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Firm Valuation, and Dividend Payout: The Case of Hong Kong
Small-Cap Listed Firms**

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VOLUNTARY DISCLOSURE OF CORPORATE PRACTICES, FIRM VALUATION, AND DIVIDEND PAYOUT: THE CASE OF HONG KONG SMALL-CAP LISTED FIRMS

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ABSTRACT

Ownership of small Hong Kong companies tends to be concentrated, posing a threat of expropriation of minority shareholders despite the strong legal protection of investors. We investigate the relationship between corporate governance (CG) disclosure and firm valuation for small Hong-Kong firms, controlling for dividend payout and ownership concentration. We find CG disclosure to have a significant positive impact on firm valuation, even in a setting of strong legal protection. We also find firms with high CG disclosure pay lower dividends, suggesting investors view CG disclosure and dividends as alternative means of investor protection.

Our study has implications for managers and policy makers as it documents empirical evidence to show that voluntary disclosure of CG practices has tangible benefits. By voluntarily disclosing more about their CG practices, managers can improve their firm's market valuation, and investors seem to allow companies with more transparent CG practices to pay lower dividends. This is especially important for small-cap firms who may often encounter financing difficulty during their growth stage. To the policy makers, this study offers empirical evidence that investors would use voluntary disclosure of CG practices to scrutinise firms and make their investment decisions accordingly. Over-regulating may suffocate the firm's incentive and minimise the range of voluntary disclosure. In so doing, it may backfire and defeat the purpose of enhancing investor protection.

KEYWORDS

Ownership structure, corporate governance, dividend payout, agency models of dividends

1. INTRODUCTION

The primary aim of this study is to investigate whether a relationship exists between firm valuation and the voluntary disclosure of corporate governance (CG) practices by small-cap firms listed on the Hong Kong Exchange (HKEx). Hong Kong provides an unique example to study this relationship because (i) Hong Kong is renowned for its high level of investor protection due to its common law jurisdiction (see Beck *et al*, 2003; La Porta, Lopez-de-Silanes, Shleifer, and Vishny, henceforth LLSV, 1998); and (ii) the small-cap firms are dominated by high percentage of family ownership with the presence of a predominant shareholder or members of the same family (Chau and Leung, 2006). Family firms tend to disclose less voluntary disclosure (Chen *et al*, 2008). Very often, a small-cap firm is managed by its founder; and it is not uncommon in Hong Kong that both the founder and the founder's relatives sit on the board of directors (Chau and Leung, 2006; Ho *et al*, 2004). Their entrenched positions are further enhanced by the predominant shareholding that they own. With entrenched directors on board, the strategic decisions tend to be made quickly and informally. Typically in a small-cap firm, the rationale for appointing or firing key personnel is seldom disclosed to the outsiders.

Hong Kong small-cap firms are generally not cross-listed, and have limited analyst following. Therefore, a larger information asymmetry tends to exist between the management and outside investors for small-cap firms. If the regulations permit, small-cap firms could choose to disclose their state of CG practices as little as they please, or not to disclose at all as long as it is not against the HKEx regulations to do so. Given that the cultural environment of Asian Chinese firms does not encourage voluntary disclosure (see Chau and Gray, 2002; Chen and Jaggi, 2000)¹, to what extent then, does the voluntary disclosure of CG practices in the annual reports impact on the valuation of the firm? In this paper, we evaluate the *voluntary* disclosure of CG practices made

by the small-cap firms publicly traded on the HKEx, and investigate how it affects the firms' valuation and their dividend payouts.

The annual reports are likely to be a major source of information for outside investors to understand how the firm is being managed and whether their own equity in the firm is being treated fairly. Recent reports in Europe (Newby, 2001) and Asia (Lee, 2001) have shown that investors are increasingly basing on companies' CG records in the annual reports to make their investment decisions. Without such knowledge of a firm's CG, outside investors will be bearing a higher risk than the insiders (i.e., the managers) who are often the predominant shareholder in most cases of Hong Kong small-cap firms. Moreover, research studies have shown that better governance enables firms to access capital markets on better terms (Doidge *et al*, 2007). A firm of good CG should have a positive impact on its firm valuation. Indeed, surveys in the U.S. reveal that investors are willing to pay a premium for firms that show better CG (Coombes and Watson, 2000; Felton *et al*, 1996). This premium for well-governed firms is explained, in part, by the role of CG in a firm's overall risk management strategy (Bujaki and McConomy, 2002). Given that most small-cap firms in Hong Kong have predominant equity owners who bear most of the consequences of their own risk management, would the minority outside investor be willing to pay a premium for good-governance firms in Hong Kong? This paper aims at investigating this proposition by examining the relationship between firm valuation, as proxied by *Tobin's Q*, and the voluntary CG disclosure of the small-cap firms, as measured by a disclosure index (CGDscore).

Following previous research (Cremers and Nair, 2005; Gompers *et al*, 2003; Haniffa and Cook 2002) we measure CG disclosure by a disclosure index (CGDscore). We construct the CGDscore using a checklist based on the Appendix 23 of the *Listing Rules* (2005) of the HKEx. It is constructed to measure retrospectively the CG disclosure of the Hang

¹ Hope (2003) presents empirical evidence that, although legal origin is an important factor in explaining variations in firm-level disclosure, cultural values can shape a firm's reporting practice and can mitigate significantly the role of legal origin in firm's disclosure. Stulz and Williamson (2003) do not find correlation between legal origin and enforcement. However, they find evidence to establish a correlation between culture and enforcement. Hence, culture does play a role in explaining differences in disclosure practices amongst countries of the same legal origin.

Seng Hong Kong (HK) SmallCap Index in 2003-2005, when the disclosure of CG practices was not mandatory. We find that CG disclosure is positively associated with firm valuation, as proxied by Tobin's Q. Furthermore, firms with high level (i.e., higher than the median) of CG disclosure but low directors' ownership show the highest market valuation; whereas firms with low CG disclosure and limited directors' ownership appear to have the lowest market valuation.

1.1. Corporate governance disclosure practices in Hong Kong

When disclosure becomes mandatory, companies are obliged to comply with the regulatory bodies' requirements, resulting in no or little cross-sectional variation in disclosure. Compliance with the HKEx regulations, if in full, would therefore standardize the level of CG disclosure across all firms. However, as the HKEx adopts the comply-or-explain doctrine for the Code on Corporate Governance (the Code) in the *Listing Rules 2005*, member firms listed on the HKEx are able to deviate from full adherence to the disclosure requirements on their CG practices, so long as they can provide an explanation for not doing so. The resultant effect is that there had been great variations in terms of the CG disclosure amongst the Hong Kong listed firms before the implementation year (2005).

From 2003 to 2005, some firms had begun to incorporate the CG disclosure requirements into their annual reports. Furthermore, some companies opted to disclose more in-depth information regarding their CG practices than others. Without the fear of being penalised for non-compliance with regulations, these voluntary disclosures seemed to be all the more credible. Previous research on voluntary disclosure suggests that credible voluntary disclosure of non-financial information plays a pivotal role in investor decision-making (Healy and Palepu, 2001). An interesting empirical issue, therefore, is whether such differences in terms of voluntary CG disclosures would impact on firm valuation.

1.2. Research aims

If the voluntary disclosure is deemed to be credible and is found to be useful to outside investors, then more voluntary disclosure –

i.e. *on top of those mandatorily required* – should also have relevance to a firm's valuation. Our study addresses this question by evaluating the firm valuation, as proxied by Tobin's Q, in light of the level of voluntary CG disclosure, as measured by the CGDscore.

Even after the Code became mandatory, only 89% of all the 691 member issuers were found to comply with 41 or more of the 44 code provisions in CG disclosure in their 2005 annual reports; and 96% of the 1,114 issuers in their 2006 annual reports were found to comply with the Code at similar level². Why would some firms be more willing to comply with the CG Code than other firms? An investigation into the voluntarily disclosure behaviour of the firms may help shedding light on this question.

In this study, we focus on the CG disclosure behaviour of the small-cap firms *before* the Code was implemented, and thus make our analysis more pertinent to the literature of voluntary disclosure. Our findings suggest that investors reward those firms that have more voluntary CG disclosure with a *higher* market valuation and a *lower* demand for dividend payout. This has significant implications to the small-cap firms even the CG disclosure is now mandatory: if they want to stand out from their peers they need to disclose more than what the regulations are currently stipulating.

A second aim of this paper is to test the agency models of dividends (see LLSV, 2000a). LLSV propose two opposing models, namely, the *outcome agency model* and the *substitution model* of dividends. The outcome agency model suggests that dividends can play a useful role in mitigating the conflicts between insiders (i.e., controlling shareholders) and outsiders (i.e., minority shareholders) of a firm. By paying dividends, insiders return corporate earnings to investors rather than use them to benefit themselves. Moreover, a good investor protection environment would make asset diversion (e.g., tunnelling) legally riskier for the insiders, thereby encouraging them to pay dividends if the firm has no worthwhile investment opportunities. Viewed from this perspective, dividends are an outcome of an effective system of legal protection for shareholders.

² *Analysis of Corporate Governance Practices Disclosure in 2006 Annual Reports* (HKEx, 2008).

A logical extension of this outcome agency model of dividends is that, in a country with strong shareholder protection, shareholders who feel protected would accept lower dividend payouts, and higher reinvestment rates, from a company with good investment opportunities. On the other hand, if a good corporate governance firm is faced with mature or poor investment opportunities, the shareholders would expect the management to refrain from investing unprofitably. It follows that with strong shareholder protection and good corporate governance, high growth companies should have significantly lower dividend payouts than low growth companies.

The *substitution model* suggests that dividends are a substitute for external legal protection rights for the investors. In a regime with weak investor legal protection, outsiders would demand a higher dividend payout in order to minimize or discourage the holding of idle cash within the firm because they have no other protection mechanism to rely on (their last resort is to sell out all their shares). At the same time, LLSV posit that firms in a weak legal protection regime need to establish a reputation for treating all investors fairly if they want to attract external financing. Offering an attractive dividend payout rate provides a strong signal to outsiders that they can expect to share equally with insiders in the success of the firm. The final effect is that firms operating in a weak legal protection environment are expected to pay a higher dividend payout. What, then, if firms are operating in a strong protection environment but different in their CG disclosure? Would they be expected to pay different levels of dividends as their CG disclosure varied?

This study tests the above hypotheses using a sample of small-cap Hong Kong companies which are often owned by insiders or members of the same family. We find that dividend payouts are jointly affected by corporate governance disclosure and the level of directors' (i.e., insiders') ownership. Holding the level of directors' ownership constant, CG disclosure tends to have a substitution effect with dividend payout. On the other hand, if the level of CG disclosure is held constant, the dividend payout is significantly related to

the level of directors' ownership. In particular, firms with medium levels of directors' ownership (i.e., 25%-50%) exhibit the lowest dividend payout rate compared with firms that have low (0 – 25%) or predominant (over 50%) directors' ownership. The differences in dividend payouts for companies with different levels of ownerships are statistically significant.

Cross country studies on CG tend to affirm that legal system matters in explaining the relationship between a firm's performance and its CG (e.g., Anderson and Gupta, 2009; Beck *et al*, 2003; LLSV, 2002). They show that common law countries usually provide better legal protection to outside investors. Yet, the sample countries of these studies are mainly drawn from large corporations, which have a diverse ownership and do not often have a predominant share-holder (i.e. having more than 50% equity). In contrast, we use small-cap firms in our sample, which exhibit concentrated ownership with family members or trusted associates usually in charge (Claessens *et al*, 2000). As concentrated ownership and management by insiders are the norm rather than the exception outside of the US and UK (La Porta *et al*, 1999; Morck *et al*, 2005), our investigation will be more relevant to investors and policy-makers in most other countries where CG problems mainly involve entrenchment of the controlling owners.

