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Corporate Governance in China

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Introduction

While China's transition from a state-planned into a market-oriented economy started almost two decades ago, corporate governance reform gained prominence only in the past three years. In 2001, a local business publication, *Caijing Magazine*, unveiled the YingGuangXia RMB745 million fraud, the biggest economic scandal in Mainland China's history. This revelation not only drew attention from regulators and public investors to the importance of corporate governance but also exposed the weakness of the country's legal, regulatory, and accounting systems. Corporate governance since then has been placed at the very top of the Government's agenda. This high profile topic has been mentioned frequently in all of the recent keynote speeches by China's Premier, the Chairman of the Central Bank, the Chairman of the China Securities Regulatory Commission ("CSRC"), and numerous other government officials and scholars. Within a mere two years, China has made some tremendous strides on the corporate governance front. The mandate to improve corporate governance is a top priority amongst all sectors, including government bodies, regulators, intermediaries, corporations, and investors. Legislators, regulators, and professional institutions have since issued various laws, rules, regulations, and standards with a view towards laying a foundation for good corporate governance. However, change will not happen overnight as separation of ownership and management of a company is still a very new concept in China.

The progress of corporate governance reform will depend on both the efforts at the individual company level to close the gap with global best practices as well as ongoing country-level initiatives that will shape China's corporate governance infrastructure. Individual companies, through their own efforts, can achieve world-class corporate governance regardless of the local market's governance infrastructure. On the other hand, such external environment factors can play a critical role in raising the country's overall standards by incentivizing or mandating sound governance practices. This report will focus on the broader, country-level characteristics of China's financial markets that impact corporate governance. Specifically, the review focuses on four major areas that comprise China's corporate governance infrastructure – market infrastructure, legal environment, regulatory environment, and informational infrastructure.

As the China market continues the transformation from a planned economy to a market economy, the government's role in corporate ownership is likewise in a transition state. Given the current trends relating to the privatization of State Owned Enterprises ("SOEs"), the separation of regulatory and management roles, and the development of domestic capital markets, the government must appropriately manage and reconcile its concurrent but sometimes conflicting roles as majority shareholder, business manager, industry regulator, and sovereign ruler. While the ongoing market reforms should lead towards gradual improvements in the external market environment that impacts corporate governance at the company level, however, several key characteristics that underscore some fundamental weaknesses of China's corporate governance infrastructure. Specifically, the continued concentration of government ownership and influence in privatized state-owned enterprises, complex and opaque corporate ownership structures, enforcement of shareholder rights, financial accounting transparency and disclosure, board of director independence and effectiveness, and the lack of shareholder activism are all matters that require serious attention in order to achieve meaningful advances in corporate governance. Underlying these challenges is the rapid but uneven development of the domestic capital markets. While retail investors remain a significant presence on the two major stock exchanges, they have not, as a group, demonstrated a strong interest in corporate governance matters. Over time, however, the Qualified Foreign Institutional Investor ("QFII") scheme will lead to more market-driven improvements in corporate governance.

While there have been some positive developments on the legal and regulatory fronts that have led to some world-class corporate governance codes, guidelines, and listing requirements, effective implementation and enforcement of such standards may prove elusive for years to come. China's legal and regulatory environment has moved forward significantly in order to keep pace with the country's rapid economic growth and evolution to a market economy with the passage of new laws and regulations and the establishment of new regulatory bodies. However, such progress has been partially undermined by some inconsistencies and redundancies around these new rules and institutions, partly as a result of different government and market sector groups pursuing reform without full coordination and common oversight. Key rules and regulations safeguarding governance of the financial and capital markets are imbedded in the PRC Company Law, Securities Law, and the Code of Corporate Governance. Companies traded on a public exchanges are required to adapt a two-tiered board system. There are no clear requirements regarding the responsibility and accountability of the board members. In practice, truly independent and effective board oversight over executive appointments and compensation cannot be simultaneously legislated and implemented. Selective enforcement is still commonly sighted.

