necessary.

(e) A system of performance indicators which enables the CEO to measure objectively how the company is operating in relation to the plan, and which provides an objective means of assessing executive performance.

2.4.4 In addition to the governance practices relevant to category 1 and 2 enterprises, category 3 companies will probably need:

(a) A written Articles of Association [constitution] which reserves some powers for the exercise by shareholders in general meeting. Many companies will choose to adopt the Model Articles set out in the Companies (Model Articles) Notice contains a set of model articles of association, but they are free to choose other arrangements.

(b) An accountable board of directors which is seen to fairly represent the interests of all investors. If there are comparatively few shareholders it may be appropriate for each of them to be a member of the board, or for the directors to be people who are personally known to the shareholders and who enjoy their confidence. Legally the board receives its authority from the shareholders and is responsible for the management of the company. Since the board receives its authority collectively it can act only when it meets, and since boards meet only periodically while management requires continuing attention, the board itself cannot manage and must appoint management which is accountable to it.

(c) A system for delegating authority from the board to management so that everyone knows who is responsible for doing what. It is valuable for this to be set down in writing either in the CEO's letter of appointment, or the CEO's job description, or a board charter, or a statement of delegations or a statement of matters reserved for the board. The latter is usually found to be briefer and more flexible and is therefore the most convenient. The statement of matters reserved for the board may include perhaps twenty or thirty items, but the most important are:

  (i) Processes which allow the directors to be satisfied that the accounts are true and fair, and the internal control systems robust and reliable.

  (ii) Arrangements for meeting the auditors and satisfying themselves about the adequacy of the scope of the audit and the integrity, competence and independence of the auditors.

  (iii) A system by which the board involves itself in the formation of strategy.

  (iv) The means by which the board satisfies itself that the risks facing the company have been identified, assessed, and the material ones are being managed.

  (v) Some form of succession planning.

(d) A mechanism for ensuring that the board performs the functions which it has reserved for itself and refrains from hampering management by second guessing it on matters which have been delegated to it.

(e) A system for involving the board and management in setting the goals and strategies for the company, and for agreeing the performance indicators which are to be used for measuring progress towards the objectives.

(f) If managers or executives have been employed, it will be necessary for them to have written job descriptions which ensure that all concerned know who is responsible for what, and which provide the basis for regular reviews of management performance. It is good practice for family members in management positions to have a clear understanding of their responsibilities and the limits of their authority.

2.4.5 If the company's founder or entrepreneur continues to hold shares [perhaps a majority of the shares], it is likely that he will be a shareholder, a director and the CEO at the same time.

(a) As a shareholder, the entrepreneur is entitled to exercise the powers reserved for a shareholder in his own interests, including the right to requisition a general meeting of shareholders for the purpose of removing one or more of the directors if he believes that to be necessary.

(b) In exercising the powers of a director, the entrepreneur must act in the interests of the company as a whole, even if those interests conflict with his interests as a shareholder. Of course all the directors have equal responsibility and their votes have equal weight, so that a founder and major shareholder could, at least theoretically, be outvoted on the board.

(c) In exercising the powers of the CEO, which have been delegated by the board, the entrepreneur is accountable to the board and is responsible for carrying out its instructions in accordance with the policies which have been laid down by it.

These different responsibilities are often difficult to understand, and they can cause major problems if other shareholders or directors insist on their legal rights.

2.4.6 The directors of the company, whether family members or not, are also in a difficult position. They will probably have been appointed by the entrepreneur, may well be receiving remuneration arranged by him, and are likely to feel some loyalty to him. On the other hand, as company directors they owe their loyalty to the company and not to a single shareholder, and they are required by law to exercise their judgement independently in the interests of the company.

2.4.7 The appropriate distinctions are often difficult to make and, in many companies, breaches of the principle that management must be accountable to the board and the board accountable to shareholders cause serious dissatisfaction among shareholders, and possibly damage to the company. In category 3 companies the strength and independence of the board, and other corporate governance principles, emphasised for listed companies, are beginning to become important.

2.5 CATEGORY 4: Large medium private or public companies with a substantial number of shareholders and with representative boards.

2.5.1 Companies with a substantial number of shareholders, whether they are part of an extended family or include outside investors, can be classified as category 4. They may be public or private companies, and some may be considering listing. In this category there are too many shareholders for all of them to be members of the board and it is therefore necessary for them to elect directors to represent them. All members of the board have a clear duty to act in the interests of the company as a whole and not in the special interests of any shareholder or group of shareholders. In such companies there is a real possibility that the interests of the entrepreneur/CEO may differ from those of some other shareholders and it is important that the directors exercise independent judgement in deciding matters of difference.

CASE STUDY 5: Change in Direction

After some years of rapid growth it had become clear that the business needed a substantial increase in capital and the founder asked four of his friends to invest in the company. In order to persuade them he produced a written plan which forecast strong growth and attractive profits. The friends agreed to contribute the necessary capital on condition that the founder appointed a board on which they would sit as directors.

The board met monthly and the directors were pleased with the progress of the business, and delighted with their first dividends. At the August meeting the founder brought to the board a revised business plan which laid out a major change in direction. He explained that the changes were urgent and he asked the board to ratify the plan immediately. The other directors refused, saying that they needed time to study the plan and to discuss the changes proposed. The founder argued that he understood the business far better than they did, but they insisted that as the majority of the board they had the right to consider and approve the company's strategy, and that they were not going to be rushed into an instant decision. The founder had never imagined that he would lose control of his business and was very upset.

2.5.2 Operations in category 4 companies will be relatively complex and they will probably employ a substantial number of people, towards the top of the range of SMEs, i.e. 100 employees in manufacturing and 50 employees in non-manufacturing. There will probably be two or more levels of management and at least some of the executives will probably not be family members.

2.5.3 Such companies will need a more sophisticated governance system than those in categories 1 to 3. Its principal purpose is still to ensure the ongoing prosperity of the company [that is to preserve and enhance the investment in perpetuity], but the presence on the company register of shareholders who cannot participate directly in control, means that the main decisions about the company's future must be made [or at least reviewed and endorsed] by a board which exercises independent judgements in the interests of the shareholders as a whole. The board must be able to provide strategic guidance for the company and effective oversight of management.

2.5.4 In category 4 companies the principle of accountability is of fundamental importance: the board must be accountable to the shareholders and management must be accountable to the board. No single individual should have unfettered powers.

2.5.5 Category 4 companies which are considering listing on the SEHK will need to take the principle of accountability very seriously. Prospective shareholders, who may be considering investing in the company, will be influenced to a considerable extent by the way in which the company has been governed. It would be prudent for such companies to establish a track record of good governance, lasting at least three years, before applying to list.

2.5.6 Category 4 companies will have developed all the processes and mechanisms listed for companies in categories 1, 2 and 3 in considerable detail, and a number of other policies and procedures will be found to be valuable. The differences in the pattern of ownership make a different form of analysis of the governance of category 4 companies appropriate.

Shareholders Delegate Power to the Board

2.5.7 The governance structure of category 4 companies rests on the recognition that it is the shareholders' investment that creates the company and that the power of ownership rests with the shareholders. But because there are too many shareholders for them to be assembled quickly, or for them to take effective decisions on the many complex issues which occur in the course of business, they must delegate most of their powers, and the authority to manage the company, to a few of their number who they elect to represent them on the board. The authority and responsibilities of the board are set out in the Articles of Association and it is important that careful thought be given to ensuring that the Articles are appropriate to the company's circumstances and needs.

Buy Sell Arrangements

2.5.8 Since existing shareholders may die, or experience a change in their circumstances which leads them to wish to sell their shares, and since it may become desirable to admit new shareholders to the register, unlisted companies need a mechanism which permits shares to be bought and sold. There are two broad possibilities:

- Arrangements can be agreed under which the company will buy back shares from existing shareholders, or issue shares to new prospective shareholders, in pre-agreed circumstances and on an objective price basis; the company itself would then be a party to all share transactions; or

- Rules, including a pricing formula, can be agreed which allow individual shareholders to buy and sell shares with each other, and perhaps to sell them to outside parties.

2.5.9 In either case the arrangements must be seen to be objective, consistent and fair to all. It will usually be desirable for them to be set out in detail in the Articles of Association or in a separate shareholders' agreement.

The Composition of the Board

2.5.10 The Articles of Association will normally establish the maximum size of the board and may lay down some basic rules about its composition and its operations. While the shareholders formally elect the directors, the members of the board are in a far better position to know which of them are performing well, what type of person would contribute most when a vacancy occurs, and who would best fit the specification of the ideal candidate. It is therefore good practice for the board to establish mechanisms for:

(a) Reviewing the performance of the board as a whole.

(b) Reviewing the performance of individual members.

(c) Reviewing the composition of the board.

(d) Drawing up the specification of the ideal next director.

(e) Identifying/selecting the best available candidate.

(f) Recommending that candidate to the shareholders for election.

(g) Making appropriate appointments when casual vacancies need to be filled between Annual General Meetings.

2.5.11 The chairman of the board has a particular responsibility to ensure that these functions are carried out properly, and it has been found that a Nomination Committee of, say, three senior directors, probably chaired by the chairman of the board, can make a valuable contribution. If a Nomination Committee is appointed it is important that it be given a written charter which sets out its responsibilities, the limits of its authority, the way it is to operate, and the mechanism by which it reports to the board as a whole. The Nomination Committee Charter will probably be similar in structure and outline to the model Audit Committee Charter shown as Appendix II.G.

2.5.12 Since the shareholders elect the directors, it is important that they be given sufficient information about the candidates to enable shareholders to be satisfied that the board is capable of representing them appropriately and that there is a balance of experience and skills among the candidates.

2.5.13 The board should be structured so that it makes the maximum contribution to the overall objective of preserving and creating wealth. The directors therefore need a proper understanding of, and competence to deal with, the current and emerging issues of the business. It is equally important that the board is strong enough to review and challenge the performance of management and to exercise independent judgement. Boards are likely to be strengthened if:

(a) A majority of their members are independent of management, of any substantial shareholder, and of any other interest or relationship which could materially interfere with the director's ability to act in the best interests of the company as a whole.

(b) The chairman of the board is an independent director and not the CEO or a controlling shareholder.

(c) The non-executive directors meet periodically in the absence of management to review the progress of the company.

(d) The company secretary is able to act independently. His independence will be enhanced if his appointment, and any question of his removal, is a matter for the board as a whole.

2.5.14 Directors will be more effective if they understand what is expected of them and it is valuable for the board to provide each incoming director with a letter of appointment setting out the key terms and conditions of appointment. It is useful for this to include information on the term of appointment, the time commitment envisaged, the powers and duties of directors, remuneration and expenses and the induction training programme. The letter may include a copy of the Board Protocol if one exists [see para 2. 5.19].

2.5.15 The chairman of the board is normally elected by the directors, from amongst the members of the board, and it permits the directors to remove the chairman at any time without notice. The authority of the chairman is not set by the Ordinance but rests on delegation from the board and may vary from company to company. It is prudent for the chairman to be delegated extensive power to lead and manage the board but very little power over the affairs of the company. The chairman should be able to exercise great authority to control board meetings, such as authority to determine the agenda, to control the allocation of the board's time in meetings, to require that information be provided to the board and to consider the minutes in draft before they are sent to the other directors. He should also represent the board between meetings and make administrative and minor decisions on behalf of the board, but he should have no authority to decide substantive matters or to instruct the CEO.

"The chairman manages the board, the CEO manages the company."

2.5.16 It is usually found that boards function better if they are chaired by an independent chairman who has no connections with management or a controlling shareholder. In those companies where a controlling shareholder, perhaps the founder, insists on taking the chair, it is good practice for the non-executive directors [NEDs] to elect one of their number to act as a "lead director" who is able to speak for the NEDs and to convene and chair private meetings of the non-executive directors.

Communications with Shareholders

2.5.17 All shareholders have an equal right to be informed of material matters relating to the company and the board is responsible for the establishment and monitoring of policies which will ensure that shareholders are treated equally.

Board Harmony and Teamwork

2.5.18 Since the shareholders delegate authority to the board as a whole, its members are collectively responsible for its decisions. It follows that a board will be more effective if it operates harmoniously and as a team. The chairman has a major role in leading the board to act harmoniously and, in addition social activities involving board members and reviews of board performance which focus attention on the board's common purpose are valuable.

2.5.19 Board harmony will also be enhanced if the major potential causes of friction are identified and resolved in advance in written agreements. It is prudent for these agreements to be incorporated in a Board Protocol, or a Board Charter which provides guidance for directors on the way they should conduct themselves, and strengthens the position of the chairman in leading and managing the board. The main matters for inclusion in a Board Protocol are likely to be:

(a) Recognition of responsibility and common purpose.

(b) What is expected of directors:
- loyalty.
- confidentiality.
- not acting in a way that brings discredit on the company.
- bringing material matters to the attention of the board.
- induction training.
- ongoing training.
- declarations of conflicts of interest.
- tenure of directors.

(c) Directors' rights:
- to information.
- access to executives.

(d) Directors benefits:
- remuneration.
- expenses.
- disclosure of other benefits.

(e) Board leadership and the role of the chairman.

(f) The position of the company secretary. A model protocol is included in Appendix II.C.

The Functions of the Board

2.5.20 The board is responsible for the management of the company but, since it receives its authority collectively, it can act only when it meets; and since boards meet only periodically, while management requires continuing attention, the board cannot manage. What the board can do, and must do, is to:

(a) Appoint management, [see paras 2.5.21-2.5.22].

(b) Reserve certain decisions and actions for itself and to perform them effectively, [see paras 2.5.23-2.5.38].

(c) Delegate all other matters to management, [see paras 2.5.39-2.5.41].

(d) See to it that management is managing properly.

(e) Monitor the solvency of the company.

(f) Help management to manage better, [see para 2.5.42].

(g) Ask the penetrating questions that management might not ask itself.

CASE STUDY 6: CEO's Investment Proposal

A CEO brought to his board a major investment proposal which at first sight appeared to be brilliant. It involved the production and marketing of a new product which seemed to have enormous potential. The plan was presented in a board paper which was distributed to the directors a week before the board meeting and most of the directors arrived at the meeting ready to congratulate the CEO and ratify the proposal. He spoke persuasively and the chairman was about to bring the discussion to a close by approving the expenditure when one of the directors said "just before we agree, would you please clarify a few points. You said that this new product depended on our access to the XXX patent; please explain how we get that access. The CEO set out three steps required and gave details on how they would be taken. "If we can do that", said the director, "why can't our competitors follow exactly the same steps?" The CEO's explanation was unconvincing and the director pointed out that the high profit margin built into the case rested on a price premium being charged for the new product. "If our competitors follow us and gain access to the patent, we won't be able to command the price premium and the high profit margin will disappear" he said. The board decided that the CEO had not made a convincing case and the project was dropped.

The Appointment of Management

2.5.21 The board has the right and the duty to select the CEO, to appoint him on whatever terms it considers to be in the best interests of the company, and to remove him if necessary. In most cases this will require a formal letter of appointment setting out the requirements of the position, the basis for remuneration and any conditions of employment. It will provide the basis for the board to terminate the relationship if that is considered to be in the best interests of the company. Of course, where a controlling shareholder wishes to be CEO special problems arise, but it is always important that the terms of appointment be clearly understood by all concerned.