Following LLSV (2000a) and Mitton (2004), this study also tests the outcome agency model of dividends. The results support the outcome agency model of dividends, which suggests outside investors would treat dividends as an additional protection mechanism for firms that may have either agency (or entrenchment) problems with low CG disclosure. It implies that, when minority outsiders are powerless to remove entrenched managers despite under a strong legal protection regime, they would anticipate a higher dividend payout to enhance their protection from the potential expropriation by the predominant shareholders. Voluntary disclosure of CG practices, as suggested by the empirical evidence of this study, does seem to have a mitigation effect on a firm's dividend payout.

We make several contributions to the literature. First, we document evidence that small-cap firms' voluntary CG disclosure can enhance firm value, no matter what levels of insiders' ownership. Our findings suggest that firms with higher voluntary CG disclosure rank (i.e., their CGDscore above the median) have a *Tobin's Q* generally higher than their counterparts with a low GC disclosure rank (i.e., CGDscore below the median) of comparable levels of insiders' ownership. Second, we find evidence to show that more voluntary CG disclosure can substitute for dividend payout. A small-cap firm that is more transparent in its CG disclosure can pay lesser dividend (and hence retain more earnings within the firm) and accumulate its internal capital at a faster rate. Third, given that the levels of CG disclosure and directors' ownership are endogenously determined by the insiders and are beyond the outsiders' control, the dividend payout becomes the insiders' response to the outsiders' demand for more investor protection. The dividend payout, though mainly decided by the insiders, acts as an additional means of protection to outside investors in order to avoid an undue suppression in the firm's valuation. Therefore, even though a common law regime is perceived as capable of providing strong investor protection (LLSV, 1998, 2000a), minority outsiders can still seek additional ways to protect themselves from potential expropriation by the controlling owners.

The remainder of this paper is organized as follows: Section 2 discusses some of the core prior literature on the relationship between corporate governance and firm value. Section 3 provides an overview of Hong Kong economy and listed companies in terms of their corporate governance characteristics. Section 4 describes the sample collection while the variables and hypotheses are described in Section 5. Our results are discussed in Section 6, while the final section concludes.

2. RELATED LITERATURE ON CORPORATE GOVERNANCE AND FIRM VALUE

The extant literature is replete with studies examining the relationship between ownership structure and firm value for US firms (e.g., McConnell and Servaes, 1990; Morck *et al*, 1988; Demsetz and Lehn, 1985;

among others). Other research focuses on non-US firms, and these are often cross-country studies. Several studies investigate how the macro corporate governance framework – the legal origin, the legislature and judicial systems, and the extent of legal enforcement of minority shareholders' protection – impacts on the firms' valuation and the capital market development (Boubakri *et al*, 2005; Lins 2003; Chang *et al*, 2000; Claessens *et al*, 1999; LLSV 1998). However, the sample firms tend to be large-capitalisation (large-cap) firms and the number of sample firms per country is usually restricted.

Cross-country research has documented that an economy's legal system and its legal origin would offer different degrees of investor protection. Common law economies (such as the US and the UK) tend to offer better outside investor protection than do the countries (such as France and Germany) that adopt a civil law system (Johnson *et al*, 2000b; LLSV, 1998). Furthermore, when investor rights are extensive and well enforced, investors are willing to finance firms located in such regimes (LLSV, 2000b). Results of a study comprising a sample of 539 large firms from 27 developed economies reported by LLSV (2002) support the view that better investor protection is associated with higher valuation of firms (proxied by the median *Tobin's Q*). The results also show that poor shareholder protection is penalized with lower valuation. LLSV conclude that investor protection is important for financial market development.

Regarding aspects of corporate governance other than ownership structure, the early non-US evidence tends to be focused on Japan, Germany, and the UK (Denis and McConnell, 2003, p. 11). While the UK is similar to the US in terms of diversity of ownership of firms, Japan and Germany have historically been bank-centred economies. Both Japan and Germany have a higher concentration in company ownership than other market-driven economies such as the US and the UK (Franks and Mayer, 2001; Morck *et al*, 2000; Edwards and Fischer, 1994). Moreover, Japan and Germany do not possess a common law legal origin, which LLSV (2000b) point out is one of the cornerstone

components of CG in providing investor protection.

Within the common law economies, there is some empirical research on the corporate governance issues for small-capitalisation (small-cap) firms in the US (Ang *et al*, 2000; Eisenberg *et al*, 1998). However, little work exists in the study of small-cap firms for other countries. Eisenberg *et al* (1998) find that there is an inverse relationship between board size and profitability for small- and mid-size companies in Finland. Klein *et al* (2005) find no evidence in Canada that a total governance index affects firm performance, whilst Switzer and Kelly (2006) provide evidence to the contrary in their study of Canadian small-cap companies and report that certain governance mechanisms do impact on firm's performance as measured by *Tobin's Q*.

Single country studies on non-US/UK firms often focus on the internal corporate governance mechanisms, such as the composition of the board of directors, the board size, and ownership structure. One characteristic of non-US/UK firms is that they tend to have higher ownership concentration. In the case of Asian companies, ownership is usually either tightly held by families (Claessens *et al*, 2000, for Hong Kong; Yeh *et al*, 2001 for Taiwan; and Joh, 2003, for South Korea), closely affiliated to banks (Hoshi *et al* 1990, for Japan), or it is controlled by the state or quasi-state institutions (Qi *et al*, 2000; Chen *et al*, 2006, for China).

As regards corporate governance research on Asian companies that are characterised by high concentration in ownership, Chen and Jaggi (2000) find empirical evidence to support a positive relationship between the proportion of Independent Non-Executive Directors (INED) on corporate boards and the comprehensiveness of financial disclosures for the 100 largest Hong Kong firms. Mak and Kusnadi (2005) also report an inverse relationship between board size and *Tobin's Q* in listed firms in Singapore and Malaysia. All these economies had once been UK colonies, and all of them have a common law legal origin. According to LLSV, common law regimes offer higher shareholder rights, creditor rights, and higher level of enforcement of investor-

protection laws (LLSV, 1998, 2000b). Yet, during the 1997-1998 Asian economic crisis, there were plenty of examples of expropriation of outside investors' holdings by the controlling shareholders of firms in Asian economies (see Johnson *et al*, 2000a; Mitton, 2002). Even *before* the 1997 economic crisis, empirical studies show that the controlling shareholders of Asian firms with poor internal corporate governance mechanism expropriated minority shareholders rights in times of low profitability (Joh, 2003). Internal corporate governance mechanism at firm level does seem to be as important as, if not more important than, external mechanism at country level.

Using data of firms from single Asian country studies, the literature reveals conflicting relationship amongst ownership structure, corporate governance disclosure, and dividend payout. For instance, based on a pooled sample of 412 large- and medium-sized listed companies in Hong Kong in 1995-1998, Chen *et al* (2005) find a *negative* relationship between dividend payouts and family ownership of up to 10% of common stock. However, they find a *positive* relationship when the family ownership rises within 10%-35%. Chen *et al* therefore posit that dividend payouts may be used by controlling shareholders as a way of extracting resources out of the firms.

In Australia, Setia-Atmaja (2009) studies 316 listed firms over the period 2000-2005 and investigates their relationship between ownership concentration, board independence, and dividend payout. He finds evidence for a positive relationship between board independence and firm performance, and that the performance impact of board independence is stronger in firms which have low dividend payouts. His findings suggest that an independent board (as measured by a higher proportion of independent directors on the board) enhances firm value, and that such a positive relationship is also found to be stronger in closely-held Australian firms. The findings by Setia-Atmaja are consistent with those of Bonn *et al* (2004), who document that a higher proportion of independent directors on the board leads to stronger firm performance (as measured by return on assets, ROA) in Australian firms but not in Japanese firms (*ibid*, p. 120).

Few studies look at small-cap companies where the founders would usually act as the Chairman of the Board as well as the Chief Executive Officer (CEO). In many cases, the founder would appoint his/her family members to sit on the board or to take up responsible managerial positions inside the firm (see Chen and Jaggi, 2000; Lam *et al*, 1994; Mok *et al*, 1992). If these small-cap firms aspire to become mid-cap firms soon, and hopefully large-cap firms in the future, they need to make an effort in communicating to the investors that a sound CG system is in place and implemented inside their organisations. This study, therefore, contributes to the limited extant literature by providing empirical evidence on governance mechanisms and firm valuation for *small-cap firms*. It also documents that investors do not rely entirely on the legislation for investor protection. They would also take into consideration the voluntary disclosure to form their investment decision in a strong legal protection regime such as Hong Kong. The results of this study will also supplement other disclosure studies carried out in other weaker legal protection regimes.

3. HONG KONG CAPITAL MARKET AND CORPORATE GOVERNANCE

3.1. Stage of development of the Hong Kong capital market

Hong Kong offers a unique setting for the study of corporate governance. First, it is a market-driven economy, with a strong emphasis on the rule of law. There are no barriers of market entry on foreign businesses. For 16 consecutive years (1995-2010), Hong Kong has been ranked first in the world in terms of economic freedom³. Interventions from the government in the capital market are rare. There are no restrictions on capital flows into or out of Hong Kong either. Hence, Hong Kong has much lower capital market frictions than elsewhere in Asia. Second, Hong Kong is one of the major players in the global financial markets. Hong Kong's

stock market was the 7th largest in the world, and the 3rd largest in Asia (it used to be second after Tokyo, but surpassed by Shanghai in 2007) in terms of market capitalisation as at end 2009⁴. In terms of total equity capital raised in the first half of 2009, Hong Kong ranked 3rd in the world and first in Asia⁵. Third, to sustain Hong Kong as a major financial centre in Asia, the Hong Kong Special Administrative Region (HKSAR) Government has been active in providing accounting regulations that meet international standards. Yet, it abstains from intervention in the financial markets. The open market policy has been credited for fostering a favourable environment for local and international business to operate. Furthermore, the HKSAR Government is committed to enhancing the CG of all the firms listed on the HKEx. In terms of investor protection, Hong Kong follows the international accounting standards and CG codes closely. The legal system is based on the UK's common law, and the development of CG regulations has been heavily influenced by the UK, as discussed in the following section.

3.2. Development of Corporate Governance in Hong Kong

Historically, many countries often developed or improved CG codes in response to capital market failures. In East Asia, the overhaul of listing regulations and company laws carried out in Thailand, South Korea, Indonesian, and Taiwan took place after the Asian financial crisis 1997-1998. In the case of Hong Kong, however, the CG reforms did not result directly from major company failure, but rather resulted from the *Cadbury Report in 1992* in the UK⁶. Earlier than most other Asian countries, Hong Kong commenced major CG reforms in 1995 when the Corporate Governance Working Group (later known as the Corporate Governance Committee, CGC) of the Hong Kong Society of Accountants (HKSA) compiled the first report on CG standards and practices. The report contained 19

³ Index of Economic Freedom 2009, the Heritage Foundation website, <http://www.heritage.org/index> (Accessed on June 30, 2010)

⁴ World Federation of Exchanges.

