

CORPORATE GOVERNANCE

DIRECTORS' REMUNERATION - RECOMMENDATIONS FOR ENHANCED TRANSPARENCY AND ACCOUNTABILITY

By Directors' Remuneration Task Force
Corporate Governance Committee
Hong Kong Society of Accountants

November 1999



Composition of the HKSA Corporate Governance Committee (1999)

Chairman	: Mr Edward KF Chow	China Infrastructure Group Holdings PLC
Members	: Mr Nicholas Allen	PricewaterhouseCoopers
	Professor Gary Biddle <i>(Since September 1999)</i>	The Hong Kong University of Science & Technology
	Mr Michael KH Chan	Guoco Group Limited
	Mr David Cheng	HLB Hodgson Impey Cheng
	Mr Alex Chu	Dresdner RCM Global Investors Asia Limited
	Mr Richard George	Deloitte Touche Tohmatsu
	Mr Quinn YK Law	The Wharf (Holdings) Limited
	Mr Peter Nixon	Potential Associates Limited
	Mr David Sun	Ernst & Young
	Ms Nancy Tse	Hospital Authority
	Professor Judy Tsui	City University of Hong Kong
	Mr Jim Wardell	Rutledge Group Limited
	Mr Stephen Yiu	KPMG
Secretary	: Ms Winnie Cheung	Director of Professional Practices, HKSA

Composition of the Directors' Remuneration Task Force

Convenor	: Mr Nicholas Allen	PricewaterhouseCoopers
Members	: Mr Edward KF Chow	China Infrastructure Group Holdings PLC
	Mr Richard George	Deloitte Touche Tohmatsu
	Professor Judy Tsui	City University of Hong Kong
	Mr Jim Wardell	Rutledge Group Limited
Secretary	: Ms Winnie Cheung	Director of Professional Practices, HKSA

Hong Kong Society of Accountants
4th Floor, Tower Two, Lippo Centre, 89 Queensway, Hong Kong
Tel : 2287 7228 Fax : 2865 6603
E-mail : hksa@hksa.org.hk
Website : <http://www.hksa.org.hk>

DIRECTORS' REMUNERATION – RECOMMENDATIONS FOR ENHANCED TRANSPARENCY AND ACCOUNTABILITY

CONTENTS

	Paragraphs
INTRODUCTION	1 - 6
INTERNATIONAL STANDARDS	7 - 9
BASIC PREMISE	10
COMPARATIVE STUDY	11 - 14
CONCLUSIONS & RECOMMENDATIONS	15 - 18
Appendix I - Directors' Remuneration Comparative Study: Summary Results and Recommendations for Hong Kong Listed Companies	
Appendix II - Greenbury recommendation of key issues to be covered in General Policy Statement on Directors' Remuneration	

Introduction

1. In the First Report of the HKSA Corporate Governance Committee [formerly a Working Group] issued in December 1995 there was some discussion of the recommendations by the Cadbury Report regarding Board remuneration. This report attempts to revisit this issue.
2. It is a common practice in many countries that the Board generally determines its own remuneration. This raises the issue of accountability of the Board when granting its own pay.
3. In Hong Kong and generally countries in Asia, as noted in our first two reports, many Boards of listed companies are controlled by a dominant or controlling shareholder, who also commonly performs the dual role of Chairmanship of the Board and Chief Executive of the company. While the Board approves the remuneration of the directors in total, the Chief Executive is often the only person who knows how the total amount of remuneration of the Board is allocated among the directors.
4. This lack of transparency and accountability in the process of determining directors' remuneration is commonly a concern to other shareholders and investors.
5. At the time of writing the First Report in 1995, the Stock Exchange of Hong Kong had just introduced a package of measures including requirements to disclose the banding of directors' remuneration in the company's annual report and compulsory appointment of two independent non-executive directors to the Board. These measures were aimed at introducing more transparency to individual directors' remuneration levels and more objectivity in the operation of the Board, including the setting of directors' remuneration. We expressed the view at the time that these measures should be allowed time to operate before desirability of other measures, such as Remuneration Committees, should be considered not least because it will take time for the independent directors to find their place/weight in the Board and for more market information to be developed over time through the additional disclosure requirements to provide objective benchmarks for a proper assessment of directors' remuneration.
6. After 3 years of implementation of the above measures, the Corporate Governance Committee considers it appropriate to once again revisit the questions of transparency and accountability in relation to directors' remuneration. In this context, it should now be practical to reconsider the effectiveness of Remuneration Committees as a means to increase Board accountability and transparency in directors' pay determinations and disclosures.

