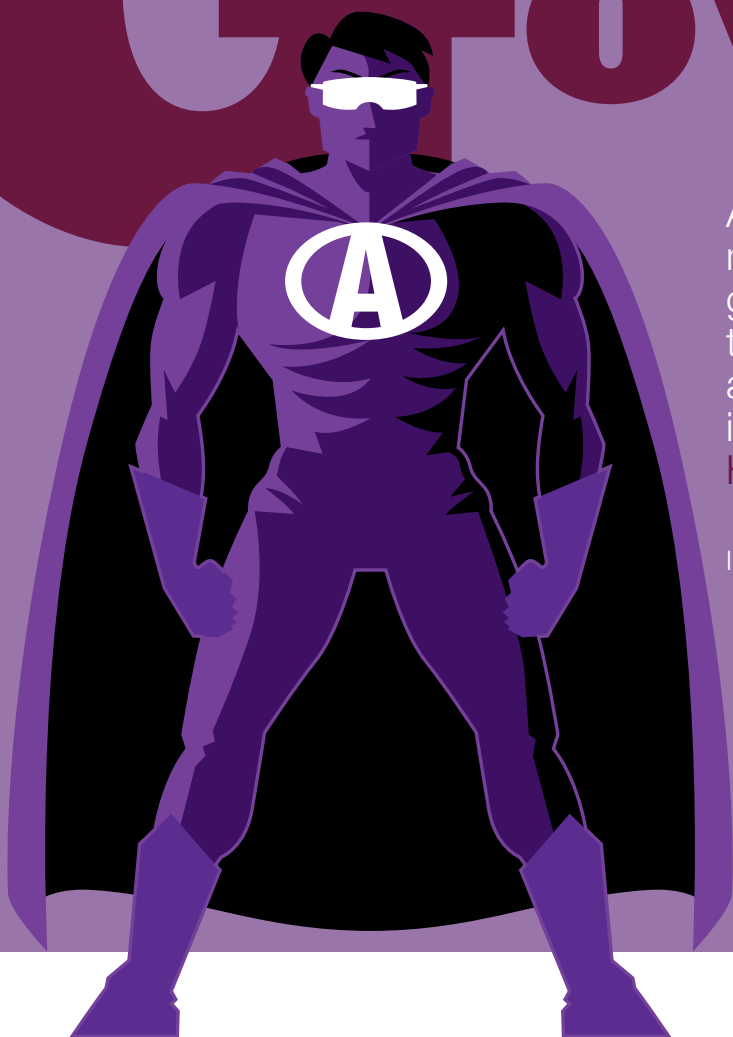


Guard T Over



Audit committee members shoulder a growing responsibility to monitor risk oversight and protect shareholder interest, [Helen Luk](#) and [Heda Bayron](#) report

Illustrations by Emilio Rivera III

The financial crisis has turned what used to be a genteel, friendly and cosy club – the boardroom – into a much tougher place, where talk can be rough and people can sometimes forget their manners.

Mitchells & Butlers, one of the biggest U.K. pub operators, has been rocked in recent months by a bitter and public row with its biggest shareholder, Joe Lewis,

the Bahamas-based currency tycoon. His investment vehicle, Piedmont, criticized M&B's board and its advisers for being "predominantly the same group of individuals that have cost shareholders £500 million through their mistakes in recent years," citing a hedging loss suffered by the company in 2008 and 2009. Lewis eventually won a sweeping victory, managing to replace the company chairman and three other board members.

Last month, shareholders of Bermuda-based insurer Omega Insurance, led by Invesco Perpetual, won a vote

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to overhaul the company's board, replacing the chairman and four other board members. The move followed the departure of Omega's founder, John Robinson, as he was reportedly uncomfortable with how the company was managed and clashed with the chief executive.

In the U.K. and the U.S., board members are facing mounting pressure from governments, regulators, shareholders and the public to improve governance and boost transparency. Add to this financial regulatory overhaul contemplated by many governments and this may be just the beginning of more boardroom brawls.

The U.K. has published two reports about reform in recent months—one by Sir David Walker, who reviewed governance weaknesses in the U.K. financial services industry, and the other by the Financial Reporting Council.

The new requirements being proposed want companies to take a look at their boards, for example, by re-electing the company chairman and maybe the entire board once a year, reviewing the board's performance every three years and focusing on the board's attitude towards risk. The Walker report said non-executive directors should have greater skills, experience, time and access to critical information about the present and future risks of the company.

Closer scrutiny

As boards face tougher scrutiny, so do audit committees: The audit committees for failed companies such as Lehman Brothers, Northern Rock and AIG, for example, were criticized for failing to flag impending financial troubles.

Critics have accused company boards of being too lax with their risk oversight, which enabled large financial institutions to party on with risk-taking.