⁵ Financial Services Branch (2009) *Hong Kong: The Facts*, August 2009, The Information Services Department, Hong Kong Special Administrative Region Government. http://www.gov.hk/en/about/abouthk/factsheets/docs/financial_services.pdf (Accessed on March 21, 2010)

⁶ As a British colony before 1997, Hong Kong followed closely the UK accounting standards and financial reporting regulations then.

recommendations for improvement. In 1997, the CGC published a survey report (the "second report") on the contemporary disclosure in the annual reports of listed firms on directors, shareholders and audit committees. Based on the survey result, the CGC later issued a series of recommended guidelines⁷. These guidelines were accepted by the Stock Exchange of Hong Kong (SEHK) (later renamed as the Hong Kong Exchange (HKEx) after its public listing) as part of its *Code of Best Practice* in 1998.

Further development in CG in other advanced economies led Hong Kong to codify the recommended best practices into the *Code on Corporate Governance Practices* (the *Code*). In January 2004, the HKEx published an exposure draft to seek market views on the timing of the proposed implementation of the *Code*. There was a prolonged period of consultation. In November 2004, the HKEx formally adopted the recommended *Code* into their listing rules as *Appendix 14* which was to take effect from January 1st, 2005. All listed companies and issuers of securities on the HKEx were required to include a Corporate Governance (CG) Report in their annual reports. The CG report would be compiled according to the principles as set in *Appendix 14* and there is another *Appendix 23* that stipulates the contents of mandatory disclosure requirements as well as the recommended disclosures (*HKEx Listing Rule*, 2005).

3.3. Characteristics of Hong Kong Firms

Historically, most board members of Hong Kong firms would belong to the management team or to the family that owned the firm (SEHK, 1994) and "substantial shareholders are often themselves directors" (SEHK, 1996). In 1997, a survey by the Hong Kong Society of Accountants (HKSA)— now renamed as the Hong Kong Institute of Certified Public Accountants (HKICPA)— showed that there was a significant control of listed companies in Hong Kong by one shareholder or one family group of shareholders (HKSA, 1997). Concentrated ownership by families is not unique to Hong Kong firms. In fact, it is very

common in East Asian region (Luo, 2006). Claessens *et al* (2000) report that there is extensive family-controlled ownership in more than half of East Asian corporations, and that the top fifteen family controlled pyramids hold corporate assets worth 84% of GDP in Hong Kong.

A concentration of control could lead to the expropriation of minority rights by means of 'tunnelling' of company assets by the majority shareholders and raises the likelihood of crony capitalism (Johnson *et al*, 2000b; Claessens *et al*, 2000). Yet, Hong Kong differs from other Asian economies in that it adopts an Anglo-Saxon legal and corporate governance system (Cheung *et al*, 2005; LLSV, 1998). According to these studies, common-law economies (such as the UK, US, Australia, and Hong Kong) generally have the strongest legal protections of investors. Small minority investors can rely on the legal system and proper litigation procedures to provide themselves adequate protection from malpractices by the majority shareholders. However, Hong Kong differs from most other common law economies in that concentrated ownership prevails, often in the hands of few wealthy families, with the presence of predominant equity holding. A predominant ownership (i.e., 50% of shares plus one vote) legitimately entitles the majority shareholder a complete control over the use of the firm's assets, hence subjecting the minority shareholders to the tunnelling risk. As the HKSAR government tends to refrain from active interventions into the capital market, a study of the CG practices of the Hong Kong firms, and the voluntary disclosure thereof, would yield significant understanding of the roles of the CG Code in investor protection.

4. SAMPLE AND DATA COLLECTION

Our sample consists of small-cap constituent firms in the Hong Kong stock market index. The Hang Seng Composite Index Series (HSCI) covers 90% of the market capitalisation of stocks listed on the Main Board of the SEHK. However, some of the listed firms derive their main source of business income not in Hong Kong (e.g. in

⁷ A Guide for the Formation of Audit Committee (1997); Directors' Remuneration: Recommendations for Enhanced Transparency and Accountability (1999); Corporate Governance Disclosure in annual Reports: A Guide to Current Requirements and Recommendations for Enhancement (2001); A guide for Effective Audit Committees (2002), and Corporate Governance for Public Bodies: A Basic Framework (2004).

mainland China). The Hang Seng Hong Kong Composite Index (HSHKCI) thus came into being to cover the constituent stocks of the HSCI, which derive the majority of their sales revenue from Hong Kong or places other than mainland China. The HSHKCI has 3 sub-indices: the Hang Seng HK LargeCap Index (HSHKLI), the Hang Seng HK MidCap Index (HSHKMI), and the Hang Seng HK SmallCap Index (HSHKSI). The HSHKSI covers the 51st constituent stock and below in the HSHKCI by market capitalisation until the threshold of 90% is reached. As at September 2005, there were 55 stocks within this category.

This study focuses on the HSHKSI constituent firms. Of these 55 constituent stocks, 7 companies are excluded from this study⁸. The gross number of firm-years in the sample for 2003, 2004, and 2005 is 44, 48 and 48 respectively, giving a total of 140 firm-years.

Since the *mandatory* disclosure of corporate governance practices only came into being on January 1, 2005, any such disclosure by the listed firms in their annual reports *prior* to that date would be regarded as voluntary in the context of this study. The following sections of the companies' annual reports are screened to collect information regarding their CG practices:

1. Directors' Report;
2. Corporate Governance Report (if any);
3. Audit Committee Report (if any);
4. Remuneration or Compensation Committee Report (if any);
5. Nomination Committee Report (if any);
6. Auditors' Report;
7. Profile (or Biography) of Directors and Senior Management;
8. Corporate Information;
9. Financial Calendar (if any);
10. Investors' Relations (if any).

The information regarding their corporate governance is coded against a checklist, which is developed according to the Code Provisions and Recommended Best Practices as stipulated in Appendix 23 of the

Listing Rules (HKEx). The checklist consists of 66 single-barrel questions on CG disclosure, of which 2/3 belong to Code Provisions and 1/3 belongs to Best Recommended Practices. These questions may have 3 possible answers: 'yes' if there is disclosure of such contents in the annual report, 'no' if no disclosure is found, or 'not applicable' if the question does not apply to the sample firm in case. (For example, a question may ask whether a Nomination Committee has been set up. If a company has no Nomination Committee established, then the ensuing question on the disclosure of the composition of the Nomination Committee will have a 'not applicable' answer.) One mark is given if there is a 'yes' and nil for a 'no' answer. The total score of CG disclosure — the CGDscore — is the sum of all 'yes' answers, divided by the net number of relevant questions (i.e., 66 minus the number of 'not applicable' answers) and expressed in terms of percentage.

Since the checklist is derived from the *Listing Rules* effective January 1, 2005, the same checklist can be employed to indicate how well prepared and how willing these small-cap companies were to disclose their CG practices for 2003 and 2004 on a *voluntary* basis (as they had been informed by the HKEx in prior and consulted by the HKSA in the years leading up to the formalisation of the *Code on Corporate Governance Practices*). In other words, firms were already well informed of the need to disclose their CG before the regulation came into effect. They had been given the freedom to choose how much to disclose, or whether to disclose at all, in their annual reports prior to their fiscal year 2005. And even for the year 2005, firms were not penalised for not complying in full with the regulations provided they offered an explanation. Also, firms were exempted from compliance with the CG disclosure requirements related to their internal control if they were not ready during the first half of 2005. Therefore, the CG disclosure for 2005 can largely be considered as voluntary.

⁸ One of the companies was privatised in March 2006, thus no annual report for 2005 need to be published, while another company was acquired for its sole enlisted status by another non-constituent stock firm with a completely different business nature, and was subsequently disposed by the acquiring firm in September 2004. 5 firms in the Banking, Insurance & Financial Institutions sector are subject to close monitoring and tight regulations by the HKSAR Financial Services Branch, rendering their CG systems and practices significantly different from other companies.

5. RESEARCH MODELS AND VARIABLES DEFINITIONS

5.1. Corporate Governance and Firm Valuation

The first aim of this study is to analyse the impact of corporate governance disclosure on firm valuation. Following Morck *et al* (1988); McConnell and Servaes (1990); Kaplan and Zingales (1997); Gompers *et al* (2003); Cremers and Nair (2005); and Durnev and Kim (2005), firm valuation is proxied by the approximation of *Tobin's Q*, calculated as:

$$Q_{i,t} = \left(\frac{TA_{i,t} + MV_{i,t} - BV_{i,t} - Deferred\ tax_{i,t}}{TA_{i,t}} \right)$$

Where $TA_{i,t}$ is the total assets, $MV_{i,t}$ is the market value of equity, $BV_{i,t}$ is the book value of equity, and $Q_{i,t}$ is the estimate for *Tobin's Q* for firm i in period t .

The basic model (Model 1) used in this study is:

$$Q_{i,t} = \beta_0 + \beta_1 CGDscore_{i,t} + \epsilon_{i,t} \tag{1}$$

where $Q_{i,t}$ is as defined previously and $CGDscore_{i,t}$ is the corporate governance score for firm i in period t , while β_0 and β_1 are parameter estimates. ϵ is the error term.

This model is then extended to incorporate other aspects of a company's corporate governance, collectively named as CG practices variables which include: board size (BoDsize), the number of independent non-executive directors (NumINED), the proportion of the board members (INED%), percentage of common shares owned by directors (Dir%Own), and the duality of Chairperson and Chief Executive Officer (SplitRole). They are collectively termed as CG practices variables ($CGprac$) and their descriptions are shown in Table 1. Model 2, which is an extended version of Model 1, is given by:

$$Q_{i,t} = \beta_0 + \beta_1 CGDscore_{i,t} + \sum \beta_2 CGprac_{i,t} + \epsilon_{i,t} \tag{2}$$

where all terms in the equation are as defined previously (see Table 1).

Prior research also suggests a number of financial performance factors, which are

related to a company's characteristics and unrelated to a company's corporate governance, may also influence company valuation (e.g., Cheung *et al*, 2007; Berglof and Pajuste, 2005; Hutchison and Gul, 2004; Eng and Mak, 2003; Mitton, 2002; Chen and Jaggi, 2000). The model is therefore extended (Model 3) to take into account various company characteristic variables ($ComChar$) as control variables such as: company size (proxied by the natural log of equity, $LnEqty$), the capital structure (proxied by the debt ratio, $Debt/TA$), profitability (proxied by return on equity, ROE), sustainable income (proxied by the natural log of sale, $LnSales$), and growth potential (proxied by year-on-year sales growth, $SalGrow$):

$$Q_{i,t} = \beta_0 + \beta_1 CGDscore_{i,t} + \sum \beta_2 CGprac_{i,t} + \sum \beta_3 ComChar_{i,t} + \epsilon_{i,t} \tag{3}$$

where all terms in the equation are as defined previously (see Table 1).