International Standards

7. Since 1996, the Organisation for Economic Co-operation and Development (OECD) has been working to review and analyse international corporate governance issues. It has recently passed (in May 1999) a set of principles on corporate governance which is the first inter-governmental attempt to develop international standards for corporate governance.

8. In respect of directors' remuneration, the OECD has set principles under two headings: Disclosure and Role of the Board.

'Board and executive remuneration are of concern to shareholders. Companies are generally expected to disclose sufficient information on the remuneration of board members and key executives (either individually or in the aggregate) in order for investors to properly assess the costs and benefits of remuneration plans and the contribution of incentive schemes, such as stock option schemes, to performance.' [OECD, May 1999]

'Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest.' [OECD, May 1999] Examples given of such key responsibilities included executive remuneration. The others are financial reporting and nomination of the Board and key executive.

9. This report has been prepared with reference to the OECD Corporate Governance Principles, and from findings of a comparative study on directors' remuneration disclosures in major financial markets, conducted by the Corporate Governance Committee.

Basic Premise

10. There is a basic premise underlying the discussion of this issue which should be made explicit, namely that

'Directors are accountable to the shareholders for their performance. In this context, all shareholders should have the ability to know the quantum, and basis of calculation of the remuneration received/receivable by directors for duties performed so as to compare this remuneration with the financial performance of the company - in order to assess the performance of the directors.'

Comparative Study

Purpose of Comparison

11. For the purpose of assessing the adequacy of directors' remuneration disclosures in Hong Kong, the Corporate Governance Committee has completed a comparative study to compare the directors' remuneration disclosure requirements for listed companies in Hong Kong with those in other principal financial markets. In terms of accountability, the comparative study has also considered the establishment of Remuneration Committee.
12. The aim of the study was to determine if the basic premise outlined above was being achieved in Hong Kong as compared to other jurisdictions and, whether there are additional measures that should be recommended to enhance our position.

Scope of Comparison

13. The comparison benchmarks Hong Kong with the US, UK, Australia and Singapore.

Key Findings

14. The results of the comparative study are set out in Appendix I to this report. The key findings are identified below:-

I. Disclosure of individual directors' remuneration

- (i) Hong Kong rules do not require disclosure of the remuneration of the individual highest paid directors as is required in US and UK. Indeed, UK requires disclosure of each element of the remuneration package for each individual director, not just the highest paid. In common with Hong Kong, neither Australia nor Singapore currently require disclosure of remuneration of the directors individually.
- (ii) It might be argued that the levels of directors' remuneration can be ascertained from the required disclosure of directors' emoluments in the bandings under existing Hong Kong Listing Rules: HK\$Nil to HK\$1,000,000 and thereafter, bandings of HK\$500,000. The bandings do not, however, provide:
 - disclosure of the emoluments of individual directors by name;
 - any analysis of the constituent elements of directors' emoluments; and
 - precision of disclosure below HK\$1,000,000 or thereafter within the HK\$500,000 bands.
- (iii) The OECD Corporate Governance Principles recognise however that disclosure individually as well as in aggregate may be acceptable for the achievement of the international benchmark or the basic premise as identified in para.10 above.
- (iv) The US and UK disclosures would arguably enhance transparency regarding individual directors' remuneration which cannot be determined under existing Hong Kong disclosure requirements, and allow more informed judgement to be made by all shareholders on the fairness and reasonableness of the directors' remuneration.
- (v) On the other hand, disclosure is not an end in itself, there is a need to consider the benefit of such disclosure in its effectiveness as a measure to improve accountability of the Board towards directors' pay awards. At the same time, such information is generally regarded as sensitive and confidential information, which is a relevant factor that needs to be balanced when considering whether such disclosure should be made a requirement. It could also be argued that the Board operates collectively, and that an assessment of directors' pay and performance should be made on a Board as opposed to an individual basis.