Although the Mainland China's information infrastructure is still a weak link from a corporate governance standpoint, the relevant regulators, including the Ministry of Finance ("MoF") and the China Accounting Standards Committee ("CASC"), have made significant progress in setting a variety of accounting standards and licensing systems that have helped close some major gaps vis-à-vis International Accounting Standards ("IAS"). As with the legal and regulatory reforms, the key issue is still enforcement. A recent survey conducted by the regulator revealed a high rate of fraud performed by licensed accounting firms. This survey directly points to the urgency of improving governance standards amongst corporate and professional firms. Recently, the new Ordinance on Disclosure established by the CSRC sets some very strict rules regarding public company disclosure requirements. Nevertheless, while comprehensive laws, regulations, and guidelines, proactive government regulatory bodies, and strong

financial institutions and other intermediaries provide an important foundation for market development, significant corporate governance advances at both the macro level as well as at the individual company level also require the discipline of global market-based forces.

Component 1: Market Infrastructure

1.1 General Stages of Economic Development

Transforming from a planned economy to a market economy

Since her birth in 1949 until the late 1970s, The People's Republic of China ("PRC") operated under a strict planned economy system. During the more than 30-year planned economy period, the Communist Party of China ("CPC"), under the leadership of Chairman Mao Zedong, was the sole ruler and creator of all policies and regulations. The country experienced remarkable economic development in the early stages but eventually witnessed a drastic downturn due to the political turmoil that culminated in the Cultural Revolution. As a result, in 1976 when the Culture Revolution ended, the national economy faced a deep predicament.

When the new generation of government under the leadership of Deng Xiaoping assumed power, a market economy was introduced as a complement to the existing planned economy. During the 1980s, domestic economic reform officially took off nationwide. The entire 1980s represented an initial experimentation period for the market economy concept.

The first real and effective changes came in the early 1990s. In 1991, China established her very first stock exchange in Shanghai, and then in Shenzhen (1992). In 1992, Deng toured the major southeast coastal cities and reemphasized the government's commitment to the development of a market economy and the establishment of market-based systems in China. Deng's "Communist market economy theory" was further carried forward by his predecessor Jiang Zemin and Zhu Rongji in the 1990s. By end of the last century, the China market had become a market economy phenomenon.

Into the new century, the transformation continues. Although certain industries such as banking, telecommunications, media and publication still remain highly regulated, China's accession to WTO will speed up deregulation of these industries. As more international competitors enter the market, the PRC economy will need to break away from its heavy reliance on administrative and policy support from the Government and adapt to the rules of a true market economy.

Role changes of government bodies

Under the leadership of the CPC, the Chinese government acted simultaneously as policy maker, implementer, enforcer, and evaluator. Unlike in other market economies, one of the Chinese government's roles was to approve or endorse any business activity. With government being the sole owner of most businesses, it also served as the strategic decision maker whose representatives managed and ran the SOEs.

The late 1980s marked the beginning of a concerted effort to separate governmental functions from business functions within the SOEs based on the notion that government officials should not hold any executive position in any commercial entities. However, given the existing government structure, the top executives of the large strategic SOEs are all appointed by the Organization Department of the CPC Central Committee. These executives, inevitably, have strong ties to top government officials; thus,

government is still the key influential force within these large SOEs. The management of the small and medium size enterprises (“SMEs”), theoretically, is appointed by their board, and thus should have operational autonomy and decision-making power. However, given the complex cross shareholding situation that is common among the SOEs, government influence still plays a key role in impacting the SMEs’ decision-making processes.

Furthermore, at the local government levels, a decentralization program was introduced in 1998 whereby the local governments were given more incentives and autonomy to introduce and implement local administrative and fiscal policies according to the local needs and economic conditions. As a result, the bureaucratic entrepreneurialism at the local level generated dynamic growth rates at the beginning stages of the reform. However, this also created tensions between the local and central governments caused by sometimes conflicting priorities.

1.2 Ownership Structure

State Ownership

The largest owner of PRC businesses is the government. From the early 1950s to the late 1970s, the SOEs constituted the sole corporate structure that was allowed to exist. Government owned every asset in the country, from farmland to large enterprises. The entire nation during this period was educated to work for the interests of the country and the Party only. Under this type of propaganda, different interests were not allowed to exist, and thus, no effective governance system was considered necessary.

Not until the 1980s when the market economy concept been introduced did small, private workshops and entrepreneurs start to emerge, first in the rural areas and later in the cities. For example, in 1978, 100% of investment in China was from the government. This figure reduced to 82% in 1980, and further reduced to 66% in 1985. However, most of the private businesses at the time were mainly owned and managed by the same group of people, and conflicts of interests had not been brought into the spotlight.