2.5.22 The role of the board in the appointment of the second line of management, those reporting directly to the CEO, can raise difficult questions. Generally it is important that, if the board is to hold the CEO accountable for performance, he must have confidence in those who report to him and to whom he will delegate important responsibilities. At the same time the quality of the executives reporting to the CEO can make a significant difference to the performance of the company and since the board is responsible to shareholders for the performance of the company, it must be satisfied that they are appropriate for their tasks. When the question of a successor to the CEO comes up, the quality of the second line executives becomes a crucial matter.

Delegations to Management and Reserving Matters for the Board

2.5.23 There is no simple rule which determines what matters the board should reserve for itself, and there are likely to be considerable differences in detail between individual companies. However there are several matters, other than management appointments, which must be included in the board's functions, though there will be wide differences in the detail of how boards involve themselves.

2.5.24 Perhaps most important, the law lays down that the accounts of the company are the directors' accounts and it is essential that the board makes arrangements which will allow them to be satisfied that the accounts are true and fair. As a minimum this will involve regular reporting, concern with the system of internal control, and some relationship with the auditors.

2.5.25 Similarly, the directors are legally obliged to make certain disclosures to shareholders, as well as arrangements for shareholders' meetings. There are also likely to be contractual obligation to make disclosures to lenders.

2.5.26 It is essential that the board is satisfied that the short and medium term objectives of the company, and the plans for achieving them, are realistic and will allow them to discharge their duty to maximise shareholder value. With this comes the need for monitoring and reporting mechanisms.

2.5.27 The management of risk is an equally important task. The board must satisfy itself that the risks facing the company have been identified, that the material ones have been assessed, and that there are policies in place for handling them. Again there is a need for mechanisms which allow the board to be satisfied that the policies are up to date and are being complied with.

2.5.28 The board is responsible for setting the tone and character of the company and it should clarify the standards of ethical behaviour required of directors and executives and encourage adherence to those standards. This may require a written code of conduct.

2.5.29 It is probable that an effective board will reserve some twenty or thirty matters for its consideration and decision. Some, such as the ratification of the use of the company seal, will be the sole responsibility of the board; others, such as the authorization of capital expenditures, will be a shared responsibility – with the CEO having delegated authority up to an agreed level and the board making the decision above the level. A pro forma list of matters reserved for the board is included as Appendix II.B. See also Appendix II.F on delegation of authority.

2.5.30 In order to avoid confusion it is important that the division of functions between management and the board should be set out in writing and reviewed periodically. A Statement of Matters Reserved for the Board is flexible and will probably be the simplest and shortest, but alternatively a Board Charter, a Statement of Delegations, the CEO's job description or the CEO's letter of appointment could be used.

2.5.31 If the board allows itself, or any individual director, to meddle in the matters which have been delegated to management, the authority of the CEO may be undermined and the company damaged. It is important to stick to the general rule:

> "Management formulates, the board ratifies,
> Management implements, the board monitors."

Effective Operating Systems for the Board

2.5.32 The board's responsibilities are numerous, varied and onerous, and to be effective the board needs systems that will facilitate its operations. It is helpful for it to agree an annual agenda which sets out all the functions it proposes to carry out in the following year including the major steps which it proposes to take. For instance, if the board has decided to take part in a strategic planning conference with management, or if it has decided to review the succession plan, those items should be allocated to scheduled meetings and included in the agenda. There may well be thirty items on the agenda and they should be distributed among the scheduled board meetings which have been planned for the year; this will produce a set of pro forma agendas, one for each of the planned meetings. A pro forma annual agenda is included as Appendix II.E.

2.5.33 The agenda for each individual board meeting should be settled by the chairman, with the assistance of the CEO, and possibly the company secretary, about a fortnight before the meeting. Unless there are very good reasons, the pro forma agenda for the meeting will form the core of the actual agenda, with additional items proposed by the CEO and arising from current operating issues, for example, capital expenditure approvals. It is also good practice for the board to have agreed that each director has the right and the duty to bring to the attention of the board any matters of serious concern to the director and for such matters to be raised with the chairman, who can include them on the agenda.

2.5.34 Since items which are placed at the top of the agenda tend to be allocated more time than those at the bottom, the ordering of the agenda is an important way in which the allocation of the board's time can be influenced. Since the chairman is responsible for the management of the board, he should consider which of the matters for consideration at the meeting are of the greatest importance and which deserve most time, and he should order the agenda so that the most important matters are considered first. Standard agenda orders usually reduce the effectiveness of the board.

2.5.35 The board's deliberations will be made more effective if there is a board paper for every item on the agenda, which provides directors with all necessary background information and which draws attention to any significant issues. Each board paper should include a written recommendation from management [even if it is only that "the board note the above"] which acts as the motion before the meeting. The practice of moving and seconding motions during the meeting is usually found to be unnecessary, time consuming and divisive.

In order to discharge their duties properly, directors must have a right to identify the information which they need, and to receive it in a timely manner. [The board may wish to specify the way in which board papers are to be set out and the amount of time prior to meetings which they required in order to consider them].

Individual directors have a right to obtain information necessary to discharge their duties from the executives of the company, but it must be recognised that questions and requests involving a substantial amount of work may disrupt the management of the company. Accordingly the directors should agree on a procedure by which a director seeks information, which is understood by both the directors and the management alike.

2.5.36 It is the chairman's responsibility to control board meetings, to lead the board's discussions to clear conclusions, and to satisfy himself that the company secretary has understood each conclusion reached.

2.5.37 Since the board is responsible for the management of the company, the information it receives must be adequate for it to understand what is really going on and for it to be satisfied that the company is being managed properly. The directors must therefore be satisfied that the regular reports on the company's performance, and the board papers which they receive on individual agenda items fully satisfy their needs, that the appropriate executives are in attendance to make presentations and to answer questions, and that generally they are being properly informed. Much of the responsibility for carrying out this function is delegated by the board to the chairman, but the board is responsible for seeing that it is being done effectively. While the board's information requirements must be discussed with management, the underlying principle is that the board must insist on getting the information that it needs, it should not rely on what information management wishes to give it.

2.5.38 Not only is it essential that the minutes of board meetings are clear, concise and complete, but it is valuable for each set to be followed by an Action Item Sheet which lists all the actions which the board had decided should be taken. It is good practice for these to show each action to be taken, the person responsible and the date by which the action is to be completed. If the actions are listed in the order in which they should be completed, it is easy for the board to check that those which should have been completed by the date of the next board meeting have been dealt with. If the board is rigorous and consistent in checking the Action Item Sheets at each board meeting, it is likely that it will be in effective control of management.

Seeing to it that Management is Managing Properly

2.5.39 Since most boards schedule twelve meetings or less per year, and since the average meeting usually lasts not more than half a day, the amount of work that can be done by the board is limited and most matters must be delegated to management. But since the board is still responsible for the management of the company, it must see to it that management is managing properly. To discharge this responsibility it needs a set of yardsticks and benchmarks. While these will vary, the following are generally found to be useful:

- A clear set of written objectives.
- A written plan, or set of plans for reaching them.
- A budget and a system for reporting against it.
- A set of financial performance indicators.
- A set of non-financial performance indicators.

2.5.40 For every chosen yardstick a benchmark which sets out what is an acceptable level of performance is needed. The board should also agree with management how the data which will be used to monitor performance is to be presented. The questions which will have to be answered include:

- The frequency of reporting.
- Whether there is to be a written narrative report.
- Whether charts or graphs are required.
- Whether oral presentations are needed.
- Whether the reports will be made to the board as a whole or to a committee of the board.

CASE STUDY 7: Setting KPIs

After two major customers had transferred their business to a competitor, the board of a manufacturing company became concerned about whether the remaining customers were satisfied with its service. They considered several possible Key Performance Indicators ("KPIs") which would give accurate information, which would be cheap to collect and which would provide a reasonable reflection of customer attitudes. The Marketing Manager suggested that if the customers got what they had asked for, when they asked for it, they would be more likely to be satisfied than if they didn't. When the board agreed, he proposed that the directors should receive, at each meeting, a graph showing the percentage of shipments which were delivered in full and on time. The figures were to be plotted on a monthly basis and to show performance over a twelve month period. The board set a benchmark of 95% achievement as acceptable and this was also plotted on the graphs.

After the first year of use the board reviewed the system and concluded that it had been a great success. Because management had to produce the figures regularly they focused more attention on customer service and only once in the year had the actual performance fallen below the benchmark. No further customers were lost, and the board noted that it had to spend very little time on monitoring a vital aspect of performance.

2.5.41 If the board is sufficiently large it may be desirable for it to establish an Audit Committee and/or other committees. All such committees should be given written charters. A model Audit Committee Charter is included as Appendix II.G.

Helping Management to Manage Better

2.5.42 The duties of a CEO are complex and stressful and there are such constant pressures that there is a real danger that urgent problems will displace consideration of more important ones. If a board is functioning well, it can help management to manage more effectively in several ways. The most important are:

(a) Regular board meetings, and the need to prepare for them, ensure that management will periodically focus on the longer view and, in particular, be reminded of the objectives of the company and the progress which is being made towards them.

(b) The board's attention to shareholders interests will help to ensure that they are not forgotten.

(c) If the board frequently asks penetrating questions, which management might not ask itself, a wider range of perspectives will be considered and the quality of decision making will be improved.

(d) If the board is experienced and knowledgeable, it will be able to provide management with constructive reactions to its proposals and will be a valuable source of advice.

(e) If the objectives, plans and budgets are well set, and if performance is well monitored, management will be stretched and the company's performance improved.

(f) A perceptive board will be able to arrange specific training or experience which will strengthen the performance of the CEO.

(g) Since there is always a danger that a strong CEO will be surrounded by sycophants and will become over-confident, a strong board will help to avoid hubris.

(h) An independent board is in a position to set the CEO's remuneration and incentives objectively and effectively.

(i) If the relationship between the chairman and the CEO is healthy, if it is close but not too close, the chairman will be able to act as a mentor for the CEO, whose position is usually lonely and exposed.

2.6 CATEGORY 5: Companies listed on the Stock Exchange of Hong Kong ("SEHK").

2.6.1 The few SMEs in Hong Kong which are listed on the SEHK make up category 5. They are bound by the Listing Rules. All the governance guidelines set out for category 4 companies are relevant to them and, in addition, they have substantial obligation to make disclosures and to comply with the rules.

CHAPTER 3

THE SPECIAL ISSUES OF FAMILY COMPANIES

3.1 CHARACTERISTICS AND ISSUES

3.1.1 Family companies are those controlled by a single individual or a group of close relatives. In most cases they own all the equity in the business, but it is useful to include those companies in which a minority of shares is held by non-family members, but where the family exercises effective control. In many cases non-family members are employed by family companies, sometimes in positions of substantial responsibility.

3.1.2 Over three quarters of the world's companies fall into this category and, while most of them are small, in many countries they employ around half the workforce and contribute a substantial part of the gross national product. In Hong Kong their economic significance is of major importance.

3.1.3 The governance of such companies is relatively simple and, in most cases, they enjoy several significant advantages over those in which there is a wider spread of shareholdings:

(a) Since there is little or no separation of ownership from control, the identification of objectives, and other decision making, can be streamlined.

(b) Since the company controller(s) benefit directly from the successes of the company, personal incentives are very strong.

(c) The loyalty of family workers is usually great, particularly if they are also shareholders.

3.1.4 However the long term survival rate of family companies is low: less than half are carried on by the second generation, and less than a quarter are passed on to the third generation. This high failure rate is frequently associated with several special governance problems which, while they have been recognised for a very long time, have become more acute in recent years. Three new factors have come into play:

(a) The rapid changes in technology, and intensifying competitive pressures, have meant that many small family companies have had to gain access to specialized skills. If the necessary experience cannot be provided by training family members, it becomes necessary to recruit outsiders at such senior levels that they are effectively involved in the direction and control of the company.

(b) At the same time social and educational changes have provided new and attractive opportunities, and have led a growing number of family members to prefer careers outside the family business.

(c) An additional issue for family companies in Hong Kong has been created by developments in Mainland China. The emergence of business opportunities in, and competition from, a country with vast supplies of low cost labour has caused many Hong Kong companies to change the pattern of their activities and to focus their efforts on service industries, or alternatively to complicate their business activities by establishing manufacturing activities on the Mainland.

3.1.5 The special issues of family companies are potentially serious and it would be imprudent for company controllers not to take them into account in establishing their governance structures. Five principal problems require consideration.

3.2 SUCCESSION

3.2.1 Considerable waste is common when companies are taken over by outsiders, and liquidation involves an even greater dissipation of resources. The comparatively high proportion of companies which are not passed on to succeeding generations is therefore a cause for concern. Seven main reasons can be distinguished:

(a) Some companies are not successful enough to provide a retirement income for the founder as well as a sufficiently attractive income for a family successor, and they therefore have to be sold when the founder is no longer able to work.

(b) Some children are not interested in the family business and prefer to do other things.

(c) Some children have received training overseas and are influenced by different life styles. They may look on succession as a sacrifice.

(d) Some are not sufficiently competent, or sufficiently well trained, to take over.

(e) Sometimes the arrangements for integrating and training family members, and handing over control to them, are inadequate and the intended heirs become frustrated and depart to take up other opportunities.

(f) In some cases disputes arise between heirs who want to split the business in order to pursue different objectives, or simply to gain personal independence.

(g) Sometimes death, ill-health or other disasters occur before the founder has prepared the heir(s) sufficiently for a successful handover.

3.2.2 To ensure the continuity of a family company it is important that the following steps be taken:

(a) The founder needs to decide whether the interests of the company or the family are to be given priority. Increasingly, founders are more concerned about the preservation of their wealth than establishing a dynasty, and are tending to stay on in the business after their children are ready to take over. In a growing number of cases founders intend to sell their business or to hand it over to professional managers.

(b) If it is intended that the company will be inherited by a member, or members, of the family, a clear succession plan should be developed as early as possible. It should be discussed with the heir(s) and the founder should be satisfied that it is understood and accepted. From an early stage there should be contingency plans covering the possible early death or disability of the founder.

(c) The interests and preferences of family members involved in the business should be taken into account.

(d) The interest and competence of the heir(s), and indeed all family members involved with the company, should be developed through careful planning of their education, experience outside the company, and internal training. Transfers and promotions that provide experience of different aspects of the company, and increasing levels of responsibility are important.

(e) The involvement of family members in strategic thinking and planning, from a relatively early age, will increase their competence and sense of involvement. This may involve membership of the board.

(f) Consideration should be given to allocating shares to prospective heirs, and probably all family members involved in the company.

(g) Since the needs of the company and the circumstances, or interests, of family members may change, it is important to establish a system by which shareholders can sell their shares, and others buy in. It is important that all concerned understand this system and consider it to be objective and fair. The system will need to be more open if it is intended that control of the company will be passed to outsiders. [See para 2.5.8].

