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20 December 2004

The Hon. Bernard Chan,
Chairman of the Panel on Financial Affairs,
Legislative Council Secretariat,
3rd floor, Citibank Tower,
3 Garden Road,
Central, Hong Kong.

Dear Mr. Chan,

**Proposal of splitting the post of the chairman of the SFC
into a chairman post and a chief executive officer post**

I am writing in response to your invitation to provide views on the subject proposal. We thank you for inviting the Hong Kong Institute of Certified Public Accountants' (HKICPA) views on this matter. Our comments below relate to issues of principle and are not intended, either explicitly or implicitly, to be a reflection on the existing operations of the Securities and Futures Commission (SFC) and its office bearers.

A. The proposal

The HKICPA supports the principle of splitting the post of the chairman of the SFC into the separate positions of chairman and chief executive officer (CEO), so as to distinguish the duties and functions of the chairman from the CEO and avoid the concentration of authority in one position. This is in line with good corporate governance practice and is one of the recommended best practices advocated by the HKICPA in the Institute's public sector corporate governance guide, entitled "**Corporate Governance for Public Bodies – A Basic Framework**", published in May this year. We have also advocated the same for a number of years in our recommendations for the private and listed company sectors.

As suggested in paragraph 9(b) of the paper from the Administration, splitting the posts would also be useful from the point of view of enabling the CEO to be able to consult the chairman on major issues. This view we also support and is one practised by the HKEx, another financial market regulator.

By way of background, the HKICPA's guide provides a basic framework of corporate governance principles and recommended best practices for public sector organisations. It is directed at governing boards of public sector bodies and aims to assist the governing board to understand fully its role and responsibilities and to discharge its responsibilities efficiently and effectively.

--- A printed copy of the [guide](#) is enclosed for your reference.



B. Chairman of the SFC

(i) Executive or non-executive

In order to avoid any confusion of roles and overlapping of responsibilities, both from the perspective of internal management and external perceptions, in our view, the chief executive should have line responsibility for all aspects of executive management of the SFC and the chairman should ideally be an independent non-executive member of the governing board.

(ii) Independence

We consider that it is important for any chairman of the SFC be, and to be seen to be, free from bias and independent from external influence, so as to preserve the integrity, reputation and image of the SFC as a credible and independent market regulator. In this regard, the Institute agrees with the requirements set out in paragraph 14 of the Administration's paper on the proposal, namely, that the chairman should not:

- be a director of any listed company in Hong Kong; or
- have any material interest in any principal business activity of, or be involved in any material business dealing with, a listed company, or any person or institution engaged in activities regulated by the SFC.

We are of the view that the above conditions should apply, not only during the chairman's tenure of the office, but also extend for a certain period after his term of office has ended.

(iii) Role of the chairman

The role and responsibilities of the chairman should be formally defined in writing to include responsibility for providing strategic direction to the board and effective leadership in implementing the board's work, so as to ensure that the governing board can successfully discharge its overall responsibility for the activities of the SFC.

It is noted that paragraph 8 of the Administration's paper sets out briefly the various responsibilities of the chairman. We would suggest that some of the responsibilities contained therein could be more clearly defined. Our observations are as follows:

8(b) setting agenda and establishing priorities

As regards "setting agenda", this could cover, (a) determining the agenda of board meetings or (b) defining the mission and strategic objectives/direction for the governing board and the organisation as a whole, or both (a) and (b). In our view, the chairman's role entails driving (a) and being a principal participant in (b). In relation to this item, therefore, we would suggest that the relevant responsibilities should be further clarified and elaborated upon.



8(c) *facilitating effective contribution of non-executive directors (NEDs)*

We consider that the chairman's role should include facilitating and encouraging a full and effective contribution to the board by all board members, including NEDs.

8(d) *representing the SFC publicly, in liaison with local and international financial institutions and other stakeholders*

We consider that one of the chairman's roles should be to ensure that the SFC communicates effectively with its stakeholders. As to whether the chairman or another person (e.g. the CEO) should be the public face of the SFC, this is, to some extent, a matter of style and of the personalities of the individuals involved. We would suggest that there is no need to adopt a hard and fast rule, although we acknowledge that the decision as to who represents the public face of the organisation, on which occasion, could well have a bearing on the issue of who, in the eyes of the public, should be held accountable for any major deficiencies. The question of the detailed allocation of roles of representation between the chairman and the CEO on different issues could be agreed between the chairman, the CEO and the governing board in due course.

In the light of the above, we believe that it would be helpful if the key responsibility of the CEO set out in paragraph 9(c) of the Administration's paper were to be more clearly-defined, so as to avoid any confusion or overlapping of the roles and responsibilities of the CEO and the chairman:

9(c) *developing and delivering the strategic objectives agreed with the governing board*

As we see it, there could be a conflict between the responsibilities referred to in paragraphs 8(b) and 9(c). The responsibility for "developing" the strategic objectives of an organisation should be the role of the governing board, whereas the CEO's responsibilities should include implementing the policies and achieving the strategic objectives determined by the board. Nevertheless, the CEO may also contribute towards the development of the strategic objectives.

We would like to draw your attention to **Section 6** of our public sector corporate governance guide – ***Organisational Structures and Processes***, in which the respective roles and responsibilities of the governing board, the functional board committees, the chairman, the non-executive members of the board and the executive management of the organisation are set out. The Panel on Financial Affairs may wish to make reference to the Institute's guide when considering the specific roles and responsibilities of the chairman and the CEO.

We would also recommend that, apart from having well-defined roles and responsibilities, the respective accountabilities of the chairman and the CEO should be established clearly. We suggest that the chairman should be accountable to stakeholders for the SFC's policy and management issues, whereas the CEO should be accountable to the governing board for the operation and performance of the SFC and the implementation of the board's strategy and policies.



(iv) Part-time or full-time

We are of the view that it is not necessary to define the chairman as either a “full-time” or a “part-time” chairman. The role and responsibilities of, and expectations on, the chairman should be specified clearly and in some detail and, thereafter, the incumbent should be given the flexibility to decide how much time is required to fulfil the requirements of the position.

It is essential that the chairman should have, not only the competence to undertake the prescribed role and responsibilities, but also sufficient time and dedication to devote to the SFC’s affairs and the ability to obtain the support and confidence of the governing board members.

C. Other matters

(i) Remuneration

In our view the non-executive chairman of the SFC should be adequately remunerated having regard, on the one hand, to the role and responsibilities of the position and, on the other hand, to the fact that he should be non-executive and not an employee of the SFC.

(ii) Identification of independent non-executive directors

As a general matter, those members of the governing board of public sector organisations that are regarded as being independent non-executive directors (INEDs), as opposed to being only NEDs, should be clearly identified in the organisations’ annual report and other appropriate external reports, and the criteria for assessing independence should be made clear.

We hope that you find our comments to be useful and constructive. If you have any questions on them, please contact the undersigned or Mr. Peter Tisman, Technical Director (Business Members and Specialist Practices) at the Institute.

Yours sincerely,

WINNIE C.W. CHEUNG
CHIEF EXECUTIVE & REGISTRAR
HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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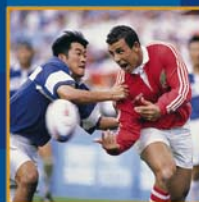
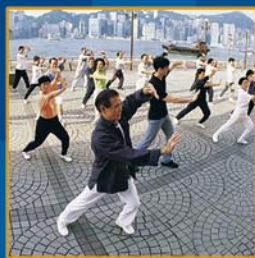
Hong Kong Society of Accountants

Corporate Governance

for

Public Bodies

A Basic Framework



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President's Message

I am pleased to note that the Hong Kong Society of Accountants continues to play a significant role in promoting greater awareness and higher standards of corporate governance in Hong Kong. This new guide, *Corporate Governance for Public Bodies – A Basic Framework*, contains key principles and recommendations on best practice for the boards of public sector organisations. It is our eighth publication in almost the same number of years and confirms our commitment to the cause of good governance.

Although the origins of corporate governance can be found in the desire to improve the transparency and accountability of financial reporting by listed companies to their shareholders, it has since developed far beyond this. Transparency and accountability remain fundamental elements and now embrace, amongst other things, effective communications with a more diverse range of stakeholders, both internal and external, on a wider range of issues. The “footprint” of corporate governance is also larger, having extended from the private sector into the public sector with the desire for greater efficiency and economy in the deployment of public resources, and higher expectations in respect of openness and accountability in this sector.

I hope that this new guide, in addition to being of direct practical benefit, will help to stimulate more discussion and interest in the subject of corporate governance. I also hope that it will foster an appreciation of the need to monitor and upgrade standards over time, given the importance of good corporate governance in both the private and public sectors to Hong Kong's continuing success and prosperity.

