

Boardroom Update

A newsletter for audit committees and directors

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Issue 1

Revised Hong Kong Corporate Governance Requirements

In this issue:

Overview	2
Key issues that may impact on boardroom practices	2
The Code	3
Corporate Governance Report	4
Amendments to the Listing Rules	5
Transitional arrangements and subsequent reporting	6
Some key questions to consider	7
Further information	8
Appendix 1: Key provisions of the Code	9
Appendix 2: Summary of terms of reference for committees	17

Common abbreviations used in this Update are as follows:

the Exchange – The Stock Exchange of Hong Kong Limited

HKEx - Hong Kong Exchanges and Clearing Limited

the "Code" – the revised Code on Corporate Governance Practices issued by the Exchange

the "Listing Rules" – the Rules Governing the Listing of Securities on the Exchange ("Main Board Rules") and the Rules Governing the Listing of Securities on the Growth Enterprise Market of the Exchange ("GEM Rules")

Rules on the CGR – Rules on the Corporate Governance Report

Issuer – as defined in the Main Board Rule 1.01 and GEM Rule 1.01

The Hong Kong Stock Exchange has recently revised its corporate governance requirements to help strengthen the overall standard of corporate governance of Hong Kong issuers. The main changes in requirements comprise:

- a revised Code on corporate governance in a revised Appendix 14 to the Main Board Rules and in a new Appendix 15 to the GEM Rules (replacing the previous Code of Best Practice in Appendix 14 to the Main Board Rules and the GEM Rules 5.35 to 5.45, respectively); and
- new rules requiring the board of directors to prepare an additional report, the Corporate Governance Report ("CGR"), for inclusion in the annual report. These requirements are set out in a new Appendix 23 to the Main Board Rules and a new Appendix 16 to the GEM Rules.

Some of the key issues and questions that boards may need to address on initial application of the Code are discussed in separate sections of this Update.

Amongst other areas, members of audit committees will need to pay close attention to Section C of the Code, Accountability and Audit, which sets out a wide range of requirements and recommendations on financial reporting, internal controls, and the audit committee. In particular, Code Provision C.3 sets out a number of duties for the audit committee. These include aspects covering the interaction between an issuer and its external auditors, which are further highlighted in this Update.

As an indication of the increased requirements in the revised Code, the revised Appendix 14 to the Main Board Rules comprises 24 pages compared to the previous Code of Best Practice consisting of 2 pages.

The Exchange draws a distinction between non-compliance with the Code and non-compliance with the Rules on the CGR. Non-compliance with the Code would not constitute a breach of the Listing Rules (although issuers must provide considered reasons for each non-compliance in their half-year reports and for the annual report, in the CGR). However, non-compliance with Rules on the CGR would be regarded by the Exchange as a breach of the Listing Rules.

The revised Code and the Rules on the CGR are effective for accounting periods commencing on or after 1 January 2005, apart from Code Provision C.2, Internal Controls, which is effective for accounting periods commencing on or after 1 July 2005.

Transitional arrangements for first-time reporting under the new requirements are discussed in this Update.

The Exchange has commented that the revised Code is a significant move towards adoption of international benchmarks of corporate governance, best practice and disclosure¹

Overview

In November 2004, the Exchange published its **Conclusions on Exposure of Draft Code on Corporate Governance Practices and Corporate Governance Report** ("Conclusions Report"). The Conclusions Report summarises the main comments raised on the Exchange's initial proposals and sets out the final conclusions of the Exchange.

When introducing the revised Code and the Rules on the CGR, the Exchange noted that the Code represents a significant move towards the adoption of international benchmarks of corporate governance, best practice and disclosure for Hong Kong listed entities. The Exchange also highlighted that the Code has taken into account the Combined Code on Corporate Governance in the United Kingdom ("UK Code").

Similar to the UK Code, the Exchange adopted a "comply or explain" approach which provides a measure of flexibility for issuers in implementing the Code. Where an issuer does not comply with any of the provisions in the Code, the board must give considered reasons for the deviation in its half-year report and, in the case of the annual report, the explanations must be given in the CGR. Non-compliance with Code Provisions would not in itself constitute a breach of the Listing Rules.

For the Rules on the CGR, the Exchange sets out mandatory and recommended disclosures for inclusion in the CGR, which is a new report that boards must prepare and include in the annual report. These disclosure requirements are set out in the new Appendix 23 to the Main Board Rules and the new Appendix 16 to the GEM Rules, respectively. Failure to include any of the mandatory disclosures in the CGR will be regarded by the Exchange as a breach of the Listing Rules.

The same Code and Rules on the CGR apply to Main Board and GEM issuers with one exception: quarterly financial reporting is a recommended best practice for Main Board issuers, whereas it remains a mandatory requirement for GEM issuers.

This Update gives an introduction to the Code and the Rules on the CGR, for audit committees and directors to use as a point of reference. As this publication is a high level summary, it is therefore not a substitute for reading the revised Listing Rules and related documents issued by the Exchange.

Key issues that may impact on boardroom practices

The new requirements may give rise to the need for change in some boardroom practices by Hong Kong issuers. Although not a comprehensive list, some changes may arise from the following:

- the Code requires that the roles of chairman and chief executive officer should be separated and should not be performed by the same individual;
- the Code sets out minimum duties for the audit committee and, where established, the remuneration committee, which should be set out in written terms of reference that are made publicly available;
- the Code further strengthens the role of the audit committee and its role in monitoring the integrity of the issuer's financial statements as well as being primarily responsible for the issuer's relationship with the external auditors;
- the Code requires disclosure of directors' remuneration on a named basis and also recommends disclosure of senior management's remuneration on a named basis;
- the Code sets out a number of provisions relevant to the administration of the issuer, including requirements relating to board and general meetings and the role and duties of directors. The Code sets out specific responsibilities for the chairman and includes an explicit statement that duties of care and skill and fiduciary duties of executive directors and non-executive directors are the same;

¹ Refer to the News Release issued by the Exchange on 19 November 2004 which is available on the HKEx's website at www.hkex.com.hk under "Press Room".