(h) The CEO successor should be clearly designated.

(i) The date at which the CEO intends to retire should be made clear.

CASE STUDY 8: Founder's Retirement III

After forty-one years building a modestly successful business the founder was ageing and in worsening health. He was anxious to retire and expected that the sale of the company would provide a reasonable level of comfort for him and his wife. He had never encouraged his son to come into the business and was pleased that he had become well established as an IT engineer in a big firm. It proved easy to find interested buyers for the company, but very difficult to reach agreement on price. While the founder calculated the value on the basis of the return the business was yielding, with some allowance for growth, all the prospective buyers wanted to integrate the business with their own and argued that several of its major customers were likely to transfer their business once the connection with the family was broken. The prices they were prepared to offer were much less than the entrepreneur was expecting and were insufficient to provide a reasonable standard of living in retirement.

In the hope of retaining the value of the family's connection with the business the founder approached his son but found him too interested in his own career and unprepared to take the risk of entering a business of which he knew little. None of the employees was of sufficient calibre to run the company successfully and the founder had to settle for the best price he could.

3.3 FAMILY INTERESTS AND COMPANY INTERESTS

3.3.1 The company's interests will focus on the preservation and enhancement of the investment which created it, by the pursuit of the most effective strategies, and without regard to the ambitions or preferences of individual shareholders or managers. In many cases family interests are likely to be more diverse and may include:

(a) Maintaining the living standards of family members in preference to growing the company.

(b) Providing employment for less competent family members. It is not uncommon for an obligation to be felt towards a relative who, in the absence of the family connection, would not be considered sufficiently capable to be employed at an acceptable level. This issue can raise serious problems if it is felt that the individual's position in the family requires a company post of some seniority.

(c) Bringing new family members into the business – [particularly sons-in-law]. New spouses may well have different backgrounds, interests and ambitions and wish to take the company in different directions.

(d) Accommodating the developing interests of family members – even if their chosen direction is not easily aligned to the company's best interests.

(e) Paying out family members who wish to leave the company [perhaps to start another business] – even when the company needs the capital.

(f) Adjusting for death, invalidity and other family developments.

3.3.2 These problems will be exacerbated if there are personal frictions within the family, and, as the number of members increases [particularly when the third generation is reached], the danger of real differences and conflicts becomes very considerable. Disputes which have little or nothing to do with the company can often become emotional and can colour business relationships. Disagreements about company policy can be magnified by emotions generated outside it. Even non-working family members such as spouses and relatives can undermine the harmony of a family business.

CASE STUDY 9: Family Involvement

By the time the fourth generation of family members had begun to enter the company, there were already sixteen children and grand-children of the founder employed in it. The eldest daughter had married a fisherman and the couple were heavily involved with the trawlers which had been bought at their urging. The trawling business was capital hungry but far less profitable than the land transport activities in which the rest of the family was involved and there were constant disputes about the allocation of capital. Over time a great deal of animosity had been generated between the branches of the family and when the manager of the fishing business announced that he and his wife wished their four children to enter the company, and for new boats to be purchased for them, there was strong resistance. On the one side it was argued that all the founder's grand-children had equal rights in the company, while on the other side it was urged that the benefits received should be commensurate with the financial contribution to the company. No written agreement existed and, at 82, the founder had neither the energy nor the determination to resolve the situation.

3.3.3 It is important that a formal written agreement, which may take the form of Articles of Association, or a Constitution, be prepared, that it be understood by all members of the family, and that it be accepted as fair to all. If confidentiality is considered to be of paramount importance then the arrangements can be put into the founder's will, but if younger family members do not feel secure about the way in which they will be treated they may decide not to join the family company. It can be prepared by the founder and a copy given to all family members before they enter the company, or it can be negotiated and agreed between them. It is desirable that the following matters be considered and, if appropriate, covered in the document:

(a) The number of shares on issue, the allocation of shares to each member of the family, and the career stage at which shares will be allocated.

(b) The dividend policy and the proposed allocation of resources to those who work in the company and those who don't. Confusion can easily develop over the distribution of rewards to family members by way of dividends or salaries. The retirement arrangements of the founder and other members of the family also need to be considered.

(c) The conditions on which family members can have a job in the company and what is expected of them. This will include:

(i) whether children's education should be geared towards the needs of the company.

(ii) the required outside experience before entry.

(iii) whether they will be required to start at the bottom or whether, with suitable qualifications they can enter in a senior position.

(iv) training requirements on the job.

(v) the contribution expected of them.

(vi) whether, and at what stage, they will be invited onto the board.

(d) The mechanism by which disagreements will be considered and resolved. It may be desirable for strategic and policy decisions to be taken openly by a board of directors, and for the board to include non-family members, and possibly a non-family chairman.

3.3.4 It is also important that all concerned have a clear understanding of the value of the company. Independent valuations on an objective basis will probably be of real benefit. It may be desirable to have the company valued annually.

3.4 ATTRACTING NON-FAMILY EXECUTIVES

3.4.1 It is likely that the company will need to recruit non-family executives who have specialist skills and experience not available within the family. There is a real risk that they will feel that their careers will be restricted by preferment given to family members. If they perceive that incompetent family members are promoted ahead of them, or if the company's direction or policy is changed for family rather than company reasons, their loyalty and enthusiasm will be undermined and they may seek other employment. It is also possible that non-family executives may be confused by the demeanor of family members if the lines of authority are not clear.

3.4.2 Many SMEs are finding it increasingly important to be able to attract and retain good external people, and it is important that clear policies are introduced which are understood and accepted from the beginning. Subsequent decisions should be seen to be consistent with those policies.

3.5 PROVIDING PERSPECTIVE

3.5.1 There is a serious risk that family companies will be so restricted in their vision that their flexibility and competitiveness will be compromised. The responsibility of directors is to the company as a whole, but when there is only one owner who has a strong view, the other directors are likely to accommodate him without challenge. At the same time executives may well feel too dependent on the owner to question his decisions, and family members may be too inward looking to provide perspective.

3.5.2 Yet all companies are strengthened if the board is caused to consider its decisions carefully and if, as a matter of routine, penetrating questions are asked from an independent perspective. The dominance of a founder, or the head of a family, may well restrict boardroom discussion and it is valuable for family companies to consider appointing strong outside directors, and creating an atmosphere in which constructive questions and disagreements are welcomed. As competitive pressures drive companies towards more professional management, the need for good boardroom practice, which takes advantage of sophisticated governance techniques, is becoming more pressing.

3.6 CAPITAL FOR GROWTH AND LOSS OF CONTROL

3.6.1 Successful family companies frequently find that attractive expansion opportunities require more capital that can be internally generated and that they are faced with the alternatives of either declining to accept opportunities and so constraining growth, or seeing family control diluted as outside shareholders come onto the register and seek to influence the direction of the company. This dilemma is likely to appear more quickly if the company's resources have been used to a large extent to maintain a high standard of living for the family.

CASE STUDY 10: Expansion Alternatives

After a period of impressive expansion a company had entered a consolidation phase; for three years 70% of profits were paid out as dividends and no significant investments were made. The founder took the opportunity to strengthen the board and an independent chairman, and another outside director, as well as a new CEO were appointed. The Company's constitutional documents were reviewed and the board ratified a new strategic plan which emphasised the objective of growing the company.

The new CEO then set out on a search for fresh opportunities and soon brought a major expansion proposal to the board which involved expenditure far greater than could be financed from the company's reserves. The proposal was accompanied by two financing alternatives: a long term loan which could only be serviced by reducing the dividend rate to 40%; and alternatively an injection of equity from a venture capitalist who wanted 30% of the equity and two seats on the board. The family members who were not involved in the company and were minority shareholders of the company were outraged at the proposal to reduce the dividend, the founder was strongly opposed to diluting the family equity, and the executive directors, who constituted the majority on the board, insisted that the expansion should go ahead. The independent directors agreed that the proposal implemented the plan which the board had ratified, and decided that the company's gearing would justify the loan proposal. The dividends were reduced and family relations severely strained.

3.7 OVERALL INTERESTS OF THE COMPANY

3.7.1 The way in which these five problems are resolved in each particular case will affect greatly the way in which the company is governed. As long as a single individual, or a united family, owns a company, they have the right to subordinate the company's interests to those of the family. However, once non-family shareholders entrust their investments to the board, both the law and ethical standards require that the interests of the company as a whole must take preference over the interests of the family.

3.7.2 Whatever the pattern of shareholdings, family companies encounter special governance problems that require careful consideration and precise understandings among the parties involved.

CHAPTER 4

MANAGEMENT PRACTICE GUIDELINES

4.1 INTEGRATING MANAGEMENT PRACTICES WITH GOVERNANCE

4.1.1 In the case of SMEs there is a close relationship between governance and management. Indeed in the case of the smaller SMEs they are usually indistinguishable. The Core Competencies for Directors defined by The Hong Kong Institute of Directors include five groups of skills and knowledge required for fulfilling a director's role:

- Corporate business functions at a strategic management level.
- The role and responsibilities of a director.
- Development of the board.
- Personal and inter-personal skills.
- Business ethics.

As the first group of the required skill-sets, management practice at a strategic level is an essential part of the Guidelines and is covered in this Chapter.

4.1.2 Management is about planning and implementation. Implementation can be further broken down into organising, leading and controlling. The management practices of different types of business will necessarily differ but they all involve these concepts.

Essential to effective management is the need to separate the planning phase from the implementation/operational elements of the role. Larger enterprises are able to install the planning function in the board, quite separate from the implementation roles of the CEO and the Management team. While few SMEs will have this luxury, it is important that even a sole trader separates these roles. As was seen in a previous case study (see Ch 2, para 2.2.2 [Case Study 1: Bank Loan]), failure to do so will often lead to poor decision making.

4.1.3 Therefore, Management can be separated into two roles, Planning and Operations (implementation). Effective separation of these two distinct management roles will lead to the following advantages:

(a) Important strategic decisions being made in a sterile environment, without the immediate pressures of day-to-day management which often lead to decisions based on short-term convenience despite long-term detriment.

(b) Greater accountability – a CEO is accountable to the board, and the board to its shareholders. Separation in time and space of these two roles can make even a sole-trader stop and reflect on his decisions (past and future), and the effect they will have on the business.

(c) By focus on areas of strategic importance by identifying KPI in the Planning role, the Management role-player will be accountable and therefore focused on these areas of strategic importance.

4.2 PLANNING

4.2.1 Each SME has to determine its own business strategy objectives. Professor Michael Porter of Harvard Business School identifies five environmental forces which affect a new venture. These are:

- Barriers to entry.
- Bargaining power of customers.
- Threat of substitute products.
- Bargaining power of suppliers.
- Jockeying for position in crowded markets.

4.2.2 With these forces in mind, each business then implements its strategy by planning in the following areas:

- Marketing.
- Finance.
- Product/operations.
- Research and development (where appropriate).
- Human resources.

4.2.3 The bridge between the Planning (Planner) and Implementation (Operator) roles can then be formed by formulation of KPIs in each area of strategic importance to the Planner. Good KPIs will simultaneously:

(a) Reflect the broad strategy of the business plan.

(b) Focus the Manager's day-to-day decision making on areas of strategic importance.

(c) Identify when the business is departing from or suffering in an area of strategic importance.

(d) Provide a "snap-shot" for both the Planner and the Operator, of the health of the business in an area of strategic importance.

(e) Be capable of easy compilation and measurement.

(f) Be understood to be indicators of performance, not absolutes. Therefore they are designed to indicate areas needing attention, not triggers for automatic responses.

(g) Be measured and reviewed on a constant basis, ie weekly, monthly, quarterly or annually, depending on their nature.

4.3 EXAMPLES OF KEY PERFORMANCE INDICATORS

4.3.1 Financial

Financial strategies will vary from business to business, depending on the type of business and its stage of development. They will also be affected by business cycles and the investment and reinvestment needs of the business. Some businesses may have substantial capital backing with a long-term view to profit, whereas others may require almost immediate profitability or cash-flow to survive. Therefore KPIs will vary according to the businesses needs.

For example, the business plan for a restaurant could insist that the cost of goods sold (COGS) immediately reflect a pre-determined percentage of sales from startup. This is due to the fact that regardless of a restaurant's maturity, the cost of raw materials of a meal will not change. Therefore, the Planner could calculate the costs of providing a meal and, considering the eventual menu-price, determine what percentage of the income this would represent (eg 33%). Subsequently a KPI for a restaurant may be COGS as a percentage of Income. A high figure in this KPI may indicate any number of operational concerns, from excessive wastage or over-buying, to register sales not reflecting bills for any number of reasons.

The same restaurant may also wish to evaluate other costs, such as rent and wages, as a percentage of income in accordance with existing business plans or cash-flow projections. However, these would need to reflect and accept that as a business and its turnover grows, fixed costs such as rent will proportionally reduce. It is also important to identify that some costs, such as wages, will be somewhere between the fixed cost of rent and the variable cost of raw materials; reflecting the fact that the minimum staff required to operate is fixed regardless of turnover, but wages will need to expand and contract to meet service needs of cyclical nature of any service oriented operation.

Therefore a Planner may wish to separate the wage budget into fixed salaries and casual labour costs. For example, a business plan may allow for a set percentage of turnover to allocate casual staff costs. Obviously this will vary from business to business, and industry to industry; however careful planning may create a useful indicator both for future planning (ie staff rosters) and past performance. For example, a KPI reflecting excessive casual wages may highlight lower than expected income or poor staff-rostering. Conversely a lower than expected figure may indicate understaffing and potentially the inability to provide the expected level of customer service.

4.3.2 Marketing

The Business Plan, or the Planner may allow for a set Marketing expenditure. Depending on the business and its stage of development, this may be a set figure, or it may be a percentage of turnover, or perhaps a combination of the two.

The allocation of a set percentage of turnover gives the Manager an automatic budgetary control mechanism that he can easily be made accountable for. This figure is often around 4%, which allows the Manager of an operation the ability to capitalise on growing turnover by automatically reinvesting some of that success in more marketing. Conversely, this set percentage applies an automatic brake on expenditure in slower than expected periods.

Obviously periods of lower than expected incomes can often be a result of poor marketing; therefore the opposite response is required. However, this reduction in the Manager's ability to spend is still an appropriate response as the Marketing Plan will need to be reassessed at the Planning rather than Implementation role.

Well planned Marketing campaigns will usually have the ability to measure their results. This may be done in any number of ways, from coupons redeemed to growth in revenue on target days. Good Planners will create a method for measuring the change in the area of the business they are aiming to improve.

4.3.3 Product/Operations

Operational KPIs will vary significantly from business to business. They will also overlap considerably with Financial KPIs as any operational implementation is the result of a financial goal or strategy.

For example a service related industry such as telephone sales may rely on KPIs such as the number of outgoing calls made by each salesperson each day, the number of sales made as a percentage of calls (conversion rate), the number of calls made by an individual as a percentage of the sales team, conversion rates during different times of the day, week, or month. Anything can be used to highlight areas of success or failure requiring further investigation with a view to eliminating the negative and capitalising on the positive.

A video shop may measure the average number of videos rented on average by each customer visit. This may reflect on any number of other areas of the business plan, such as marketing or customer service.