II. All other compensation

The Hong Kong Listing Rules require the disclosure of the aggregate of directors' basic salaries, housing allowances, other allowances and benefits in kind. In comparison, the US is highly prescriptive as to the constituent parts into which directors' remuneration disclosure should be analysed. Similarly, the UK requires disclosure of "each element" of directors' remuneration while Singapore requires directors' remuneration to be "categorised into appropriate components".

The extensive US requirements reflect the relative sophistication of US directors' remuneration packages; not least through contracts to link directors' remuneration to company performance. Nevertheless, in the absence of a disclosure requirement similar to "appropriate components", there is arguably a lack of flexibility in the current Hong Kong rules which may result in non-standard elements of directors remuneration packages being "hidden" within the disclosure heading dealing with basic salaries, housing allowances, other allowances and benefits in kind.

III. Share options

The US and UK disclosure requirements relating to share options provide greater transparency regarding the value afforded to directors from share options. In particular, disclosure is required of the aggregate value realised by directors on the exercise of options, the aggregate value of in-the-money, unexercised options at the end of the fiscal year and the aggregate gains made by the directors on the exercise of share options.

IV. General policy on directors' remuneration

In the US, companies have to provide a description of their arrangements with regard to directors' remuneration. In the UK, companies are required to make a statement regarding their policy on executive directors' remuneration. Such requirements may improve communication of companies' approach to the remuneration of directors.

V. Description of contracts and terms of remuneration

The US and the UK require disclosure describing employment contracts and termination of employment and change-in-control arrangements. Such disclosure may provide a clearer understanding of the terms on which directors are employed.

VI. Remuneration Committee

Remuneration Committees are widely practised in US and UK. Both the US Securities and Exchange Commission and London Stock Exchange Rules prescribe functions for the Remuneration Committee. The concept, however, has not yet taken hold in Hong Kong and executive remuneration is generally determined by the Board based on recommendation of the executive directors. There is little dispute that Remuneration Committees which include, and are chaired by, independent, non-executive directors provide a better mechanism for objectively setting remuneration.

Conclusions & Recommendations

15. The overall conclusion is that while the basic level of disclosures requirements on directors' remuneration for listed companies is comparable to other principal financial markets, the basic premise of transparency and accountability can be better achieved in Hong Kong by adoption of several further measures. The following specific recommendations arise from the study:-

Enhanced Disclosures

- **A statement regarding the company's policy on executive directors' remuneration and share options should be given in the company's annual report.** Appendix II provides guidance to a list of key issues that were recommended by the UK Greenbury Report on directors' remuneration for inclusion in a general policy statement.
- The statement should also **state how, and by whom, the fees and other benefits of the non-executive directors are determined.**
- To enhance comparability and transparency of the way directors are compensated, in particular, the extent they are linked to the company's performance, the introduction of a requirement should be made for **separate disclosure of directors' remuneration into 'non-performance based' and 'performance based'.**
- In addition to standard remuneration, provision should be added for **disclosure of all other compensation in appropriate components.**
- The disclosure requirement on **directors' share options should be expanded to include disclosure of the aggregate value realised by directors on the exercise of options, of the aggregate value of in-the-money, unexercised options at the end of the fiscal year and of the aggregate gains made by the directors on the exercise of options.**
- Provision should be added for **nil disclosure.**
- The HKSA should develop specific recommendations on pro forma disclosure when regulators/Listing Rules adopt the above recommendation.