Roger Best

President,
Hong Kong Society of Accountants

May 2004



Foreword


Since the formation of the Corporate Governance Committee in 1995, the Hong Kong Society of Accountants has been taking a proactive role to promote the practice of good corporate governance in Hong Kong and internationally. It has published seven guides for use by the commercial sector.

This new publication, *Corporate Governance for Public Bodies – A Basic Framework*, is prepared to address specifically corporate governance in the public sector. The aim of this guide is to provide a basic framework of corporate governance principles and recommended best practices for public sector organisations.

Public sector organisations in Hong Kong make a vital contribution to our community by providing a range of essential public services, in areas such as healthcare, welfare, housing, education, transportation and regulation of the markets. The effectiveness with which they provide those services, and the efficiency with which they utilise the public resources at their disposal, are matters of considerable public interest. Yet, there is no common approach or guidance in the public sector in relation to even such basic matters as reporting on performance and communicating with stakeholders, let alone standards.

Public sector organisations in Hong Kong are many and varied in terms of, for example, their nature, size and modus operandi. For the more sophisticated organisations enjoying substantial resources, some of the recommendations in this guide may represent only a starting point, while for smaller organisations with limited resources, some recommendations may reasonably be regarded as longer-term targets that would need to be adopted in stages, having regard to their present circumstances.

For all public sector organisations, good corporate governance practices should assist and encourage their governing boards, councils and management to establish and maintain a clear focus on performance, transparency and accountability. Such practices can highlight to board members the importance of key board functions, such as providing strategic direction and developing proper business plans and strategies, establishing realisable financial and non-financial benchmarks of performance, ensuring effective monitoring of compliance with relevant laws, regulations, standards and guidelines, instituting sustainable human resources and remuneration policies, and ensuring the adequacy of financial systems and controls, and risk management policies and practices.



However, good systems, processes and organisational structures are not a panacea for all the potential pitfalls and problems that may arise in the day-to-day operations of public sector organisations. Personal integrity, and the right mix of skills and experience amongst the individuals involved at the board level, including executive and non-executive board members, and the management and employees in such organisations are also essential components of their overall success.

It is clear that the environment in which public sector organisations operate, and the rights and expectations of stakeholders and the public interest are evolving rapidly. In this dynamic and challenging environment, I hope that members of the Hong Kong Society of Accountants, and others, who serve on the boards and management of public sector organisations, will find this guide to be of benefit in helping them to understand and discharge their duties, and that it will enable them to highlight areas to which their boards may need to pay particular attention. Boards may wish to consider tabling the guide for discussion and implementation.

I wish to express my deep appreciation for the time and effort that the convenor and members of the Task Force, members of the Corporate Governance Committee, and the secretariat of the Hong Kong Society of Accountants have devoted to producing this guide.

Edward K.F. Chow

Vice President, and Chairman, Corporate Governance Committee
Hong Kong Society of Accountants

May 2004



Composition of the HKSA Corporate Governance Committee

Chairman:	Edward K.F. Chow	China Infrastructure Group Holdings Plc.
Deputy Chairmen:	Judy Tsui Jim Wardell	The Hong Kong Polytechnic University CCIF Corporate Advisory Services Ltd.
Members:	Michael K.H. Chan David Cheng Richard George Gordon W.E. Jones Quinn Y.K. Law Stephen Lee Fanny Li Kenneth G. Morrison Peter Nixon Nigel Reid James Siu Richard Sun Tommy Tam Nancy Tse	Lam Soon (Hong Kong) Ltd. HLB Hodgson Impey Cheng Deloitte Touche Tohmatsu Companies Registry The Wharf (Holdings) Ltd. KPMG BDO McCabe Lo & Co. Moores Rowland Mazars Potential Associates Ltd. Ernst & Young Li & Fung Ltd. PricewaterhouseCoopers National Electronics (Consolidated) Ltd. Hospital Authority
Secretaries:	Peter Tisman Mary Lam	Technical Director (Business Members & Specialist Practices), HKSA Assistant Director (Business Members & Specialist Practices), HKSA

Composition of the Public Sector Corporate Governance Task Force

Convenor:	Nancy Tse	Hospital Authority
Members:	Gordon W.E. Jones Peter Nixon James Siu Richard Sun Judy Tsui Jim Wardell	Companies Registry Potential Associates Ltd. Li & Fung Ltd. PricewaterhouseCoopers The Hong Kong Polytechnic University CCIF Corporate Advisory Services Ltd.
Secretaries:	Peter Tisman Mary Lam	Technical Director (Business Members & Specialist Practices), HKSA Assistant Director (Business Members & Specialist Practices), HKSA

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1. Introduction

What is corporate governance and what is its scope?

1. Broadly speaking, the term “corporate governance” refers to the processes, and the related organisational structures, by which organisations are directed, controlled and held to account. It *“involves a set of relationships between an organisation’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the organisation are set, and the means of attaining those objectives and monitoring performance are determined.”*¹
2. Good corporate governance assists the board and management to pursue objectives that are in the interests of the organisation and its stakeholders, facilitates effective monitoring and encourages an organisation to use its resources more efficiently.
3. The issue of corporate governance has been high on the agenda in the private sector for more than a decade. The focus has been primarily on listed companies and the role of the board not only in providing a strategic direction for the company, but also in ensuring that the company is responsive to the broader interests of shareholders and stakeholders, rather than merely the interests of controlling and major shareholders and executive management. Transparency, accountability and integrity are key concepts in the promotion of good corporate governance.

Background information

4. Important work in governance was carried out in the late 1980’s and early 1990’s by, amongst others, the National Commission on Fraudulent Financial Reporting (“Treadway Commission”) in the United States (“US”), and the Committee on the Financial Aspects of Corporate Governance (“Cadbury Committee”) in the United Kingdom (“UK”). In 1999, the subject was taken up at the global level when the Organisation for Economic Co-operation and Development (“OECD”) published *Principles of Corporate Governance*. In June 2003, the OECD issued a status report and a set of recommendations for the further development of corporate governance in Asia, entitled, *White Paper on Corporate Governance in Asia*. Following consultation, an updated and expanded version of the *OECD Principles of Corporate Governance* was issued in April 2004.

¹ Adapted from the preamble to the Organisation for Economic Co-operation and Development (OECD)’s *Principles of Corporate Governance*.

5. In Hong Kong, the Hong Kong Society of Accountants (“HKSA”) has been closely involved in the promotion of better standards of corporate governance over the past nine years. The HKSA issued its first report, *Report of the Working Group on Corporate Governance*, in 1995 and has in all produced seven reports on different aspects of corporate governance prior to this document. A full list of these publications can be found in Appendix I. In addition, the HKSA instituted an annual *Best Corporate Governance Disclosure Awards* competition in 2000 to give recognition to those companies/organisations whose annual reports set the standard in terms of the quality and extent of corporate governance disclosures and the soundness of the companies’/organisations’ underlying governance structures and practices.
6. In the context of *the Awards* competition, the judges noted the difficulty of assessing the Public sector/Not-for-profit organisations category because of the absence of corporate governance benchmarks and generally-accepted standards in the public sector. One of the reasons for the lack of benchmarks is that corporate governance in the public sector has generally received less attention than that in the private sector. However, private sector business models are now being adopted more often in the public sector, as pressure on resources has led to greater commercial awareness and concern about value-for-money, as well as demands for more openness and accountability. As a result, the focus is now also turning towards improving corporate governance in the public sector.

The importance of good corporate governance in Hong Kong

7. The HKSA believes that in order to remain successful in an increasingly competitive global investment market, Hong Kong must continue to be a regional leader in the development of its corporate governance regime and standards, in terms of both the statutory and regulatory framework and the prevailing practices. While this is hardly open to doubt in relation to the listed company sector, we believe it is equally true for the public sector because public sector organisations –
 - make a vital contribution to the well-being, success and prosperity of our community, through the provision of essential public services, such as transport, health, education, housing and the regulation of key markets and industries. Good governance contributes to the effective performance of these roles;




- are accountable to the public for the proper use and stewardship of the funds and other assets with which they are entrusted. Good governance and appropriate checks and balances serve to gain and maintain that trust;
- rely on the continuing support and confidence of their stakeholders including, as the case may be, customers, employees, lenders, suppliers and business partners. These stakeholders need to be assured of the quality and the ethical standards of the public bodies with which they deal; and
- are expected by the community to set an example in terms of transparency, openness, accountability, and organisational and personal integrity, in relation to matters such as human resources, procurement, remuneration and disclosure policies. In doing so, public sector organisations can set the tone or standards of governance and ethical behaviour for the wider business community.