- a mandatory CGR must be prepared for inclusion in annual reports for accounting periods commencing on or after 1 January 2005, and failure to contain any of the mandatory disclosures will be regarded by the Exchange as a breach of the Listing Rules; and
- Code Provision C.2 on internal controls, and the related disclosure requirements in the CGR relating to issuers' internal controls are required to be implemented for accounting periods commencing on or after 1 July 2005².

The Code

Structure of the Code

The revised Code is structured in five Sections as follows:

- directors;
- remuneration of directors and senior management;
- accountability and audit;
- delegation by the board; and
- communication with shareholders.

For each of the five Sections in the Code, the Exchange sets out its Principles of good corporate governance and two levels of recommendations, namely *Code Provisions* and *Recommended Best Practices*:

- *Code Provisions* – the Exchange expects issuers to comply with, but issuers may deviate from, the Code Provisions. For the relevant accounting period in an issuer's half-year report and annual report, the issuer must state:
 - whether it has complied with the Code Provisions; and
 - for deviations from any of the Code Provisions, explain the deviations and give considered reasons³.

Similar requirements apply in respect of the summary half-year report and summary financial report, where prepared.

- *Recommended Best Practices* – the Exchange encourages issuers to comply with the Recommended Best Practices and also encourages issuers to state whether they have complied with them and to provide explanations for any deviation.

- Refer to Appendices 1 and 2 for a summary of the Code

A brief summary of the Code, including its Principles, Code Provisions and Recommended Best Practices for each of the five Sections, is set out in Appendices 1 and 2 to this Update.

Audit committee's role and its relationship with the external auditors

- Code Principle C.3 states that the board should establish formal and transparent arrangements ... for maintaining an appropriate relationship with the issuer's auditors

Section C of the Code, Accountability and Audit, includes extensive requirements and recommendations on the role and duties of the audit committee.

In addition to the audit committee's responsibility to monitor the integrity of financial statements and to review the issuer's financial controls and internal controls, amongst other items, the Code requires the responsibility for the relationship between the issuer and the external auditors to rest primarily with the audit committee.

The Code sets out minimum duties that are to be included in an audit committee's terms of reference. Aspects relevant to the relationship with the external auditors, include the audit committee's duties:

- to recommend to the board on the appointment, reappointment and removal of the external auditors, to approve the remuneration and terms of engagement of the external auditors and any questions of resignation or dismissal of the external auditors;

² It should be noted that the Hong Kong Institute of Certified Public Accountants ("HKICPA") has stated that it is currently working on guidance on internal controls to help listed issuers understand and implement the Code requirements relating to internal control and to devise their internal control procedures. For further details, reference should be made to HKICPA's *Techwatch*, Issue 29 of November 2004.

³ Refer to page 6 of this Update for details of transitional arrangements.

- to review and monitor the external auditors' independence and objectivity and the effectiveness of the audit process in accordance with applicable standards;
- to develop and implement the issuer's policy on the engagement of the external auditors to supply non-audit services⁴;
- to meet at least once a year with the external auditors⁵;
- to ensure coordination between the internal audit function (where it exists) and the external auditors;
- to review the external auditors' management letter, any material queries raised by the external auditors to management in respect of the accounting records, financial accounts or systems of control and management's response; and
- to ensure that the board provides a timely response to the issues raised in the external auditors' management letter.

Although not part of the Code provisions, the Exchange provides some additional suggestions for the audit committee to consider when assessing the issuer's relationship with the external auditors and their independence. These include suggestions by the Exchange for audit committees to:

- consider all relationships between the issuer and the external auditors;
- seek information from the external auditors on an annual basis on the external auditors' processes for maintaining independence and monitoring compliance with relevant requirements, including any applicable requirements regarding rotation of audit team members;
- meet with the external auditors, at least annually, in the absence of management, to discuss matters relating to their audit fees, any issues arising from the audit and any other matters the auditors may wish to raise; and
- consider establishing policies with respect to hiring employees or former employees of the external auditors.

Furthermore, Code Provision C.3.2 states that a former partner of an issuer's existing auditing firm should be prohibited from acting as a member of the issuer's audit committee for a period of one year commencing on the date that such a partner ceases (a) to be a partner of the firm, or (b) to have any financial interest in the firm, whichever is the later.

Further details on the foregoing areas, as well as other responsibilities of the audit committee under the Code are summarised in Appendices 1 and 2 to this Update.

Corporate Governance Report ("CGR")

Requirements to prepare a CGR

- *CGR is mandatory for annual reports and includes two levels of disclosures*

For accounting periods commencing on or after 1 January 2005, listed issuers are required to include a CGR in each annual report and summary financial report (if any). The CGR should contain the mandatory disclosures set out in Appendix 23 to the Main Board Rules and Appendix 16 to the GEM Rules, as applicable. In addition, the Code also requires certain matters to be disclosed in the CGR.

The Rules on the CGR set out two levels of disclosure:

- *Failure to include mandatory disclosures in the CGR will constitute a breach of the Listing Rules*
- *Mandatory disclosure requirements* – The Exchange requires listed issuers to include the items listed under "Mandatory Disclosure Requirements" in the CGR. Failure to include any mandatory disclosure in the CGR will be regarded by the Exchange as a breach of the Listing Rules⁶; and

⁴ In addition, under the Rules on the CGR, the annual CGR is required to include an analysis of the remuneration of the external auditors for audit and non-audit services, including for each significant non-audit service assignment, details of the nature of the services and fees paid.

⁵ Code Provision 3.3(b) also requires that the audit committee should discuss the nature and scope of the external audit and reporting obligations before the external audit commences.

⁶ Refer to the Main Board Rules, Appendix 23 (paragraph 1) and the GEM Rules, Appendix 16 (paragraph 1).

- *Recommended disclosures* – The Exchange encourages issuers to include the items listed under “Recommended Disclosures” in the CGR. The Exchange notes that the list of recommended disclosures is provided for listed issuers’ reference and is not intended to be exhaustive or mandatory.

Mandatory disclosure requirements

These relate to disclosures in respect of the following areas:

- *Detailed disclosures for inclusion in the CGR cover a wide range of areas and are set out in the new Rules on the CGR*

- corporate governance practices⁷;
- directors’ securities transactions;
- board details;
- identity and segregation of chairman and chief executive roles;
- non-executive directors’ terms of appointment;
- directors’ remuneration policy;
- directors’ nomination;
- auditors’ remuneration; and
- audit committee.