Privatization

The establishment of China’s first stock exchanges in the early 1990s marked the beginning of a true ownership diversification process. Upon approval from the relevant ministries, SOEs can float a portion of their shares in the public markets. Listed companies’ capital structure can consist of state owned shares, legal person shares, A shares, B shares, H shares and other foreign investment shares. In 2003, authorized foreign mutual funds with joint venture local partners (foreign stakes must stay below 33% in 2003, and below 49% in 2005) were allowed to invest in domestic securities. SOEs ownership will be further diversified by foreign shareholdings.

As of the end of 2002, the average state ownership stake in Shenzhen and Shanghai listed companies stood at about 70%. This shareholding structure will not change significantly in the foreseeable future, given that the PRC Company Law stipulates that initial investors must maintain their investment for at least three years. Furthermore, the government, in general, may not yet want to sell down its controlling stakes in most key industries.

1.3 Financial Markets

Macroeconomic condition

China is one of the few markets that have maintained a strong growth trend during the recent global downturns. According to National Bureau of Statistics, in 2002, China enjoyed an 8% GDP growth rate to reach RMB10.24 trillion (approximately US\$1.2 trillion) and became the world's second largest economy after the United States. Imports and exports remain strong. There is a US\$30.4 billion surplus in exports. Foreign direct investment in 2002 reached US\$52.7 billion. As of the end of 2002, national foreign reserves reached US\$286.4 billion, a 35% Y-o-Y growth from 2001. The national currency (RMB) is still not fully convertible. The official rate is fixed at US\$1 to RMB8.3 range.

Despite the strong growth, there are some fundamental weaknesses in the fiscal and national economy. Shortage in effective demand, an imbalanced supply structure, the growing discrepancy in living standards between rural and urban areas, and an increasing unemployment rate are some of the primary issues yet to be addressed by the fiscal policy makers.

Banking industry

China has a savings rate equivalent to about 40% of total GDP, one of the highest in the world. In 2002, total savings reached US\$1 trillion. Most of the savings are in bank deposits, with a small percentage in equity investments. Bank financing is the primary funding source for companies in China. Corporations, especially SOEs, rely largely on bank loans and policy lending for their Cap-ex needs.

The "big four" State owned commercial banks and two State policy banks have dominated both lending and bank deposit markets. From the 1970s to the 1990s, while the PRC strived to transition from a planned economy to a market economy, most of the banks' lending was still policy lending. Coupled with the fact that all of these banks had poor internal risk control mechanisms and the SOEs faced financial difficulties, mounting non-performing loan ("NPL") problems inevitably became very serious. Official statistics estimated that NPLs comprise about 24% of total lending. However, Standard & Poor's Ratings Services estimates that this figure could be as high as 45%.

The second group of banks forms the newer joint-stock banks. Since these banks are owned jointly by government and by private entities, they have more operational autonomy compared to the State owned banks. In addition, since these banks had less policy lending responsibilities and a shorter history, their NPL problems are far less serious than the State owned banks. On the other hand, because of their smaller scale and less government linkages, their market shares and relative influence are also significantly smaller than that of the State owned banks.

China's accession to WTO will bring both opportunities and challenges to China's banking industry. In the initial stages, opening up the markets to international competition will put considerable pressure on the domestic banks. However, over the longer term, the foreign banks are expected to positively influence the domestic banks in terms of management skills, customer service awareness, product diversification, new technology, and additional funding sources. We expect to see a more open and competitive banking market by the end of this decade.

Development of the equity markets

Aside from bank financing, the equity market represents the other main funding source for corporations in China. The PRC equity market has developed into a size with market capitalization of RMB4,253.05 billion (over \$500 billion), 1,229 domestic listed companies, and 592.55 billion outstanding shares (as of end January 2003). 32.5% of the total capital is floating and tradable. There are two stock exchanges located in Shanghai and in Shenzhen trading four types of equity stocks – Shanghai A shares, Shenzhen A shares, Shanghai B shares and Shenzhen B shares. All stock issuance is subject to the approval of the CSRC.

Individual investors dominate the PRC equity market. Of about 39.1 million investors, over 99.6% are individual investors. Only less than 0.4% of total investments are under the name of institutional investors. However, since these institutional investors may be representing a group of individual investors, the actual percentage of institutional investors should be less than this official figure. Going forward, the percentage of institutional investors should increase as international funds are gradually allowed to enter the market.