Enhanced Accountability

- Shareholders have a role to play in influencing Boardroom pay. Transparency in disclosure is an important element to enable shareholders to perform this role. However, disclosure cannot be an end in itself, shareholders should have greater means of holding the Board accountable and be prepared to exert actual influence on this issue. We propose two measures:-
 - **Boards should appoint remuneration committees composed of wholly or mainly non-executive directors to recommend to the Board the remuneration of the executive directors.** (Small company to have combined audit and remuneration committee.)

The OECD's view, which we support, is that 'where independence has been generally discussed in the context of companies with broad and fragmented ownership, any majority controlled company could benefit from independent directors. It is expected that they would help provide a higher level of assurance to minority investors that their interests are being protected.' [OECD, June 1999]

- To reiterate a proposal in the First Report, in order to strengthen shareholder control over level of compensation for loss of office, **directors' service contract should not exceed 3 years without shareholders' approval, and directors' termination arrangements should be disclosed.**
16. We agree with the Cadbury Report that 'a director's remuneration is not a matter which can be sensibly reduced to a vote for or against: were the vote to go against a particular remuneration package, the Board would still have to determine the remuneration of the directors concerned.' [Cadbury Report, December 1992]
- Further changes to the rules for disclosure, such as consideration to require directors' remuneration to be individually identified and the role which shareholders could play in voting on particular aspects of remuneration along the lines developing in US and UK will need to be reviewed in light of experience and changes in environment both locally and internationally.
17. We believe that the practice of sound corporate governance, enhanced disclosures and enhanced accountability should be self-initiated decisions of individual boards rather than matters for compliance with company or securities laws, Listing Rules and Code of Best Practice. Nevertheless, where subject matters are part of public expectation or fall short of public expectation the regulators and government would have to ensure that appropriate requirements are included in the Listing Rules and company law.
18. The HKSA urges its members, listed companies, public corporations and the regulators to adopt recommendations made in this report.

Appendix I – Directors’ Remuneration Comparative Study :
Summary Results and Recommendations for Hong Kong Listed Companies

Table A - Disclosure

AREA	FINDINGS			RECOMMENDATION
	Overseas	Hong Kong	Discussion	
<p>I. Disclosure of the remuneration of individual directors</p>	<ul style="list-style-type: none"> • The US requires disclosure of the remuneration individually of the CEO, the four highest paid executive and up to two additional highest paid non-executive directors. • The UK requires disclosure of each element of the remuneration package for each individual director, not just the highest paid. • In common with Hong Kong, neither Australia nor Singapore currently require disclosure of remuneration of individual directors. 	<p>The Hong Kong Listing Rules require disclosure of directors’ pay in the bandings of HK\$Nil to HK\$1 million and thereafter bandings of HK\$500,000. They do not require disclosure of the remuneration of individual directors as is required in the US and the UK.</p>	<p>It might be argued that the levels of directors’ pay can be ascertained from the required disclosure of directors’ emoluments in the bandings. The bandings do not, however, provide:</p> <ul style="list-style-type: none"> • disclosure of the emoluments of individual directors by name; • any analysis of the constituent elements of directors’ emoluments; and • precision of disclosure below HK\$1,000,000 or thereafter within the HK\$500,000 bands. <p>The additional disclosure requirements in the US and the UK would arguably enhance transparency regarding individual directors’ remuneration which cannot be determined under existing Hong Kong disclosure requirements.</p> <p>It could be argued that such disclosure would also provide additional information to enable judgments to be made as regards the relationship, if any, between remuneration and performance.</p>	<p><i>On the premise that shareholders should be provided with information as to the level and terms of directors’ remuneration so as to assess directors’ performance, disclosure of all directors’ remuneration on an individual basis, as under the UK and the US model, will produce greater transparency towards achievement of the basic premise.</i></p> <p><i>However, disclosure is not an end in itself. There is a need to balance the benefits as against the sensitivity of the disclosure. This needs to be reviewed in light of experience and the changing environment locally and internationally.</i></p>