5.2. Variables Computation

CGDscore is arrived at by adding the total sum of the disclosed CG practices, expressed as a percentage. It is also the summation of the following sub-scores based on the required disclosures as stipulated in the *Listing Rules* of the HKEx (see Appendix 1):

1. Dir_trans: Directors' securities transactions disclosure;
2. BoD_disc: Board of directors disclosure;
3. ChCEO_disc: Chairman & CEO disclosure;
4. NED_disc: Non-executive directors disclosure;
5. Rem_disc: Remuneration of directors disclosure;
6. Nom_disc: Nomination of directors disclosure;
7. Audfee_disc: Auditor's remuneration disclosure;
8. AudCom_disc: Audit committee disclosure;
9. OtherAdd_disc: Additional disclosure on the App. 14 Code Provisions;
10. Rec_Mgm-Sha: Recommended disclosure on management's share interests;

TABLE 1: DEFINITION OF VARIABLES

Name	Description
Dependent Variables	
Q (the approximation of Tobin's Q)	Total assets plus market value of equity, less the book value of equity and deferred tax, and scaled by total assets
CGDscore	Total sum of CG disclosure, expressed as a percentage of 'yes' answers to all applicable questions in the CG disclosure score sheet
Independent Variables	
CGprac	A set of CG practices variables which include: BoDsize, Dir%Own, INED%, SplitRole
ComChar	A set of company characteristics variables which include: LnEqty, Debt/TA, ROE, LnSales, and SalGrow
BoDsize	Number of members of the Board of Directors
Dir%Own	Percentage of common shares owned by directors
INED%	Number of independent non-executives as a percentage of the board size
NumINED	Number of Independent Non-Executive Directors on the board
SplitRole	Dummy variable; 1 if the chairperson's role is performed by separate individual from the CEO's, 0 otherwise
Control Variables	
Debt/TA	Debt/Total Assets ratio'
DivPay	Dividend payout ratio (= $DPS \times 100 / EPS$);
LnEqty	The natural log of a firm's equity
LnSales	The natural log of sales
ROE	Return on equity
SalGrow	Sales in year t less the sales in year $(t-1)$, and expressed as a percentage of sales in year t
Dummy Variables	
DV_LL	Low CG rank and low Director's Ownership
DV_LM	Low CG rank and medium Director's Ownership
DV_LP	Low CG rank and predominant Director's Ownership
DV_HL	High CG rank and low Directors' Ownership
DV_HM	High CG rank and medium Directors' Ownership
DV_HP	High CG rank and predominant Directors' Ownership
Source Variables and explanations	
BV	Book value of equity
DefTax	Deferred Tax
DPS	Dividend per share
EPS	Earnings per share
LnMV	The natural log of the firm's market value
MV	Market value of equity as at date of release of annual reports to the HKEx
TA	Total assets

- 11. Rec_Shd-rights: Recommended disclosure on shareholders' rights;
 - 12. Rec_Inv-Rel: Recommended disclosure on investor relations;
 - 13. Rec_Int-Ctr: Recommended disclosure on internal control;
 - 14. Rec_Mgm-fun: Recommended disclosure on management functions.
- SalGrow: the growth in sales revenue over previous year (%);
 - DivPay: the dividend payout ratio (= $DPS \times 100 / EPS$);
 - SplitRole: the dummy variable for split roles of the Chairman and CEO (1 for separate persons, 0 for same person).

Based on the information collected from the annual reports, the following *CG practices* variables (CGprac) are computed: BoDsize, INED%, Dir%Own, and SplitRole. The definition of each CG practice variable is presented in Table 1.

The accounting information and market data specific to these small-cap companies are collected from Datastream. They include the market value of the firm's equity (MV), the book value of the firm's equity (Eqty), the sales revenue (Sales), the return on equity (ROE), the debt ratio (Debt/TA), the dividend per share (DPS), the earnings per share (EPS), and the amount of deferred tax (DefTax) for the firm in the fiscal year. Based on such data, the dependent variable Q^9 and the following ComChar variables are computed:

- Q : the approximation of Tobin's Q ;
- LnEqty: the natural log of the firm's equity;
- LnSales: the natural log of the firm's sales revenue;

In addition to investigating the CGDscore and director ownership as separate and continuous variables, the interaction between them is also analysed. The firms' CGDscores are ranked into 2 categories at the median: Low and High. Similarly, the Directors' ownership of shares (Dir%Own) is also classified into 3 categories: Low (0-24.99%), Medium (25.00–50.00%), and Predominant (>50.00%). The grouping of firms between CG disclosure and director ownership is displayed in Table 2.

There are 6 combinations of CG_rank and Director Ownership groups (LL, LM, LP, HL, HM, and HP). In the regression, the High CG_rank and Low Directors' Ownership (HL) serves as the base group. Five dummy variables are then assigned to the rest of these joint groups. For instance, a Low CG_rank and Low Dir%Own (defined as DV_LL) is assigned a value of 1, and zero otherwise. The rest of the variables are defined analogously.

1. DV_LL: Low CG_rank and Low Dir%Own;
2. DV_LM: Low CG_rank and Medium Dir%Own;
3. DV_LP: Low CG_rank and Predominant Dir%Own;

TABLE 2: CORPORATE GOVERNANCE AND DIRECTOR OWNERSHIP

The table analyses the grouping between the corporate governance scores (CG_rank), ranked as Low (below the median of 31.68) and High (above median), and the percentage of directors' ownership (Dir%Own) of common shares. Director ownership is split into three categories (DirOwnGrp) as Low (below 25%), Medium (25% to 50%), and Predominant (above 50%).

	Director Ownership Groups (DirOwnGrp)			
CG_rank	Low	Medium	Predominant	Total
High	24	14	32	70
Low	18	23	29	70
Total	42	37	51	140

⁹ This approximation of Tobin's Q follows Kaplan and Zingales (1997), Gompers et al, (2003), Cremers and Nair (2005), and Durnev and Kim (2005).

4. DV_HM: High CG_rank and Medium Dir%Own;
5. DV_HP: High CG_rank and Predominant Dir%Own.

5.3. Hypotheses

In a family-controlled firm, agency problem may be less severe (Jensen and Meckling, 1976). However, the entrenchment problem may be paramount because minority shareholders are legally powerless to remove the controlling directors, *even within a high investor protection framework*. Investors will not pay a high price for a tightly controlled firm's stock if the firm does not implement good corporate governance, and will "discount stocks according to perceived corporate governance issues" (Claessens and Fan, 2002, p. 95). Hence, *a priori*, low CGDscore firms in this study should exhibit lower Tobin's Q than high CGDscore firms at similar insider ownership levels if governance information is a concern to investors and is used in their buy-hold-sell decisions. Conversely, high CGDscore firms should exhibit higher Tobin's Q across various levels of insider ownership. Thus, hypothesis one can be formulated as:

Hypothesis 1

H₀: Low CGDscore firms and high CGDscore firms have equal Tobin's Q.

H_a: Low CGDscore firms and high CGDscore firms do not have equal Tobin's Q.

Another issue investigated in this study is related to the substitute model of the agency theory of dividends proposed by LLSV (2000a). The model is based on the notion that dividends are a substitute for legal protection. A firm has the need to establish a reputation for moderation in expropriating shareholders' wealth if it desires to be able to raise external funds on attractive terms. Paying dividends is one of the ways to establish such reputation (this is the supply side of the dividends argument). LLSV point out that a good reputation for treating shareholders fairly is highly valuable for firms in countries with weak legal protection of minority shareholders' interest because the minority shareholders have nothing else to rely on. As a consequence, the need for paying dividends to establish a reputation is greatest for firms in such countries.

On the demand side of the dividend payout argument, LLSV point out that investors would rather have as many dividends to be paid out as possible, than leave any undistributed dividends inside the firm. It is because the temptation is greater for managers (or insiders) to expropriate the surplus cash for their own benefits when the minority shareholders have no effective way to monitor the agents (i.e. managers), or when the minority outsiders have no legal way to have the same access to the information that the insiders may have. Therefore, LLSV argue that, *other things equal*, dividend payout ratios should be higher in countries with weak legal protection of shareholders' interest than in those countries with strong protection of such interest (see LLSV 2000a, p. 7).

The same reasoning may be employed to argue that, under the same legal investor protection regime and similar levels of agency or entrenchment problem, small-cap firms with greater CG disclosure may be inclined to pay out lesser dividends than firms with less CG disclosure. Small-cap firms do not often attract international investors' or fund managers' attention. Regardless they are highly transparent in CG disclosure or not, they share the same need to establish a reputation to treat minority shareholders. It is the outside investor who decides which firm is more trust-worthy in terms of the firm's CG practices. In the absence of detailed knowledge of how the firm is being run, outsider investors will have to rely on the amount of CG disclosure to cast their vote of confidence. A firm with higher CG *voluntary* disclosure ranking may have investors' confidence in the *quality* of the firm's CG practices, and thus a lower dividend payout ratio may be acceptable to outside investors. Both arguments suggest that a substitution effect exists. Hence, the high CGDscore firms group should exhibit a lower dividend payout ratio (DivPay) than the low CGDscore firms group and results in formulation of hypothesis 2 thus:

Hypothesis 2

H₀: Low CG_rank firms and high CG_rank firms have equal dividend payout ratios.

H_a: Low CG_rank firms and high CG_rank firms do not have equal dividend payout ratios.

Under a strong external legal protection environment, investors can seek additional protection from potential expropriation by the predominant insider shareholders. According to LLSV (2000a), dividends can be used to deal with agency problems, particularly in an effective system of legal protection of shareholders. Their outcome agency model of dividends suggests that minority shareholders in a high protection country can use their legal powers to force companies to make higher payout by voting for directors who offer better dividend policies, by selling shares to potential hostile raiders, or by suing companies on activities that benefit only the insiders. LLSV propose that, the greater the rights of the minority shareholders, the more cash they can extract from the company, other things equal (see LLSV, 2000a, p. 5). In other words, in a strong legal protection country, shareholders are able to extract dividends from companies.

Their theory can be applied to the case where outsider investors would demand higher dividend payout in a scenario when they are powerless to remove the entrenched, controlling shareholders. Only when the outsider investors feel satisfied and secured about their investments are in good hands would they tolerate a lower level of dividend payout. It would take place only when the outsiders' interests are in alignment with the insiders' interests or — in the case of tightly held family ownership where the principals are often the agents (i.e., the managers) themselves — when the minority investors' interests are in alignment with the management's interests. Such scenario would be the case when the insiders are neither firmly entrenched nor act purely as agents for the company. It follows

that, within similar grouping of CG disclosure by rank, firms that are prone to the agency problem (as proxied by 0-25% insiders' ownership) and firms that suffer from the entrenchment problem (as proxied by over 50% insiders' ownership) would exhibit higher dividend payout ratio than firms which have insiders' ownership of 25-50%:

Hypothesis 3

H₀: Firms with different levels of insiders' ownership exhibit equal dividend payout ratios.

H_a: Firms with different levels of insiders' ownership do not exhibit equal dividend payout ratios.

6. RESULTS

6.1. Descriptive statistics

The summary statistics, reported in Table 3, show that there was a clear shift in the CG disclosure of the small-cap firms in Hong Kong over the 3-year period:

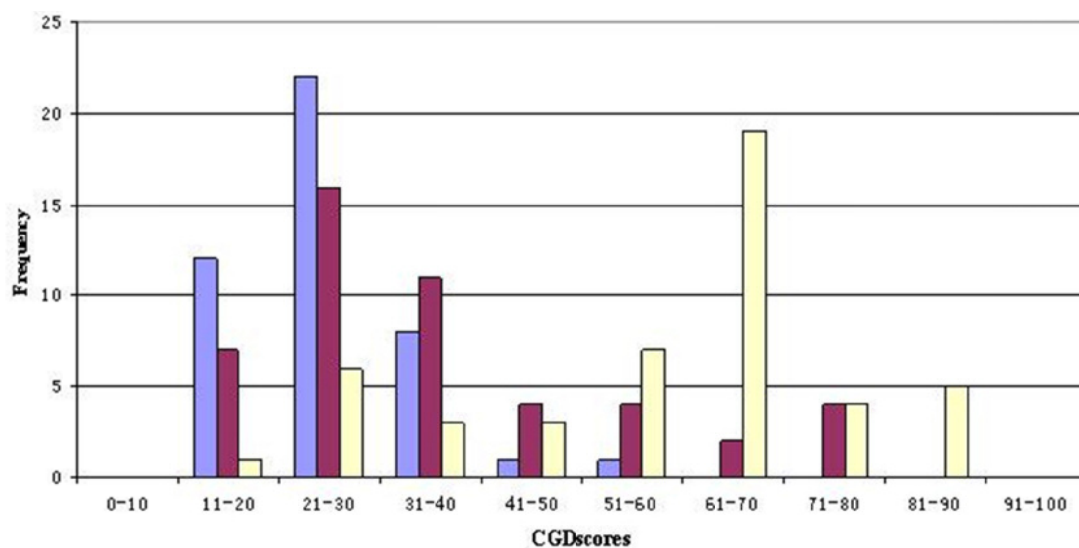
The mean CGDscore increased from 25.61 in 2003 to 57.91 in 2005. Nevertheless, the median disclosure in 2005 was 62.71. It indicates that not all companies had reached the 66% threshold (for the mandatory Code Provisions). The relative frequency of disclosures is displayed in Figure 1, in which the mode of the CGDscore in 2003 falls within the 21-30 interval, whilst the same for 2005 has shifted to 61-70 interval.