Domestic bond market

The domestic bond market is small and underdeveloped. Currently, there are three types of bonds traded on the domestic bond market, treasury bonds, policy financial bonds and corporate bonds. Corporate bonds only constitute a small percentage of the market as issuance of these bonds is still heavily controlled by the central and local government. As of the end of 2002, only 4% of the total bonds issued were corporate bonds, compared to 63% for treasury bonds and 33% for financial bonds. Though the central government has demonstrated a strong intention of encouraging development of the corporate bond market, the growth pace is much slower than that of other capital market sectors. Similar to the equity market situation, retail investors make up a majority percentage of the investor base for the domestic bond market. Although there are over a dozen local credit rating agencies with the number constantly increasing, none of them has been able to establish a recognized domestic benchmarking standard.

1.4 Other Institutional/Cultural Factors

Role of state and non-governmental organizations (“NGOs”)

Social and industrial associations in China also play important roles in providing guidelines, policies, and most importantly, business connections. These associations are categorized into three classes. The first class institutions are directly under the leadership of the State Council and/or the Ministries. The district and provincial associations normally are also members of these first class associations. These associations normally act as quasi government bodies in regulating and monitoring their members. They may also act as a positive enforcer in improving the Corporate Governance standards of their members. However, in certain situation, when the enforcement adversely affects the associations’ own interests, they may also act as obstacles to achieving good governance.

The research institutes are the other type of non-governmental organization that exerts considerable influence. Such research institutes including the one under the Chinese Academy of Social Sciences and the research center under the People’s Bank of China, act as think-tanks for the Central Government.

Lack of shareholder activism

As in most other emerging markets, shareholder activism is almost an unheard of term in the PRC market, although this is attributable mainly to this market's short history and lack of institutional investors. As of end March 2003, about 10% of the Shanghai and Shenzhen A-share companies are also listed on markets open for foreign investors, and less than 1% of the A-share companies have cross-border capital programs. These companies are likely to be the first ones to make the most progressive strides towards better government standards. Looking forward, as China's capital markets open up more to international investors and the general public's awareness of corporate governance increases, shareholders should eventually become more actively focused on protecting their own interests and ownership rights.

Importance of relationships/connections

To transform from the traditional "rule of person", to the more systematic "rule of law" will require not only a good system but also a major learning and cultural transformation. Although China has already adopted the system to separate government from business over the past 20 years, strong personnel ties and interlocked relationship networks still make the two inseparable. Relationships are still one of the most important factors in China influencing the conduct of business. In some situations, relationships can actually take precedence over legitimate decisions based on laws or regulations.

Component 2: Legal Infrastructure

2.1 Background on Legal System and Legal Tradition

Legal development

This current Mainland China legal system has a history of only about half a century. Compared to the developed European continental and the U.S. legal systems, the Chinese system is only at a stage of infancy. PRC Constitutions were drawn out in 1949. The National People's Congress ("NPC") has the highest authorization to legislate and to amend the Constitutions and Laws. The standing Committee of the NPC has the power to interpret laws and draw up decrees. Only the Chairman of the PRC has the power to issue these laws and decrees.

Legal development was given the highest priority from 1949 to 1956. Many laws, rules, and codes were preliminarily drawn up during this period. Unfortunately, due to historical reasons and political turmoil, the system not only had not advanced, but, rather, had retracted during the following twenty years. Not until 1978 was the importance of a sound legal system recognized and brought back to top of the party's agenda.

Legal system and tradition

The existing PRC legal system basically follows the Continental legal system, which in turn is based on fiduciary duty, governmental regulations and legislation. However, the system is still heavily impacted by China's over 2000-year feudalistic history. Therefore, the true "system" consists of not only laws and rules, but also a large element of the Chinese culture, which in turn, allows the implementation and enforcement processes to be more discretionary. Under some circumstances, relationships can totally undermine a legal decision. Selective enforcement is often seen as a result of either the law enforcer's personal interests, or (better, but equally dangerous) the special interests of certain market groups.