Table A - Disclosure (continued)

AREA	FINDINGS			RECOMMENDATION
II. Disclosure of the constituent elements of directors' compensation	Overseas	Hong Kong	Discussion	<p><i>To enhance comparability and transparency of the way directors are compensated, in particular, the extent they are linked to the company's performance, the following are proposed:-</i></p> <ul style="list-style-type: none"> • <i>Introduce a requirement for separate disclosure of directors' remuneration into those which are</i> - <i>non-performance based;</i> and - <i>performance based.</i>
	<ul style="list-style-type: none"> • The US is highly prescriptive as to the constituent parts into which directors' remuneration disclosure should be analysed. • Similarly, the UK requires disclosure of "each element" of the remuneration package for each individual director (generally in tabular form). • Singapore requires directors' remuneration to be "categorised into appropriate components". 	<p>a) The Hong Kong Listing Rules require the disclosure of the total directors' emoluments and further analysis of them into the following different constituents:-</p> <ul style="list-style-type: none"> • Fees • Basic salaries, housing and other allowances and benefits in kind • Pension contributions • Performance (discretionary) bonuses • Payments on joining and payments on leaving. 	<p>a) The extensive US requirements reflect the relative sophistication of US directors' remuneration packages; not least through arrangements designed to align directors' remuneration with enhancements in shareholders' value.</p> <p>It can be argued that the current disclosure requirement in Hong Kong, although not in as great a detail as the UK and the US, do provide for the major components, and an indication of the fixed elements (i.e. fees, basic salaries and pension contribution) and variable elements (performance bonuses, joining and leaving payments) of total directors' emolument.</p> <p>As a further enhancement of comparability and transparency, a requirement for separate disclosure of the total of directors' remunerations into those which are non-performance based, and performance based should be adopted.</p>	

Table A - Disclosure (continued)

AREA	FINDINGS			RECOMMENDATION
	Overseas	Hong Kong	Discussion	
		<p>b) There is no catch-all components for non-standard elements of directors' pay.</p> <p>c) There is also no requirement for negative disclosure of nil items in the above components.</p> <p>d) The Companies Ordinance (to which the Listing Rules refer) stipulates that directors' remuneration disclosures should be made in the annual report. It is common for companies to disclose details of directors' remuneration in the notes to the financial statements and details of directors' interests in options in the directors' report. However, there is no universal consistency on this.</p>	<p>b) There is arguably a lack of flexibility in the current Hong Kong rules which may result in non-standard elements of directors' remuneration packages (e.g. profit sharing, consulting and professional fees, etc.) being "hidden" within the disclosure heading dealing with basic salaries, housing allowances, other allowances and benefits in kind.</p> <p>c) Requirements to give negative confirmations and/or disclosure of nil items as appropriate would contribute to improve comparability.</p> <p>d) Prescribing the position of disclosure of directors' remuneration and details of directors' interest in options in the annual report would improve consistency of disclosure.</p>	<ul style="list-style-type: none"> • <i>Provision should be added for disclosure of all other compensation in appropriate components under the two major categories recommended above.</i> • <i>A general policy statement should be made in relation to the formulation of directors' remuneration and share options.</i> • <i>Provision should be added for negative disclosure.</i> • <i>Specific recommendations on proforma disclosure should be developed when regulators/ Listing Rules adopt the above recommendations.</i>

Table A - Disclosure (continued)