So in addition to their financial reporting oversight duties, industry insiders say audit committees, which many say are probably the most important in the board's structure in terms of ensuring sound governance, will be preoccupied with risk this year.

"We've talked with many audit committee members of listed companies across the world. Their risk awareness

has risen a lot since the financial crisis. They have become more active in understanding the company's risk assessment: How can they make sure that the company is not overexposed to risk?" says Carlson Tong, chairman of KPMG in China and Asia Pacific, and former chairman of the listing committee of the Hong Kong stock exchange's main board and Growth Enterprise Market board.

Randy Hung, executive director of Hong Kong-listed China Shineway Pharmaceutical Group, says the external auditor's risk appetite has lowered. He sits on the audit committee of two Hong Kong-listed mainland companies—Zhongtian International, a hardware and software developer, and Zhongyu Gas Holdings, a natural gas provider.

"Since the financial crisis, external auditors have become much more concerned about cash flows and receivables, whether companies can recover their assets and whether there are hidden and undisclosed liabilities," he says, adding that audit committee members now more actively help management explain a company's operations and decisions to the external auditors.

To improve risk monitoring, HSBC is following a recommendation of the Walker report and is setting up a risk committee, which will take over risk monitoring from the audit committee. The risk committee will report to the board, according to Marvin Cheung, one of the bank's four audit committee members. He says the split will make the workload of the audit committee more manageable.

Most importantly though, Tong says it is up to audit committee members to urge management to get past the bottom line. "Companies often failed to look at the downside of the exposure. Some firms took big risks in exchange for a small fee," he says. "If you just look at the past and assume it will be okay, that's wrong because every time there is a crisis, it's never based on what has already happened, it's something you don't expect."

With today's fast-changing economic environment, expecting the unexpected is harder than ever, say some independent directors.

"In the modern business world, the tides of fortune can turn extremely rapidly within a single accounting

period and conventional accounting techniques are falling behind advanced financial tools and instruments to be able to foresee such crisis,” says Eric Li, senior partner of Li, Tang, Chen & Co. and the audit committee chairman of companies including Hang Seng Bank Ltd., Sun Hung Kai Properties Ltd. and SmarTone Telecommunications Holdings Ltd.

In the case of Lehman Brothers, an examiner’s report released last month on its bankruptcy said management failed to disclose or decidedly suppressed information on its use of repurchase agreements that allowed the bank to unload massive bad loans from its books in 2008, thus manipulating its balance sheet. The company’s external auditor, Ernst & Young, allegedly did not challenge management about its use even after a senior finance executive alerted the firm, and failed to report the incident to the audit committee. The firm denied these allegations.

Effective monitoring

Li says audit committee members, if they’re going to be effective, need to know the company’s business operations and its underlying risks.

“My main concern is whether I actually know what’s going on in the company,” he says. “Don’t be shy to ask questions and challenge management’s assumptions and perform due diligence to know about the business. If in doubt, do not sign any statement without performing your own due diligence.”

In a KPMG survey of 1,300 U.S. directors and senior executives in May and June last year, 27 percent said the ability or willingness of boards to challenge management is the weakest area in corporate governance. The Walker review also ranked “effectiveness of challenge” at the board level as an area of concern, especially in relation to the determination and approval of strategy, risk appetite and risk management.

“When I was chairing the listing committee and there were companies that ran into trouble, some independent non-executive directors would just say, ‘We didn’t know.’ But shouldn’t you have asked questions? For example, if the company was way past its deadline in announcing results and it didn’t contact you, do you not have a fundamental duty to ask for its financial statements?” says Tong.

Marvin Cheung, who also chairs the Hong Kong Airport Authority and sits on the board of Hang Seng Bank, Hong Kong Exchanges and Clearing Ltd. and property developer HKR International, says while audit committee members rely on the CFO and the external

auditor for updates on accounting rule changes, they should equip themselves properly by staying familiar with accounting standards relevant to the company.

“If you sit on the board, you need to discharge your duties properly. A company entrusts you with its financial statements and you can’t just rely on what the chief financial officer and the external auditor present to you, you need to actively challenge them,” he says.

Cheung, who is also a former chairman of HKEx’s listing committee, says he has often encountered situations where the CFO and the external auditor might have “misinterpreted or misapplied the accounting standards because they failed to consider all relevant facts.”

“Sometimes the CFO and the external auditor blame the standard setters for getting the rules wrong, but they might have misunderstood the rules themselves,” he says, citing an example of how he, as an audit committee member of a financial organization he declines to name, spotted an error in relation to its treatment of financial instruments.

“I asked the CFO to check the figures beforehand, but it was not until I questioned him further during the meeting that he and the external auditor admitted that the figure was wrong and needed to be changed,” he says. “He tried to apply a new standard based on its technical interpretation but failed to see that in doing so, the accounts didn’t make sense because he overlooked certain key factors that were relevant to the matter at hand.”