Recommended disclosures

These cover the following areas:

- share interests of senior management;
- shareholders’ rights;
- investor relations;
- additional disclosures regarding internal controls; and
- division of responsibility between the board and management.

A discussion of the detailed requirements in respect of the CGR is outside the scope of this Update.

Amendments to the Listing Rules

The revisions made to the Main Board and GEM Rules to implement the new requirements are highlighted as follows:

- *Listing Rules amended to implement the Code and the Rules on the CGR*

	<i>Main Board Rules</i>	<i>GEM Rules</i>
<i>The Code</i>	<i>Supersedes the previous Code of Best Practice and is set out in revised Appendix 14</i>	<i>Supersedes GEM Rules 5.35 to 5.45 and is inserted as new Appendix 15</i>
<i>Rules on the CGR</i>	<i>New Appendix 23</i>	<i>New Appendix 16</i>

Various other consequential amendments to the Listing Rules have also been made following the introduction of the Code and Rules on the CGR.⁸

⁷ Although the Code does not explicitly state where the following disclosures are to be made in the CGR, they could be included under this heading:

- directors’ statement on their responsibility for the financial statements (Code Provision C.1.2); and
- directors’ report to shareholders, following their annual review of the effectiveness of the system of internal control of the issuer and its subsidiaries (once Code Provision C.2 is effective). This disclosure would be in addition to the mandatory disclosures on internal control covered under the section “audit committee”.

⁸ For the Main Board Rules, amendments or additions were made to Chapter 3 and Appendices 10, 14, 16 and 23. For the GEM Rules, amendments or additions were made to Chapters 5, 18 and Appendices 15 and 16. Full details of the amended Listing Rules are available on the HKEx’s website at www.hkex.com.hk under “Regulatory Framework and Rules”.

Transitional arrangements and subsequent reporting

- *Transitional arrangements for first-time reporting*

The Code and the Rules on the CGR are effective for accounting periods commencing on or after 1 January 2005, apart from Code Provision C.2 on internal controls. Code Provision C.2 is effective for accounting periods commencing on or after 1 July 2005.

Appendix 2 to the Conclusions Report includes a table containing a brief summary of transitional disclosure requirements, key aspects of which are set out below. However, the Exchange has further stated that the table in the Conclusions Report is for reference only and does not form part of the Listing Rules. The reporting arrangements set out by the Exchange are summarised as follows:

Financial period	Reporting document	First-time reporting (transitional arrangement)	Subsequent reporting
1st and 3rd quarter	<ul style="list-style-type: none"> • preliminary results announcement • financial report 	<ul style="list-style-type: none"> • no obligation to report on compliance with the Code 	<ul style="list-style-type: none"> • no obligation to report on compliance with the Code
Half-year and annual	<ul style="list-style-type: none"> • preliminary results announcement 	<ul style="list-style-type: none"> • summary of the major areas of deviation • need not give considered reasons for deviations 	<ul style="list-style-type: none"> • statement whether the issuer has complied with the Code Provisions • disclose any deviations from the Code Provisions and give considered reasons for such deviations <p>(issuer may refer to the immediately preceding half-year or annual report, as applicable, and summarise any changes since that report as described in the Conclusions Report's table)</p>
Half-year	<ul style="list-style-type: none"> • financial report • summary half-year report 	<ul style="list-style-type: none"> • disclose deviations from the Code Provisions • need not give considered reasons for deviations • in respect of each deviation, either: <ul style="list-style-type: none"> - give considered reasons as to why the issuer does not propose to comply with the relevant Code Provisions in the future; or - set out the steps the issuer has taken or proposes to take to comply with the relevant Code Provisions in the future 	<ul style="list-style-type: none"> • statement whether the issuer has complied with the Code Provisions • either: <ul style="list-style-type: none"> - give considered reasons for each deviation; or - refer to the CGR in the immediately preceding annual report, and provide details of any changes together with considered reasons for any deviation not reported in that annual report
Annual	<ul style="list-style-type: none"> • financial report 	<ul style="list-style-type: none"> • no transitional arrangements 	<ul style="list-style-type: none"> • a separate CGR containing the minimum information required under Appendix 23 or 16 to Main Board Rules and GEM Rules, as applicable
	<ul style="list-style-type: none"> • summary financial report 	<ul style="list-style-type: none"> • no transitional arrangements 	<ul style="list-style-type: none"> • same requirements as annual financial report <p>(issuer may issue a summary of the CGR which contains some minimum information as described in the Conclusions Report's table)</p>

Refer to the Conclusions Report and Listing Rules for further details.

Some key questions to consider

As noted earlier, the new and revised requirements may have a significant impact on many Hong Kong issuers. Some key questions that issuers may need to consider when applying the Code are set out below.

References in brackets relate to the Principles, Code Provisions or Recommended Best Practices of the Code.

Section A: Directors

- Have the roles of chairman and chief executive officer been separated? (A.2.1)
- Are arrangements relating to regular board meetings appropriate or do they need to be revised? (A.1.1)
- Are there adequate guidelines on access by members of the board to the company secretary? (A.1.4)
- Will the board follow the recommended best practice of at least one-third of the board consisting of independent non-executive directors? (A.3.2)
- Are the existing policies on the appointment and re-election of directors appropriate or do they need to be revised? (A.4)
- Are there arrangements in place to require all directors to retire by rotation at least once every three years? (A.4.2)
- Will the board establish a nomination committee? (A.4.4)
- Do all newly appointed directors receive a comprehensive, formal and tailored induction and are subsequent briefings and professional development sufficient? (A.5.1)
- Are all directors and senior management aware of the impact of the Code and the Rules on the CGR?