Differences between public sector and private sector corporate governance

8. In the field of public sector corporate governance, the work of the Committee on Standards in Public Life (“Nolan Committee”), established in the UK in 1994, has helped to identify the key personal qualities required of governing board members as well as senior management of public sector bodies. Other work on public sector corporate governance is also being undertaken, and studies and guidance have also been issued, in various jurisdictions, by officially-appointed and professional bodies.
9. In August 2001, the International Federation of Accountants (“IFAC”) issued a report entitled, *Governance in the Public Sector: A Governing Body Perspective*, (“IFAC Study”)². The IFAC Study provides a comprehensive international benchmark for public sector corporate governance and in preparing this guide, the HKSA has drawn on it.
10. Whilst it is difficult, and it would not be appropriate, to adopt a “one size fits all” approach in the public sector, given the fact that public sector bodies operate in different statutory, regulatory and managerial frameworks, nevertheless, certain fundamental principles are common to all such entities. The IFAC Study notes that “*public sector entities have to satisfy a complex range of political, economic*

²Study 13, IFAC Public Sector Committee



and social objectives, which subject them to a different set of external constraints. They are also subject to forms of accountability to various stakeholders, which are different to those that a company in the private sector has to its shareholders, customers etc.” The stakeholders in public sector entities may be many and varied, “each with a legitimate interest in public sector entities, but not necessarily with any ‘ownership rights’.”³

11. Although the private sector model of corporate governance, which tends to view shareholders as the main stakeholder group, requires some adaptation for the public sector, many of the underlying principles of good corporate governance still apply. In the public sector, specific user groups, those directly responsible for funding, and the community at large, from which public resources ultimately derive, assume a greater importance as stakeholders. However, the pivotal role of the governing board and the issues of transparency and accountability are as relevant to the public sector as they are to the private sector.
12. Accountability for the use and stewardship of public funds and assets (including direct subventions and designated streams of public revenue, and other benefits, such as free or concessionary land grants and nominal rents) is a particularly important concept in the public sector.

³IFAC Study, paragraph.005



2. Objective of the Framework

Purpose of the guide


13. In contrast to the situation of companies formed and registered or listed in Hong Kong, which are governed by the Companies Ordinance (Cap. 32), and/or the Listing Rules, there is no predominant legislative or regulatory framework applicable to public sector organisations. The purpose of this guide, therefore, is to provide guidance on a basic framework for public sector corporate governance by outlining common principles that are applicable to most categories of public sector organisations, and by recommending good corporate governance practices.
14. However, not all of the recommendations contained in the guide will be applicable to all organisations, particularly very small organisations that do not operate through a traditional governing board structure. At the other end of the spectrum, large complex organisations will need to build upon the outline contained in this guide in order to achieve an effective and sufficiently extensive corporate governance system.

Diverse nature of public bodies

15. Terms such as “public sector organisations” or “public sector bodies” can encompass a diverse range of entities including “quasi-profit-orientated”, largely or fully self-funding and subvented bodies.
16. In addition, there are other entities, which may serve a public purpose, e.g. the promotion of recreation or art, that are in receipt of “benefits in kind”, such as concessionary land or nominal rentals. While there is a public interest element in the functions they perform, and for this reason they receive government support, they cannot be properly regarded as public sector organisations. In this respect they are more akin to charities which, if they meet criteria laid down by the Inland Revenue Department, are eligible for a tax exemption concession, which is another form of subvention.

Scope of the guide

17. This guide is directed primarily at the types of entities referred to in paragraph 15, but the principles and recommendations contained in it may also be relevant to entities referred to in paragraph 16, at least in relation to the accountability



for the public benefits that they receive. For this reason, non-subvented, non-governmental organisations (“NGOs”), charities, clubs and societies that fulfil a “public good”, and which receive benefits from the public purse, directly or indirectly, are also encouraged to draw on the recommended practice contained in this guide.

18. Nearly all significant public sector organisations will be under the direction of some form of board or governing body (referred to in this guide as “the governing board”), that is a group of people who set the organisation’s strategic direction, provide leadership, define its control mechanisms, and take overall responsibility for its performance and for reporting on its operation, stewardship and performance to stakeholders.
19. This guide addresses those organisations that have in place or should have in place a governing board. As stated above, in some cases, it may need to be adapted to the particular circumstances of the entity concerned.



3. Fundamental Principles and Personal Qualities

20. Three commonly accepted fundamental principles of good corporate governance were identified in the report of the Cadbury Committee (“Cadbury Report”)⁴. These are – **Openness, Integrity and Accountability** (“Fundamental Principles”). In the context of the Cadbury Report they were used to apply to the corporate governance of listed companies and with a particular emphasis on financial reporting (see Appendix II(A)). However, they have come to be accepted as having a wider application. They are now regarded as being relevant not only to financial reporting but more broadly to a company’s key processes, practices and communications.
21. The IFAC Study adapts them to the public sector having regard also to the key personal qualities required of members of public sector boards (see Appendix II(B)).
22. While the principles were originally targeted at the “organisational level”, the Cadbury Committee was aware that, in practice, adherence to them is also dependent upon the individuals that implement them. The Cadbury Report therefore acknowledged that “the integrity of reports depends upon the integrity of those who prepare and present them”.⁵
23. Other studies have considered the personal qualities that are needed by those taking up senior positions in public life in order to fully discharge their responsibilities, notably the work of the Nolan Committee (see paragraph 8 above), the first report of which was published in May 1995. The Nolan Committee identified key personal qualities, referred to as the Seven Principles of Public Life (“Personal Qualities”). These are **Selflessness, Integrity, Objectivity, Accountability, Openness, Honesty** and **Leadership**. We believe that emphasis should be placed on the Personal Qualities because they are the foundation upon which good governance is built. (See Appendix III for a more detailed description of the Personal Qualities.)

⁴ Report of the Committee on the Financial Aspects of Corporate Governance (UK, 1992)

⁵ Cadbury Report, paragraph 3.3

4. Application of the Fundamental Principles and Personal Qualities

24. The Fundamental Principles and underlying Personal Qualities are reflected in each of the main areas or “dimensions” of the governance of public sector organisations discussed in this guide, which are –

- **Standards of Behaviour**
- **Organisational Structures and Processes**
- **Risk Management and Control**
- **Accountability, Reporting and Disclosure**

25. This guide derives a set of recommendations on public sector corporate governance from applying the principles and qualities to the dimensions referred to above. The scope of the recommendations is illustrated below.

Standards of Behaviour		
<ul style="list-style-type: none"> • Ethical conduct <ul style="list-style-type: none"> ➢ <i>Personal Qualities</i> ➢ <i>Leading by example</i> ➢ <i>Integrity, honesty and objectivity</i> ➢ <i>Openness and accountability</i> ➢ <i>Selflessness and dealing with conflicts of interest</i> • Codes of conduct 		
Organisational Structures and Processes	Risk Management and Control	Accountability, Reporting and Disclosure
<ul style="list-style-type: none"> • Regulatory accountability • Accountability for public monies • Communication with stakeholders • Roles and responsibilities <ul style="list-style-type: none"> ➢ <i>Governing board</i> ➢ <i>Chairman</i> ➢ <i>Non-executive members</i> ➢ <i>Executive management</i> ➢ <i>Human resources and remuneration policies</i> ➢ <i>Staff training</i> 	<ul style="list-style-type: none"> • Internal control • Risk management • Internal audit • Audit committee • External audit • Budgeting and financial management 	<ul style="list-style-type: none"> • Internal reporting • External reporting • Use of appropriate accounting policies and standards • Performance measures

Adapted from the IFAC Study



5. Standards of Behaviour

Ethical conduct

Personal Qualities

26. Members of the governing board of a public sector organisation should endeavour to exemplify the Personal Qualities in their entirety. While, for the sake of simplicity, the illustrations below emphasise different qualities in different circumstances, in practice, these qualities are not completely separate and distinct from one another and they cannot be compartmentalised. They are interrelated elements of a single mindset that is required to uphold ethical and proper conduct in the public sector, and in combination they should underpin governing board members' participation in all organisational deliberation and decision-making.

Leading by example

27. As well as exercising leadership in relation to the direction and strategy of a public sector organisation, governing board members should lead by example in terms of their behaviour. They should observe the highest standards of conduct and serve as role models for those within the organisation. They must appreciate that they may also be expected to be seen by the wider community to be setting standards of good conduct.