As Q the metric for market valuation of firms is itself a ratio, it is a continuous variable and varies over a wide range with outliers. To avoid undue influence from outliers on further analysis, the Q 's of the entire sample set (140 firm-years) are winsorized at 5%

TABLE 3: SUMMARY STATISTICS FOR THE CORPORATE GOVERNANCE SCORE

CGDscore is the percentage corporate governance score, based on 66 disclosure items.

	Total count	Mean	Standard Deviation	Minimum	Median	Maximum
CGDscore (3-years)	140	40.05	20.54	12.12	31.68	89.83
CGDscore 2003	44	25.61	8.05	15.38	24.19	52.46
CGDscore 2004	48	35.42	16.56	12.12	30.51	78.69
CGDscore 2005	48	57.91	19.28	20.00	62.71	89.83

FIGURE 1: FREQUENCY OF CORPORATE GOVERNANCE DISCLOSURE SCORE FOR SMALLCAP FIRMS, 2003-2005

and 95%, i.e., setting the lower 5% and the uppermost 5% of the Q's equal to values at the 5th and 95th percentiles respectively. This process of winsorizing the extreme values of a variable before conducting a regression model is commonly practised within the accounting research literature (e.g., see Fan and Wong, 2005; Lang *et al*, 2004).

The missing records on Datastream files for dividend per share (DPS) due to zero earnings per share (EPS) are assigned zeros. Descriptive statistics of the winsorized sample set are given in Table 4.

The descriptive sample statistics show that most small-cap firms are closely held by the members of the board of directors. The

TABLE 4: DESCRIPTIVE STATISTICS

Q is defined as: (the firm's total assets + market value of equity – book value of equity – deferred tax) / (total assets); CGDscore is the % of CG disclosure score; BoDsize is the total number of members of the Board of Directors; NumINED is the number of independent non-executive directors sitting on the board of directors; INED% is the percentage of independent non-executive directors as members of the board; Dir%Own is the percentage of ordinary shares owned by all the directors; SplitRoles is the dummy variable for duality of Chairperson and the CEO (i.e., 1 being split roles, 0 otherwise); DivPay is the dividend payout ratio (i.e. Dividend per share x 100/Earnings per share); ROE is the percentage return on equity; LnSales is the natural log of the firm's sales revenue; SalGrow is the percentage growth in sales revenue over previous year; LnEqty is the natural log of the firm's equity; and. Is Debt/TA is the debt-to-total assets ratio in percentage;

2003-2005 SmallCap	Mean	Median	Std Dev	Minimum	Maximum
Q	1.42	1.13	0.96	0.34	6.37
CGDscore	40.05	31.68	20.54	12.12	89.83
BoDsize	9.61	10.00	2.57	4.00	18.00
NumINED	3.09	3.00	0.95	0.00	6.00
INED%	33.75	33.33	11.99	0.00	66.67
Dir%Own	50.82	55.59	18.33	0.97	78.73
SplitRole*	0.49	0.00	0.50	0.00	1.00
DivPay	42.47	40.88	28.57	0.00	100.00
ROE	16.34	12.58	17.95	-12.60	130.52
LnSales	21.42	21.48	0.97	18.50	24.39
SalGrow	32.54	11.70	95.65	-83.28	799.35
LnEqty	22.03	21.92	0.75	20.33	24.21
Debt/TA	18.34	14.35	16.48	0.00	72.11

Notes: Number of counts for each of the variables: 140

* SplitRole is a dummy variable with value = 1 if split roles of Chairman and CEO, 0 otherwise.

median Dir%Own across all firm-years is 55.59%. The mean Dir%Own is 50.82%, which supports the general impression of concentrated director ownership of small firms in Hong Kong. The findings are in line with previous studies on the ownership structure and the tight control by the same families (insiders) of Hong Kong firms (e.g., Fan and Wong, 2005; Claessens and Fang, 2002; Ho and Wong, 2001; HKSA, 1997a; Mok *et al*, 1992). As regards the presence of Independent Non-Executive Directors (INEDs) on the board, the mean of NumINED is 3.09 and the median is 3.00 over the period 2003-2005, which barely satisfies the minimum requirement of the HKEx (at least 3 INEDs sitting on the board). Coupled with the average board size of these Hong Kong SmallCap firms being 9.61 directors, the influence exerted by the INEDs on the board is highly restricted (as shown by the median of the percentage of INEDs on the board, 33.33%). The requirement of segregated roles of Chairman and CEO is not commonly observed either. The mean SplitRole (a dummy variable with value equals either 0 or 1) is 0.49, suggesting that less than half of the SmallCap firms in Hong Kong have the roles of Chairman and CEO performed by separate individuals. Taken together, Hong Kong SmallCap firms tend to be tightly owned and controlled by insiders, which makes the voluntary disclosure of CG practices all the more important to outside investors.

The correlation matrix for all the variables in the study is given in Table 5. *P*-values for the correlation between variables are indicated in brackets underneath the correlations. There is a significant and positive correlation between CGDscore and Q (correlation = 0.155, $p = 0.067$), suggesting companies with good corporate governance disclosure are valued more highly than other small firms without good governance disclosure. Companies that split the role of Chairperson and CEO (SplitRole) are found to have higher CG disclosures (the correlation between SplitRole and CGDscore is 0.337, with $p < 0.0001$), while ROE is found to be positively correlated with CGDscore (correlation = 0.241, $p = 0.004$). ROE and Q (correlation = 0.241, $p = 0.004$). They are both statistically significant at 0.5% significance level.

However, a univariate analysis may not adequately explain the relationship between corporate governance disclosure and firm valuation. For example, while there is a significant positive correlation ($p=0.034$) between board size (BoDsize) and the CGDscore, there is a negative correlation between board size and Q. It may therefore be important to control for CG disclosure and CG practices at the same time in determining the firm valuation by regression analysis.

6.2 Corporate Governance Disclosure and Firm Valuation

The results of the empirical regression analysis are contained in Table 6. Columns 2 to 5 report the results for fitting Models 1 to 4 respectively. The *p*-values for each parameter are indicated in parentheses. [Insert Table 6]

Model 1 (column 2 of Table 6) tests whether firms with higher corporate governance disclosure have larger market valuation. The dependent variable is Q. The independent variable is the CGDscore without any control variables. The coefficient on CGDscore is positive, and shows that a unit increase in the disclosure score CGDscore is associated with a 0.007 percentage-point increase in the firm's market valuation. The coefficient is statistically significant at the 10% level.

In Model 2 (column 3 of Table 6), five more CG practices variables are added into the regression model to test for their relationship with Q:

- Board size (BoDsize);
- Number of INEDs on the board;
- Proportion of INEDs on the board (INED%),
- Directors' ownership of common shares (Dir%Own), and
- Splitting the roles of Chairman and CEO (a dummy variable SplitRole with 1 for split role, 0 otherwise).

The coefficient of CGDscore in Model 2 is positive and its *p*-value is statistically significant at 5% level ($p = 0.029$). Consistent with previous research (e.g., Cheng, 2008; Boone *et al*, 2007; Eisenberg *et al*, 1998; Yermack, 1996), board size (BoDsize) has a negative relation with Q but is not significant. Small boards of directors

TABLE 5: 2003-2005 SMALLCAP FIRMS VARIABLES CORRELATIONS

	Q	CGDscore	NumINED	BoDsize	INED%	Dir%Own	SplitRole	DivPay	ROE	LnSales	SalGrow	LnEqty	Debt/TA
CGDscore	0.155 (0.067)												
NumINED	-0.012 (0.888)	0.285** (0.001)											
BoDsize	-0.097 (0.252)	0.180* (0.034)	0.244** (0.004)										
INED%	0.065 (0.446)	0.106 (0.213)	0.652** (0.000)	- 0.500** (0.000)									
Dir%Own	-0.114 (0.180)	-0.204* (0.016)	0.010 (0.909)	0.026 (0.759)	-0.041 (0.631)								
SplitRole	0.036 (0.672)	0.337** (0.000)	0.168* (0.048)	0.229** (0.006)	-0.068 (0.425)	0.010 (0.905)							
DivPay	0.155 (0.068)	-0.014 (0.869)	-0.019 (0.827)	0.102 (0.231)	-0.066 (0.442)	-0.011 (0.901)	-0.035 (0.681)						
ROE	0.241** (0.004)	0.237** (0.005)	0.178* (0.035)	-0.006 (0.942)	0.130 (0.127)	-0.092 (0.279)	-0.003 (0.972)	-0.218* (0.010)					
LnSales	-0.006 (0.947)	0.110 (0.195)	-0.073 (0.392)	0.029 (0.730)	-0.079 (0.357)	-0.197* (0.020)	0.039 (0.649)	-0.025 (0.771)	0.159 (0.061)				
SalGrow	0.050 (0.560)	0.091 (0.284)	0.030 (0.722)	-0.112 (0.186)	0.098 (0.250)	-0.029 (0.732)	0.003 (0.971)	-0.200* (0.018)	0.108 (0.204)	-0.086 (0.311)			
LnEqty	0.462** (0.000)	0.051 (0.550)	-0.030 (0.728)	0.241** (0.004)	- 0.192* (0.023)	0.074 (0.387)	-0.028 (0.738)	0.309** (0.000)	-0.086 (0.313)	0.225** (0.007)	-0.048 (0.570)		
Debt/TA	0.313** (0.000)	0.044 (0.608)	0.003 (0.974)	0.131 (0.122)	-0.138 (0.103)	0.050 (0.558)	-0.015 (0.865)	0.390** (0.000)	0.179* (0.034)	-0.078 (0.361)	0.077 (0.363)	0.249** (0.003)	
PTBV	0.785** (0.000)	0.318** (0.000)	0.001 (0.993)	-0.069 (0.415)	0.062 (0.467)	-0.206 (0.014)	0.003 (0.975)	0.051 (0.552)	0.367** (0.000)	0.230** (0.006)	0.040 (0.638)	0.415** (0.000)	0.227** (0.007)

(p-values are shown in brackets. Coefficients are **bold** if p-value < 0.10; * if p-value < 0.05; ** if p-value < 0.01. PTBV denotes Price-to-Book Value of Equity of firms, all other variables are defined as in Table 1)

TABLE 6: CORPORATE GOVERNANCE DISCLOSURE AND FIRM VALUE

This table contains regression output of the relationship between firm value, as proxied by Q , and corporate governance disclosure. Variables as defined in Table 4. Model 1 regresses Q on the CGDscore, while Model 2 controls for corporate governance practices. Model 3 controls for both corporate governance practices and company-specific characteristics. In models 4 and 5, DV_HL (dummy variable for High CG_rank and Low Director Ownership group) is used as the base, while dummy variables for the five other joint groups LL, LM, LP, HM, HP representing respectively: Low CG_rank and Low Director Ownership, Low CG_rank and Medium Director Ownership, Low CG_rank and Predominant Director Ownership, High CG_rank and Medium Director Ownership, and High CG_rank and Predominant Director Ownership. P -values are given in parentheses, with variables significant at the 10% level or better highlighted. Model 4 excludes CGDscore and Dir%Own as they are replaced by the joint variables of CG_rank and the level of Directors' Ownership. Number of observations is 140 for all models.