Section B: Remuneration of directors and senior management

- Is there a formal and transparent procedure for setting policy on remuneration and for fixing the remuneration packages for all directors? (B.1)
- What comparable companies are to be used as a benchmark, and how is the benchmark to be applied, when the remuneration committee considers remuneration of executive directors and senior management? (B.1.3(b))
- How will fixed and performance-related elements of a remuneration package be determined for directors and senior management? (B.1.3(c))
- Will remuneration of senior management be disclosed in the annual report and financial statements on an individual and named basis? (B.1.7)

Section C: Accountability and audit

- For Main Board listed issuers, will quarterly financial reporting be adopted? (C.1.4)
- How do the directors plan to review the effectiveness of the system of internal control? (C.2.1)
- For issuers without an internal audit function, will a policy and procedure be established for reviewing the need for one? (C.2.5)
- Are the audit committee's terms of reference appropriate and in line with the Code Provisions? (C.3.3)
- Has adequate consideration been given to the impact that the Code and Rules on the CGR will have on the reporting process and timetable?

Section D: Delegation by the board

- Have the matters that are specifically reserved for decision by the board been clearly established and communicated to directors and management? (D.1.2)
- Have board committees been established with clear written terms of reference? (D.2.1)

Section E: Communication with shareholders

- Is the ongoing dialogue with shareholders adequate?

This completes our introduction to the Code and the Rules on the CGR. In addition, the following appendices have been attached:

- Appendix 1 - a table summarising the Principles, Code Provisions and Recommended Best Practices; and
- Appendix 2 - a table summarising those aspects of the Code dealing with terms of reference for the audit, remuneration and nomination committees.

As mentioned at the outset, since this is a high level summary, it should not be relied upon as a substitute for reading the revised Listing Rules and related documents issued by the Exchange.

Should you have further questions concerning the Code or if you require additional copies of this *Boardroom Update*, please contact your usual KPMG contact.

Further information

Set out below are details of resources that issuers may access for further information:

- The Conclusions Report is available on the HKEx's website at www.hkex.com.hk/consul/conclusion/expocon.pdf
- Details of amendments to the Main Board Rules relating to the Code and Rules on the CGR (19 November, 2004) are available on HKEx's website at www.hkex.com.hk/rule/mbrule/mbrule_amendment_22_DEC_04.htm
- Details of amendments to the GEM Rules relating to the Code and Rules on the CGR (19 November, 2004) are available on the HKEx's website at www.hkex.com.hk/rule/gemrule/gem_rupdate3_cover.htm
- Visit KPMG's Audit Committee Institute at www.kpmg.com/aci for additional publications and tools on corporate governance
- The HKICPA's guides on Corporate Governance are available on the HKICPA's website at www.hkicpa.org.hk under "Publications"

This is the first edition of *Boardroom Update*, a newsletter for audit committees and directors. *Boardroom Update*'s primary purpose is to highlight key issues relevant to financial reporting, internal controls, and related topics.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

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Appendix 1 – Key provisions of the Code

Section A: DIRECTORS

Principles	Code Provisions	Recommended Best Practices
<p>A.1 The board – An issuer should be headed by an effective board which should:</p> <ul style="list-style-type: none"> assume responsibility for leadership and control of the issuer; collectively as the board, be responsible for promoting the success of the issuer by directing and supervising the issuer's affairs; and individually as directors, take decisions objectively in the interests of the issuer. 	<p>A.1.1 The board should meet regularly and at least four times a year at approximately quarterly intervals. A regular meeting does not include the practice of obtaining board consent through circulation of written resolutions</p> <p>A.1.2 All directors should be given an opportunity to include matters in the agenda for regular board meetings</p> <p>A.1.3 All directors should be given at least 14 days' notice for regular board meetings, and for all other board meetings, "reasonable notice" should be given</p> <p>A.1.4 All directors should have access to the advice and services of the company secretary with a view to ensuring that board procedures and all applicable rules and regulations, are followed</p> <p>A.1.5 Minutes of meetings should be kept by a duly appointed secretary of the meeting and should be open for inspection at any reasonable time on reasonable notice by any director</p> <p>A.1.6 Minutes of meetings should record in sufficient detail the matters considered by the board and decisions reached, including any concerns raised by the directors or dissenting views expressed. Draft and final versions of minutes should be sent to all directors for their comment and records, respectively, in both cases within a reasonable time after the meeting is held</p> <p>A.1.7 The board should agree procedures to enable directors, upon reasonable request, to seek independent professional advice at the issuer's expense</p> <p>A.1.8 If a substantial shareholder or a director has a conflict of interest in a matter to be considered by the board, which the board has determined to be material, the matter should not be dealt with by way of circulation but a board meeting should be held. INEDs⁹ who, and whose associates, have no material interest in the transaction, should be present at such a board meeting</p>	<p>A.1.9 An issuer should arrange appropriate insurance cover in respect of legal action against its directors</p> <p>A.1.10 The board committees should adopt, so far as practicable, Code Provisions A.1.1 to A.1.8</p>
<p>A.2 Chairman and chief executive officer - There are two key aspects of the management of every issuer:</p> <ul style="list-style-type: none"> management of the board; and day-to-day management of the issuer's business. <p>There should be a clear division of responsibilities at the board level to ensure a balance of power and authority, so that power is not concentrated in any one individual.</p>	<p>A.2.1 The roles of chairman and chief executive officer should be separated and should not be performed by the same individual. The division of responsibilities should be clear and set out in writing</p> <p>A.2.2 The chairman should ensure that all directors are properly briefed on issues arising at board meetings</p> <p>A.2.3 The chairman is responsible for ensuring that directors receive adequate information, which must be complete and reliable, in a timely manner</p>	<p>A.2.4 The chairman should:</p> <ul style="list-style-type: none"> provide leadership for the board; ensure that the board works effectively and discharges its responsibilities and that all key and appropriate issues are discussed by the board in a timely manner; and be primarily responsible for drawing up and approving the agenda for each board meeting (this responsibility may be delegated to another director or to the company secretary) <p>A.2.5 The chairman should take responsibility for ensuring good corporate governance practices and procedures are established</p> <p>A.2.6 The chairman should encourage all directors to make a full and active contribution to the board and take the lead to ensure that the board acts in the issuer's best interest</p> <p>A.2.7 At least once a year, the chairman should hold a meeting with NEDs⁹ (including INEDs) without the EDs⁹ being present</p>

⁹ ED, NED and INED represent executive director, non-executive director and independent non-executive director, respectively.