Integrity, honesty and objectivity

28. It is important that members of the governing board demonstrate integrity and honesty in the handling and management of public funds and resources, as well as probity and care in safeguarding property, assets, confidential information, etc. Objectivity and fairness should be demonstrated in dealings with all stakeholders. Governing board members should not be influenced by prejudice, bias or conflicts of interest.

Openness and accountability

29. Being open is part of the process of being accountable, within any reasonable organisational constraints imposed in relation to confidentiality, and so governing board members need to be open and accountable to stakeholders for their part in the decision-making process.

Selflessness and dealing with conflicts of interest

30. Board members (and employees) of a public sector organisation should not use their position in the organisation mainly as a means to further their private business or other interests outside the organisation. Board members should always act and make decisions based on the public interest and the interests of the organisation, not primarily in order to gain financial or other material benefits for themselves, their family, friends, etc.
31. To this end, it is important that they are aware of, and take steps to address or, where possible, avoid altogether, any situations of conflict. While mechanisms, such as codes of conduct, requiring disclosure of interests and conflicts, should in principle be put in place, their effectiveness depends upon the mindset of the individuals concerned. Complete openness needs to be observed in relation to the disclosure of conflicts. The appearance of a conflict of interest can be as damaging as the existence of a real conflict, and governing board members therefore must strive to ensure that in all their activities, both professional and private, the appearance of conflicts as well as actual conflicts of interest are avoided.

Codes of conduct

32. The governing board should ensure that a formal code of ethical conduct is in place, defining standards of acceptable conduct for governing board members and employees. This should not require “reinventing the wheel” and could involve adapting or simply adopting an existing code. The breadth and depth of such code may also depend upon the nature and size of the organisation, but any code should as a minimum include mechanisms for recognising and dealing with conflicts of interest, including prescribing procedures for declaring interests. It should also make reference to the sources of relevant legislative and regulatory provisions, and to relevant guides issued for specific sectors. It would be advisable for the code to spell out the basic legal duties owed by governing board members and employees (see paragraphs 53-54 below).



6. Organisational Structures and Processes

33. At the organisational level, accountability to stakeholders is a key issue for public sector bodies. While the Personal Qualities should go hand in hand with the Fundamental Principles, as outlined above, an organisation still needs to establish an environment that reinforces and encourages the ethical and responsible conduct of the individuals working within it. This necessitates having structures and processes in place to ensure –
- compliance with statutory and regulatory requirements;
 - safeguarding of and proper and effective use of public funds; and
 - proper stewardship of assets and resources.

Regulatory accountability

Compliance with statutory and regulatory requirements

34. The governing board needs to establish effective mechanisms to ensure that it complies with all applicable statutes and regulations. Other than specific governing ordinances, these may include, for example, more general legislation and rules relating to public finances (e.g. the Public Finance Ordinance (Cap. 2), and the Audit Ordinance (Cap. 122), under which the Director of Audit has wide powers in relation to the audit of public monies). The governing board should also be aware of any relevant statements of best practice.
35. Many public sector organisations may have specific statutory functions and constraints on incurring expenditure, as well as responsibilities to deliver certain services. There may also be limitations and procedural requirements imposed on a public sector organisation by its own internal constitution. Mechanisms need to be in place to ensure that the organisation does not exceed its powers and that it complies with relevant legal and regulatory/administrative requirements. Larger organisations should consider designating a senior executive officer as a compliance officer to be responsible to the governing board for ensuring that the board is kept fully informed of the parameters within which it should operate and that it follows proper procedures to remain within those limits.

Accountability for public monies

Safeguarding of and proper and effective use of public funds

36. The governing board is accountable for the organisation's use of public funds. The board's responsibilities should include establishing suitable arrangements to ensure that public funds are properly safeguarded and are used efficiently and effectively, and in accordance with any governing regulations or requirements.
37. Its accountability to the public stems not only from the fact that the organisation receives funding that derives ultimately from taxpayers, but often also because the organisation is a monopoly service-provider or is operating in a non-competitive or protected market. The public may therefore have no choice but to use the services of the relevant organisation.
38. Amongst other things this accountability encompasses –
 - the stewardship of assets and resources (see paragraphs 39-43 below);
 - the financial performance, that is, the use of those assets and resources and the incurring of liabilities in the delivery of services (see paragraphs 146-153 below);
 - non-financial aspects of performance, including accountability for the organisation's priorities and the quality of service (see paragraphs 146-153 below); and
 - communication with stakeholders (see paragraphs 44-52 below).

Proper stewardship of assets and resources

39. Strategic responsibility for the proper management of public funds is a basic component of the accountability of the governing board, and larger organisations, in particular those that receive substantial funding, can expect to be subject to close scrutiny in relation to their use of such funds.
40. The governing board is in effect a trustee of public assets and, as such, it should ensure that those assets are employed effectively and in the best long-term interests of the beneficiaries, who are the members of the public using the relevant services and, at a broader level, the community as a whole.




41. At the highest levels, proper stewardship entails such activities as giving strategic direction, establishing and maintaining an adequate control system (see section 7 below), adopting reasonable, justifiable and transparent accounting policies and practices, establishing and maintaining open channels of communication, and conducting periodic reviews of systems and processes to ensure that they are working effectively.
42. At a more basic level, it entails matters such as ensuring that proper and adequate books and records are kept, that relevant supporting/source documents are retained, in an accessible form, that receipts and expenditure are properly recorded, and basic procedures are in place to safeguard against misuse of funds or theft of assets. In addition, suitable policies on the replacement of assets should be established and clear records on the utilisation of assets should be maintained.
43. Accordingly, the governing board of a larger public sector organisation, in particular, needs to ensure that the chief executive designates a suitably qualified senior person to be specifically responsible for ensuring that appropriate advice is given to the governing board on all financial matters, that adequate financial records and accounts are kept, and an effective system of internal financial control is maintained.

Communication with stakeholders

44. The governing board should make an explicit commitment to openness and transparency in all of the main activities of the organisation, subject only to the need to preserve confidentiality in those specific circumstances where it is proper and appropriate to do so.

Openness and transparency

45. Being fully accountable also requires being seen to be accountable. In this connection, the governing board needs to establish –
 - (a) clear and effective channels of communication with major stakeholders in relation, for example, to the organisation's mission, objectives and performance; and
 - (b) mechanisms to monitor the effectiveness of (a).

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46. The governing board needs to identify the organisation's stakeholders, which may include –
- the entity or individual (e.g. government bureau or department, or the HKSAR⁶ chief executive or relevant principal official) who is responsible for appointing the governing board and/or who has the front-line responsibility for appraising its performance;
 - the Legislative Council (“LegCo”): larger public sector organisations may be required to table their accounts in LegCo;
 - providers of resources, such as taxpayers, bondholders and creditors, and service providers and partners (e.g. employees, contractors, suppliers and other government entities);
 - users of the services, e.g. the specific sectors of the public, businesses and individuals that benefit particularly from the relevant services, and specific interest and consumer groups; and
 - the community generally, having regard to the public interest in relation to issues such as environmental protection and sustainability.
47. Communication should as a minimum be through periodic reporting (see section 8 below). It can also include publication of information on the organisation's website and/or through newsletters, press releases, press conferences and media briefings on specific or ongoing issues. At a more basic level, the governing board should ensure that clear points of contact for receipt of enquiries, suggestions, comments and complaints from stakeholders are established and sufficiently publicised, and a procedure laid down for dealing with and recording enquiries and feedback.
48. In order to be effective, communications should be focused. This may for example involve –
- establishing and publishing predetermined standards and measures of financial and non-financial performance (e.g. key performance indicators (“KPI”)) and reporting performance against them and other relevant benchmarks where available. This is all the more important given that, as pointed out above, public sector organisations are often operating in a monopolistic or non-competitive environment;

⁶Hong Kong Special Administrative Region



- publishing or making available information on significant areas of policy and practice, such as procurement and recruitment policies and internal codes of conduct;
 - informing stakeholders of their rights to information and services and the relevant procedures relating to exercising those rights;
 - developing and publishing formal procedures for external enquiries and complaints and for ensuring that enquiries, suggestions, comments and complaints are dealt with promptly and effectively;
 - publishing information periodically about the number and nature of complaints and how they have been dealt with;
 - developing and promulgating procedures for internal enquiries, comments and complaints and for soliciting constructive suggestions for improvements; and
 - setting in place procedures for employees to voice concerns or complaints about maladministration, breaches of the law or ethical concerns, in a supportive environment where they will be protected from reprisals. These should include clear channels for raising concerns with line management up to the chief executive and governing board members, as well as information on any appropriate independent bodies to which they may take their concerns if they are not satisfied with the action taken internally.
49. The governing board should ascertain whether it is covered by existing guidelines on access to information and, if it is not, should consider whether it should establish and publish its own guidelines. The general presumption is that as much information as possible about public sector organisations should be in the public domain, subject to properly defined confidentiality criteria and the requirements of personal privacy data protection legislation and guidelines. The governing board should also consider establishing standard procedures in relation to, the manner and timing of releasing information.
50. In communications with stakeholders, it may be helpful for the governing board to ask itself the following questions –



- Is the communication open and transparent?
 - Is it relevant and substantial?
 - Is it timely and clear?
 - Does it set out the position honestly and objectively?
51. The procedures for making appointments to the governing board should be reported transparently in an organisation's annual report and the names of all governing board members and their terms of office should be made publicly available. There is also a need to establish appropriate mechanisms and procedures to ensure that the governing board members disclose and declare their related interests. Such interests would include membership of boards or senior executive positions in other public sector organisations, any significant office-holding, including political offices, undertaken in the past five years, substantial shareholdings or senior executive positions in contractors for or business partners of public sector organisations.
52. Mechanisms should be put in place to periodically assess the effectiveness of the channels, processes and procedures for communicating with stakeholders. This should for example form part of any independent review of the operations of the organisation. Periodic surveys could also be conducted to gauge how satisfied stakeholders are with the exchange of communication and their views on how this could be improved.