Criminal laws were traditionally given more emphasis than commercial laws. The existing PRC legislation also inherited some of these traditions. Therefore, Criminal Law, Civil Procedures Law, Administration Law, People's Court Administration Law, etc. were amongst the earliest ones to be issued (in 1978). The promulgation in 1st July 1979 of the Law on Joint Ventures Using Chinese and Foreign Investment marked a new era in China's legislation on foreign investment and corporate laws. It was not until the late 1980s and early 1990s that the bulk of rules and regulations dealing with civil and commercial law issues were promulgated.

Besides these issues, there are also some major conflicts or inconsistencies in China's existing legal system. Many of these issues were untouchable and were never publicly discussed during the first 30 years of PRC history. Most of these issues are still being debated among the legal scholars and practitioners. Legal versus human rights, the independence of the legal system, whether the CPC can overrule the laws, and whether the CPC can interfere with legal decisions, are just some of these issues.

2.2 Principal Legal Provisions

Company Law

The PRC Company Law was first passed at the 8th National People's Congress in December 1993, (effective 1st July 1994) and amended in December 1999. The Company Law is intended to regulate corporate structures and activities, and to protect commercial interests of the companies, their shareholders, and creditors. Two types of companies are stipulated under the Company Law: limited liability companies and joint stock companies. The Law also articulates the responsibilities, rights, and liabilities of shareholders, the board of directors, managers, and the board of supervisors. Among the unique aspects of PRC Company Law are the requirements for minimum registered capital, fixed office space and certain legal representatives.

All limited liability companies should set up a Board of Directors ("BoD"). For "large" companies, there should be a separate Board of Supervisors ("BoS") consisting of at least three independent supervisors. Under the PRC Company Law, directors and managers are "insiders". Their responsibilities are articulated under the same section. However, BoS is the independent "outsider" that should exercise supervision authority to monitor the company's activities. The Law also gives shareholders the right to appoint and to remove directors and supervisors and decide their remuneration. A series of listing rules and regulations have been enacted to supplement the Company Law in terms of regulating capital market activities. This will be further discussed under the section on "Regulatory Environment".

Securities Law

The PRC Securities Law, passed and effective on 29th December 1998, is the law that regulates capital market issuance, trading activities, and related matters. The Law articulates that the regulatory organization under the State Council is the central regulator for the PRC's capital markets. The Law states that "a public stock issuance shall follow the conditions as stipulated in the Company Law and be submitted to the securities regulatory agency under the State Council for verification". It also stipulates that all stock exchanges, securities houses, securities clearing houses, and securities regulators must file regular reports to the State Statistic Bureau for auditing purposes. The Law states that insider trading and market manipulation are strictly prohibited. It also provides specific guidelines for each of the areas relating to securities market activities.

Other commercial laws

The other major commercial laws that guide the PRC commercial world include:

- Contract Law (1999) which assigns rights and securities to all parties of the contracts;
- Bankruptcy Law (1988) which addresses only bankruptcies of state-owned entities;
- PRC Trust Law (2001) which deals with issues relating to the establishment and operation of trustees;
- PRC Security Law (1995) which stipulates the creation of security interests such as guarantees, mortgages, pledges, liens and deposits; and
- The Law of Commercial Instruments which deals with issues such as types of commercial instruments, and issue, transfer, endorsement, acceptance, recourse, etc. of commercial instruments.

Component 3: Regulatory Framework

3.1 Regulatory Bodies

NDRC and the Ministries

The State Council has final and overriding authority over all regulatory bodies. Under its supervision, there are 28 Ministries and the National Development and Reform Commission (“NDRC”) involved in overall strategic planning. With input from the Ministries, especially the MOF and the Ministry of Commerce (“MOC”), NDRC researches and oversees implementation of nationwide strategic planning. One of NDRC’s core responsibilities is to balance out the overall economy in terms of demand and, the pace of growth, urban and rural resource allocation, and industrial adjustment. Companies that raise funds from the capital markets, either domestic or cross-boarder, need to get formal approval from NDRC.

Banking Regulatory Committee

The People’s Bank of China (“PBOC”) has been the regulator for the PRC’s financial industry since 1983. Besides regulating financial markets, the Bank also acted as an administrator in formulating and implementing monetary policy, issuing and administering the circulation of the currency, licensing and supervising financial institutions, managing official foreign exchange and gold reserves, acting as fiscal agent, maintaining payment and settlement system, collecting and analyzing financial statistical data, and participating in international financial activities in the capacity of a central bank. To streamline the regulatory process while providing additional checks and balances to the existing PBOC functions, the State Council set up a new China Banking Regulatory Commission (“CBRC”) during the 10th National People’s Congress in March 2003. This new CBRC is taking over the regulatory responsibilities from PBOC to oversee banks, asset management companies, and trust investment companies. The CBRC will also be responsible for drafting and enforcing banking related laws, rules and regulations.