A restaurant may use the financial measure of the average spending of each customer as an indicator of staff service levels. Low average spending may reflect anything from an inadequate dessert menu to slow table service, which are both operational concerns.

4.4 OPERATIONS/IMPLEMENTATION

4.4.1 Chapter 2 referred to a number of important underlying principles likely to increase chances of survival and success. One of these principles was the adoption and development of systems which enhance the quality of decision making (Ch 2, para 2.1.10). Effective management is essentially the implementation of this principle.

4.4.2 Having identified areas of strategic importance and subsequently translated those to KPIs, the Planner now has the ability to guide and measure the effectiveness of the Operator on a consistent basis. The Operator also has a clear indication of expectations and will be automatically focused in strategically important areas. Importantly for smaller businesses where both the planning and operational roles are undertaken by the same person, KPIs provide an objective account of performance in areas that have been identified as important without operational pressures or influences to muddy the decision making process. KPIs, when used properly, become signposts on a predetermined route – it is important to remember that they do not determine the route, they merely flag when there is deviation from it.

4.4.3 As indicated at the start of this chapter, implementation can be further broken down into organising, leading and controlling.

4.5 ORGANISING

4.5.1 Each SME must determine its own organisational structure and management system operating within the basic framework provided by the law. It is important that the organisational structure is designed with a view towards bridging the gap between the Planner and the Operator while simultaneously maintaining the division. The roles are quite distinct, yet must be able to work in tandem for management of any SME to be effective.

4.5.2 Much emphasis has been placed on a system of benchmarking tools or KPIs for the reason that it is an effective manner of achieving this end. This is particularly important for the Sole Trader, who must effectively balance the conflicting duties and demands of the separate roles in one person.

4.5.3 Important elements of organisation can be significantly improved by an effective management style. Strong organisation, which uses sound management principles and tools, such as benchmarking and KPIs, will enhance the following:

(a) Managing conflict – by using KPIs as a management tool, the Planner and the Operator will both be measuring the success of the business in the same manner, reducing the likelihood of conflict between the roles.

(b) Coping with necessary change – by marking the trends in fundamental areas of the business, past performance can be used to highlight needs for change, increasing the likelihood of acceptance of change. Tracking fundamentals can also measure the success of any organisational change.

(c) Effective communication – by focusing both Planning and Operational roles on the same fundamentals of the business.

(d) Having a sound recruitment policy and human resource management which complies with the law on matters such as industrial relations and health and safety at work.

(e) Providing adequate incentive systems based on KPIs automatically focuses employees on areas important to the Planner.

(f) Providing for adequate training and individual career development of employees.

4.6 LEADING

4.6.1 It is difficult to define leadership in the abstract. There are various styles of leadership. A common characteristic of family business is a measure of paternalism. Leadership style may need to change as the business develops. The main attributes of leaderships of a business are task related and employee related.

4.6.2 Management involves allocating tasks, coaching and monitoring performance, delegation and dealing with conflict. It also involves motivation and developing a team spirit. This requires effective communication both formal and informal. Once again, effective monitoring of KPIs will create a "no-surprises" leadership style, leading to a more harmonious working relationship between Planner and Operator.

4.6.3 In the modern world SMEs increasingly need good public relations and the development of good standards of commercial practice. Leadership involves an awareness of social responsibility and good corporate governance is a reflection of this.

4.7 CONTROLLING

4.7.1 Governance is about exercising effective control. Management by KPIs allows the Operator the autonomy to run the business, while the Planner can be comfortable that the controls set in place will highlight any deviation from the business plan.

4.7.2 Control involves:

(a) Designing production/operation systems and management information systems. These have been covered at length in the previous discussions of KPIs.

(b) Planning and control decisions.

(c) Quality control of goods and services.

(d) Measurement of productivity of employees.

(e) Financial control by:

- The budgetary process.
- Financial statements.
- Inventory control.
- Internal and external.
- Auditing.

4.7.3 Of the five types of control, the bottom line is financial control. Directors and managers must safeguard the solvency of the SME and run the risk of personal liability if they fail. It is important to note that the same principles of benchmarking can be just as effectively applied to financial management.

4.7.4 Financial indicators will often overlap with operational standards, as was evidenced in the earlier restaurant examples, i.e. *Average Spend per Customer or Average Cost of Goods Sold per meal* were both financial indicators of operational results. As was indicated earlier, there is no restriction or definition of how a business should be controlled. The most effective control mechanisms will be designed for the individual business. However, as mentioned earlier, the fundamental principles that should be followed in order to achieve the most effective control include:

(a) Reflecting the broad strategy of the business plan.

(b) Focusing the Manager's day-to-day decision making on areas of strategic importance.

(c) Identifying when the business is departing from or underperforming in an area of strategic importance.

(d) Providing a "snap-shot" for both the Planner and the Operator, of the health of the business in an area of strategic importance.

(e) Being capable of easy compilation and measurement.

(f) Being understood to be indicators of performance, not absolutes. Therefore they are designed to indicate areas needing attention, not triggers for automatic responses.

(g) Being measured and reviewed on a constant basis, ie weekly, monthly, quarterly or annually, depending on their nature.

4.7.5 All of the above can be achieved in a vertical relationship, allowing the paternal figure to maintain overall control of the business, while still allowing the junior members a strong level of independence which will encourage business growth. Strong control mechanisms may actually enhance the independence of the junior members because of the greater level of confidence that comes with effective Key Performance measures.

APPENDIX I

THE LEGAL CORE AND REGULATORY BACKGROUND

The purpose of this part of the Guidelines is to give a summary of the main legal provisions as a guide. It does not aim to provide legal advice and should not be relied on for that purpose.

The majority of the SMEs surveyed were sole traders which may represent characteristics of the sampling rather than the economic significance of the businesses. Partnerships and companies were the next in significance in the sampling with the number of companies slightly exceeding that of partnerships. In this part we will deal first with sole traders, then partnerships followed by a more extensive discussion of companies, given their innate complexity and economic significance.

A. SMEs WHICH ARE SOLE TRADERS

1. Sole traders are SMEs owned by a single person and registered as such with the Commissioner of Inland Revenue who issues a Business Registration Certificate. They are popular in Hong Kong because of the low start up cost. Many SMEs surveyed were sole traders. They cover every line of business and profession. There are few formalities necessary for carrying on business as a sole trader unless the business is one which requires a licence or is a profession. The sole trader is subject to normal business regulation such as tax law, consumer protection, health and safety and workers compensation laws. They are not required to submit audited accounts.

   Subject to the above, there are few requirements for establishing business as a sole trader.

2. There are advantages of carrying on business in this way. The main advantages are:

   (a) Independence.

   (b) The business is relatively cheap and easy to run although the relevant legislation must be complied with.

   (c) The sole trader normally keeps all the net profits after tax.

   (d) Flexibility.

   (e) Privacy.

3. There are, however, disadvantages. The main disadvantages are:

   (a) Unlimited liability for the debts incurred in the business.

   (b) The business is limited to the working life of the sole trader unless he can sell the business as a going concern.

   (c) Limited access to funds for investment.

   (d) The need to rely on others, particularly for specialist advice.

B. SMEs WHICH ARE PARTNERSHIPS

1. Where two or more persons carry on business, they may use the partnership form. Partnerships are businesses owned by two or more persons who are registered as such with the Commissioner of Inland Revenue. These are popular in Hong Kong because of the low start up costs, but they involve a degree of risk of personal liability. In Hong Kong partnerships are dealt with by the Partnership Ordinance (Chapter 38 Laws of Hong Kong). This legislation is a codification of the common law and equitable rules based on contract and agency principles. Under the Ordinance, a partnership is called a firm.

2. The Partnership Ordinance states that partnership is the relation which subsists between persons carrying on a business in common with a view to profit.

3. There are rules in the Partnership Ordinance about when ownership of property and sharing profits give rise to the existence of a partnership which need not concern us except to say that they are helpful in determining whether a joint venture amounts to a partnership. The consequence of being a partnership is that the duties of the partners are well defined by the Ordinance. It is important to set out clearly in a partnership agreement or deed any desired variations of the position under the Partnership Ordinance (e.g., the division of profits) otherwise the provisions of the Partnership Ordinance in relation thereto will automatically apply.

4. Each partner has authority to bind the firm for matters in the ordinary course of business. The partnership is not a separate legal entity but merely the aggregate of partners. Each partner is liable jointly for partnership debts and jointly and severally for wrongs committed by another partner. Liability goes beyond the partnership assets and partners can be liable to the extent of their personal fortune. It is possible to limit the authority of a partner internally, but for this to have external effect there must be notice to creditors and if possible express agreement by them.

5. In terms of internal governance the following rules under the Partnership Ordinance apply in the absence of contrary agreement:

   (a) Equal sharing in profits and losses.

   (b) Right to indemnification for liabilities incurred on behalf of the partnership.

   (c) Equal participation in management.

(d) No new partners admitted without unanimous consent.

(e) Differences to be resolved by majority decision, but no change in the nature of the partnership business without unanimous consent.

(f) No right to expel a partner by majority decision unless expressly reserved.

(g) Each partner must render true accounts.

(h) Each partner must account for private profits derived without consent from the partnership, its property, name or connection.

(i) Each partner must not compete with the firm.

Most partnerships have written partnership agreements which may vary some of these governance provisions.

6. A partnership can be dissolved by notice or effluxion of time or court order. Death or illegality also terminates a partnership.

7. Professional partnerships are also regulated by legislation and self regulation which applies to the particular profession.

C. SMEs WHICH ARE LIMITED COMPANIES

1. What incorporation means

1.1 Separate legal entity that has its own property and powers

As far as the law is concerned, a company, either with or without limited liability has a separate legal existence that is distinct from that of its owners, managers, operators, employees and agents. A company has its own property, its own rights and its own obligations. A company's money and other assets belong to the company and must be used for the company's purposes.

A company has the legal and economic powers of an individual, including the powers to:

- Own and dispose of property and other assets.
- Enter into contracts.
- Sue and be sued.

Once a company is registered with the Companies Registry, its separate legal status, property rights and liabilities continue until it is removed from the register.

1.2 Limited liability of shareholders

Shareholders of a company are not liable (in their capacity as shareholders) for the company's debts. As shareholders, their only obligation is to pay the company any amount unpaid on their shares if they are called upon to do so. However, this limitation may be affected by other laws and the commercial practices discussed in 1.3 and 1.4.

1.3 Personal liability for company's debts

A person who is knowingly party to carrying on the business of the company with intent to defraud creditors or for other fraudulent purposes may be liable upon winding up for debts incurred by the company.

A director of a company may be liable to compensate the company for any losses the company suffers from a breach of certain of the director's duties to the company (see 7.3.2).

1.4 Director's liability as guarantor/security over personal assets

As a matter of commercial practice, a bank or anyone else providing finance or credit to a company may ask a director of the company:

- For a personal guarantee of the company's liabilities; and

- For some form of security over his house or personal assets to secure the performance by the company of its obligations.

Taking security of this kind is very common.

The director of a company may, for example, be asked by a bank to give a mortgage over his property to secure the company's repayment of a loan. If the company does not repay the loan as agreed with the bank, the director may lose the property.

1.5 Continuous existence

A company continues to exist even if one or more of its shareholders or directors sells their shares, dies or leaves the company.

1.6 Rules for the internal management of a company

Under the Old Companies Ordinance, the constitutional documents of a company formed in Hong Kong are the memorandum of association ("Memorandum") and the articles of association ("Articles"). The New Companies Ordinance abolishes the requirement for a company to have a Memorandum, so that private companies will only have a single constitutional document (the Articles). For an existing company, provisions set out in its Memorandum are deemed to be provisions of its Articles.

The Articles deal with internal management and are tantamount to two agreements, one amongst the shareholders of the company and another between the shareholders and the company.

The Companies (Model Articles) Notice contains a set of model articles of association ("Model Articles") which a company incorporated under the New Companies Ordinance may adopt in whole or in part. The Model Articles will apply to the company by default if not excluded or modified by specific articles registered by the company.

The Model Articles contain a basic set of rules for the internal management of a company (appointments, meetings etc).

The Model Articles will have no impact on existing companies incorporated under the Old Companies Ordinance. Table A in Schedule 1 to the Old Companies Ordinance ("Table A Articles") will continue to apply to such existing companies unless excluded or modified by the articles. However, an existing company can amend its articles to follow the Model Articles if it so chooses.

1.7 How a company acts

A company is a creature of the law and does not have a physical existence. It must act through natural persons. Individual directors, the company secretary, company employees or agents may be authorised to enter into contracts that bind the company.

In some circumstances, a company will be bound by the acts or omissions of certain people (see 1.8).

1.8 Directors

Unless specifically authorised by the company, a director cannot act for his company by himself. All corporate decisions are conducted by the board of directors as a whole: the board of directors of a company are responsible for managing the company's business. Generally the board of directors may exercise all the powers of the company except a power that the law, or a provision of the company's Articles (if any) requires the company to exercise in general meeting. The Articles may however make the directors' general power of management subject to directions given by a special resolution of the shareholders.

The Model Articles/Table A Articles set out rules dealing with the calling and conduct of directors' meetings (which will apply unless excluded or modified by a company's articles). Under the New Companies Ordinance, a company must keep written minutes of meetings of its directors. Under the Model Articles/Table A Articles, there are 2 ways that directors may pass resolutions of the board of directors:

- At a duly convened meeting; or
- By having all of the directors record and sign their unanimous decision in a written resolution.

Where a private company has only one director, any decision of that director must be evidenced by a written resolution or a written record of the decision must be delivered to the company within seven days after the decision is made.

1.9 Shareholders

The shareholders of a company own the company, but the company has a separate legal existence and the company's assets belong to the company and not its shareholders. Shareholders can make decisions about the company by passing a resolution, usually at a meeting. Resolutions are either ordinary or special. Ordinary resolutions require a simple majority, special resolutions a majority of at least 75%.

The New Companies Ordinance provides that certain matters require to be approved by special resolution, including the following:

(a) Alteration of the objects (Sections 89 and 90).

(b) Alteration of the Articles (Sections 87 and 88) (except alteration as to the maximum number of shares a company may issue, which can be effected by ordinary resolution).

(c) Re-registration of an unlimited company with limited liability (Section 130).

(d) Change of the company's name (Section 22).

(e) Alteration of conditions in the Memorandum of an existing company (i.e. incorporated under the Old Companies Ordinance) which could have been contained in the Articles (Section 90(1)).

(f) Listed companies making a general offer to buy back their shares, which may result in members being compelled to sell their shares under Division 5 of Part 13 (compulsory acquisition after general offer for share buy back), and buy-backs which are neither a market purchase nor a general offer (Sections 238 and 240).

(g) Unlisted companies buying back their own shares (Section 244).

(h) Contingent buy-back contracts (Section 244).

(i) Release from buy-back contracts (Sections 243 and 251).

(j) A private company redeeming or buying back its shares out of capital (Section 258).

(k) The reduction of the company's share capital (Sections 210 and 211).