Appendix 1 – Key provisions of the Code

Section A: DIRECTORS (cont'd)

Principles	Code Provisions	Recommended Best Practices
<p>A.3 Board composition – The board should:</p> <ul style="list-style-type: none"> • have a balance of skills and experience appropriate for the requirements of the issuer's business; • ensure that changes to board composition can be managed without undue disruption; and • include a balanced composition of EDs and NEDs (including INEDs) so that there is a strong independent element on the board, which can effectively exercise independent judgement. NEDs should be of sufficient calibre and number for their views to carry weight. 	<p>A.3.1 INEDs¹⁰ should be expressly identified as such in all corporate communications that disclose directors' names</p>	<p>A.2.8 The chairman should ensure appropriate steps are taken to provide effective communication with shareholders and that the views of shareholders are communicated to the board as a whole</p> <p>A.2.9 The chairman should facilitate the effective contribution of NEDs and ensure constructive relations between EDs and NEDs</p> <p>A.3.2 An issuer should appoint INEDs representing at least one-third of the board</p> <p>A.3.3 An issuer should maintain on its website an updated list of its directors identifying their role and function and whether they are INEDs</p>
<p>A.4 Appointments, re-election & removal - There should be:</p> <ul style="list-style-type: none"> • a formal, considered and transparent procedure for appointment of new directors; • plans in place for orderly succession for board appointments; • re-elections of all directors at regular intervals; and • explanations and reasons given for the resignation or removal of any director. 	<p>A.4.1 NEDs should be appointed for a specific term, and subject to re-election</p> <p>A.4.2 Directors appointed to fill a casual vacancy should be subject to election by shareholders at the first general meeting after their appointment. All directors should retire by rotation at least once every three years (including those appointed for a specific term)</p>	<p>A.4.3 Serving more than 9 years could be relevant to the determination of a NED's independence. If an INED serves for more than 9 years, any further appointment should be subject to a separate resolution to be approved by shareholders. The board should also set out the reasons why it believes that such an individual continues to be independent in the papers accompanying a resolution to re-elect that individual</p> <p>A.4.4 An issuer should establish a nomination committee, comprising a majority of INEDs</p> <p>A.4.5 The nomination committee should be established with written terms of reference that include minimum duties - refer to Appendix 2 to this Update for further details</p> <p>A.4.6 The nomination committee should make available its terms of reference explaining its role and the authority delegated to it by the board (for example, by including it on the issuer's website or making them available on request)</p>

¹⁰

Note also that the Listing Rules (Main Board Rules 3.10(1) and (2) / GEM Rules 5.05(1) and (2)) were amended in March 2004, with a transitional period of six months from 31 March 2004, to increase the minimum number of INEDs on the board of an issuer from 2 to 3 of which at least 1 INED should have the appropriate professional qualifications or accounting or related financial management expertise. Non-compliance with those requirements constitutes a breach of the Listing Rules. Additional factors are also included in the Listing Rules (Main Board Rule 3.13 and GEM Rule 5.09) to assist issuers in assessing the independence of INEDs.

Appendix 1 – Key provisions of the Code

Section A: DIRECTORS (cont'd)

Principles	Code Provisions	Recommended Best Practices
<p>A.5 Directors' responsibilities – Every director should keep abreast of:</p> <ul style="list-style-type: none"> his/her responsibilities as a director of an issuer; and the conduct, business activities and development of that issuer. <p>NEDs have same duties of care and skill and fiduciary duties as EDs.</p>	<p>A.5.1 Every newly appointed director of an issuer should receive a comprehensive, formal and tailored induction on the first occasion of his/her appointment, and subsequently such briefing and professional development as is necessary, to ensure that the director has:</p> <ul style="list-style-type: none"> a proper understanding of issuer's operations and business; and full awareness of his/her responsibilities under statute and common law, the Listing Rules, applicable legal requirements and other regulatory requirements and the business and governance policies of the issuer <p>A.5.2 NEDs should, among others:</p> <ul style="list-style-type: none"> participate in board meetings and bring independent judgement on issues of strategy, policy, performance, accountability, resources, key appointments and standards of conduct; take the lead when potential conflicts of interests arise; serve on audit, remuneration, nomination and other corporate governance committees, if invited; and scrutinise the issuer's performance in achieving agreed corporate goals and objectives, and monitor the reporting of performance <p>A.5.3 Every director should give sufficient time and attention to the issuer's affairs and should not accept appointment if unable to do so</p> <p>A.5.4 Directors must comply with their obligations under the Model Code for Securities Transactions by Directors of Listed Issuers (Appendix 10 to the Main Board Rules) and the required standard of dealings (GEM Rules 5.48 to 5.67), as applicable. The board should also establish written guidelines on no less exacting terms than those set out in the Model Code and the required standard of dealings, as applicable, for relevant employees¹¹ in respect of their dealings in the issuer's securities</p>	<p>A.4.7 An issuer should provide sufficient resources to the nomination committee to enable it to discharge its duties</p> <p>A.4.8 Where the board proposes a resolution to elect an individual as an INED at a general meeting, the board should explain why it believes the individual should be elected and why it considers the individual to be independent</p> <p>A.5.5 All directors should participate in continuous professional development and the issuer should arrange and fund a suitable development programme</p> <p>A.5.6 Directors should disclose to the issuer the number and nature of offices held in public companies or organisations and other significant commitments. The board should determine for itself how frequently such disclosure should be made</p> <p>A.5.7 NEDs should give the board and any committees on which they serve the benefit of their skills, expertise and varied backgrounds and qualifications through regular attendance and active participation. NEDs should attend general meetings and develop a balanced understanding of shareholders' views</p> <p>A.5.8 NEDs should provide independent, constructive and informed comments on the development of issuer's strategy and policies</p>

¹¹ "Relevant employee" is defined in the Code for this purpose to include any employee of the issuer or a director or employee of a subsidiary or holding company of the issuer who, because of such office or employment, is likely to be in possession of unpublished price sensitive information in relation to the issuer or its securities.