	1	2	3	4	5
	Models				
Variables	1	2	3	4	5
Constant	1.181** (<0.001)	1.472* (0.045)	7.900** (<0.001)	8.016** (<0.001)	
CGDscore	0.007 (0.072)	0.009* (0.029)	0.008* (0.030)		
BoDsize		-0.025 (0.718)	0.012 (0.844)	0.022 (0.720)	
NumINED		-0.095 (0.660)	-0.104 (0.586)	-0.149 (0.451)	
INED%		0.005 (0.773)	0.001 (0.963)	-0.004 (0.797)	
Dir%Own		-0.002 (0.515)	-0.001 (0.827)		
SplitRole		-0.019 (0.911)	-0.042 (0.779)	0.004 (0.976)	
LnSales			0.029 (0.694)	0.036 (0.638)	
SalGrow			0.000 (0.591)	0.000 (0.571)	
ROE			0.013** (0.001)	0.014** (<0.001)	
LnEqty			-0.324** (<0.001)	-0.312** (0.001)	
Debt/TA			-0.017** (<0.001)	-0.015** (0.002)	
DV_LL				-0.486 (0.059)	
DV_LM				-0.452 (0.055)	
DV_LP				-0.560* (0.016)	
DV_HM				-0.390 (0.159)	
DV_HP				-0.289 (0.184)	
Adj R^2 (%)	1.6	5.0	25.5	24.8	
F significance	(0.072)	(0.367)	(<0.001)	(<0.001)	

(p -values are shown in brackets. Coefficients with $p < 0.10$ are bold, $p < 0.05$ are *, and $p < 0.01$ are **)

are generally considered as more effective, with lower potential to be controlled by the CEO. However, in Hong Kong firms, the CEO tends to be the insider who is closely related to the predominant shareholder. Outside investors can seldom successfully challenge the decisions made by the board. The bigger the board size, the more the directors' remuneration will be. In this study, the relation between BoDsize and Q is negative but not significant. The adjusted R^2 shows a moderate explanatory power (5.0 %) for the regression model and the value of the constant term is highly significant at 0.05 alpha level. It indicates that there may be missing variables in the model.

In Model 3, another five company characteristics variables (the ComChar variables) are added into the multiple regression as control variables to test whether they can improve the explanation power of Model 2. These control variables are:

- The natural log of total sales (LnSales), as a proxy for earnings ability,
- Sales growth (SalGrow), as a proxy for business potential,
- Return on equity (ROE), as a proxy for profitability,
- The natural log of the firm's equity (LnEqty), as a proxy for firm size, and
- The debt ratio (Debt/TA), as a proxy for gearing.

The results of Model 3 (column 4 of Table 6) show that the CGDscore is still positive and highly significant ($p < 0.05$) in explaining changes in Q when more variables are added to the model. Also, a firm's profitability (as proxied by ROE), firm size (LnEqty), and the debt ratio (Debt/TA) are highly statistically significant ($p < 0.001$) in explaining the cross-sectional variations in Q . Compared with the ComChar variables, the CGprac variables such as BoDsize, NumINED, INED%, and SplitRole are again non-significant. The p -value of the constant remains significant indicating the possibility of omitted variables. The F -statistics of the multiple regression shows a p -value that is highly significant ($p < 0.001$), suggesting that it is a better fit model than Model 2 and Model 1 in explaining the relationship between Q and the other explanatory variables.

Model 4 (column 5 of Table 6) replaces the CGDscore and Dir%Own with the dummy variables of the joint CG_rank-and-DirOwnGroup into the multiple regression. It aims to test for the joint effect of the various CG_rank and Directors' Ownership Groups on Q relative to the base group HL (i.e., high CG rank and low Directors' Ownership). The results indicate that, apart from the ComChar variables (such as ROE, LnEqty, and Debt/TA), the coefficients of all the joint variables are negative but only those coefficients for the LL, LM, and LP groups are significant (at 0.10 alpha level) in relation to Q . The empirical results indicate that all the low CGDscores firms (i.e., with low CG_rank) tend to display lower Q than the base group HL (i.e., high CG_rank and low Directors' Ownership) of firms. This suggests that the joint combinations of CG_rank and Dir%Own may have different impact on Q . The highest Q among the joint groups is the HL group: high ranking in CGDscore and low level in Dir%Own.

Table 7 (panel A) displays the coefficients of all dummy variables of firms belonging to the 6 joint groups of CG ranks and Directors' Ownership. The low CG_rank category (LL, LM, and LP) of firms registers bigger reduction in market valuation across all levels of Directors' Ownership than firms with high CG_rank category (HL, HM, and HP). Singularly, the group HL (high CG_rank and low Directors' ownership) has relatively the highest Q .

To further test the effects of the CGDscore and Dir%Own jointly on Q , the non-parametric Kruskal-Wallis test is performed on the 6 CG_rank-DirOwnGroups to test the following hypotheses:

Hypothesis 4

H_0 : There is no difference in the impact on Q among the 6 corporate governance – ownership groups.

H_a : There is difference in their impact on Q .

The results are reported in Table 7, panel B. The H-test statistic is 17.258 with p -value = 0.004. The null hypothesis that *there is no impact on Q for all corporate governance ownership groups* is therefore rejected at the 0.05 alpha level, which suggests that different groupings of CG_rank and Dir%Own have different Q 's. The test results

TABLE 7: THE IMPACT OF GOVERNANCE AND DIRECTORS' OWNERSHIP INTERACTIONS ON FIRM VALUATION Q

Panel A provides an analysis of the coefficients on market value (Q) for the 6 corporate governance score and directors' ownership interaction groups, while Panel B shows the Z-scores of the various groupings' H statistics of the Kruskal-Wallis Test. CG_rank is the corporate governance score ranked as Low (below median) and High (above median). DirOwnGrp is the percentage of directors' ownership (Dir%Own) of common shares classified as Low, Medium, and Predominant. See the criteria for ranking the CGDscore and classifying the Dir%Own in Table 3. The group of High-CG_rank-and-Low-DirOwnGrp (HL) is the base group for comparison of coefficients, hence has by default a coefficient of zero.

Regression coefficients			
	Level of Directors' Ownership (DirOwnGrp)		
CG_rank	Low	Medium	Predominant
High	HL 0.000	HM -0.390 (0.159)	HP -0.289 (0.184)
Low	LL -0.486 (0.059)	LM -0.452 (0.055)	LP -0.560* (0.016)

Panel B – Kruskal-Wallis H statistics			
Group	Sample Size	Sum of Ranks	Mean Ranks
HL	24	2421	100.875
HM	14	882	63.000
HP	32	2196	68.625
LL	18	1207	67.056
LM	23	1460	63.478
LP	29	1704	58.759
Sum of Squared Ranks/Sample Size			724223.88
Sum of Sample Sizes			140
Number of Groups			6
H Test Statistic			17.258
Critical Value			11.070
p-value			(0.004)**

(p-values are shown in brackets. Coefficients with $p < 0.10$ are bold, $p < 0.05$ are *, and $p < 0.01$ are **)

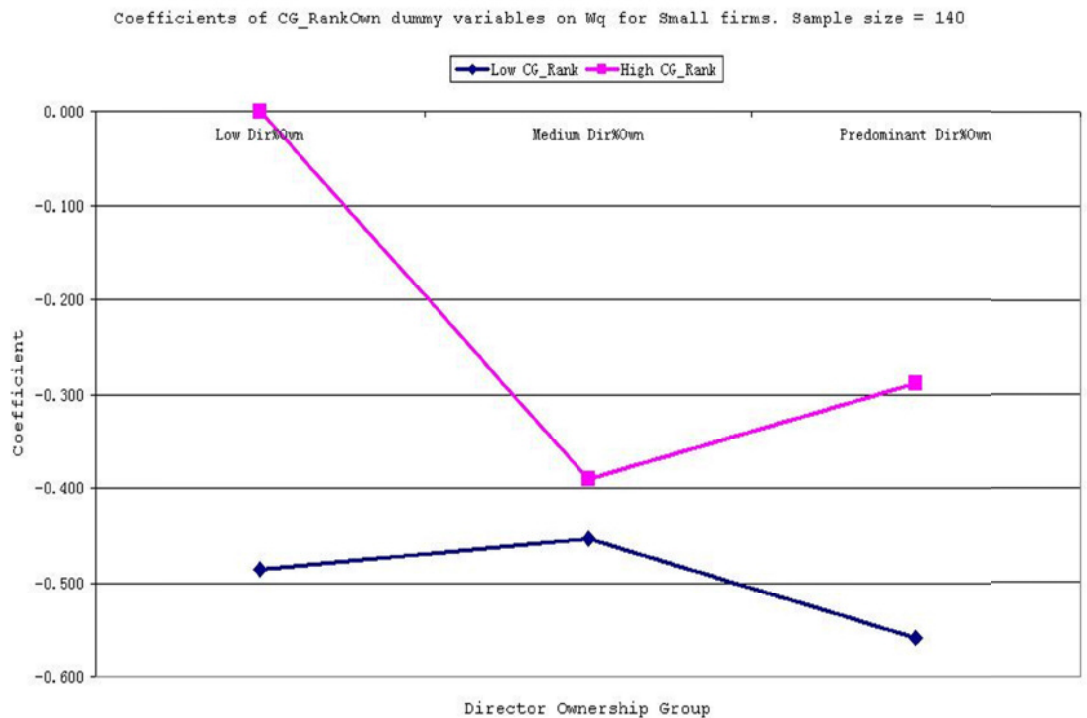
show that there are significant differences among the 6 corporate governance-ownership groups in terms of their impact on Q and such differences are not likely to happen by chance.

The impact on Q across different groupings of CG_rank and Dir%Own is depicted more clearly in Figure 2 below, where the coefficients of Q for various groups are joined by line segments:

There are several observations that can be made from Figure 2. First, it shows that, generally, high CG_rank firms tend to have higher Q when compared with low CG_rank firms. Secondly, in relative term, the lowest average Q is associated with the firms with

the LP group, which represents the firms with low CG_rank and predominantly owned by the insiders. In contrast, the highest average Q is associated with the HL group, with high CG_rank and low insider ownership. This result suggests that firms with a higher transparency in CG disclosure and a lower insider ownership are valued most by the market. This is consistent with agency theory when outside investors tend to have more confidence in a firm whose insiders are only agents but are more transparent about the CG practices within the firm. Outsider investors tend to have the least confidence when the firm's insiders are predominant owners who are also less transparent about the firm's CG practices.