(l) The company be wound up by the court (s 177(1)(a) of the Companies (Winding up and Miscellaneous Provisions) Ordinance).

(m) To wind up the company voluntarily (Section 228(1)(b) of the Companies (Winding up and Miscellaneous Provisions) Ordinance).

(n) To authorise the liquidator to accept shares as consideration for the sale of the company's property in a voluntary liquidation (Companies (Winding Up and Miscellaneous Provisions) Ordinance) (Section 237).

There are two ways that shareholders of a company may pass a resolution:

- At a meeting where the requisite majority of votes is obtained; or

- By having all of the shareholders record and sign their decision in a written resolution.

A general meeting requires notice unless this is waived by all the members in the case of an Annual General Meeting (AGM) or shareholders holding 95% of the shares having the right to attend and vote in the case of an Extraordinary General Meeting (EGM).

AGMs and EGMs are normally chaired by the chair of the board of directors.

A company must keep written minutes of the members' resolutions and meetings. All special resolutions and certain ordinary resolutions must be filed with the Companies Registry of Hong Kong.

1.10 What others can safely assume about the company

Anyone who does any business with the company is entitled to assume that the company has a legal right to conduct that business unless the person knows, or suspects, otherwise. The "indoor management rule" provides that a third party dealing in good faith with a company is not bound to inquire whether acts of internal management have been regular and is entitled to presume that acts within the company's constitution and powers have been properly and duly performed.

The New Companies Ordinance now also provides statutory protection for persons dealing with a company in addition to the common law indoor management rule. Section 117 of the New Companies Ordinance provides that, in favour of a person dealing with a company in good faith, the power of the directors to bind the company will be deemed to be free of any limitation under the Articles, any resolutions of the company or any agreement between the members of the company. However, this protection will not apply where the party to a transaction with a company is an "insider" (for example, a director of the company or of a holding company of the company, or an entity connected with such a director).

An outsider dealing with the company is also entitled to assume:

(a) that a person who is shown in a notice lodged with the Companies Registrar ("Registrar") as being the director or company secretary of a company has been properly appointed and is authorised to act for the company within his usual scope of authority and

(b) that a person who is held out by the company to be a director, company secretary or agent of the company has been properly appointed and is authorised to act for the company within his usual scope of authority.

2. The usual corporate structure for SMEs

Generally, a private company limited by shares is the most suitable company structure for use by SMEs. A private company is a company whose Articles restrict the right to transfer its shares, limit the number of its shareholders to 50 (not counting employee shareholders) and prohibit any invitation to the public to subscribe for its shares or debentures. Such a company is allowed to have just one director who may also be the sole shareholder. At the other end of the spectrum, SMEs in Hong Kong which adopt a listed public company structure have no upper limit on the number of shareholders.

3. Setting up a new company

The operators of small businesses can either buy "shelf" companies or set up new companies themselves.

3.1 "Shelf" companies

The operator of a small business may find it more convenient to buy a "shelf" company (a company that has already been registered but has not traded) from businesses which set up companies for this purpose or from some legal or accounting firms.

3.2 Setting up a company

To set up a new company, it is necessary to apply to the Registrar for registration of the company.

A private company limited by shares may have just one shareholder who may also be the only director. Where a private company has only one shareholder and that shareholder is also the sole director of the company, a reserve director (being a person over 18) can be nominated to act in place of the sole director in the event of his death. Companies other than private companies must have at least two directors. Public companies and private companies within the same group as a listed company may not have corporate directors. Other private companies (other than those within the same group as a listed company) must have at least one director who is a natural person.

To obtain registration, a person must submit an incorporation form, a copy of the company's Articles of Association certified as true by a founder member of the company and the appropriate fees to the Registrar. The company comes into existence when the Registrar registers it.

3.3 Contracts entered into before the company is registered

A company can ratify a contract entered into by someone on its behalf or for its benefit before it was registered. If the company does not ratify the contract, the person who entered into the contract may be personally liable.

3.4 First shareholders, directors and company secretary

The founder member of a company (i.e. the person who signs the articles of a company incorporated under the New Companies Ordinance, or the person who subscribed to or signed the memorandum of an existing company incorporated under the Old Companies Ordinance) is to be regarded as having agreed to become a member of the company and his names should be entered in the register of members on registration of the company. With effect from the date of incorporation, the first directors of the company are the persons named as directors in the incorporation form.

The same person may be both a director of the company and the company secretary except in the case of a private company having only one director. The company secretary of a private company having only one director may not be a body corporate the sole director of which is the sole director of the private company.

See 7.1 and 7.2 for directors and 7.6 for company secretaries. See 8.1 for shareholders.

3.5 Issuing shares and options

Directors may only allot new shares (other than rights issues and allotments to founder members) with prior approval of the company in a general meeting. In addition, shareholders' approval is also required for grants of rights to subscribe for, or to convert securities into, shares. If approval is given for the grant of an option, there would not be a need to obtain further approval of the allotment of shares pursuant to that option.

Under the Old Companies Ordinance, companies were required to have a "par" or "nominal" value ascribed to their shares, which was the minimum price at which shares can generally be issued. The New Companies Ordinance has abolished the concept of par value (as well as related concepts of share premium and authorized capital) and introduced a mandatory system of no-par (i.e. a company's shares will have no par value). Deeming provisions are included in the New Companies Ordinance to ensure that contractual rights defined by reference to par value and related concepts will not be affected by the abolition of par value.

Instead of authorized share capital (which has been abolished), a company way amend its Articles to specify a maximum number of shares that may be issued (and that maximum number may then be changed by way of ordinary resolution).

A company may issue shares at a price it determines. With the abolition of par value, there is no longer any statutory restrictions on the price at which shares can be issued.

3.6 Registered office

A company must have a registered office in Hong Kong. The purpose of the registered office is to have a place where all communications and notices to the company may be sent.

The company must notify the Registrar within 15 days of any change of address of its registered office.

3.7 Registers kept by the company

A company must keep registers, including a register of shareholders and a register of charges. A company must keep its registers at:

- the company's registered office; or

- any place in Hong Kong.

3.8 Register of shareholders

A company must keep in its register of shareholders such information as:

- The names and addresses of its shareholders; and

- Details of shares held by individual shareholders.

3.9 Register of charges

A company must keep a register of charges if the company gives a bank, trade creditor or anybody else security over company assets whether situated in Hong Kong or outside Hong Kong. Charges are either fixed or floating charges. Fixed charges attach to specific assets. Floating charges "float" over assets such as stock in trade until crystallisation which is usually caused by winding up or the appointment of a receiver.

4. Continuing obligations after the company is set up

The New Companies Ordinance and other laws impose obligations on companies themselves and on their directors and company secretaries. Some of the more important obligations imposed under the New Companies Ordinance are discussed below.

4.1 Use of company name

The name of a company must be shown at a company's registered office and any business premises that are open to the public. The company's name must appear:

- On communication such as letters and notices, invoices, and

- On transaction documents such as cheques, invoices and receipts; and

- On all documents lodged with the Registrar; and

- On its common seal.

4.2 Annual return

A company must lodge with the Registrar an annual return which contains such information as:

(a) The company name, its registered number and business name (if any).

(b) The type of company.

(c) The address of the registered office.

(d) The date to which the company has made up the return.

(e) If the register of members or the register of debenture holders is not kept at the registered office, the address where they are kept.

(f) In the case of a company having a share capital, particulars relating to members and share capital and the amount of shares (if any) held by existing members. (for listed companies, only particulars relating to members who hold 5% or more of the issued share of any class are required).

(g) In the case of a company not having a share capital (unless registered with an unlimited number of shareholders) the number of members of the company.

(h) The amount of indebtedness of the company in respect of all mortgages and charges which are required to be registered with the Registrar.

(i) Particulars of the directors, reserve director (if any) and secretary, and particulars of any other person who at the date of the return are required to be contained in the register of directors and secretaries.

4.3 Annual fee

A company must pay an annual fee to the Registrar on lodgement of the annual return.

4.4 Notification to the Registrar of changes

The company must notify the Registrar if certain basic changes to the company occur. The following table sets out these notification requirements.

NOTIFICATION REQUIREMENTS

If ...		**the company must notify the Registrar of the change**
1.	a company issues shares	within one month after the allotment
2.	a company changes the address of its registered office or principal place of business	within 15 days after the change.
3.	a company changes its directors or company secretary	within 15 days after the change
4.	there is a change in the name or address of the company's directors, reserve director (if any) or secretary	within 15 days after the change
5.	a company creates certain kinds of charges	within one calendar month after the charge is created

5. The division of power in a company

5.1 The ultimate power in a company rests with the shareholders, and certain fundamental corporate actions must be approved by shareholders (see, for example, the matters that require to be approved by special resolution of shareholders set out in 1.9 above). The amount of control they have depends on what is required to be done in the general meeting and how. A simple majority is required for an ordinary resolution but a three quarters majority for a special resolution. Unanimous written resolutions can substitute for a meeting.

5.2 The shareholders have the right under the Companies Ordinance to remove directors by ordinary resolution. Shareholders can sell the control of the company in a takeover by selling their shares. Public company takeovers are governed by the Code on Takeovers and Mergers administered by the Securities and Futures Commission.

Most Articles expressly vest the power of management of the company in the board of directors which operates by majority decision unless there are special powers of veto in the Articles.

5.3 Article 82 of the Table A Articles was revised with effect from February 2004 to provide that the directors' general power of management is subject to directions given by a special resolution of shareholders, thus giving the shareholders a means to control the board. This reserve power for shareholders has been retained in Article 4 of the Model Articles for private companies (or Article 3 of the Model Articles for public companies) Otherwise, the shareholders can only intervene in exceptional circumstances. Shareholders can intervene where there is deadlock on the board or no effective board; by ratification of an act lacking authority; or under the statutory powers to remove directors or alter the company's Articles.

5.4 Boards usually delegate management to a managing director (CEO) subject sometimes to residual controls. Often in larger companies there are committees of the board.

6. The role of the board

The role of the board is not very clearly defined by the law but the assumption in Article 82 of the Table A Articles (Article 3 of the Model Articles for private companies (or Article 2 of the Model Articles for public companies) is that it is to manage or supervise the management of a company. Corporate governance practice is more explicit as we saw in Chapter 4.

7. Company directors and company secretaries

7.1 Who can be a director

An individual must be at least 18 years old to be a director. Corporate directors may be appointed in the case of a private company which is not a member of a group of companies which includes a Hong Kong listed company, and provided such private company also has at least one director who is a natural person. A director must consent in writing to holding the position of director. The company must send the consent together with notice of appointment to the Registrar.

Section 2 of the New Companies Ordinance defines a director as including any person occupying the position of director by whatever named called. The definition includes a shadow director, which means a person in accordance with whose directions or instructions the directors or a majority of them are accustomed to act but does not include a person merely giving professional advice. These definitions, however, do not extend to employees.

The court may prohibit a person from being a director or from otherwise being involved in the management of a company if, for example, the person has persistently breached certain provisions of the New Companies Ordinance.

A person needs the court's permission to be involved in certain company affairs if the person has been disqualified.

Generally, a director may resign by giving notice of the resignation to the company. The company must notify the Registrar of a director's resignation. If a resigning director has reasonable grounds to believe that the company will not notify the Registrar, the director must notify the Registrar himself.

7.2 Appointment of new directors

Shareholders may appoint directors by resolution at a general meeting. The board of directors usually has power under the Articles to fill casual vacancies and to make additional appointments. However, under the Table A Articles and the Model Articles, a director appointed by the board only holds office until the next AGM, but he is then eligible for re-election.

7.3 Duties and liabilities of directors

7.3.1 In managing the business of a company (see 1.7), each of its directors is subject to a wide range of duties under the New Companies Ordinance and case law. Some of the more important duties are:

(a) To act in good faith.

(b) To act in the best interests of the company.

(c) To avoid conflicts between the interests of the company and the director's interests.

(d) To exercise care, diligence and skill.

(e) To avoid fraudulent trading.

(f) If the company is being wound up – to report to the liquidator on the affairs of the company.

(g) If the company is being wound up – to assist the liquidator (by, for example, giving to the liquidator any records of the company that the director has).

CASE STUDY 11: Kishimoto Sangyo Co Ltd v Akio Oba

In Kishimoto Sangyo Co Ltd v Akio Oba [1996] 2 HKC 260 O was the managing director of KS and was negotiating on behalf of KS with a Taiwanese company for substantial contracts. He later resigned and joined another company and negotiated on behalf of this company with the Taiwanese company for the same contract. The Court of Appeal reversed the High Court and held that this was not a maturing business opportunity belonging to KS. It was at best only prospective. O was, therefore, not in breach of duty. This is a lenient decision. Overseas jurisdictions are generally tougher on executives.

The Old Companies Ordinance did not contain specific provisions on directors' duty of care, skill and diligence, and general common law and fiduciary duties of directors are based on case law. However, the New Companies Ordinance clarifies a director's duty to exercise reasonable care, skill and diligence. Section 465 of the New Companies Ordinance requires a director to exercise reasonable care, skill and diligence, meaning the care, skill and diligence that would be exercised by a reasonably diligent person with:

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company (an objective test); and

(b) the general knowledge, skill and experience that the director has (a subjective test).

Therefore, in carrying out his or her duties, a director must bring to bear his or her own general knowledge, skills and experience (a subjective test), as well as the knowledge, skills and experience that would reasonably be expected of a director carrying out the same functions (an objective test). If a director has special knowledge, skill or experience, then such director will be subject to a higher standard of care under the New Companies Ordinance compared to a director without such knowledge. Conversely, a director will still be expected to meet an objective reasonable standard of care, even if the director is in fact under-qualified for the role.

7.3.2 A director who fails to perform his duties:

- May be guilty of a criminal offence; or
- May be personally liable to compensate the company or others for any loss or damage they suffer; and
- May be prohibited from managing a company.

7.3.3 At common law, shareholders can ratify breaches by directors of their fiduciary duties, which has the effect of barring the company from bringing actions against the director for damages suffered by the company as a result of the ratified act or omission (although a dissenting minority shareholder may still be able to pursue an unfair prejudice or statutory derivative claim). The New Companies Ordinance requires that any ratification by a company of conduct by a director amounting to negligence, default, breach of duty or breach of trust in relation to the company to be approved by a resolution of disinterested shareholders (i.e., shareholders that are not connected to the director or to any of his trusts or other connected entities). If none of the shareholders are disinterested, then approval must be by unanimous consent of all shareholders.

7.4 Loans to directors

Section 500 of the New Companies Ordinance prohibits a company making loans to its directors, the directors of its holding company ("holdco directors"), or to companies controlled by such directors or holdco directors. The prohibition also extends to guarantees and security for such loans. For "specified company" (i.e. a public company, or a private company (or company limited by guarantee) that is a subsidiary of a public company), the prohibition also extends to the provision of quasi-loans and entering into credit transactions as creditors. These prohibitions are also extended in the case of "specified companies" to include certain categories of persons connected with a company's directors or holdco directors (such as family members and trusts). Breach of these provisions can lead to civil and criminal consequences. There are limited exceptions to the prohibition on loans and similar transactions described above. These include transactions that have been approved by shareholders (or disinterested shareholders, in the case of specified companies), transactions with a value below 5% of the net assets of the company or 5% of the called up share capital, and expenditure in connection with defending any proceeding or investigation or regulatory action for misconduct provided that the director has to repay the company if he is found guilty or to have committed the misconduct.