Appendix 1 – Key provisions of the Code

Section A: DIRECTORS (cont'd)

Principles	Code Provisions	Recommended Best Practices
A.6 Supply of and access to information - Directors should be provided with timely information in appropriate quantity and quality to enable them to:	A.6.1 For regular board meetings and as far as practicable for all other meetings, directors should receive the agenda and accompanying board papers in full at least 3 days before the intended meeting date (or such longer period as agreed)	(No recommended best practices for Principle A.6)
<ul style="list-style-type: none"> • make an informed decision; and • discharge their duties and responsibilities as directors. 	A.6.2 Management should supply the board and its committees with adequate information in a timely manner. Such information must be complete and reliable. The board and each director should have separate and independent access to the issuer's senior management ¹²	
	A.6.3 All directors are entitled to have access to board papers and related materials. Where queries are raised by directors, steps must be taken to respond as promptly and fully as possible	

Section B: REMUNERATION OF DIRECTORS AND SENIOR MANAGEMENT

Principles	Code Provisions	Recommended Best Practices
B.1 Level and make-up of remuneration and disclosure – An issuer should disclose information relating to directors' remuneration policy and other remuneration related matters. There should be:	B.1.1 An issuer should establish a remuneration committee, the majority of whose members should be INEDs, with specific written terms of reference which deal clearly with its authority and duties	B.1.6 A significant proportion of EDs' remuneration should be structured so as to link rewards to corporate and individual performance
<ul style="list-style-type: none"> • a formal and transparent procedure for setting policy on EDs' remuneration and for fixing the remuneration packages for all directors; • sufficient levels of remuneration to attract and retain the directors needed to run the entity successfully but paying more than is necessary should be avoided; and • no involvement of a director in deciding his/her own remuneration. 	B.1.2 The remuneration committee should consult the chairman and/or chief executive officer about its proposals relating to the remuneration of other EDs and should have access to professional advice if considered necessary	B.1.7 An issuer should disclose details of any remuneration payable to members of senior management ¹² , on an individual and named basis, in its annual reports and accounts ¹³
	B.1.3 Written terms of reference of the remuneration committee should include minimum duties - refer to Appendix 2 to this Update for further details	B.1.8 Where the board resolves to approve any remuneration or compensation arrangements which the remuneration committee has previously resolved not to approve, the board must disclose the reasons in the next annual report
	B.1.4 The remuneration committee should make available its terms of reference explaining its role and the authority delegated to it by the board (for example, by including it on the issuer's website or making them available on request)	
	B.1.5 An issuer should provide sufficient resources to the remuneration committee to discharge its duties	

Section C: ACCOUNTABILITY AND AUDIT

Principles	Code Provisions	Recommended Best Practices
C.1 Financial reporting – The board should present a balanced, clear and comprehensible assessment of the company's performance, position and prospects.	C.1.1 Management should provide explanations and information to the board to enable the board to make an informed assessment of the financial and other information put before the board for approval	C.1.4 An issuer should announce and publish quarterly financial results within 45 days after the end of the relevant quarter using the accounting policies applied to the issuer's half-year and annual accounts

¹² "Senior management" should refer to the same category of persons as referred to in the issuer's annual report and which is required to be disclosed under the Listing Rules (for Main Board, paragraph 12 of Appendix 16 and for GEM, Rule 18.39).

¹³ Such disclosure should be the same standard as that required for directors of issuers under the Listing Rules (for Main Board, paragraph 24 of Appendix 16 and for GEM, Rule 18.28).

Appendix 1 – Key provisions of the Code

Section C: ACCOUNTABILITY AND AUDIT (cont'd)

Principles	Code Provisions	Recommended Best Practices
<p>c.2 <i>Internal controls</i> – The board should ensure that the issuer maintains sound and effective internal controls to safeguard the shareholders' investment and the issuer's assets. (note: effective for accounting periods commencing on or after 1 July 2005)</p>	<p>c.1.2 The directors should acknowledge in the CGR their responsibility for preparing the accounts. There should also be a statement by the auditors about their reporting responsibilities in the auditors' report on the financial statements. The financial statements should be prepared on a going concern basis unless it is inappropriate to do so. If the directors are aware of material uncertainties that cast doubt on the issuer's ability to continue as a going concern, such uncertainties should be clearly and prominently set out and discussed at length in the CGR. The CGR should contain sufficient information so as to enable investors to understand the severity and significance of the matters</p> <p>c.1.3 The board's responsibility to present a balanced, clear and understandable assessment extends to annual and interim/half-year reports¹⁴, other price-sensitive announcements and other financial disclosures required under the Listing Rules, and reports to regulators as well as to information required to be disclosed under statutory requirements</p>	<p>c.1.5 If quarterly reporting is adopted, an issuer should continue to adopt such quarterly reporting for each of the first 3 and 9 months periods of subsequent financial years (note: C.1.4 and C.1.5 above only apply to Main Board issuers. For GEM issuers, quarterly reporting is mandatory under GEM Rules 18.66 and 18.79)</p>
<p>c.2</p>	<p>c.2.1 The directors should at least annually conduct a review of the effectiveness of the system of internal control of the issuer and its subsidiaries and report to shareholders in the CGR that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management functions</p>	<p>c.2.2 The board's annual review should, in particular, consider:</p> <ul style="list-style-type: none"> • the changes since the last annual review in the nature and extent of significant risks, and the issuer's ability to respond to changes in its business and the external environment; • the scope and quality of management's ongoing monitoring of risks and of the system of internal control, and where applicable, the work of its internal audit function and other providers of assurance; • the extent and frequency of communicating the results of that monitoring to the board (or board committees) which enables the board to build up a cumulative assessment of the state of control in the issuer and the effectiveness with which risk is being managed; • the incidence of significant control failings or weakness that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the issuer's financial performance or condition; and • the effectiveness of the issuer's processes relating to financial reporting and Listing Rules compliance

¹⁴ Extends to quarterly financial reports for GEM issuers.