Roles and responsibilities

53. Governing board members need to apprise themselves of their basic legal duties and responsibilities and potential liabilities. However well-intentioned they are, it is unlikely that they will be able to perform their role adequately if they are unaware of their basic legal duties and responsibilities towards the organisation that they serve.
54. In the case of organisations that are incorporated under the Companies Ordinance, for example, board members, as directors, will be required in the same way as their private sector counterparts, to fulfil fiduciary duties and the duty of skill and care, whether they are non-executive or executive board members. They should consider their possible liabilities as governing board



members and whether, for example, they are, or should be, covered by directors and officers' or other insurance, or whether they are provided with an indemnity if they have acted in good faith and without negligence. Some guidance on the duties of company directors in Hong Kong has been published by the Companies Registry (see Appendix IV) and by the Hong Kong Institute of Directors.

55. It is the duty of the governing board to ensure that the roles and responsibilities of the governing board, any committees of the board, the chairman, the non-executive members and the executive management should be spelled out clearly, including in the annual report or other public documents. The attribution of such roles and responsibilities should be checked against and comply with any relevant statutory requirements and constitutional documents of the organisation.

Governing board

56. The role of the governing board includes the provision of strategic guidance, oversight and monitoring, but it should not be involved directly in day-to-day management other than on a temporary basis in exceptional circumstances.
57. The board should meet reasonably regularly and members of it have collective responsibility for the stewardship of the organisation, including –
 - adopting a strategic planning process, involving:
 - defining and keeping under review the mission and the annual and longer-term objectives, and agreeing plans to achieve them; and
 - overseeing the delivery of the planned results by monitoring performance against the objectives and targets and ensuring corrective action is taken where necessary;
 - overseeing the appointment, compensation, development and, where necessary, replacement of senior management;
 - ensuring the integrity of the organisation's financial and non-financial reporting systems and formally approving and adopting the financial statements and the annual report;

- ensuring that high standards of corporate governance are observed at all times;
 - ensuring that the organisation complies with any statutory or administrative requirements for the use of public funds and that the board itself operates within the limits of its statutory authority and/or delegated authority;
 - ensuring that an effective communication policy is in place, in relation to both internal and external communications, and that its operation is monitored; and
 - establishing effective processes for identification and management of risks and an effective system of internal control.
58. An effective governing board that can give direction, oversee the organisation and monitor executive management is necessary in order for a public sector organisation to fulfil the objectives of being efficient and open in its operations.
59. The majority of non-executive members of the governing board should be independent of management and free from any business or other relationship that could materially interfere with the exercise of their independent judgment. Non-executive members considered by the governing board to be independent in this sense should be clearly identified in the annual report.
60. In order to strengthen the structural checks and balances, it is recommended that the roles of chairman of the board and chief executive be separated and that the positions be occupied by different persons. Ideally, the chairman should be an independent non-executive member.

Functional committees

61. The establishment of functional committees, e.g. audit, finance and human resources committees, involving non-executive members, is good practice for larger organisations. Such committees can help to provide the checks and balances that are necessary for an effective system of internal control (see section 7 below). They can also capitalise on the specific expertise and experience of individual non-executive governing board members and so help to refine and expedite the decision-making process. Functional committees should report regularly to the full board on progress and on decisions to be approved or ratified by the board.




62. Where functional committees are set up, their meetings should be properly minuted and records should be kept of their recommendations and decisions.

Delegation and reserved powers

63. To ensure that the direction and control of the organisation is firmly in its hands, the governing board should establish and maintain an up-to-date framework of delegated or reserved powers, including a formal schedule of those matters specifically reserved for the collective decision of the governing board.
64. The framework for delegating certain powers to the executive management should be in an explicit written form.
65. The governing board may have authority to delegate responsibility for specified matters to individual members or committees of the board. If this is to be done, it is important to ensure that the responsibility and accountability for decisions taken is clearly established.
66. The governing board should reserve strategic and other key matters, such as major decisions in relation to resources and senior appointments, for collective decision-making.

Governing board management best practices and procedures

67. Good management of the governing board is essential for the board to be able to carry out its oversight function effectively.
68. To support it in carrying out its duties, as part of the system of control (see section 7 below), the governing board of a public sector organisation needs to establish clearly-documented and well-understood management processes for policy development, implementation and review, decision-making, and monitoring, control and reporting. It also needs to develop formal procedural and financial regulations to govern the conduct of the board's operations. However, consideration may need to be given to the relative costs and benefits of such processes, procedures and regulations, having regard to the size and complexity of the individual organisation concerned.

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69. Matters dealt with in procedural documentation should include notice of meetings and arrangements for non-executive members of the governing board to call meetings, voting, records of attendance, any interests declared and how they were dealt with, and decisions made.
 70. At a more basic level, it is important that meetings are organised regularly, at least once every six months and in most cases more frequently, that they are run as effectively as possible, and that proper minutes and records of decisions are kept.

Appointments

71. There should be a formal process governing appointments to the governing board.
72. Where the governing board has responsibility for the appointment of its members, in the case of larger organisations, consideration may be given to forming a nomination committee, which should ideally contain a majority of non-executive members and be chaired by a non-executive member. The terms of reference of the committee should include ensuring that appointments to the governing board are made in accordance with specific criteria, which should have regard to competence and individual merit, in the light of the role the prospective candidate is expected to fulfil within the organisation.
73. The governing board should aim to have a good balance and an appropriate mix of individuals with a variety of skills, experience and backgrounds. In a large organisation, this should include members with expertise in areas such as operational and technical, financial, legal, government and regulatory matters. In smaller organisations, financial expertise, in particular, is important given the need to control and account for the use of public resources.
74. Non-executive members should be appointed for a fixed term. Their letters of appointment should set out clearly their duties and responsibilities, as well as any fee and/or arrangements in relation to expenses.
75. Senior executive members of the organisation should be appointed based on contracts or other terms approved by the governing board, which ideally should also contain performance standards.



Information, advice and training

76. The governing board of a public sector organisation should establish appropriate arrangements to ensure that it has access to all the necessary information, advice and resources to enable it to carry out its role effectively.
77. Members of the governing board should ensure that they are provided with all the information that they need to properly consider issues to be discussed at a governing board meeting, in good time before the meeting. There should be agreed channels for members who feel that they do not have all the information they require, to approach the management to obtain more information.
78. For public sector organisations in receipt of substantial funding, whose governing boards may be subject to greater scrutiny and accountability, there should also be agreed procedures for members of the governing board to obtain independent professional advice at the organisation's expense, if they consider this to be necessary for them to be able to fulfil their duties properly.
79. Members of the governing board should be provided with appropriate induction training upon their first appointment and opportunities for further training as necessary thereafter. Such training should amongst other things aim to enable members of the board to gain an understanding of both the public sector context in which the organisation operates and its specific operations and environment, as well as to enhance their awareness of public sector values and expectations in relation to the standards of integrity and accountability.
80. As part of the induction process, new governing board members should receive written information on the organisation's aims and objectives, control environment and control activities, including key policies and procedures, organisational risks and risk management practices, key personnel, delegation arrangements, governing board and staff structure, as well as its budgeting, planning and performance arrangements.
81. They also need to be made aware of their wider responsibilities as members of the governing board, particularly their duty to comply with the rules relating to the use of public resources, as well as their other duties, including the requirement to act in good faith and in the best interests of the organisation.