FIGURE 2: COEFFICIENTS OF DUMMY VARIABLES OF CG RANK AND DIRECTORS' OWNERSHIP ON FIRM VALUATION Q FOR SMALLCAP FIRMS



Second, the biggest difference in impact on Q can be seen within the low Dir%Own (<25%) category, where the low CG_rank firms exhibit a reduction of Q by 0.486 points compared with the high CG_rank firms on average. The second biggest difference is found in the predominant Dir%Own (>50%) category, where the low CG_rank firms have a lesser Q by 0.271 points (the absolute difference between -0.560 and -0.289). The implication of this observation is that, when the firm is predominantly owned by insiders (as in most cases of SmallCap firms in Hong Kong and elsewhere), a more transparent attitude towards the CG practices disclosure would be rewarded with a higher valuation by the market. Given the fact that ownership structure seldom drastically changes over time (and thus the Directors' Ownership is an endogenously determined variable), this has practical meaning to the owners-cum-managers of the SmallCap firms: more transparency in CG practices will give a boost to the firm's valuation.

Third, the inverted V-shape of the line segment of Q for the low CG_rank firms provides explanations to the puzzle why there is conflicting evidence in the relationship between insiders' ownership and firm valuation (e.g., Demsetz and

Villalonga, 2001; McConnell and Servaes, 1990; Morck *et al*, 1988; Demsetz and Lehn, 1985). When assessing a firm's value, the market also considers the state of CG (among other company performance factors such as profitability, gearing, and firm size) *in the context* of the firm's ownership structure. Within low CG_rank firms, firm valuation Q tends to rise with insiders' ownership but starts to decline when the insiders become entrenched (i.e., ownership in excess of 50% of equity rights). Within high CG_rank firms, Q reaches a relative minimum when insiders' ownership falls within the medium range (25%-50%). A high CG_rank firm with the presence of a predominant insiders' ownership seem to enjoy a higher market valuation. The empirical findings of this study suggest that there seems to be a packing order amongst general investors (i.e., the market) in valuing a firm where both the CG practices and the ownership structure can cast their impact.

6.3 Results on Dividend Payout Ratio

According to the outcome agency model of dividends suggested by LLSV (2000a), firms operating within the same country with good shareholder protection that have good investment opportunities and growth prospects should have significantly lower dividend payouts than low growth

companies. This is so because shareholders who feel protected by the external CG mechanism would accept low dividend payouts, and high reinvestment rates, from a company with good investment opportunities as they know when the company's investments pay off, they are able to extract high dividends in the future.

However, in LLSV's model, concentrated ownership is not considered. In an open economy characterized with highly concentrated family ownership such as Hong Kong, would firms behave as predicted by the outcome agency model of dividends? This theory is tested in Model 5 and the results are reported in Table 8. The dividend payout ratio (DivPay) is the dependent variable while the independent variables are the CG disclosure score (CGDscore) and the CG practices variables (BoDsize, NumINED, INED%, Dir%Own, SplitRole). The control variables on company characteristics are LnSales, SalGrow, ROE, Debt/TA, and LnEqty. Following LLSV (2000a), the growth prospects metric is proxied by the past sales growth (SalGrow).¹⁰

The test results of Model 5 (column 2 in Table 8) show that the dividend payout ratio (DivPay) is not significantly related to any CG practices variables but is significantly related to the ComChar variables. DivPay is significantly but negatively related to SalGrow (p -value = 0.012), ROE (p -value = 0.042), Debt/TA (p -value = 0.001) and LnEqty (p -value = 0.001). The CG disclosure (CGDscore) is not significant in explaining the dividend payout ratio either.

While leverage (proxied by Debt/TA ratio) can be regarded as an external CG mechanism provided by debt holders, which explains higher monitoring efforts will restrain the insiders from paying unduly high dividend payouts, there are two possible views on the negative coefficients of profitability (ROE), firm size (LnEqty), and sales growth (SalGrow) on dividend payout. First, the small-cap firms need to retain their profits as internal capital reserve for future business development. The higher the firm's profitability, the less reliant is the firm on

external borrowings, so that the small firms can grow at a faster pace based on internally generated funds. Higher ROE will therefore tend to associate with a lower DivPay for the small firms. The negative coefficient on sales growth (SalGrow) lends support to this argument, as its p -value is statistically significant at 0.05 alpha level.

A second view on the negative relationship with LnEqty and ROE is that external investors are willing to let firms at such early developing stage retain their profit and hence tolerate a lower dividend payout ratio. This is based on the assumption that the insiders' interests and the outsiders' interests are in alignment and that outsiders are confident that, when the reinvestment comes to fruition later on, they can extract high dividends from the firm under a strong legal regime for investor protection (LLSV, 2000a).

To test this assumption, the dividend payout ratio is regressed on the different groupings of CG ranking and Directors' Ownership and reported in Table 8 under Model 6, using the high CG_rank and low directors' ownership (HL) group as the base group (similar to the test conducted for testing firm valuation Q in section 6.2).

The empirical test results of Model 6 are similar to those in Model 5. The statistically significant independent ComChar variables in explaining DivPay are: SalGrow (p -value = 0.003), ROE (p -value = 0.028), Debt/TA (p -value = 0.010), and LnEqty (p -value = 0.001), all being negatively related to DivPay.

Another intriguing observation reported in Table 8 is that the DV_HM group (high CG_rank, medium in directors' ownership) has the lowest coefficient on dividend payout ratio (-27.885) within the high CG_rank category. Similarly, the DV_LM firms (low CG_rank, medium in director ownership) have the relatively lowest coefficient (-19.949) within the low CG_rank category. It suggests that when firms have a medium level of directors' ownership, i.e., when firms are neither predominantly owned nor do they have low level of directors'

¹⁰ LLSV (2000a) use the firm's annual real sales growth rate over the 5-year period from 1989 to 1994. They also use the decile rank of the past average annual sales growth rate for each firm as a second metric.

TABLE 8: DIVIDEND PAYOUT AND CORPORATE GOVERNANCE

The dependent variable is DivPay defined as: (the firm's dividend per share x 100)/earnings per share; CGDscore is the % of CG disclosure score; BoDsize is the total number of members of the Board of Directors; Dir%Own is the % of ordinary shares owned by all the directors; SplitRole is the dummy variable for duality of Chairperson and the CEO (i.e., 1 being split roles, 0 otherwise); LnSales is the natural log of the firm's sales revenue; SalGrow is the % growth in sales revenue over previous year; ROE is the % return on equity; Debt/TA is the Debt/Total Assets ratio in %; LnEqty is the natural log of the firm's equity; DV_HL (dummy variable for High CG_rank and Low Director Ownership group) is used as the base, while dummy variables for the five other joint groups LL, LM, LP, HM, HP representing respectively: Low CG_rank and Low Director Ownership, Low CG_rank and Medium Director Ownership, Low CG_rank and Predominant Director Ownership, High CG_rank and Medium Director Ownership, and High CG_rank and Predominant Director Ownership. *P*-values less than 0.10 are stated in bold.

Variables	Model	
	5	6
Constant	204.590** (0.004)	207.433* (0.003)
CGDscore	0.074 (0.542)	
BoDsize	2.631 (0.192)	2.318 (0.247)
NumINED	-1.302 (0.836)	-0.716 (0.910)
INED%	0.082 (0.882)	0.057 (0.918)
Dir%Own	-0.113 (0.227)	
SplitRole	-4.158 (0.396)	-1.905 (0.679)
LnSales	1.826 (0.461)	2.400 (0.320)
SalGrow	-0.072** (0.012)	-0.083** (0.003)
ROE	-0.274* (0.042)	-0.280* (0.028)
Debt/TA	-0.499** (0.001)	-0.397* (0.010)
LnEqty	-9.322** (0.001)	-9.530** (0.001)
DV_LL		-7.289 (0.371)
DV_LM		- 19.949** (0.008)
DV_LP		-9.961 (0.174)
DV_HM		- 27.885** (0.002)
DV_HP		-16.785* (0.016)
Observations	140	140
Adj R^2 %	24.2	26.4
F significance	(<0.001)	(<0.001)

(*p*-values are shown in brackets. Coefficients with $p < 0.10$ are bold, $p < 0.05$ are *, and $p < 0.01$ are **)

ownership, the dividend payout ratios are the lowest. Table 9, panel A, summarizes the coefficients of the dummy variables of these 6 corporate governance-ownership groups on DivPay:

In similar fashion, the relative differences of the coefficients on DivPay are presented in Figure 3 which illustrates the two categories of CG_rank firms with respect to their DivPay. A double V-shape of two line-segments can be observed for the two categories of CG_rank firms in terms of their coefficients on DivPay:

Figure 3 illustrates two V-shapes of DivPay coefficients for the high CG_rank firms and the low CG_rank firms. Both groups of firms have their lowest dividend payout ratios when the firms have a medium level of directors' ownership (25% - 50%).

Compared to the low CG_rank firms, the high CG_rank firms have a minimum payout that is even *lower*. Amongst the six groups of SmallCap firms, the High CG_rank and Medium Director Ownership group (HM) has the lowest dividend payout, which deviates the greatest (27.89 percent points) from that of the base group (HL). Such level is statistically significant (p -value = 0.002).

TABLE 9: THE IMPACT OF GOVERNANCE AND DIRECTORS' OWNERSHIP INTERACTIONS ON DIVIDEND PAYOUT

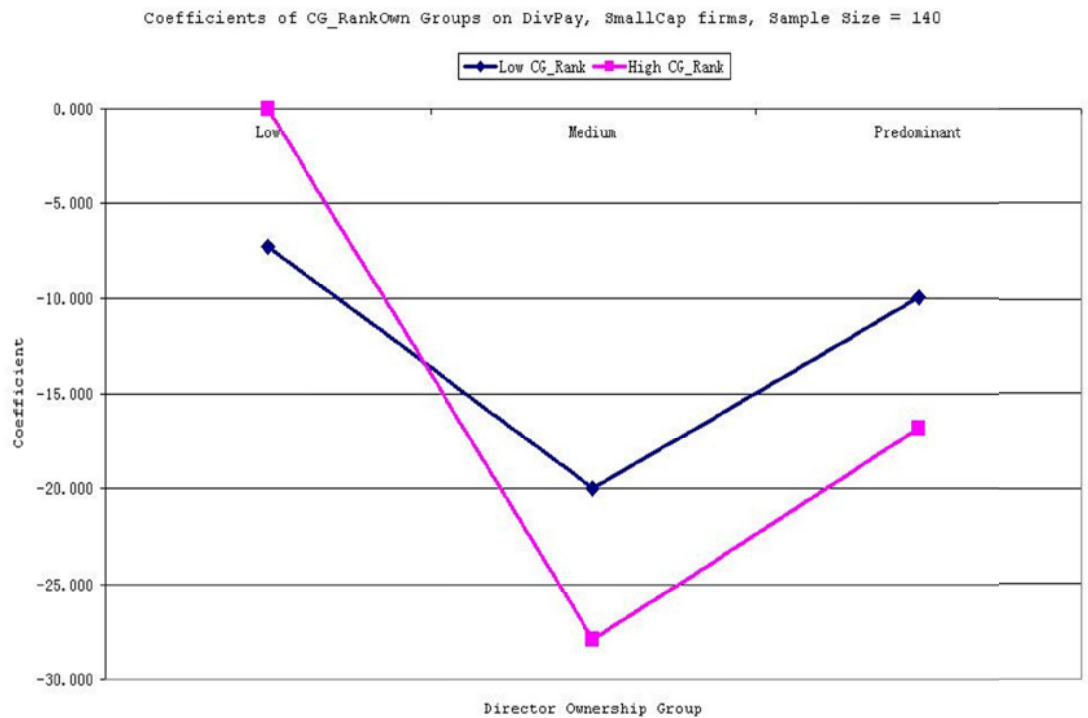
Panel A provides an analysis of the coefficients on dividend payouts for the 6 corporate governance score and directors' ownership interaction groups, while Panel B shows the Z-scores of the various groupings' H statistics of the Kruskal-Wallis Test. CG_rank is the corporate governance score ranked as Low (below median) and High (above median). DirOwnGrp is the percentage of directors' ownership (Dir%Own) of common shares classified as Low, Medium, and Predominant. See the criteria for ranking the CGDscore and classifying the Dir%Own in Table 4. The group of High CG_rank and Low DirOwnGrp (HL) is the base group for comparison of coefficients, hence has by default a coefficient of zero.