Foreign exchange

The PRC’s national currency, RMB, is still not fully convertible on the international exchange markets. Currency control therefore is one of the key functional areas under the central bank. The State Administration of Foreign Exchange (“SAFE”), under the supervision of PBOC, is the regulator for the Chinese foreign currency market. SAFE, on a daily basis, looks after foreign currency trading, borrowing/lending, transferring, international clearing, and exchange rate setting. It also monitors foreign exchange market activities. Therefore, for cross border debt or equity issuance, the issuer needs to also get SAFE’s approval in addition to NDRC’s mandate.

Capital markets

The PRC's capital market is highly and centrally regulated. The State Council Securities Commission ("SCSC") is the highest authority body for the capital markets. The CSRC is the executive arm of the SCSC responsible for conducting supervision and regulation duties.

With its centralized supervisory system, the CSRC establishes its supervisory authority over all securities and futures business, including, stock and futures exchanges, the listed companies, fund management companies, investment consulting firms, and other intermediaries involved in the securities and futures business.

3.2 Key Listing Rules

Securities Codes and regulations

There are four types of shares that list and trade in the domestic equity markets. Shanghai A and Shenzhen A shares are for domestic investors, while Shanghai B and Shenzhen B shares are for foreign investors. All listings must comply with PRC Company Law, the Memorandum by the State Council Regarding Standardizing Limited Company and Joint-stock Company According to Company Law (1995), and the Circular by the State Economic and Trading Commission Regarding and Implementation of Standardizing Limited Company and Joint-stock Company According to Company Law(1997).

In January 2002, the CSRC released its Code of Corporate Governance for Listed Companies in China. The Code emphasizes the importance of credibility and integrity and identifies the relationships between shareholders and directors, executives and management, and trustors and the trustees. The Code requires that all AGM details comply with PRC Company Law. Requirements for directors and supervisors as well as stakeholders rights and related items are articulated. The Code also sets additional disclosure requirements of corporate governance for listed companies.

Board structure

The Company Law requires listed companies to adopt a two-tier board structure. The Board of Directors consists of two-thirds top executives and one-third independent directors. The BoD is accountable directly to shareholders. The second board, the Board of Supervisors, consists of independent shareholders and employees (employees cannot be less than one third). According to the listing rules, directors and top management cannot be appointed as supervisors.

Under this two-tier structure, BoD, as the core board that works closely with the management (in most cases, board members and top management are held by same group of person), operates the company on a day-to-day basis. BoS is the independent board that provides independent views and monitors the executive management and the BoD. Given that, in most cases, BoS members are connected to major shareholder(s), they may only represent a single interest group but not all stakeholders. Furthermore, since the employee-members on the BoS must have a reporting line to the top management who make annual evaluation, promotion, and remuneration decisions, it is difficult for the employee-members to play a totally independent role without considering their personal career interests.

Shareholders rights

Under the existing share registration system, all listed shares are secured and fully transferable. Shareholders should have equal rights in terms of profit sharing, participation in shareholder meetings in person or via proxy, voting, and monitoring/questioning/making recommendations to the management. However, given that the most common shareholding structures have one major shareholder, it is difficult for the minority shareholders to form a large enough pool to reach the minimum thresholds needed to enjoy some of their rights, such as nominating directors, calling special meetings, and raising a resolution to the board and/or at the shareholder meetings.

From a legal standpoint, a company's Articles of Association have binding force on all shareholders, directors, supervisors and managers. The Articles should be approved at shareholder meetings. The Law also allows shareholders to amend the content of the Articles.

The PRC laws give shareholders pre-emptive rights. Such rights can effectively prevent the issuance of shares to new shareholders and thus mitigate the potential for dilution of existing shareholder's ownership stakes and voting rights.

Disclosure Requirements

In addition to the Company Law, the Code of Corporate Governance requires listed companies to disclose Corporate Governance related information such as the composition of the BoD and BoS, evaluations of BoD and BoS members, attendance records of independent directors, and their independent opinions on connected party transactions and executive appointment/removal. This code also requires disclosure on the establishment of functional subcommittee and their operating details, the discrepancy between the actual situation and the requirements stipulated in the Code, and the improvement plan for corporate governance.