Chairman

82. The responsibilities of the chairman should be formally defined in writing. He or she should ensure effective implementation of the various aspects of the board's work, so that the governing board can successfully discharge its overall responsibility for the activities of the organisation. The chairman's roles include –
- providing leadership to the governing board;
 - facilitating board members to make a full contribution to the board's affairs, including ensuring that they are fully briefed on the terms of their appointment and on their duties and responsibilities;
 - ensuring that there is an effective process of review of the performance of individual members and of the governing board as a whole;
 - ensuring that key issues are discussed by the board in a timely manner, that the board has adequate support and is provided with all the necessary information on which to base decisions;
 - ensuring that the board takes proper account of statutory and other requirements and makes decisions based on a full consideration of all relevant issues;
 - ensuring that the governing board meets regularly and that minutes of meetings accurately record decisions taken, interests declared and, where appropriate, the views of individual board members; and
 - ensuring that the organisation communicates effectively with its stakeholders.
83. Given these pivotal responsibilities, the chairman must have not only the competence to undertake them, but also sufficient time to devote to the organisation's affairs and the ability to obtain the support and confidence of the governing board members.




Non-executive members

84. Non-executive members of the governing board should provide an independent judgment on issues of strategy, performance, resources and standards of conduct. Apart from any directors' fees that they may receive, they should be independent of the management and free from any other relationships that could materially interfere with their role. Their duties, terms of office, remuneration and the review thereof, need to be defined clearly.
85. Although maintaining a complete separation between non-executive board members and the management remains the objective, it is nevertheless recognised that in some smaller public sector organisations with limited resources, such a clear division, in practice, may not be possible.

Executive management

86. The chief executive should have line responsibility for all aspects of executive management, whether as a member of the governing board or not. He or she is accountable to the governing board for the performance of the organisation and the implementation of the board's strategy and policies.
87. In addition, a senior executive, normally a chief financial officer, whether a member of the governing board or not, should be made responsible for the matters referred to in paragraph 43 above, that is, to ensure that appropriate advice is given to the governing board on all financial matters, that proper financial records and accounts are kept, and that an effective system of internal financial control is maintained. Given the importance of the finance function, in the case of all other than smaller organisations, the responsible senior executive should be a qualified accountant and a member of a recognised accountancy body. For the same reason, if the responsible person is not a member of the governing board, he or she should have direct access to the board, or at least to the non-executive directors on the audit committee, if an audit committee has been formed.
88. A senior executive, whether a member of the governing board or not, should be given the role of compliance officer and made responsible to the board for the matters referred to in paragraphs 34-35 above, that is, to ensure that the board



procedures are followed, and that all the applicable statutes and regulations and other relevant statements of best practice are complied with. This is comparable to the role of a company secretary in the private sector.

89. It is good practice for the three roles indicated above to be taken up by three separate individuals in order to avoid a concentration of power and to ensure that proper checks and balances exist within the system. It is recognised, however, that this may not always be possible in smaller organisations.

Human resources and remuneration policies

90. A public sector organisation's overall human resources policy should include effective policies and procedures for the recruitment and retention of suitable staff. These in turn will need to take into account appropriate packages to attract, retain and motivate senior executives. Issues relating to the engagement and dismissal of staff may be subject to greater external scrutiny in the public sector and the broad policies in relation to such matters should be approved by the governing board.
91. A public sector organisation should establish formal and transparent procedures for developing policies on executive remuneration and, where applicable, for fixing the remuneration of individual members of the governing board. No member of the governing board or the management should be involved in deciding his or her own remuneration.
92. Non-executive members are not employees of the relevant organisation and are not paid for their services under a service or employment contract with the organisation, although they may receive a fee or honorarium having regard to their responsibilities and the time commitment required, and there should be arrangements for them to be able to claim out-of-pocket expenses.
93. To avoid potential conflicts of interest, the governing board may consider setting up a remuneration committee of independent non-executive members to make recommendations to the governing board, within agreed terms of reference, in respect of the organisation's framework for executive remuneration, and to determine specific remuneration packages for each of the executive members, including pension rights and any compensation payments. Where applicable, public service regulations need to be observed.



94. A proportion of the executive members' remuneration could be structured so as to link rewards to the organisation's and the individual's performance. The committee needs to be sensitive to the wider environment, including pay and conditions of service elsewhere in the public sector, when considering remuneration packages and annual pay reviews.

Staff training

95. The recruitment process and the conditions of employment, including training programmes, have an important role to play in determining the ability to attract and retain good, qualified financial and programme managers, as well as other staff.
96. Appropriate training opportunities, which can cater for the immediate requirements of the job as well as for career development, should be provided to all staff.
97. Staff should be appropriately supervised and be given regular feedback on their performance. Their performance should be evaluated against a suitable and clearly-understood profile.

7. Risk Management and Control

Internal control

98. The governing board needs to ensure that an effective system of internal control is in place and that it is operating effectively.
99. “Internal control” refers broadly to a process effected by the board, management and other personnel, designed to provide a reasonable assurance regarding the achievement of objectives in relation to the following –
 - effectiveness and efficiency of operations;
 - reliability of internal and external reporting; and
 - compliance with the applicable laws, regulations and internal policies, including corporate governance policies.
100. At a more fundamental level, the system of internal control is also an important means to ensure that the utilisation of public funds is properly accounted for and to avoid financial loss due to mismanagement, etc.
101. The system of internal control may be more or less extensive and complex depending upon the size of the organisation, quantum of public resources that it receives, the nature and degree of risks inherent in the organisation’s operations and objectives, etc. For some smaller organisations, it may not be cost-effective in terms of the manpower requirements, or they may lack the resources, to establish the complete segregation or division of posts and duties required for an extensive internal control system. Nevertheless, such organisations should take practical steps to avoid the situation in which the same individual is responsible for processing all stages of significant transactions from beginning to end without any objective third party input/review.
102. As part of the framework of control, the governing board of a public sector organisation should ensure that systems are established to identify and deal with risks, i.e., the uncertain factors that may impede or facilitate the achievement of organisational objectives.




Risk management

103. The process of “risk management” involves –
- understanding organisational objectives;
 - identifying the risks associated with achieving them and assessing the likelihood and potential impact of particular risks;
 - developing programmes to address the identified risks; and
 - monitoring and evaluating the risks and the arrangements in place to address them.
104. Risks may affect many areas of activity, such as strategy, operations, finance, technology and environment, and in terms of specifics may include, for example, loss of key staff, substantial reductions in resources, severe disruptions to the flow of information and communications (due to, e.g., computer viruses), fires or other physical disasters, leading to interruptions of business and/or loss of records. A public sector organisation should consider the need to develop a contingency plan for any major interruptions in its capacity to deliver services.
105. The governing board must understand what risks are acceptable to the organisation’s stakeholders, and employees of the organisation need to know what risks are acceptable to the governing board and the executive management. Recognition and communication of risks that have been accepted should be made explicit.
106. The systems and processes of control need to be sufficiently flexible to be able to change and adapt as the environment, the organisation and its objectives and activities change.

Internal audit

107. An effective internal audit function should be part of the framework of control, particularly for larger organisations. The main purpose is to provide for a degree of internal assurance in relation to the processes and systems for ensuring the completeness, accuracy and reliability of financial and other key information.

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108. In order to be effective, internal audit needs to be objective and, as far as possible, operationally independent of the management. Its work should also be given sufficient weight within the organisation, so that any significant matters of concern uncovered by internal audit are quickly brought to the attention of the chief executive officer, chief financial officer and the audit committee.
 109. The governing board, or the audit committee, if the authority has been delegated to it, should determine the scope of the internal audit. In general terms it should cover the systematic review of and reporting on the systems of managerial, financial, operational and budgetary control and their effectiveness, as well as the risk management processes.
 110. It is good practice for the chief internal auditor or, if there is none, for the chief financial officer, to have the right of direct access to the governing board or to the audit committee, through the board or committee chairman, as appropriate, on relevant matters of concern.

Audit committee

111. While it is good practice to have a separate audit committee, it is also recognised that, where an organisation has a small independent board and limited resources, the audit committee's functions may have to be taken up directly by the board.
112. The audit committee can play an important role in the control and risk management framework of an organisation. Amongst other things it can help to preserve the quality of information and ensure that the objectivity and independence of internal audit are not compromised.
113. The governing board of larger public sector organisations should aim to establish an audit committee, comprising non-executive members, which should have the responsibility, primarily, to independently review the financial information and the framework of control, in addition to the external audit process. There may also be other responsibilities delegated to the audit committee by the governing board, such as reviewing compliance with applicable laws and regulations, and the organisation's wider obligations to stakeholders and the community.