7.5 A company cannot exempt or indemnify its officers or auditors from any liability owed to the company or a related company. However, Section 469 of the New Companies Ordinance permits a company to indemnify a director against liability incurred by the director to a third party provided certain conditions are satisfied. Certain liabilities cannot be covered by the indemnity, including the following:

- criminal fines
- regulatory penalties
- defence costs of criminal proceedings in which the director is convicted

- defence costs of civil proceedings brought by or on behalf of the company and in which judgment is given against the director

Although the New Companies Ordinance prohibits a company from exempting a director from any liability in connection with any negligence, default, breach of duty or breach of trust by the director in relation to the company, it does not prohibit a company from taking out insurance against such liabilities (except for fraud).

Any permitted exemption or indemnity for liability should be set out in the director's service contract, even if the company's article already include standard indemnification and exemptions (as would be the case if the company adopts the Model Articles as its standard articles). The articles are a contract between the company and the shareholders, so a director would have difficulty enforcing an exemption or indemnity contained only in the articles.

7.6 Company secretaries

7.6.1 A company must have a company secretary. The directors appoint the company secretary. A company secretary must be a Hong Kong resident or a body corporate having its registered office or place of business in Hong Kong. However, a private company with only one director cannot appoint as secretary a body corporate whose sole director is also the only director of the private company. The company secretary of a listed company must have professional qualifications or experience to show that he is capable of acting as secretary.

7.6.2 A company secretary must consent in writing to holding the position of company secretary. The company must keep the consent and must notify the Registrar of the appointment. The same person may be both a director of a company and the company secretary, except in the case of a private company which has only one director.

7.6.3 Generally, a company secretary may resign by giving written notice of the resignation to the company. The company must notify the Registrar of a company secretary's resignation. A company secretary who resigns may also notify the Registrar of the resignation. If a resigning company secretary has reasonable grounds to believe that the company will not notify the Registrar, the company secretary must notify the Registrar.

7.6.4 The company secretary has specific responsibilities under the Companies Ordinance, including responsibility for ensuring that the company notifies the Registrar about changes to the identities, names and addresses of the company's directors and company secretaries and that the company lodges its annual return.

A company secretary's obligations may continue even after the company has been deregistered.

8. Shares and shareholders

A private company limited by shares must have a share capital and at least one shareholder. The Registrar may apply to a court to have a company wound up if it does not have any shareholders.

8.1 Becoming a shareholder and ceasing to be a shareholder

A person may become a shareholder of a company in several ways, including the following:

- by being a "founder member" by signing on the company's articles at the time of formation of the company (or, in the case of an existing company formed under the Old Companies Ordinance, by subscribing to the Memorandum of Association).
- The company allotting shares to the person.
- The person buying shares in the company from an existing shareholder and the company registering the transfer.

Some of the ways in which a person ceases to be a shareholder are:

- The person sells all of his shares in the company and the company registers the transfer of the shares.

- The company buys back all the person's shares.

8.2 Classes of shares

A company may have different classes of shares. The most common are Ordinary Shares and Preference Shares. The rights and restrictions attached to the shares in a class distinguish it from other classes of shares. Shares are in a class if the rights attached to them are in all respects uniform, and are not regarded as different only because the shares do not carry the same rights to dividends in the first 12 months immediately after allotment.

Under the New Companies Ordinance, class rights may be varied in accordance with the Articles or with written consent of holders representing at least 75% of the total voting rights of holders of shares of that class, or special resolution of the class members. Members holding at least 10% of the total voting rights of the class may apply to court to have a variation disallowed. The company must notify the Registrar of a variation within one month after the variation takes effect.

8.3 Meetings of shareholders

8.3.1 Directors have the power to call meetings of all shareholders or meetings of only those shareholders who hold a particular class of shares.

8.3.2 Shareholders who hold at least 5% of the votes which may be cast at a general meeting of a company have the power to require the directors to call a meeting or, if the directors fail to do so, to call and hold a meeting themselves. Unless the Articles provide otherwise, if a company does not have any directors, a meeting may also be called by two or more shareholders holding at least 10% of the total voting rights of the company's issued share capital. Meetings may be held regularly or to resolve specific questions about the management or business of the company.

8.3.3 The New Companies Ordinance sets out rules dealing with shareholders' meetings. A company may hold a general meeting at two or more places using any technology that enables the members of the company who are not together at the same place to listen, speak and vote at the meeting. A company may set out rules and procedures for holding a dispersed meeting in its Articles.

8.3.4 Every company (other than a single member company) is required to hold an annual general meeting ("AGM"). However, the New Companies Ordinance allows a company to dispense with the requirement for holding of AGMs by passing a written resolution or a resolution at a general meeting by all members. The company is required to deliver a copy of the resolution to the Registrar within 15 days after it is passed. After passing the resolution, the company will not be required to hold any AGMs for the financial year or for subsequent financial years to which the resolution relates. The financial statements and reports originally required to be laid before an AGM will still need to be sent to the shareholders. Any shareholder may request the company to convene an AGM for a particular year. The company may also revoke the resolution by passing an ordinary resolution to that effect.

8.35 Meetings normally require the full statutory notice unless the requirement is waived by the requisite majority under Section 571(3) of the New Companies Ordinance. As an alternative to holding a physical class or general meeting, a resolution may be passed by a written resolution signed by all members entitled to attend and vote at such meeting. However, written resolutions may not however be used to remove a director or an auditor before the expiry of their term of office.

The New Companies Ordinance establishes procedures for proposing, passing and recording written resolutions. The directors or a member of a company may propose a resolution as a written resolution. Once a written resolution is proposed, the company has a duty to circulate the resolution to every member for agreement if it has received requests from members representing not less than 5% of the total voting rights (or a lower percentage specified in the company's articles). Circulation may be effected by sending the copies in hard copy form or electronic form or by making the copies available on a website. The period for agreeing to the proposed written resolution is 28 days or such period as specified in the company's articles (and if not agreed in that period, the resolution will lapse). Members may signify their agreement to a proposed written resolution and send it back to the company either in hard copy form or electronic form. A written resolution requires agreement in writing by all eligible members of a company. If a resolution is passed as a written resolution, the company must send a notice of that fact to every member and the auditor of the company within 15 days.

The new procedures will not replace the common law doctrine of unanimous consent to the effect that, if all the members of a company actually agree on a particular decision which can be made at a general meeting, the decision is binding and effective without a meeting (Section 547(3) of the New Companies Ordinance). A company's articles may also set out alternative procedures for passing a resolution without a meeting, provided that the resolution has been agreed by the members unanimously.

8.4 Voting rights

Different rights to vote at meetings of shareholders may attach to different classes of shares. Subject to those different rights, under Article 64 of the Table A Articles (Article 46 of the Model Articles for private companies (or Article 50 of the Model Articles for public companies)) each shareholder has one vote on a show of hands and, on a poll, one vote for each share held.

8.5 Buying and selling shares

A shareholder may sell his shares but only if the sale would not breach the company's Articles. Article 24 of Table A (Article 2(2) of the Model Articles for a private company) provides that the directors of a private company have a discretion to refuse to register a transfer of shares. The New Companies Ordinance require companies to give reasons explaining their refusal to register a transfer of shares upon request and within 28 days after receiving the request. The New Companies Ordinance retains the provisions of the Old Companies Ordinance that allow a transferee, where a company refuses to register a transfer of shares, to apply to the court to have the transfer registered by the company. A court may, if it is satisfied that the application is well founded, disallow the refusal and order that the transfer be registered forthwith by the company.

9. Signing company documents

9.1 A company's power to sign, discharge and otherwise deal with contracts can be exercised by an individual acting with the company's authority and on its behalf. Under the New Companies Ordinance, companies have a choice of whether or not to adopt and use a common seal. If a company chooses to adopt a common seal, the seal must show the company's name in legible letters. The seal is equivalent to the company's signature and may be used on important company documents such as mortgages.

9.2 Under Section 127 of the New Companies Ordinance, a company may execute a document by (i) affixing its common seal in accordance with the requirements contained in its Articles; or (ii) signing the document by any two directors or any director and the company secretary or (in the case of a single director company) its sole director. In the case of a purchaser for valuable consideration who acts in good faith, a document which on its face purports to have been signed in accordance with the above requirements is deemed to have been duly executed by the company. Although a company may also continue to use other execution methods for documents (for example, by means of a board resolution authorizing a particular signatory), the statutory presumption of due execution will only apply to documents signed in accordance with Section 127.

9.3 If the document needs to be executed as a deed by a company, the New Companies Ordinance requires the company to execute the document in accordance with the requirements of Section 127. Further, the document must be expressed to be executed by the company as a deed, and delivered as a deed. As many Articles require deeds to be executed by affixing the common seal, an amendment to the Articles may be necessary to enable companies to take advantage of the new execution procedure for deeds under the Companies Ordinance.

10. Funding the company's operations

10.1 The shareholders may fund the company's operations by lending money to the company or by taking up other shares in the company. Except if it is raising funds from its own employees or shareholders, a private company must not engage in any fundraising activity with the public unless the relevant laws have been fully complied with.

10.2 The company may also borrow money from banks and other financial organisations.

10.3 Anyone who has lent money, or provided credit, to the company may ask for a mortgage or charge over the company's assets to secure the performance by the company of its obligations.

11. Returns to shareholders

Shareholders can take money out of the company in a number of ways, but only if the company complies with its Articles, the New Companies Ordinance and all other relevant laws. If a company pays out money in a way that results in the company being unable to pay its debts as they fall due, its directors may be liable:

- To pay compensation; and
- To criminal penalties.

11.1 Dividends

Dividends are payments to shareholders out of the company's after tax profits. Unless the Articles contain provisions to the contrary, the directors decide whether the company should pay a dividend.

11.2 Buy-back of shares

Subject to compliance with the applicable laws, a company may buy back shares from shareholders.

11.3 Distribution of surplus assets on winding up

If a company is wound up and there are any assets left over after all the company's debts have been paid, the surplus is distributed to shareholders in accordance with the rights attaching to their shares.

12. Annual financial reports and audit

12.1 Financial records

The New Companies Ordinance imposes various requirements in relation to the keeping of accounting records, the preparation and circulation of annual financial statements, directors' and auditors' reports and the appointment and rights of auditors.

Under the New Companies Ordinance, all companies must keep sufficient financial records to record and explain their transactions and financial position and to enable the directors to ensure that financial statements comply with the New Companies Ordinance.

12.2 Preparing annual financial reports and directors' reports

The New Companies Ordinance requires a company to prepare an annual profit and loss statement and a balance sheet and a directors' report (about the company's operations, dividends paid or recommended, options issued etc.).

12.3 Accounts of private companies

12.3.1 The New Companies Ordinance contains provisions to allow SMEs to take advantage of simplified accounting and reporting. The following types of companies are automatically qualified for simplified reporting:

- a "small private company", i.e. a private company that satisfies any two of the following conditions:
  - o total annual revenue of not more than HK$100 million
  - o total assets of not more than HK$100 million
  - o no more than 100 employees
- a private company that is the holding company of a "group of small private companies" and that satisfies any two of the following conditions:
  - o aggregate total annual revenue of not more than HK$100 million
  - o aggregate total assets of not more than HK$100 million
  - o no more than 100 employees
- a "small guarantee company" or a guarantee company that is the holding company of a "group of small guarantee companies" is also automatically qualified for simplified reporting if its total annual revenue or aggregate total annual revenue (as the case may be) does not exceed HK$25 million

In addition, an "eligible private company", or an eligible private company that is the holding company of a "group of eligible private companies", that satisfies any two of the following conditions and has the approval of members holding at least 75% of the voting rights with no other members objecting, is qualified for simplified reporting:

o total (or aggregate total) annual revenue of not more than HK$200 million

- o total (or aggregate total) assets of not more than HK$200 million

- o no more than 100 employee

For a qualifying company, simplified reporting means:

- no requirement to disclose auditor's remuneration in financial statements

- no requirement for financial statements to give a "true and fair view"

- subsidiary undertakings may be excluded from consolidated financial statements in accordance with applicable accounting standards

- no requirement to include business review in directors' report

- no requirement for auditor to express a "true and fair view" opinion on the financial statements

12.3.2 The New Companies Ordinance requires the financial statements of a company to be prepared in compliance with the applicable accounting standards. The accounting standard that will be applicable to a company falling within the reporting exemption is the Small and Medium-sized Entity-Financial Reporting Framework ("SME-FRF") and Financial Reporting Standard ("SME-FRS") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"). The accounting standards applicable to companies that prepare simplified financial reports are less onerous than the Hong Kong Financial Reporting Standards ("HKFRS") applicable to listed, public or other companies not qualified for simplified reporting.

Banking or deposit-taking companies, corporations licensed under the Securities and Futures Ordinance, or insurance companies cannot benefit from this exemption.

Audit of the financial statements is still required for all companies, except dormant companies.

13. Disagreements within the company

13.1 Special problems faced by minority shareholders

The New Companies Ordinance contains various statutory remedies for protection of minority shareholders, including the unfair prejudice remedy (for both actual and proposed acts and omissions), the right to seek an injunction to restrain conduct that breaches the New Companies Ordinance, and the statutory derivative action (in respect of wrongs done to the company).

A court may, for example, order the winding up of a company or the appointment of a receiver or a buyout by the other shareholders. The court may also order a company itself to buy back the shares of a shareholder or order the payment of damages to shareholders whose interests have been unfairly prejudiced.

CASE STUDY 12: Yun Jip Auto Services Ltd v Yuen Sau Fai

The conduct complained of included disrupting the company's business, and the abstraction of the company's money. The High Court and Court of Appeal held that this must affect the rights and interests of some part of its members and that the petitioners were entitled to seek relief. Yun Jip Auto Services Ltd v Yuen Sau Fai [1990] 1 HKC 20. Other conduct would include not paying reasonable dividends.

13.2 Selling shares

A shareholder in a company who wants to sever his relationship with the company may decide to sell his shares. However, the shareholder may not be able to sell his shares readily – particularly if he wants to sell the shares to someone who is not an existing shareholder. Some of the difficulties such shareholder may face in that case are:

- Under the Articles, the directors may have a discretion to refuse to transfer the shares; and

- Other restrictions in the company's Articles (if any) on transferring shares (such as pre-emption rights for remaining shareholders).

Subject to compliance with the applicable laws, it may be possible to get the company itself to buy back the shares.

The New Companies Ordinance require companies to give reasons explaining their refusal to register a transfer of shares upon request and within 28 days after receiving the request. The New Companies Ordinance retains the provisions of the Old Companies Ordinance that allow a transferee, where a company refuses to register a transfer of shares, to apply to the court to have the transfer registered by the company. A court may, if it is satisfied that the application is well founded, disallow the refusal and order that the transfer be registered forthwith by the company.