AREA	FINDINGS			RECOMMENDATION
	Overseas	Hong Kong	Discussion	
III. Directors' share options	<ul style="list-style-type: none"> In the US and the UK, disclosure is required of the aggregate value realised by directors on the exercise of options, of the aggregate value of in-the-money, unexercised options at the end of the fiscal year and of the aggregate gains made by the directors on the exercise of share options. Neither Australia nor Singapore currently require such additional disclosures. 	In Hong Kong, disclosure is required to be made of arrangements to enable the directors to acquire shares, details of shares acquired by each director through such arrangement, and the aggregate amount of share option benefits granted to directors.	The US and the UK disclosure requirements relating to share options provide greater transparency regarding the value afforded to directors from share options.	<p><i>The disclosure requirement on directors' share options should be expanded to include disclosure of the aggregate value realised* by directors on the exercise of options, of the aggregate value of in-the-money, unexercised options at the end of the fiscal year and of the aggregate gains made by the directors on the exercise of options.</i></p> <p><i>* Value is considered "realised" when option is exercised even if shares acquired on exercise are not themselves sold.</i></p>
IV. Directors' compensation policy	<ul style="list-style-type: none"> In the US, companies have to provide a description of their arrangements with regard to directors' remuneration. In the UK, companies are required to make a statement regarding their policy on executive directors' remuneration. Neither Australia nor Singapore currently require disclosures of directors' compensation policy. 	No such requirement.	Such requirements will improve communication of companies' approach to the remuneration of directors.	<p><i>A statement regarding the company's policy on executive directors' remuneration should be given in the annual report.</i></p>

Table A - Disclosure (continued)

AREA	FINDINGS			RECOMMENDATION
	Overseas	Hong Kong	Discussion	
V. Description of contracts and terms of employment	<ul style="list-style-type: none"> The US and the UK require disclosure in summary describing the main terms of employment contracts including termination of employment and change-in-control arrangements. There is no such requirement in Australia and Singapore. 	No such requirement.	<p>It should be noted that for many smaller companies, reported earnings are sensitive to the directors' remuneration figure. Disclosures of the main terms of contract, such as end of contract or termination arrangements may provide a clearer understanding of the terms on which directors are employed.</p> <p>It is noted that hostile takeovers are rare in Hong Kong and accordingly change-in-control clauses are rarely applicable.</p>	<p><i>To reiterate a proposal in the HKSA Corporate Governance Working Group's First Report, in order to strengthen shareholders' control over level of compensation for loss of office, directors' service contract should not exceed 3 years without shareholders' approval, and directors' termination arrangements should be disclosed.</i></p>

Table B - Accountability

AREA	FINDINGS			RECOMMENDATION
VI. Introduction of Remuneration Committees	Overseas	Hong Kong	Discussion	<i>Introduction of Remuneration Committee composed of independent non-executive directors is recommended and should be included in the Code of Best Practice.</i>
	<ul style="list-style-type: none"> Remuneration Committees are widely practised in the US and the UK. Both the US Securities and Exchange Commission and the London Stock Exchange Rules prescribe functions for the Remuneration Committee. However, Remuneration Committees are not mandatory in any of the jurisdictions studied (i.e. US, UK, Australia, Singapore, Hong Kong). 	<p>Remuneration Committees are not required or recommended as best practice in Hong Kong.</p>	<p>Remuneration Committees which include, and are chaired by, independent, non-executive directors are the appropriate mechanism for objectively setting remuneration.</p> <p>In the absence of Remuneration Committee the manner in which remuneration is determined is not seen to be transparent.</p>	

Appendix II
Greenbury recommendation of key issues
to be covered in a General Policy Statement on Directors' Remuneration

The UK Greenbury Report published in July 1995 recommended that the general policy on directors' remuneration should set out major issues such as:

- the total level of remuneration;
- the main components and the arrangements for determining them, including the division between basic and performance-related components;
- the comparator groups of companies considered;
- the main parameters and rationale for any annual bonus schemes, including caps;
- the main parameters and rationale for any share option or other long-term incentive schemes;
- how performance is measured, how rewards are related to it, how the performance measures relate to longer-term company objectives and how the company has performed over time relative to comparator companies;
- the company's policy on allowing executive directors to accept appointments and retain payments from sources outside the company;
- the company's policy on contracts of service and early termination;
- the pension and retirement benefit schemes for directors, including the type of scheme, the main terms and parameters, what elements of remuneration are personable, how the Inland Revenue pensions cap has been accommodated and whether the scheme is part of, or separate from, the main company scheme.