114. The audit committee should be a high level committee that is independent of the organisation's chief executive officer and executive management. Membership should be confined to non-executive board members, the majority of whom, including the chairman, should be independent non-executive members.
115. The chief financial officer, the chief internal auditor, if any, and other relevant members of the executive management, as well as the external auditors, should be invited to attend certain committee meetings as necessary.
116. Copies of internal audit reports should be forwarded to the audit committee and mechanisms should be in place for meetings between the audit committee and the internal auditor, independent of the management.
117. In order to ensure that the external auditors can carry out their work independently and objectively, there should also be mechanisms in place, such as private meetings between the audit committee and the external auditors independent of the management and/or regular reports made to the audit committee.
118. The audit committee should be able to obtain external professional advice and to invite outsiders with relevant expertise or experience to attend meetings, if necessary.
119. The committee should have a strong and independent chairman in order to function effectively. He or she should not be the chairman of the governing board and should not perform an executive role in the organisation, nor any other role that could conflict with his or her role as the chair of the audit committee. The chairman of the governing board should not normally be a member of the committee.
120. Members of the audit committee should possess the authority and the necessary skills and experience, and be prepared to deal with potentially complex financial, operating and other issues. The qualities required of members include sound judgment, independence of mind, objectivity, an inquiring attitude with a healthy degree of scepticism, and an ability to communicate effectively and confidently with the executive management. Members must also be prepared to devote a reasonable degree of time to participating in the work of the committee.

121. Further guidance as to best practice in relation to the composition, terms of reference, role and work of the audit committee, may be found in “*A Guide for Effective Audit Committees*”.

External audit

122. It is mandatory for public sector organisations incorporated under the Companies Ordinance, or under certain other ordinances, and is a good practice for other public sector organisations, to appoint an external auditor to conduct an audit of their financial statements. This will provide an objective and independent review of the financial reporting of the organisation, help to promote consistency and reliability in reporting and to ensure transparency and accountability in the use of financial resources.

Managing relations with external auditors

123. In the public sector particularly, the external auditors may also be in a position to review areas in addition to financial reporting. They may be asked to review compliance and governance reporting or, for example, to conduct, value-for-money and efficiency studies. Independent third party reviews of this nature can play an important part in enhancing the system of control. In this context, the governing board must ensure that an objective and professional relationship is maintained with the external auditors.
124. As suggested above, where an organisation has established an audit committee, which all but the smaller public sector organisations should aim to do, the audit committee, as a sub-committee of the governing board, should be responsible for managing the relationship with the external auditors.
125. Generally, where the external auditors are engaged to carry out non-audit work, the audit committee or, where there is no audit committee, the governing board, should satisfy itself that there are no conflicts of interest that might compromise the auditors’ independence, including those that may arise from the proportion of fees attributable to non-audit work relative to those for audit work.

⁷ Published by the HKSA in February 2002 (see Appendix I)



Budgeting and financial management

126. Budgeting is a key control process in the public sector. The governing board needs to maintain adequate oversight to ensure that procedures are in operation that will result in efficient and effective budgeting and financial management.
127. An annual budget should be prepared indicating how the resources allocated will be used. Budgeting should, as far as possible, be linked to a medium-term plan, containing measurable statements of the organisation's objectives, policies and priorities, strategies for achieving objectives and a resource framework. This encourages a clearer vision, enables proper forward planning to take place and facilitates the best use of resources over a longer time period.
128. The budget should explain the rationale for the proposed use of resources which is why it is important to identify objectives, priorities and activities. The annual budget and medium-term plan should be approved by the governing board.
129. Budgeting should be integrated with accounting and, as far as possible, a similar basis of accounting should be adopted for budgeting and financial reporting.
130. Regular monitoring against the budget should be conducted. Revenues and expenditures need to be compared with the budget and projections should be revised where necessary.
131. The governing board should also ensure effective and efficient processes of financial management are in place. The role of the financial management system is to support the management in its deployment of limited resources with the aim of maximising economy and efficiency in the delivery of the organisation's outputs.
132. Financial management includes day-to-day cash management as well as the formulation of longer-term financial objectives and strategies, encompassing areas such as capital expenditure planning, working capital management and funding and performance decisions.
133. The management needs reliable and useful information in order to evaluate the operations of the organisation. The information system and its operators should ensure that full and proper records are kept of the affairs of the organisation.

8. Accountability, Reporting and Disclosure

Internal reporting

Reporting by board (sub-)committees

134. Regular and informative reporting to the governing board is a pre-requisite for the effectiveness of committees, such as the audit committee. An organisation will not be able to benefit fully from the work of such committees unless they report their findings to the board.
135. Lines of reporting between the committees and the governing board should be formalised, normally within the terms of reference of the relevant committee. It is a good practice for the committee chairman to present periodic written reports to the board addressing the work and findings of the committee. Committees should generally circulate their meeting minutes to the board to keep the board informed of the committees' activities and recommendations on a regular basis.
136. Reports to the governing board and minutes of committee meetings should normally be formally approved by the relevant committee before being submitted to the board.

Reporting by the executive management

137. The executive management has the responsibility to support the governing board by, inter alia, ensuring that major issues, which may, for example, affect the overall performance of the organisation, are brought to the attention of the board in a timely manner and that all relevant information is presented in a clear and concise way. Financial and non-financial performance and other accountability information should also be reported to the board on a regular basis.

External reporting

138. The governing board of a public sector organisation should publish an annual report incorporating financial statements, on a timely basis after the end of the financial year. Larger organisations employing substantial public resources should also consider reporting certain key information on a half-yearly basis or more frequently. This may be achieved by posting such information on the organisation's website as well as, or instead of, issuing printed reports.



139. The annual report should provide a clear and objective account and assessment of the organisation's structure, activities, achievements, financial position and performance prospects. It should, as far as possible, include the following broad contents and disclosures –

- audited accounts and auditors' report, including a statement of going concern, as well as reference to the appointment of auditors for the coming year;
- statement of the role, functions, aims and objectives and structure of the organisation, a comparison of the performance over the year with the performance measures determined in the previous financial year, and an indication of the performance measures against which the following year's performance will be judged;
- statement of the governing board's accountability for the operation and the overall performance of the organisation;
- description of the Government's involvement in and support for the organisation;
- statement of the method and terms of appointment of the governing board members and disclosure of remuneration policy in relation to governing board members and senior executive management;
- if governing board members have been appointed pursuant to a specific statutory procedure or by a specific external nominating body, this should be stated. If they have an obligation to represent any particular interests by virtue of their appointment, such as the public interest, this should be disclosed;
- reference to the number of board meetings held during the year and attendance of individual members;
- reference to the establishment of any board committees, their terms of reference, the number of committee meetings held, the attendance of individual members and the main work carried out by the relevant committees during the year;



- honest and objective commentary on the organisation's financial performance and position, its non-financial performance and its ability to meet future liabilities and commitments;
 - results of any independent review of non-financial performance referred to in paragraph 153 below;
 - statement regarding the corporate governance policies of the organisation and assessment of how effectively they have been implemented;
 - statement in respect of internal control and risk management processes;
 - statement of accounting policies and practices, including the standards adopted;
 - statement of compliance with governing legislation and regulations; and
 - management discussion and analysis on the environment in which the public sector organisation delivers its services and the governing board's reaction to threats and changes in this environment.
140. As regards more detailed disclosures, disclosure of the total remuneration of board members and senior management should be made in the annual report. The number of governing board members and senior management whose remuneration exceeds a defined sum, expressed in bands, may also be disclosed. Such disclosure supports the governance principles of openness and integrity, particularly where members of the governing board have the ability to set their own remuneration.
141. Given the accountability of the governing board for the stewardship and the use of public resources, the board should formally approve and adopt the financial statements, and should include in the annual report a statement indicating its responsibility for, inter alia, approving the budget or financial plan and the year-end financial statements, ensuring the adoption and use of appropriate accounting policies and standards, and the maintenance of an effective framework of control.
142. It is a good practice for the annual report to be made publicly available as part of the process of public accountability and transparency.




143. In order to demonstrate its commitment to high standards of corporate governance, the governing board should include in the annual report a statement identifying the standards or code of governance adopted, or which the board aims to achieve, and indicating whether it has complied fully with relevant standards or code, or the extent to which it has complied.

Use of appropriate accounting policies and standards

144. To maintain transparency and enhance financial accountability, it is important that accounting policies and standards adopted in the preparation of financial statements are clear and consistent and that, subject to any specific requirements of applicable legislation, as far as possible, generally accepted accounting practice is followed.
145. The adoption of accrual accounting can assist in the monitoring of performance against objectives and also provides the information needed for cash management.