14. Companies in financial trouble

14.1 Monitoring solvency

There is increasing recognition by the courts that an important part of directors' duties is to monitor solvency. The modern cases on negligence are often concerned with situations which end in insolvency.

14.2 Fraudulent and insolvent trading

The current statute law as we have seen is limited to participation in fraudulent trading. There were proposals by the Law Reform Commission Insolvency Review to impose liability on directors and senior management who were at fault when a company traded while insolvent but these have not been enacted. However, based on the experience of other common law jurisdictions there is an increasing tendency in the cases on negligence to impose a higher standard of care in cases of insolvency or near insolvency.

14.3 Receivers

A receiver, or receiver and manager, may be appointed by order of a court or under an agreement with a secured creditor to take over some or all of the assets of a company. Generally this would occur if the company is in financial difficulty. A receiver may be appointed, for example, because an amount owed to a secured creditor is overdue.

14.4 Winding up and distribution

A company may be wound up by order of a Court, or voluntarily by a creditors' meeting or if the shareholders of the company pass a special resolution to do so.

A liquidator is appointed:

- When a Court orders a company to be wound up; or
- The shareholders of a company pass a resolution to wind up the company.

14.5 Liquidators

A liquidator is appointed to administer the winding up of a company. The liquidator's main functions are:

(a) To take possession of the company's assets; and

(b) To determine debts owed by the company and pay the company's creditors; and

(c) To distribute to shareholders any assets of the company left over after paying creditors (any distribution to shareholders is made according to the rights attaching to their shares); and

(d) Finally, to have the company deregistered.

There has been a developing tendency to appoint provisional liquidators under Section 193 of the Old Companies Ordinance to safeguard the assets.

14.6 Order of payment of debts

Generally, creditors who hold security over company assets are paid first over other unsecured creditors unless their security is voidable.

14.7 Cancellation of registration

If a company has ceased trading or has been wound up, it remains on the register until it is removed. Once a company is removed from the register, it ceases to exist.

15. Non Hong Kong companies

A significant number of companies doing business in Hong Kong are incorporated in overseas jurisdictions. Operating a place of business in Hong Kong necessitates compliance with the local laws (including registration as a "Part 16" company under the New Companies Ordinance), as well as the laws of the company's domestic jurisdiction. In addition, companies that are listed on the Main Board or GEM must comply with the applicable Listing Rules.

16. Companies trading overseas and in the PRC

SMEs operating outside Hong Kong must comply with the local laws as regards trading and disclosure obligations. A practical problem is debt collection.

The main issues facing a Hong Kong SME in doing business with the PRC are:

(1) The government control which differs from area to area. Some are more investor friendly than others.

(2) The different legal system and labour practices.

(3) In particular, less developed protection of property rights, especially intellectual property rights or in some cases the enforcement of rights.

(4) The tax and exchange control regimes.

(5) A different culture of management and industrial relations.

(6) Different systems of dispute resolution.

(7) Problems of debt collection and insolvency.

With regard to 7, there has been a tendency to write off bad debts but now, as a result of reforms of insolvency, the introduction of a security law and a workable contract law and the rapid development of the legal profession in the PRC, the position is improving and the future picture is likely to be more positive for enforcement of debt and restructuring. Significant developments in recent years include the The Arrangement for Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region. This arrangement is aimed at facilitating the enforcement in the Mainland of judgments in civil or commercial matters that are given in Hong Kong (and for the enforcement in Hong Kong of judgments in civil or commercial matters that are given in the Mainland). The application of such arrangements are however limited to money judgments obtained from disputes arising from civil or commercial contracts in which the parties have agreed in writing that the Mainland or Hong Kong courts have exclusive jurisdiction.

Hong Kong commercial arbitral awards can be enforced in the Mainland China under the Arrangement Concerning Mutual Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region (2000).

17. Listed companies

17.1 Listed companies are listed on either the Main Board or GEM. As such they are subject to the Main Board or GEM Listing Rules. Some of these refer expressly to corporate governance issues. For a summary of some of the principal obligations of listed companies, see "Listing in Hong Kong – Continuing Obligations" at the "Issuer Services" section of the website of SEHK at www.hkex.com.hk/issuer/listhk/continuing_obligations.htm.

17.2 Substantial amendments were made to the Main Board and GEM Listing Rules in 2004 and 2011 with the aim of raising the corporate governance standards of Hong Kong listed companies. The amendments:

- Made voting on a poll mandatory in specified situations.
- Made subsequent refreshments of the general mandate subject to independent shareholders' approval.
- Tightened the rules on notifiable and connected transactions.
- Increased the minimum number of independent non-executive directors ("INEDs") from two to three and requiring INEDs to comprise at least one third of the Board.
- Mandated the disclosure of individual directors' remuneration (and the CEO's remuneration, if not a director) in companies' annual reports and required shareholders' approval of directors' service contracts for periods exceeding three years.

- Required the establishment of an audit committee comprising non-executive directors only and a minimum of three members.

- Required shareholder approval to appoint and remove and auditor.

- Required establishment of remuneration committee comprising a majority of INEDs.

- Required publication of a company's constitutional documents on a company's website.

- Barred directors from voting where interested in a resolution.

17.3 A new Code on Corporate Governance Practices and a requirement for listed companies to include a report on their corporate governance practices in their annual reports were introduced in January 2005, with further significant amendments to the corporate governance framework in 2011. The Code contains two levels of recommended practices. First, the "code provisions" with which a listed issuer must comply or explain any deviation in its corporate governance report. For example, if a company fails to establish a nomination committee with INEDs making up a majority of its members or deviates from the recommendation that different people should occupy the offices of chairman and chief executive officer, an explanation must be given. The second level comprises the "recommended best practices" with which compliance is encouraged, but disclosure of non-compliance is optional. Examples of such practices include the recommendation for Main Board listed companies to file quarterly reports within 45 days of the quarter end.

17.4 The Hong Kong Stock Exchange has also recently adopted new measures to promote board diversity at listed issuers. Other recent measures implemented in Hong Kong include new laws to give statutory backing to the Listing Rules relating to disclosure of price sensitive information. SEHK has also consulted the market on proposals to introduce mandatory quarterly reporting for Main Board listed companies.

18. Corporate governance issues raised by our survey

Our Survey raised issues of governance awareness in family companies, private companies and one unlisted public company. These are dealt with in Chapters 2 and 3.

19. The role of independent non-executive directors

The fashion in international corporate governance is to promote the idea of independent non-executive directors on listed public company boards. Such directors can also serve a useful function on the boards of SMEs.

The basic definition of independence normally excludes directors who are:

(a) A substantial shareholder.

(b) Employee or former employee.

(c) Professional adviser to the company.

(d) A significant supplier or customer.

(e) Someone who has any other significant contractual relationship with the company.

The general advantages of appointing independent directors are:

(a) Independent check on management.

(b) New perspectives.

(c) Connections.

(d) Access to external information.

(e) Enhanced accountability.

Disadvantages are:

(a) Some are not really independent.

(b) They may be outnumbered.

(c) They have limited time to devote to the company.

(d) They lack detailed knowledge of the business.

(e) They are insufficiently linked to the shareholders.

In the case of SMEs they may perform the following additional roles:

(a) Arbitrator of disputes.

(b) Gap filler of knowledge.

(c) Additional resource generally.

(d) Father confessor.

(e) Devil's advocate to point to a worst case scenario.

(f) Catalyst for change.

(g) Image builder.

(h) Networking agent.

At the end of the day, the case for independent directors is more linked to conformity with the rules than performance, although undoubtedly the additional roles of independent directors in SMEs may add value to business development.

D. RELATED COMPANIES, GROUPS AND OTHER LEGAL STRUCTURES

1. SMEs may consist of a single company or a company may be used in connection with a sole trader or partnership. More often corporate SMEs consist of a group where a parent or holding company holds a majority of shares in one or more subsidiaries or controls their board of directors.

2. Sometimes there is no formal group but a series of related companies which are totally or substantially under common ownership. The significance of this distinction is mainly in relation to accounts. Groups have consolidated accounts.

3. Companies can also be partners or joint ventures with either natural persons or other companies. Some, but not all joint ventures are regarded as partnerships but in some sectors like resources, steps are taken in the documentation to avoid a partnership relationship, mainly for tax reasons.

   The main governance questions are:

   (a) In a normal group the extent of control exercised by the parent board over the subsidiaries.

   (b) Related party transactions between the companies where these might involve breach of directors' duties and prejudice minority shareholders or creditors of the companies in question.

   (c) In the case of partnerships or joint ventures, possible fiduciary obligations owed by the partners or joint ventures to each other. Partnerships or joint ventures may result in strict duties of loyalty and the need to avoid conflicts of interest.

In the case of (a), where the parent company is active in the business of the subsidiary it may be regarded as a shadow director or be regarded as the principal in a transaction. This can expose it to liability to creditors of the subsidiary.

In the case of (b), related party transactions which consist of providing a financial benefit to associates may give rise to a breach of directors' duties.

In our Survey 30% of the family company respondent SMEs had more than one company. Those tended to be separate entities, not members of a group. Of private companies, 73% did not respond but of the rest more than one company was involved. It was difficult to discern the pattern of ownership. Predictably the unlisted public company and the listed public company had more companies involved but again it was difficult to discern the pattern of ownership. Having a series of companies which are not a legal group leads to complications. For instance the companies may not work as an integrated economic unit. Where the companies are owned by different family members, there may be temptations to engage in related party transactions which are not for the good of the particular company but are for family reasons or done in the interests of another company. These transactions may prejudice minority shareholders or creditors. Also where there is not a legal group, appropriate tax relief may be lost.

APPENDIX II

PRINCIPLES, PROTOCOLS AND PRACTICE

A. THE OECD CORPORATE GOVERNANCE PRINCIPLES

According to the 2004 OECD Principles of Corporate Governance, the corporate governance framework should:

1. Promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.

2. Protect and facilitate the exercise of shareholders' rights.

3. Ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

4. Recognise the rights of stakeholders as established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

5. nsure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

6. Ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

B. RESPONSIBILITIES OF THE BOARD

It is important that both the board and management understand their roles and responsibilities and it is good practice for the board to ratify a written statement which will make clear who is going to do what. The dividing line will differ between organisations depending on the size, ownership structure, complexity and traditions of the company and it will be influenced by the personalities involved. It is also likely to vary from time to time: as the board gains confidence in a new CEO, more is likely to be delegated, if a crisis arises the board may feel the need to take closer control.

The written statement can be prepared in a number of ways: through the CEO's job description, a Board Charter, a Statement of Delegations or a Statement of Matters Reserved for the Board. The latter is briefer and more flexible and an example is set out below.

Matters reserved for the Board

1. Appointments

- Appointment of the CEO.
- Appointment or removal of the Secretary to the Board.
- Senior management appointments.
- Membership and terms of reference of board committees.

2. Board and senior management

- Delegations of authority to the CEO.
- Ratification of the organisation chart.
- Approval of remuneration and incentive policies.
- Approval of senior management remuneration.
- Management contracts.
- Overseas visit approvals.
- Approval of succession plans.
- Disclosure of conflicts of interest.
- Assessment of the organisation's and CEO's performance.
- Assessment of board performance.
- Matters concerning the governance of the organisation.

3. Relations with the members and stakeholders

- Arrangements for the annual general meeting and other members' meetings [if any].
- Matters relating to reports to as required by the law.
- Suggestions for nomination of directors for election by the members.

4. Financial matters

- Approval of annual accounts and directors' reports.
- Approval of accounting policies.
- Approval of the internal audit plan.
- Any question of borrowing or giving security over assets.
- Treasury policies e.g. foreign currency and interest rates.
- Bank accounts and signatories.
- Acceptance of audit reports including management letters.

5. Business strategy

- Approval of strategic objectives.
- Approval of strategic plan.
- Approval of proposals for major expansion or closures.
- Approval of budgets.
- Approval of priorities and performance indicators.

6. Capital expenditures

    - Approval of the capital expenditure budget.
    - Approval of priorities.
    - Approval of individual expenditure items above $....

7. Lease or purchase of buildings.
8. Major transactions not included in the budget.
9. Actions or transactions involving legality or propriety.
10. Internal control and reporting systems

    - Risk assessment and insurance.
    - Risk management policies, e.g. hedging.
    - Approval of company policies, including legal compliance.
    - Approval of reporting systems.

11. Use of the seal.
12. Donations and sponsorships above approved limits.

C. MODEL BOARD PROTOCOL

While not required to adopt protocols, many boards have found them to be valuable in assisting directors to understand their role and to discharge their duties effectively. They can also be of use in helping newly elected directors become accustomed to the way the board operates.

Model Board Protocol

The members of the Board of [company name] agree to adopt, and be bound by, the letter and spirit of the following Protocol. They agree that any member who breaches the Protocol will offer his resignation, and if he fails to do so the other directors will withdraw their support from him at the next election.

1. Recognition of responsibility and common purpose

1.1 The directors understand and accept that [company name] is incorporated as a company and that, under the law, they have clear duties and responsibilities:

- To act in good faith in the best interests of the company and for a proper purpose.
- To exercise their powers and discharge their duties with care and diligence.

These duties are owed to the company as a whole. No duty is owed to any individual member or group of members. It follows that directors owe their obligations to the members of [company name] alone.

1.2 The members of [company name] have delegated powers to the Board as a whole, to be exercised as a board. They have not delegated any powers to any individual member. It follows that decisions must be made collectively and members are bound by the Board's decisions.

It also follows that unless individual directors receive specific delegations from the Board they must refrain from participating in the day-to-day management of the company, making representations or agreements on its behalf, or influencing management as individuals.

1.3 In the interests of the harmony and effectiveness of the Board, and the company as a whole, the directors agree that they will conduct themselves with good will and in a harmonious manner. The importance of good teamwork is recognised and acknowledged.

2. What is expected of directors?

2.1 The directors recognise their duty of loyalty to (company name) and to the Board, and agree that outside the boardroom they will support the letter and the spirit of board decisions when in contact with other parties.

2.2 Each director has a legal duty not to use information obtained as a director for the benefit of themselves or any person or persons linked to them. The Board agrees that information obtained as a result of board membership should not be released except as decided by the Board as a whole. Board agendas, papers, minutes and discussions are confidential to the Board.

2.3 No director should act in a way likely to bring discredit on the company.

2.4 Directors have a right and a duty to consider properly all matters brought to the Board. It follows that their attendance at board meetings is important and that apologies should be tendered only in unavoidable circumstances. Proper consideration of board papers and other relevant information before each meeting is also important.

2.5 Directors have a right and a duty to raise matters of serious concern at board meetings. In order that such matters can be discussed properly it is important that management and other directors be given time to consider them, and it is good practice for a director with a serious concern to mention it to the Chairman in time for the matter to be added to the agenda.

2.6 Directors are expected to be frank and open in board meetings and to question, request information, and raise issues. They recognise that where disagreements occur every effort should be made to resolve the issue and to avoid dissention. Directors have a right to resign, but if they choose to remain on the Board they are bound by the collective decisions of the Board and may be legally liable for them.