Appendix 1 – Key provisions of the Code

Section C: ACCOUNTABILITY AND AUDIT (cont'd)

Principles	Code Provisions	Recommended Best Practices
<p>C.3 <i>Audit committee</i> – The board should establish formal and transparent arrangements for:</p> <ul style="list-style-type: none"> • considering how it will apply the financial reporting and internal control principles; and • maintaining an appropriate relationship with the company's auditors. <p>The audit committee should have clear terms of reference.</p>	<p>C.3.1 Full minutes of audit committee meetings should be kept by a duly appointed secretary of the meeting (normally the company secretary). Draft and final versions of minutes should be sent to all members of the audit committee for their comment and records respectively, in both cases, within a reasonable time after the meeting</p> <p>C.3.2 A former partner of the issuer's existing auditing firm should be prohibited from acting as a member of the issuer's audit committee for a period of 1 year commencing on the date of ceasing to be partner of the auditing firm or ceasing to have any financial interest in the auditing firm (whichever is later)</p> <p>C.3.3 Written terms of reference of the audit committee should include minimum duties - refer to Appendix 2 to this Update for further details</p> <p>C.3.4 The audit committee should make available its terms of reference explaining its role and the authority delegated to it by the board (for example, by including it on the issuer's website or making them available on request)</p> <p>C.3.5 Where the board disagrees with the audit committee's view on the selection appointment, resignation or dismissal of the external auditors, the CGR should include a statement from the audit committee explaining its recommendation and the reason(s) why the board has taken a different view</p> <p>C.3.6 An issuer should provide sufficient resources to the audit committee to discharge its duties</p>	<p>C.2.3 An issuer should disclose in the CGR a narrative statement as to how the issuer has complied with the Code Provisions on internal controls during the reporting period. The disclosures should also include the following items:</p> <ul style="list-style-type: none"> • the process that an issuer has applied for identifying, evaluating and managing the significant risks faced by it; • any additional information to assist understanding of the issuer's risk management processes and system of internal control; • an acknowledgement by the board that it is responsible for the issuer's system of internal control and for reviewing its effectiveness; • the process that an issuer has applied in reviewing the effectiveness of the system of internal control; and • the process that an issuer has applied to deal with material internal control aspects of any significant problems disclosed in its annual reports and accounts <p>C.2.4 Issuers should ensure that the disclosures provide meaningful information and do not give a misleading impression</p> <p>C.2.5 Issuers without an internal audit function should review the need for one on an annual basis and should disclose the outcome of such review in the CGR</p> <p>C.3.7 Additional terms of reference of the audit committee are recommended - refer to Appendix 2 to this Update for further details</p>

Appendix 1 – Key provisions of the Code

Section D: DELEGATION BY THE BOARD

Principles	Code Provisions	Recommended Best Practices
<p>D.1 <i>Management functions</i> –</p> <ul style="list-style-type: none"> an issuer should have a formal schedule of matters specifically reserved to the board for its decision; and the board should give clear directions to management as to the matters that must be approved by the board before decisions are made on behalf of the issuer. 	<p>D.1.1 When the board delegates aspects of its management and administration functions to management, it must at the same time give clear directions as to the powers of management, in particular, with respect to circumstances where management should report back and obtain prior approval from the board before making decisions or entering into any commitments on behalf of the issuer</p> <p>D.1.2 An issuer should formalise the functions reserved to the board and those delegated to management, and review those arrangements on a periodic basis</p>	<p>D.1.3 An issuer should disclose the division of responsibility between the board and management to assist those affected by corporate decisions to better understand the respective accountabilities and contributions of the board and management</p> <p>D.1.4 Directors should clearly understand delegation arrangements in place. Accordingly, an issuer should have formal letters of appointment for directors setting out the key terms and conditions of their appointment</p>
<p>D.2 <i>Board committees</i> – The board committees should be formed with specific written terms of reference which deal clearly with the committees' authority and duties.</p>	<p>D.2.1 Where board committees are established to deal with matters, the board should prescribe sufficiently clear terms of reference to enable such committees to discharge their functions properly</p> <p>D.2.2 Board committees' terms of reference should require such committees to report back to the board on their decisions or recommendations, unless there are legal or regulatory restrictions on their ability to do so</p>	<p>(No recommended best practices for Principle D.2)</p>

Section E: COMMUNICATION WITH SHAREHOLDERS

Principles	Code Provisions	Recommended Best Practices
<p>E.1 <i>Effective communication</i> – The board should maintain an on-going dialogue with shareholders and in particular, use annual general meetings ("AGMs") or other general meetings to communicate with shareholders and encourage their participation.</p>	<p>E.1.1 The chairman of the meeting should propose a separate resolution for each substantially separate issue discussed at a general meeting</p> <p>E.1.2 The chairman of the board should attend the AGM and arrange for the chairmen of the audit, remuneration and nomination committees (as appropriate), or in their absence another member of such committee(s) or failing this, a duly appointed delegate, to be available to answer questions at the AGM. The chairman of the independent board committee (if any) should also be available to answer questions at any general meeting to approve a connected transaction or any other transaction that is subject to independent shareholders' approval</p>	<p>(No recommended best practices for Principle E.1)</p>
<p>E.2 <i>Voting by poll</i> – An issuer should:</p> <ul style="list-style-type: none"> regularly inform shareholders of the procedures for voting by poll; and 	<p>E.2.1 The chairman of a meeting should ensure disclosure in the issuer's circulars to shareholders of the procedures for, and the rights of, shareholders to demand a poll in compliance with the requirements set out in the Listing Rules¹⁵</p>	<p>(No recommended best practices for Principle E.2)</p>

¹⁵ For Main Board, refer to Rules 13.39(3)(4) and for GEM, refer to Rules 17.47(3)(4).

Appendix 1 – Key provisions of the Code

Section E: COMMUNICATION WITH SHAREHOLDERS (cont'd)

Principles	Code Provisions	Recommended Best Practices
<ul style="list-style-type: none"> ensure compliance with the voting by poll requirements contained in the Listing Rules and the issuer's constitutional documents. 	<p>E.2.2 An issuer should count all proxy votes and, except where a poll is required, the chairman of a meeting should indicate to the meeting the level of proxies lodged on each resolution and the balance for and against the resolution, after it has been dealt with on a show of hands. The issuer should ensure that votes cast are properly counted and recorded</p> <p>E.2.3 The chairman of meeting should ensure that an explanation is provided at the commencement of the meeting of the procedures for:</p> <ul style="list-style-type: none"> demanding a poll by shareholders before putting a resolution to the vote on a show of hands; and conducting a poll and then answer any questions from shareholders whenever voting by way of a poll is required 	