3.3 Other Recent Developments

Enforcement

Over-regulation and under-enforcement is a common theme that characterizes most Asian governance systems. China is no exception in this regard. Selective enforcement is commonly seen in all sectors across China, including the capital markets. As a result, corporate risk takers are frequently willing to challenge the system, hoping that the laws or rules would not be applied to them even if they were caught. Such practices are highly detrimental to the integrity and development of China's legal and regulatory system.

Incentive systems

The Code of Corporate Governance requires listed companies to set up incentive and control systems. Listed companies are now required to establish a review system for directors, supervisors and management, and set up a performance linked remuneration mechanism. Although nomination and remuneration committees are not compulsory under the listing rules, executive directors generally are not involved directly in the decision making processes that determine their own compensation packages.

However, recent statistics are not very encouraging. Of the 1124 listed companies, only about 6% currently have such incentive systems. Of the 6% that have incorporated incentive systems, only a few companies have adopted corporate control systems.

Independent Directors

It is required that all domestic listed companies have at least two independent directors on or before 30th June 2002, and one third of the board members must be independent directors on or before 30th June 2003. Though independent directors only comprise a minority percentage on the board, it is important to have some independent voices heard. For major transactions and connected party transactions, the guidelines require independent directors' approval before the proposal can be submitted to the entire BoD. Independent directors can also provide independent views on issues such as important investment, opportunities, directors' appointment and removal, and directors and executives remuneration. However, the true effectiveness of the independent directors remains to be seen in practical terms. In particular it needs to be demonstrated that independent directors are provided a meaningful role on company boards-and are not just window dressing for compliance requirements. Active participation of the independent directors is more crucial than simple compliance with the regulatory requirements.

CSRC regularly conducts training programs for directors and independent directors. However, these short training programs can merely provide general guidance. A lack of qualified persons to take up the over 3,000 independent director positions is one of the major issues. As China continues to open up the capital markets to foreign investors, more foreign directors will need to fill this gap.

Component 4: Informational Infrastructure

4.1 Accounting Practices and Standards

Accounting system

Except for some overseas-listed companies, most companies in the PRC are only required to report their financial accounts under the local accounting standards. The local standards are based on PRC Accounting Law and individual accounting standards. Since 1993, under the supervision of the MoF, the China Accounting Standards Committee (“CASC”) started developing a range of accounting standards. This initiative was carried a step further in 1999 when a US\$27.4 million loan from the World Bank and a US\$5.6 million equivalent credit from the International Development Association (“IDA”) were provided to the Committee to fund the US\$85 million “Accounting Reform and Development Project”. This project, in turn, completed the local standards by either introducing new standards or amending the old standards. In 2002 alone, eleven accounting standards were either introduced or amended by the CASC. As of the end of 2002, a total of sixteen standards were issued.

Differences between local standards and IAS

Differences between the existing PRC standards and IAS have narrowed considerably. However, there are still some major differences in key areas such as consolidation basis, provisions and off-balance sheet treatment. Table-1 contains a detailed list of discrepancies between the PRC accounting standards and IAS as noted by the major global accounting firms. On the other hand, since the new national accounting standards became effective over the past two years, key areas where PRC standards and IAS have started to converge include business combinations, lease accounting, impairment of assets, pre-operating expenses, foreign currency translation, the calculation of earning per share, and segment reporting.

Implementation of the system

Besides the accounting standards, the overall Chinese accounting system is still evolving. Implementation is the key governance challenge relating to the PRC accounting system. In December 2001, China’s National Audit Office randomly checked the auditing work of 16 CPA firms. A total of 32 audit reports were examined, of which 21 were from local listed companies. Out of the 32 audit reports checked, 23 reports issued by 14 CPA firms were found to contain seriously inconsistent facts. The total fabricated amounts or discrepancies contained in these 23 financial reports reached as high as RMB7.1 billion (approximately US\$860 million). In this investigation, 72% of financial reports, 86% of the CPA firms’ audit engagements, and 41 accountants were involved in fabrication of financial statements. These figures directly point to the urgency for improving governance standards among the corporate and professional firms. It also sent a strong message to the regulators regarding the need for a more strict compliance requirement.