And there have been times when Cheung has stepped down from the board of some listed companies because he “didn’t feel comfortable with how things were handled,” though he declines to give specifics.

Hong Kong vs. the U.S.

An independent director and audit committee member for three mainland companies – two listed on NASDAQ and one in Hong Kong – says many Hong Kong public companies, a lot of which are family controlled or state-owned, treat independent non-executive directors as a compliance necessity.

“In Hong Kong, normally people look at independent directors as something instigated by the law or regulations, not someone that they really want to have. They are very polite, and they respect you to a certain extent, but they don’t really try to get you involved...”

They don't normally seek your advice unless the rules require them to do so," he tells *A Plus*.

In comparison, because the U.S. requires a majority of board directors to be independent (normally the ratio is two executive directors to three independent directors), companies spend more time engaging with them.

"The company will brief you about all the pending deals and major business decisions because the three of you together can overrule more or less everything – communication is much more frequent between the independent directors and company management," he says.

Another major difference is the litigation cultures of

Hong Kong and the U.S. Although the responsibilities of an INED in both places are more or less the same, the audit committee member says "in Hong Kong it is very rare for people to sue the INEDs, but they often sue the entire board in the U.S. So it feels like the risk of being an INED of a U.S. listed company is greater."

That many Hong Kong listed companies are family-owned can sometimes hinder independent directors from discharging their duties effectively. "A lot of company owners have big egos and they are not comfortable with other people telling them what to do," he says.

In the past, critics have accused family businesses of appointing friends of management as board directors. KPMG's Tong, however, says this is changing. "The major listed companies have improved and are now appointing high-quality INEDs – not all of them of course, but it is getting better and better. I am happy to see that for many of the big companies, they are really changing in

a good direction, but we need to push to extend this change to other smaller companies too."

Aloysius Tse, who chairs the audit committee of four state-owned enterprises listed in Hong Kong, namely, CNOOC, China Construction Bank, China Telecom and Sinofert, agrees that an audit committee can only be successful if there's strong management support.

"If the board cares about corporate governance, they would give you a lot of support and it filters all the way down.

If the board wants the INED as a necessary evil, you might as well not be one," he says.

In the committees he chairs, Tse says he sets out the agenda and the priority areas at the beginning of each year. Aside from reviewing financial reports, he pays attention to risk management, internal audit and related party transactions.

It is also important to maintain constant communication with the external auditor, who "should be there to listen to the internal auditor's report and to present to the audit committee their audit findings. On all the boards I sit on, I insist on having private sessions with the external auditors without the management present to know what their concerns are," he says.





Eric Li says he has withheld signing documents that are essential to deals until he was satisfied they met all requirements. If push comes to shove and INEDs find themselves at the brink, he advises them not to resign “until you have done everything you could for the minority shareholders.”

Tse says, on some occasions, he has abstained from voting on resolutions, which can raise questions in Chinese state-owned companies. “If you abstain, it’s very unusual. In a PRC A-share listing context, if someone abstains, it will appear publicly because the company has to put out its resolutions or announce its board proceedings,” he says.

He says it is important to be diplomatic in dealing with disagreements so as not to upset “various parties who legitimately think they’re correct because of their experience.”

Li says dissent can spur change. “Companies change their practice all the time on my advice as long as you are respected and are able to positively contribute with persuasion,” he says, adding that he has influenced investment decisions such as what price to offer on deals, policies on dividend, hedging and pay, the choice of executives and appointment of other directors and strengthening internal controls.

Stephen Law, chairman of the Institute’s Best Corporate Governance Disclosure Awards’ organizing committee, says the audit committees of Hong Kong listed companies should spend more time reviewing internal controls.

“As an independent director, you don’t go there to work every day. How can you gauge whether the company’s internal controls are working effectively by attending just a few audit committee meetings each year?” asks Law, who, as an executive director of a private equity firm, has a lot of experience setting up the board and governance structures for the portfolio companies he manages.

That’s why Law thinks listed companies should strengthen their internal audit function and set up a

sound structure by having the company’s internal auditor directly report to the audit committee. “Banks and some big listed financial institutions aside, many Hong Kong listed companies don’t have an internal audit function. I think this is worth investing in,” he says.

In the absence of an internal auditing department, companies should at least engage an external auditor to carry out a more detailed internal control review that goes beyond the scope of a statutory audit and report the findings to the audit committee, he adds.

Financial management expertise

Under the best practices recommended by the Institute, all audit committee members must be non-executive directors, with the majority of them, including the chairman, being independent.

In 2003, Marvin Cheung, who was then chairing the Hong Kong stock exchange’s listing committee, introduced a listing rule requiring an audit committee to comprise at least one non-executive director with accounting or related financial management expertise.