Performance measures

146. The governing board of a public sector organisation should establish and report on relevant financial and non-financial performance measures to ensure and demonstrate the efficient and effective use of resources.
147. Non-financial performance measurements are important in the drive to improve operations and deliver products and services of a good quality, at the least cost to the public purse.
148. Key performance indicators (“KPI”) provide a useful management and accountability tool, which is helpful for both internal and external users. Internally, information is required on the organisation’s effectiveness in order to improve efficiency and quality. Providers of resources may, for example, use performance information to help decide on the most appropriate allocation of resources within a particular sector, or whether a service could be undertaken more effectively by the private sector.

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149. Public sector accountability relates not only to the proper use of monies entrusted to a public sector organisation but also to the economy and efficiency with which it has used the available resources and the performance of the organisation against its objectives.
 150. As many public sector organisations are not profit-driven, unlike their private sector counterparts, performance measures need to be quantified in terms of identified goals and timeframes. They should attempt to reflect both quantity and quality.
 151. The most common bases of comparison for KPI include –
 - comparison with the performance of previous years;
 - comparison with similar organisations domestically and/or internationally;
 - comparison of actual performance against target performance.
 152. Benchmarking an organisation by measuring it against the best of its type anywhere in the world is a method that may be used to help organisational improvement, to develop better performance measurement systems, and to validate an organisation's operational position. In addition to external benchmarking, internal benchmarking may also be used to improve performance.
 153. Having regard to the importance of certain aspects of non-financial performance to a public sector organisation, the governing board should consider implementing regular independent external reviews and reporting to the board on the measurement and quality of such performance. The results of such external reviews should be incorporated in the annual report.



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Appendix I

HKSA's Publications on Corporate Governance

First Report of the Working Group on Corporate Governance (1995)

The First Report contained 19 recommendations for improved corporate governance standards and practices, covering broadly the role and responsibilities of the board of directors, financial reporting and audit/accounting, and observations relating to disclosures and corporate governance.

Second Report of the Corporate Governance Working Group (1997)

The Second Report contained the results of a detailed statistical survey of information disclosed on directors, shareholders and audit committees, as contained in the annual reports of listed companies in Hong Kong. The results of the survey also served to provide a factual basis for the further development and implementation of a number of the proposals made in the first study report.

A Guide for the Formation of an Audit Committee (1997)

The key recommendations were for the board to set up an audit committee with written terms of reference dealing clearly with the audit committee's authority and duties. The Guide also provided a basic model for the formation and composition of an audit committee (covering the structure, responsibilities and line of reporting), which companies should adopt having regard to their individual needs and circumstances.

The Stock Exchange of Hong Kong (SEHK) formally endorsed the establishment of audit committees by listed companies in 1998 by including the establishment of audit committees as part of its "Code of Best Practice". Reference was made to the Guide by SEHK as further information for the purpose of complying with the requirements of the Code.

A Guide for Directors' Business Review in the Annual Report (1998)

The Guide proposed a comprehensive framework for directors to discuss and analyse business performance, to enable investors and users of annual reports to improve their understanding of past performance with a view to enhancing their assessment of the future potential of the business.



Directors' Remuneration – Recommendations for Enhanced Transparency and Accountability (1999)

The publication provided further recommendations for enhancing transparency and accountability in relation to directors' remuneration. It also documented a comparative study on the disclosure requirements of directors' remuneration, covering Hong Kong and other principal financial markets, including the US, the UK, Singapore and Australia.

Corporate Governance Disclosure in Annual Reports – A Guide to Current Requirements and Recommendations for Enhancement (2001)

The Guide provided practical guidance and examples of corporate governance disclosures that would fulfil the regulatory requirements at that time in Hong Kong. It also included additional recommended disclosures that went beyond the then current rules and regulations and provided illustrations and examples to show how such voluntary disclosures might be presented.

A Guide for Effective Audit Committees (2002)

The Guide updated and superseded the first guide, "A Guide for the Formation of an Audit Committee" published in late 1997. This Guide emphasised effectiveness and focused on how an audit committee could best achieve its objectives and strengthen its operation. It addressed areas such as the committee's role, composition, relationships and procedures and practices.

(For information on obtaining copies of the above publications, see the HKSA's website at <http://www.hksa.org.hk/professionaltechnical/corporategov/index.php>)



Appendix II

Fundamental Principles of Corporate Governance

A) Cadbury Committee – the three key principles and their definitions

Openness (transparency): on the part of companies in relation to the disclosure of information, within the limits set by their competitive position, was seen as “the basis for the confidence which needs to exist between business and all those who have a stake in its success”.

Integrity: was defined as meaning “both straightforward dealing and completeness”. The Report stated that financial reporting, which was the primary focus of the Cadbury Committee, should be “honest and ... should present a balanced picture of the state of the company’s affairs”.

Accountability: The Report stated: “Boards of directors are accountable to their shareholders and both have to play their part in making accountability effective”, the former through the quality of information they provide and the latter through a willingness to exercise their responsibilities.

(Cadbury Report, paragraphs 3.2-3.4)

B) As adapted for the public sector in the IFAC Study

Openness

“Openness is required to ensure that stakeholders can have confidence in the decision-making processes and actions of public sector entities, in the management of their activities, and in the individuals within them. Being open through meaningful consultation with stakeholders and communication of full, accurate and clear information leads to effective and timely action and stands up to necessary scrutiny.”

Integrity

“Integrity comprises both straightforward dealing and completeness. It is based upon honesty and objectivity, and high standards of propriety and probity in the stewardship of public funds and resources, and management of an entity’s affairs. It is dependent on the effectiveness of the control framework and on the personal standards and professionalism of the individuals within the entity. It is reflected both in the entity’s decision-making procedures and in the quality of its financial and performance reporting.”



Accountability

“Accountability is the process whereby public sector entities, and the individuals within them, are responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance, and submit themselves to appropriate external scrutiny. It is achieved by all parties having a clear understanding of those responsibilities, and having clearly defined roles through a robust structure. In effect, accountability is the obligation to answer for a responsibility conferred.”

(IFAC Study, paragraph .065)



Appendix III

The Seven Principles of Public Life

- Selflessness:** Holders of public office should take decisions solely in terms of the public interest. They should not do so in order to gain financial or other material benefits for themselves, their family, or their friends.
- Integrity:** Holders of public office should not place themselves under any financial or other obligation to outside individuals or organisations that might influence them in the performance of their official duties.
- Objectivity:** In carrying out public business, including making public appointments, awarding contracts, or recommending individuals for rewards and benefits, holders of public office should make choices on merit.
- Accountability:** Holders of public office are accountable for their decisions and actions to the public and must submit themselves to whatever scrutiny is appropriate to their office.
- Openness:** Holders of public office should be as open as possible about all the decisions and actions that they take. They should give reasons for their decisions and restrict information only when the wider public interest clearly demands.
- Honesty:** Holders of public office have a duty to declare any private interests relating to their public duties and to take steps to resolve any conflicts arising in a way that protects the public interest.
- Leadership:** Holders of public office should promote and support these principles by leadership and example.

(Extracted from the "First Report of the Committee on Standards in Public Life", UK, May 1995)



Appendix IV

Non-statutory Guidelines on Directors' Duties

The Companies Registry of the Hong Kong SAR Government has published a set of “Non-statutory Guidelines on Directors’ Duties” to help company directors to better understand their roles. The objective of the Guidelines is to outline the general principles for a director in the performance of his functions and the exercise of his powers.

The general principles of directors’ duties are:

- Principle 1: Duty to act in good faith for the benefit of the company as a whole
- Principle 2: Duty to use powers for a proper purpose for the benefit of members as a whole
- Principle 3: Duty not to delegate powers except with proper authorisation and duty to exercise independent judgement
- Principle 4: Duty to exercise care, skill and diligence
- Principle 5: Duty to avoid conflicts between personal interests and interests of the company
- Principle 6: Duty not to enter into transactions in which the directors have an interest except in compliance with the requirements of the law
- Principle 7: Duty not to gain advantage from use of position as a director
- Principle 8: Duty not to make unauthorised use of company’s property or information
- Principle 9: Duty not to accept personal benefit from third parties conferred because of position as a director
- Principle 10: Duty to observe the company’s memorandum and articles of association and resolutions
- Principle 11: Duty to keep proper books of account

(Extracted from the “Non-statutory Guidelines on Directors’ Duties”, Companies Registry, January 2004. The full version of the Guidelines may be found at the Companies Registry’s website at: [http:// info.gov.hk/cr/download/ list/director_guide_e.pdf](http://info.gov.hk/cr/download/list/director_guide_e.pdf))



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