Appendix 2 – Summary of terms of reference for committees

Committees	Code Provisions	Recommended Best Practices
<p>Audit committee</p>	<p>C.3.3 Written terms of reference of the audit committee should include, at a minimum, the following duties¹⁶:</p> <p><u>Relationship with the issuer's auditors</u></p> <p>(a) to be primarily responsible for making recommendation to the board on the appointment, reappointment and removal of the external auditors¹⁷; and to approve the remuneration and terms of engagement of the external auditors, and any questions of resignation or dismissal of the external auditors</p> <p>(b) to review and monitor the external auditors' independence and objectivity and the effectiveness of the audit process. The audit committee should discuss the nature and scope of the external audit and reporting obligations before the external audit commences</p> <p>(c) to develop and implement policy on the engagement of the external auditors to supply non-audit services</p> <p><u>Review of financial information of the issuer</u></p> <p>(d) to monitor the integrity of the issuer's financial statements and its annual report and accounts, interim/half-year report and quarterly reports (if prepared)¹⁸, and to review significant financial reporting judgements contained in them¹⁹</p> <p>(e) with respect to (d) above:</p> <p>(i) members of the audit committee must liaise with the board, senior management and the issuer's qualified accountant and the audit committee must meet, at least once a year, with the issuer's external auditors; and</p> <p>(ii) to consider any significant or unusual items that are, or may need to be, reflected in such reports and accounts and must give due consideration to matters raised by the issuer's qualified accountant, compliance officer or external auditors</p> <p><u>Oversight of the issuer's financial reporting system and internal control procedures</u></p> <p>(f) to review the issuer's financial controls, internal control and risk management systems</p> <p>(g) to discuss with management the system of internal control and ensure that management has discharged its duty to have an effective internal control system</p>	<p>C.3.7 Additional recommended terms of reference of the audit committee include the following duties:</p> <p>(a) to review arrangements by which the issuer's employees may, in confidence, raise concerns about possible improprieties in financial reporting, internal control or other matters. The audit committee should ensure that proper arrangements are in place for the fair and independent investigation of such matters and for appropriate follow-up action</p> <p>(b) to act as the key representative body for overseeing the issuer's relationship with the external auditors</p>

¹⁶ The Exchange has provided some suggestions as to how compliance of Code Provision C.3.3 may be achieved. However, the suggestions do not form part of the Code Provision. For example, the Exchange suggests that the audit committee may consider the following:

- establishing procedures to review and monitor the independence of external auditors by considering all relationships between the issuer and the audit firm including the provision of non-audit services; seeking from the audit firm, on an annual basis, information about its policies and procedures for maintaining independence and monitoring compliance with relevant requirements; and meeting the external auditors at least annually in the absence of management, to discuss matters relating to their audit fees, any issues arising from the audit and any other matters that auditors may wish to raise
 - agreeing with the board the issuer's policies relating to hiring of employees and former employees of the external auditors
 - when assessing the external auditors' independence or objectivity in relation to the provision of non-audit services, considering the skills and experience of the audit firm; safeguards in place to ensure that there is no threat to objectivity and independence in the conduct of the audit resulting from the provision of such services by the external auditors; the nature of the non-audit services including related fee levels; and the criteria which govern the compensation of individuals performing the external audit
 - further external guidance on the duties of an audit committee e.g. "Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence" issued by the Technical Committee of the International Organization of Securities Commission in October 2002 and "A Guide for Effective Audit Committees", published by the HKICPA in February 2002
- Main Board Rule 13.51(4) and GEM Rule 17.50(4), as applicable, require an announcement to be published when there is a change of auditors.
- Quarterly financial reporting is mandatory for GEM issuers and is a recommended best practice for Main Board issuers.
- The audit committee should focus on any changes in accounting policies and practices; major judgemental areas; significant adjustments resulting from the audit; the going concern assumptions and any qualifications; compliance with accounting standards; and compliance with the Listing Rules and other legal requirements relating to financial reporting (Code Provision C.3.3(d)(i)-(vii)).

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Appendix 2 – Summary of terms of reference for committees (cont'd)

Committees	Code Provisions	Recommended Best Practices
Remuneration committee	<p>(h) to consider any findings of major investigations of internal control matters as delegated by the board or on its own initiative, and management's response</p> <p>(i) where an internal audit function exists, to ensure coordination between the internal and external auditors, and to ensure that the internal audit function is adequately resourced and has appropriate standing within the issuer, and to review and monitor the effectiveness of the internal audit function</p> <p>(j) to review the group's financial and accounting policies and practices</p> <p>(k) to review the external auditors' management letter, any material queries raised by the external auditors to management in respect of the accounting records, financial accounts or systems of control and management's response</p> <p>(l) to ensure that the board will provide a timely response to the issues raised in the external auditors' management letter</p> <p>(m) to report to the board on the matters set out in Code Provision C.3.3</p> <p>(n) to consider other topics, as defined by the board</p> <p>B.1.3 Written terms of reference of the remuneration committee should include, at a minimum, the following duties:</p> <p>(a) to recommend to the board the remuneration policy and structure for directors and senior management¹² and on the establishment of a formal and transparent procedure for developing policy on such remuneration</p> <p>(b) to have delegated responsibility to determine specific remuneration packages of all EDs and senior management, and make recommendations to the board on NEDs' remuneration</p> <p>(c) to review and approve performance-based remuneration by reference to corporate goals and objectives resolved by the board from time to time</p> <p>(d) to review and approve compensation payable to EDs and senior management in connection with any loss or termination of office or appointment</p> <p>(e) to review and approve compensation arrangements relating to dismissal or removal of directors for misconduct</p> <p>(f) to ensure that no director or any of his/her associates is involved in determining his/her own remuneration</p>	<p>(No additional recommended terms of reference)</p>

Appendix 2 – Summary of terms of reference for committees (cont'd)

Committees	Code Provisions	Recommended Best Practices
Nomination committee	(No minimum terms of reference)	<p>A.4.5 Recommended terms of reference of the nomination committee include the following duties:</p> <ul style="list-style-type: none"> • to review the structure, size and composition (including the skills, knowledge and experience) of the board on a regular basis and make recommendations to the board regarding any proposed changes • to identify individuals suitably qualified to become board members and select or make recommendations to the board on the selection of individuals nominated for directorships • to assess the independence of INEDs • to make recommendations to the board on relevant matters relating to the appointment or re-appointment of directors and succession planning for directors, in particular the chairman and the chief executive officer