Tse says having a CPA as the designated finance person in the audit committee spells a big difference. “That CPA is trained by profession to ask questions and to look at things critically,” he says.

As accounting standards and regulations get more complex, and the audit committee members’ list of responsibilities grows, Hung of China Shineway believes it is increasingly important that they possess a high level of expertise to handle the job. At Zhongtian International, there are two audit committee members, including Hung, that have financial management expertise.

“One of our duties is to assess whether the company has a ‘going concern’ issue. But many non-accountants do not even know what going concern is,” he says. “If every audit committee member has a certain level of financial management experience, it will of course be better, but that also depends on the size and the complexity of the company’s operations.”

REWARDS VS. RISK

A survey published last month by Incomes Data Services, a U.K. pay information group, revealed that non-executive chairmen of FTSE 100 companies took home average fees of £334,463 each in the past year, up 6.7 percent from 2008, while the compensation for non-executive directors rose by an average of 5.1 percent to £58,595.

Barclays and Royal Bank of Scotland paid their non-executive chairmen the most at £750,000 each, and Royal Dutch Shell had the highest paid non-executive directors at £111,550 a year.

The survey also showed fees for chairing a committee jumped significantly last year: Chairing an audit committee can bring an average 25.6 percent pay boost, while just being a committee member can potentially increase a non-executive director's total remuneration by about 11 percent.

"Committees are integral to good governance in leading companies and it's only right that they should receive an adequate compensation," says Nasreen Rahman, principal researcher of executive compensation review at IDS.

In Hong Kong, however, remuneration for independent directors pales in comparison. In the 2008/2009 financial year, Hang Seng Bank paid HK\$120,000 for its audit committee chairman and HK\$80,000 for its members. Directors of the company (aside from chairman and vice-chairman) received HK\$280,000, lagging far behind their U.K. counterparts.

In the same year, Sun Hung Kai Properties paid HK\$240,000 to its audit committee chairman, while members received HK\$200,000 and a separate payment of HK\$100,000 each for being directors of the company.

An independent director, who sits on the audit committee of two NASDAQ-listed mainland companies, says he gets US\$40,000 a year from one and a smaller fixed sum plus stock options from the other. The stock option element, however, could increase the annual remuneration by several folds, he says.

"Most of these companies listed in the U.S. are considering

stock options for independent directors. They look at independent directors as one of them because they carry the same risk and are involved in the decision making," he says.

Critics, including this audit committee member, say this practice raises questions about the impartiality of independent directors since their pay is tied to the company's performance. "I don't really like stock options. They may become a factor of consideration in performing my duties as an independent director. For example, when reviewing a related party transaction, I'll think about how much it will affect the company if I reject the deal," he says.

As the responsibilities for independent directors and audit committee members grow to encompass internal controls and risk management, Carlson Tong, chairman of KPMG China and Asia Pacific, believes compensation in Hong Kong is "on the low side."

"If you pay somebody HK\$100,000 to HK\$200,000 and there is so much risk, is it worth doing? If Hong Kong is serious about the responsibility of the audit committee and independent directors, it needs to pay more," he says.

In the U.K., fees for independent directors of U.K. banks and financial institutions are likely to increase because the Walker report recommends directors spend at least 30 to 36 days on the job.

"At HSBC, we are debating whether this is realistic," says Marvin Cheung, a board and audit committee member of the bank. "If this indeed becomes a requirement, only retirees can become board members and is this a good thing? Many company CEOs sit on the boards of other companies and do you expect them to be able to make this kind of time commitment?" The bank's board, for example, has seven meetings annually and he flies to London for six of them.

Cheung thinks a more reasonable requirement would be between 24 and 30 days. He himself has resigned from the board of Sun Hung Kai Properties partly because of time issues.

Cheung himself is quick to admit that staying up to date with all the accounting standards changes is a tall task, even for accountants.

"The full IFRS is 2,500-pages long and so many amendments are issued every year," says Cheung, who is a trustee of the International Accounting Standards Committee Foundation. "People will assume that you have a good understanding of international accounting standards, but that is an assumption only. In reality, many independent directors' knowledge of IFRS is not up to scratch, including me."

Both Hung and Cheung, however, believe a board should have members with diverse backgrounds and a range of skills.

"If every board member is an accountant, some other business aspect may be overlooked," Cheung says. "The

listing rules didn't specify that a board member must have production, sales or macroeconomic experience but of course they have their purpose. And a big corporation should have these professionals on its board to help monitor management."

KPMG's Tong says it's time to review Hong Kong's listing rules on corporate governance to see whether some recommended best practices should be upgraded to the "comply or explain" level or if new ones are needed.

"For example, should we increase the number of independent directors on the board? Apart from the audit and remuneration committees, are there others such as risk compliance and nomination committees that should be made compulsory? This is something we should think about." **A**