2.7 New directors are expected to complete a programme of induction training as set out in the attached schedule.

2.8 All directors are expected to keep themselves up to date with the affairs of the company and the Board.

2.9 Each director has a legal obligation to declare any material conflict of interest as soon as he becomes aware of it, and to withdraw from the discussion and decision of any matter on which he has a material conflict, unless the directors who do not have a conflict have resolved that the director should stay. The directors agree to notify the Chairman of any actual or potential conflict as soon as they are aware of it [if possible before the beginning of the meeting at which the issue is likely to be raised] and to withdraw from any discussions relating to it, unless invited to remain.

2.10 The effectiveness of the Board depends in part on the operation of its committees. The directors understand that committee work can impose a considerable burden and agree to share it as equitably as possible.

3. Directors' rights

3.1 In order to discharge their duties properly, directors must have a right to identify the information which they need and to receive it in a timely way. [The Board may wish to specify the way in which board papers are to be set out and the amount of time prior to meetings which they require in order to consider them].

3.2 Individual directors have a right to obtain information necessary for them to discharge their duties from executives employed by the company, but it is recognised that questions and requests involving a substantial amount of work may disrupt management. Accordingly the directors agree that if a question to an executive cannot be answered without special work it will be put in writing and a copy sent to the Chairman and the CEO.

3.3 Outside specialist advice at the company's expense is advice to the Board as a whole and should normally be arranged by the CEO at the request of the Board. In exceptional circumstances, if one or more directors wish to obtain special advice the matter should be raised with the Chairman who may exercise a discretion to arrange for the advice to be obtained, or may refer the matter to the Board. If such advice is obtained it should be made available to the Board as a whole.

4. Directors' benefits

4.1 Directors are entitled to remuneration, expenses and insurance cover, as set out in appointment letter. They should ensure that all other material benefits received from the company by them, or their relatives or associates, are disclosed to the Board. All contracts between directors and the company should also be disclosed.

5. Board leadership and the role of the Chairman

5.1 While the Chairman of the Board is elected by the Board, his authority derives by delegation from the Board, which must delegate to the Chairman sufficient powers to manage the board's affairs, to conduct it in the discharge of its business and to act effectively between board meetings. Unless the Board decides otherwise, the Chairman has no powers over the company's affairs beyond those of any other director and it follows that the Chairman should act as he believes the Board would wish him to act.

5.2 Directors recognise that the effectiveness of the Board will be enhanced if contributions to board discussions are kept brief and relevant, and if each builds on the previous contributions of others. The Chairman is responsible for the conduct of board meetings and directors must support him in maintaining order and making board discussions effective.

5.3 The Board may wish to delegate to the Chairman sufficient powers and discretions to act effectively on its behalf between meetings.

5.4 The Board may wish to provide guidance to the Chairman by reviewing his performance on a regular basis.

6. The Company Secretary

6.1 The Company Secretary has an important role in facilitating the proper and effective functioning of the Board and in ensuring that board procedures are followed. The Chairman and the Board will look to the Company Secretary for guidance in fulfilling their responsibilities under the rules and regulations to which they are subject and on how those responsibilities should be discharged. All directors should have access to the advice and services of the Company Secretary and the independence of the office should be recognised and supported.

D. SUGGESTIONS FOR THE CONTENTS OF A DIRECTOR'S LETTER OF APPOINTMENT

1. Term of appointment. Note that the New Companies Ordinance now requires shareholder approval for any contracts under which the guaranteed term of employment of a director with the company exceeds or may exceed three years.

2. Expectation of time commitment.

3. Power and duties of directors.

4. Special service attached to the position.

5. Circumstances in which an office of director becomes vacant.

6. Participation in committee work.

7. Remuneration and expenses.

8. Superannuation arrangements.

9. Indemnity and insurance coverage.

10. Requirement to disclose directors' interests and any matters where conflict or potential conflicts of interest may arise.

11. Policy governing dealings in securities (including any share qualifications) and related financial instruments by directors.

12. Induction training. Arrangements for continual professional development.

13. Confidentiality and rights of access to corporate information.

14. A copy of the Articles of Association.

Sample letter of appointment

[To be adjusted to the circumstances of each individual company.]

Dear [•],

It is with great pleasure that, on behalf of the Board of [company name], I write to invite you to accept appointment as a director of [company name].

It is proposed that, on receipt of your signed consent to act, you will be appointed to a casual vacancy on the Board until the next Annual General Meeting which is scheduled to be held on [•]. The Board intends that you should be nominated for election by the shareholders at that meeting for a period of three years. At the conclusion of that period you will be eligible for re-election. The composition of the Board is reviewed annually by the Nomination Committee in order to ensure that the membership of the Board is in the best interests of shareholders. It is normal practice on this Board for directors to serve no more than three terms of three years each.

The Board schedules regular meetings, usually on the third Tuesday of each month, which last approximately four hours. There is an annual two day board conference and additional meetings may be called to deal with urgent or important matters. The attendance of directors is expected at all board meetings unless leave of absence has been previously agreed with the Chairman. It is expected that each director will serve on at least one board committee. Over the last few years the time spent on their duties by members of the Board has averaged twenty three days per year. No special duties apply to your appointment.

In addition all directors are expected to commit to a programme of continuing professional development which includes not less than four visits per year to company operations. New directors are expected to complete a formal induction programme before taking up their appointment. A copy of the standard programme is enclosed and you are invited to inform Mr [•], the Company Secretary, of any additional visits or briefings which you feel would be valuable to you.

Currently the remuneration of directors is $[•] per annum, paid monthly in arrears. Additional fees for committee work or other special activities are [•]. No retirement benefits are provided. Expenses incurred in the discharge of a director's duties may be reclaimed by submission of a written claim which should be sent to the Company Secretary and countersigned by the Chairman.

The Company indemnifies directors and pays part of the premium for a Directors' and Officers' Liability Insurance Policy. A copy of the arrangements is enclosed.

The directors have agreed to be bound by the enclosed Board Protocol which covers such matters as the duties of directors, confidentiality, access to expert advice at the company's expense, contacts between directors and company executives, the handling of conflicts of interest and the positions of the Chairman and the Company Secretary. You will note that if a director should breach the Protocol he would be expected to resign.

A copy of the Company's Articles of Association, a list of the other directors with brief CVs, and a company organisation chart are attached for your information.

I look forward to welcoming you to your first meeting. Yours sincerely,

Chairman

E. SAMPLE ANNUAL AGENDA

During the next year the Board plans to deal with the following matters:

1. Establishing the plan and the criteria for success

(a) Reviewing the organisation's strategic plan and settling with management of the goals and objectives.

(b) Reviewing the economic and competitive environments and agreeing the assumptions on which the budget is based.

(c) Approving the annual budget.

(d) Approving the non-financial performance indicators and the annual targets set for each.

(e) Approving the CEO's personal objectives.

2. Monitoring the performance of the company, management and committees

(a) Reviewing the financial results for the reporting periods against the budget and prior periods.

(b) Satisfying itself about the company's overall financial position.

(c) Reviewing performance against the non-financial performance indicators.

(d) Receiving and considering reports from the board committees and ratifying their recommendations.

3. **Reporting progress to the owners/members**

(a) Settling the annual and six monthly financial accounts.

(b) Receiving the auditor's report and discussing it with the auditor.

(c) Approving the annual report.

(d) Declaring the dividend.

(e) Making the Directors' Report and Declaration.

4. **Reviewing board policies and the performance related to them**

(a) Matters reserved for the Board.

(b) Monitoring and reporting arrangements – the information the Board requires on a regular or periodic basis.

(c) Plans for management succession and development.

(d) Remuneration policies and practices, including incentives, superannuation and the employee share purchase plan.

(e) Employment policies, including recruitment, health and safety and antidiscrimination.

(f) The organisation's code of conduct and ethical standards.

(g) Compliance with legal and other external requirements and standards.

(h) Risk assessment and control, including insurance policies.

(i) Emergency response or disaster recovery plans.

(j) Shareholder relations.

(k) Customer relations, including product quality, delivery performance and handling of complaints.

(l) Credit policies and the handling of debtors, including the write-off of bad debts.

(m) Public relations and advertising policies, including the corporate image.

(n) Supplier relations, including purchasing and tendering policies and payment terms.

(o) Accounting policies, including the making of provisions.

(p) Foreign exchange management.

(q) Bank accounts and bank signatories.

(r) Donations and sponsorships.

5. Reviewing administrative arrangements

(a) Arrangements for board meetings, including rules for electronic meetings.

(b) Board committee charters, arrangements and membership.

(c) Reviewing the performance of the Board, the CEO and the Chairman.

F. DELEGATION OF AUTHORITY

A SME should expressly deal with the following delegations:

(1) The role of management vis-à-vis the board of directors or sole traders or partners.

(2) The authority of the CEO.

(3) The execution of documents.

(4) The signing of cheques and funds transfers.

See generally Table A regulations 82, 83, 87, 104, 109 and 111. (or Articles 3(1), 4 and 5 of the Model Articles for private companies (or Articles 2(1), 3, 4, 33 and 34 of the Model Articles for public companies).

G. MODEL AUDIT COMMITTEE CHARTER

The Board of Directors of [company name] resolves to establish an Audit Committee with the following terms of reference:

1. Objectives

1.1 To assist the board in fulfilling its responsibilities relating to accounting and reporting practices.

1.2 To improve the credibility and objectivity of the company's financial and other reports.

1.3 To strengthen the systems of internal control, risk management and compliance with applicable laws and regulations.

2. Duties and responsibilities

2.1 To review all financial statements to be made on behalf of the Board prior to their consideration by the full Board, and to make recommendations.

2.2 To review the company's accounting policies and consider the application to them of the prevailing Accounting Standards.

2.3 To review the audit plans of the external and internal auditors, including the extent of co-ordination between them, and to satisfy itself that they are adequate and appropriate.

2.4 To review the results of the external and internal audits and to satisfy itself that management's response to audit recommendations is adequate.

2.5 To evaluate the independence and the effectiveness of the external and internal auditors.

2.6 To review the company's system of internal control, including all computerised systems, and to identify any weaknesses that require attention.

2.7 To review the company's risk management system and to satisfy itself that all risks have been identified and assessed, and that appropriate policies are in place for the management of risks.

2.8 To monitor the implementation of the policies relating to risk.

2.9 To review all reports to regulators which require board approval.

2.10 To review the company's management information systems.

2.11 To review the company's business policies and to monitor the implementation of those policies.

2.12 To monitor the company's compliance with all applicable laws, regulations, standards and best practice guidelines.

2.13 To recommend to the Board any changes that may be required in the company's accounting or other policies.

2.14 To recommend any changes that may be required in the external or internal audit arrangements, including the appointment of auditors and the level of fees.

2.15 To carry out such other tasks as the Board may from time to time delegate to the committee.

3. Membership

3.1 The committee shall consist of not less than three independent directors appointed by the Board. The Managing Director shall attend each Audit Committee meeting as requested by the members.

3.2 A quorum shall be two, and meetings shall not proceed in the absence of a quorum.

3.3 The membership of the committee shall be reviewed by the Board each year.

3.4 The Board shall appoint one of the members to be Chairman of the Audit Committee.

4. Meetings

4.1 The Committee shall hold at least three regular meetings per year and such other meetings as shall be requested by the Chairman of the committee, or another member, or an auditor. A regular schedule of meetings shall be developed so as to discharge the committees' responsibilities.

4.2 Meetings shall be conducted formally, with agendas and supporting papers sent out in advance, and minutes taken. Papers shall be maintained at the same standard as those of the full Board. The committee shall decide the minimum notice to be given of meetings, and the arrangements for making committee papers available to members in advance of meetings.

4.3 Both external and internal auditors shall have the right to attend meetings of the committee.

4.4 Committee members may meet independently of management and/or the auditors as they shall decide.

5. Authority and access

5.1 The Committee shall have authority to require the attendance of the external or internal auditors, and such members of management as it needs to fulfil its responsibilities. It shall have authority to require any company documents it requires to discharge its duties.

5.2 The committee shall have authority to obtain external professional advice, including taking a second opinion on accounting matters, at the company's expense. The purpose and cost of such requests shall be reported to the Board.

5.3 The Assistant Company Secretary will act as secretary to the committee.

6. Reporting

6.1 The committee's proceedings shall be recorded in minutes which shall be included in the papers prepared for the next board meeting after each meeting of the committee.

6.2 The Chairman of the Audit Committee shall submit an oral report on each committee meeting to the Board as soon as possible after each committee meeting.

BIBLIOGRAPHY

H. Bosch, *Conversations Between Chairmen* (1999)

H. Bosch, *Conversations with a New Director* (1997)

H. Bosch, *The Director at Risk – Accountability in the Board Room* (1995)

Butterworths Hong Kong Company Law Handbook 4th ed (2002)

Sir Adrian Cadbury, *Corporate Governance and Chairmanship – A Personal View* (2002)

California Public Employees Retirement Scheme, *Global Corporate Governance Principles*, www.CalPERS_governance.org/principles/international/global

J. Carver and M. M. Carver, *Reinventing Your Board* (1997)

Census and Statistics Department, HKSAR Government, *Hong Kong in Figures* (2013)

Ming-Jer Chen, *Inside Chinese Business (2001) Corporations*

Act 2001 (Australia), *Small Business Guide*

Credit Lyonnais Securities Asia, *Report on Emerging Markets* (2003)

J. H. Farrar, *Corporate Governance in Australia and New Zealand* (2001)

J. H. Farrar, "*Developing Corporate Governance in Greater China*" (2002) 25 *University of New South Wales Law Journal 462*

BIBLIOGRAPHY

Harvard Business Review on Corporate Governance (2000)

J. Harvey-Jones, *Making it Happen* (1998)

The Hong Kong Institute of Directors, "*Core Competencies For Directors*" (2001), *HKIoD Members' Handbook*

The Hong Kong Institute of Directors, *Guidelines for Directors* (1995) (2005) (2009) (2014)

The Hong Kong Institute of Directors, *Guide for Independent Non-Executive Directors* (2000) (2003) (2006) (2010) (2012)

"The Companies Ordinance (Cap 622, Laws of Hong Kong)"

G. Kiel and G. Nicholson, *Boards That Work – A New Guide for Directors* (2003)
McKinsey & Co, *Global Investors Opinion Survey* (2002)

R. Monks and N. Minow, *Corporate Governance* (1995)

F. Neubauer and A. G. Lank, *The Family Business. Its Governance for Sustainability* (1998)

OECD Principles of Corporate Governance (1999) (2004)

M. Porter, *The Competitive Advantage of Nations* (1990)

S. Gordon Redding, *The Spirit of Chinese Capitalism* (1993)

P. Stiles and B. Taylor, *Boards at Work. How Directors View Their Roles and Responsibilities* (2002)

V. Stott, *Hong Kong Company Law 9th ed* (2000)

R. Tricker, *International Corporate Governance* (1994)

C. W. L. Tsui, "Corporate Governance and Director Professionalism in Hong Kong: "*Initiatives and Observations", Hong Kong Corporate Governance: A Practical Guide* (2014)

R. Ward, *Saving the Corporate Board – Why Boards Fail and How to Fix Them* (2003)