Table-1 Differences between PRC accounting standards and IAS**Chinese accounting may differ from that required by IAS because of the absence of specific Chinese rules on recognition and measurement in the following areas:**

Uniting of interests	IAS 22.8
Provisions in the context of acquisitions	IAS22.31
Employee benefit obligations	IAS 19
Discounting of liabilities	IAS 37.45
The treatment of an issuer's financial instruments	IAS 32.18/23
The derecognition of financial assets	IAS 39.69
Hedge accounting for derivatives	IAS39.142
The treatment of the cumulative amount of deferred exchange difference on disposal of a foreign entity	IAS21.37

There are no specific rules requiring disclosures of:

A primary statement of changes in equity, exceptions for joint stock limited enterprises	IAS 1.7
The fair value of financial instruments (except for listed investments)	IAS 32.77
The fair value of investment properties	IAS 40.69
Discontinuing operations	IAS 35
Diluted earnings per share	IAS 33.47
The current or FIFO cost of inventory when LIFO is used	IAS2.36

There are also inconsistencies between the PRC standards and IAS. Under the PRC standards

Certain subsidiaries with dissimilar activities can be excluded from consolidation	IAS 27.14
Subsidiaries are excluded from consolidation if intended for sale, even if previously consolidated	IAS 27.13
For most business combinations accounted for using purchase accounting, the identifiable assets and liabilities of subsidiaries acquired are consolidated based on their book values	IAS 22.40
Either provisions for major overhaul costs or deferral of incurred major overhaul costs are allowed	SIC 23
Trading and derivative financial assets and liabilities are generally not held at fair value	IAS 39.69/93
Proposed dividends are accrued	IAS10.11
Deferred tax accounting is uncommon and, when done, is calculated on the basis of timing differences, with the deferral method or the liability method allowed	IAS12
Definition of extraordinary items is wider	IAS 8.6/12
Certain disclosures relating to primary segments (for example, acquisitions and depreciation of assets) are not required	IAS 14.57/58
There are no rules addressing the consolidation of special purpose entities	SIC 12

In certain enterprises, there other issues could lead to differences from IAS:

Under some circumstances, finance leases can be recognized at the undiscounted amount of minimum lease payments	IAS 17.12
There is no specific requirement for segment reporting to be prepared	IAS 14.44

Source: Andersen, BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG, PricewaterhouseCoopers, GAAP 2001 - A Survey of National Accounting rules Section 3 - Country Summaries

4.2 Transparency and Disclosure

Quality of disclosure

In 2001 and 2002, the CSRC released a series of disclosure standards and requirements. To ensure quality of disclosure, the new Ordinance on Disclosure requires the heads of the company, the accounting department, and the external accounting firm to make a public announcement ensuring true and complete disclosure of the reports. It also requires disclosure of any cross shareholdings among the top 10 largest shareholders.

Timing of financial reporting

All publicly listed companies have to file and disclose financial results on a quarterly basis. Continuous disclosure is not required. However, any significant events that may impact stock prices have to be publicly announced immediately.

Remuneration and nomination

Matters involving executive nominations and remuneration are normally decided behind closed doors. Detailed disclosure on remuneration in the public domain is generally nonexistent. This is largely due to the fact that key directors and executive members are appointed by the major shareholder, i.e. the government. There is still a large gap between the salary levels of government officials and private sector market rates. It remains culturally awkward and sensitive to publicly compare pay levels of government officials, directors or top management appointed by the government in the listed companies, against market rates. Disclosure of detailed remuneration information at the individual level is such a sensitive issue that even the new Corporate Governance Code did not address it.

Auditor independence

The national accounting professional organization “Chinese Institute of Certified Public Accountants”, operated through the MoF, has administered and issued the professional designation “Certified Public Accountant” (“CPA”) to qualified candidates since 1988. The national examination for Chinese CPAs was introduced in 1994. The CPA firms are also licensed and required to comply with the rules and standards.

The listing rules require the external auditor of listed company to have CPA licenses. Most of these appointments are awarded without a public tendering process. Information on how and why a CPA firm is selected remains confidential within the “insider” circle of the top management. Furthermore, there is no requirement for disclosure of auditor fees versus non-audit fees in the annual reports. The regulators are currently in the process of setting rules on auditor rotations. Once implemented, it will be a positive step in enhancing auditor independence.

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