Panel A - Regression coefficients			
	Level of Directors' Ownership (DirOwnGrp)		
CG_rank	Low (0-25%)	Medium (25-50%)	Predominant (>50%)
High	HL 0.000	HM -27.885** (0.002)	HP -16.785* (0.016)
Low	LL -7.289 (0.371)	LM -19.949** (0.008)	LP -9.961 (0.174)

Panel B - Kruskal-Wallis H statistics			
Group	Sample Size	Sum of Ranks	Mean Rank
HL	24	2124.5	88.52
HM	14	612.5	43.75
HP	32	2102.0	65.69
LL	18	1420.5	78.92
LM	23	1436.5	62.46
LP	29	2174.0	74.7
Sum of Squared Ranks/Sample Size			717729.5
Sum of Sample Size			140
Number of groups			6
H test statistic			13.31*
Critical value			11.07
p-value			(0.021)*

(p-values are shown in brackets. Coefficients with $p < 0.10$ are bold, $p < 0.05$ are *, and $p < 0.01$ are **)

FIGURE 3: COEFFICIENTS OF DUMMY VARIABLES OF CG RANK AND DIRECTORS' OWNERSHIP ON DIVPAY FOR SMALLCAP FIRMS.



The evidence suggests that, for those SmallCap firms which are likely to have agency problems (as reflected by low insiders' ownership of equity 0-25%), or susceptible to entrenchment problems (as represented by predominant insiders' ownership >50%), they will offer higher dividend payout ratios relative to those firms with a medium insiders' ownership (25% - 50%). Firms that do not succumb to either problem (i.e., with insiders' ownership at 25%-50%) can afford to pay a *lower* dividend payout. This V-shape dividend payout pattern applies to both high CG_rank firms and low CG_rank firms. If a SmallCap firm has a high ranking in CG disclosure, it can afford to pay an even *lower* dividend payout ratio than its counterpart with low CG ranking, with similar level of insiders' ownership.

Prior studies have established that a greater information asymmetry normally exists between insiders and outsiders in small firms which generally receive less attention from the institutional investors or analysts. The findings as presented in Table 9 (and depicted in Figure 3) provide evidence that voluntary disclosure of CG information helps in the reduction of such information asymmetry, to an extent that there appears to be a substitution effect of voluntary CG

disclosure for dividend payout. This effect seems to be more pronounced for small firms with medium level of inside ownership. This substitution effect is observed even when the investors are safeguarded by a strong, legal, investor protection regime such as Hong Kong.

Because the coefficients for firms in the LL and LP groups are not significant, it is not clear whether a V-shape of DivPay truly exists for all the low CG_rank firms. However, the coefficient for the LM group is highly significant (p -value = 0.008). It is lower than the base group HL but higher than the HM group. The interpretation of this empirical evidence is: even for those firms that are less subject to agency problems or entrenchment problems, a firm with low CG_rank has nevertheless to offer a slightly higher DivPay than is offered by its high CG_rank counterpart. It suggests that the market expects a 'safety margin of protection' from firms with less transparency in terms of their CG disclosure. An alternative interpretation is that the markets seems to be able to differentiate high CG_rank firms from low CG_rank firms in its expectations on DivPay; and that firms of different CG ranking respond by offering different dividend payout ratios accordingly.

A Kruskal-Wallis test similar to the test of different CG_rank and Directors Ownership Groups on market valuation Q (as stated in section 6.2) is carried out. This is to test if the relationship between the dividend payout ratios of firms and the various groupings in CG rank and Ownership would be significantly different amongst the various groups. A null hypothesis is therefore postulated as follows:

Hypothesis 5

H_0 : *There is no difference in the impact on DivPay among the 6 CG_rank-ownership groups.*

H_a : *There is difference in their impact on DivPay.*

The Kruskal-Wallis test results are shown in Table 9, panel B. As the p-value of the H test statistic is 0.021, it is significant at 0.05 alpha level and therefore the null hypothesis is rejected. There are statistically significant differences among the various CG_rank and insiders' ownership groups on a firm's DivPay.

It can be seen from Table 9 and Figure 3 that, firms that tend to have agency problems (i.e., low level of directors ownership) need to pay a higher dividend payout than the rest, regardless as to whether they rank high or low in CG disclosure. It supports LLSV's view that, even under a good investor protection legal regime, outsider investors still need assurance that they will be treated fairly by the insiders. Outsiders are only willing to accept a firm that pays lower dividends provided the insiders' interest is aligned with the outsider's interest, *coupled with a higher level in CG disclosure ranking*. On the other hand, when the insiders' interest and the outsiders' interest are clearly aligned (i.e., when neither agency problems nor entrenchment problems are severe), a high rank in CG disclosure would help serve as a 'vote of confidence' that permits a firm to pay a lower dividend payout. This seems to mitigate the entrenchment problem even though the firms are predominantly owned by insiders (i.e., directors ownership > 50%).

6.4 The issue of Endogeneity

Similar to most corporate governance research, the interpretation of the regression

results in this study is subject to potential problems of self selection and endogeneity. Self selection refers to the possibility that firms that disclose more CG practices might be fundamentally different from firms that do not, and it is such differences that affect the decision to disclose and, hence, firm valuation. Endogeneity refers to the chance that firms with higher market valuation are more likely to have adopted a more transparent approach in CG disclosure.

Mitton (2004) suggests one possible solution in disentangling the endogeneity issue is to identify a variable (i.e., an *instrumental variable*) that is correlated with the key independent variable (e.g., CG disclosure score CGDscore in this study) but is otherwise uncorrelated with the dependent variable (e.g., market valuation Q or dividend payout ratios DivPay in this study) or uncorrelated with the disturbance, which is then to be tested by a two-stage or 3-stage least square regression model. This approach may help determine the causality flow direction and explain the likelihood for reverse causation.

In this study, the directors' ownership (Dir%Own) of the Hong Kong Small-cap firms appears to be a good candidate for the instrumental variable. Theoretically, Dir%Own is uncorrelated with a firm's market valuation because most Hong Kong firms have historically had concentrated ownership (HKSA, 1995, 1997). The average Dir%Own in Hong Kong firms has not changed substantially over the sample period, albeit the average CG disclosure of the small-cap firms (CGDscore) had shown an upward shift from 2003 to 2005 (Figure 1). Moreover, the Pearson correlation as between Dir%Own and Q is -0.114 with p -value = 0.180 (Table 5, column 2). On the other hand, Dir%Own is significantly correlated with CGDscore (Pearson correlation is -0.204, p -value = 0.016; see Table 5, column 3). It follows that Dir%Own would not have caused any severe endogeneity problem in estimating the market valuation Q even though the CG disclosure (CGDscore) is held as an explanatory variable (both CGDscore and Dir%Own act as regressors in the structural model).

Empirically, however, it is found in this study that the level of directors' ownership

(Dir%Own group), when joined with the firm's corporate governance disclosure ranking (CG_rank), are significantly associated with both the firm's market valuation Q and its dividend payout ratio policy (DivPay). This is contrary to the conventional views by previous managerial ownership literature which tends to treat ownership as essentially an exogenous variable (e.g., McConnell and Servaes, 1990; Morck *et al*, 1988). Indeed, Larcker and Rusticus (2007) point out that, even if individual firms are assumed to be performing at optimum, a cross-sectional regression between firm performance and managerial ownership can yield a zero coefficient (Larcker and Rusticus, 2007, p. 212). Hence, testing for endogeneity of ownership based on zero coefficient on the ownership variable can be problematic. Larcker and Rusticus conclude that the instrumental variable approaches are unlikely to solve this problem because "instrumental variables will pick up systematic variation that is shared among firms and thus less likely to be due to random error and experimentation" (*ibid*, 2007, p.212).

Chenhall and Moers (2007) suggest that endogeneity can never be entirely solved in social science theories, and that "researchers should explicitly address endogeneity issues and use theory and logic to argue why endogeneity is, or is not, a problem in their particular study" (see Chenhall and Moers, 2007, p. 219). Francis and Lennox (2008) review 30 papers published in refereed journals that had used 2SLS models in testing for self-selection problems. They empirically demonstrate some major pitfalls with such a self selection test approach and find "those selection models can easily yield results consistent with ordinary least squares (OLS) models if the researcher makes relatively minor changes to the specification" (Francis and Lennox, 2008, p. 31). They come to the conclusion that the selection model is highly sensitive to minor changes in sample composition or model specification, whereas the OLS models are robust because OLS models are resistant to such perturbations. Larcker and Rusticus (2010) also arrive at the similar conclusion with their study on the use of instrumental variables (IV). They analyse IV applications and their analytical

results indicate that, when the IV is only weakly correlated with the regressor, "IV estimates are more biased and more likely to provide the wrong statistical inference than simple OLS estimates that make no correction for endogeneity" (Larcker and Rusticus, 2010, p. 187). Following the advice offered by Chenhall and Moers (2007), Francis and Lennox (2008) and Larcker and Rusticus (2010), this study resorts to theoretical reasoning in addressing the issue of potential endogeneity in the models.

7. SUMMARY AND CONCLUSION

This study investigates the relationship between voluntary CG disclosure and firm valuation under a common law legal regime but with concentrated ownership by the directors or family members. The CG disclosure is measured by the score (CGDscore) in a checklist based on the Appendix 23 of the *Listing Rules* of the HKEx, a regulation that became effective as of January 1st, 2005. The samples are small-cap firms which are the constituent stocks of the Hang Seng HK SmallCap Index. The period under study is from 2003 to 2005.

The relation of the CGDscore with the firm's valuation, proxied by Q , is firstly investigated. Also, following LLSV (2000a) and Mitton (2004), the outcome agency model of dividends is put to test, using the small-cap firms in Hong Kong as the samples. Multiple regressions and non-parametric tests are conducted to examine the relationship between CGDscore and the firm's valuation, and between CGDscore and the firm's dividend payout ratio.

Our empirical results make several contributions to the voluntary disclosure literature. First, our study shows that the CGDscore has positive and significant impact on Q . Small firms voluntarily disclose more about their CG (i.e., characterised with higher CGDscores) tend to receive higher market valuation than firms with lower CGDscores across all levels of directors' ownership. Specifically, firms that are high with corporate governance ranking but low in directors' ownership show the highest Q ; whereas firms with low corporate governance ranking and predominantly owned by insiders receive the lowest Q .

Investors thus tend to reward more transparent firms with higher valuation.

Second, the outcome agency model of dividend put forth by LLSV (2000a) is examined in our study by regressing the dividend payout ratio (DivPay) on the CGDscore and other controlling variables. When the CG disclosure level is low, those firms that have either low level of directors' ownership (0-25%), or predominant level of directors' ownership (>50%), tend to offer higher DivPay than other firms. The results support the LLSV's hypothesis in a way that outside investors would demand higher dividends as an additional minority protection mechanism (a 'safety net margin') for firms that may be plagued with either agency problems or entrenchment problems. This extra protection mechanism is sought after in a market such as Hong Kong which is acclaimed for its high level of investors' protection (LLSV, 1998), but suffers a high concentration and a predominant ownership by insiders (Claessens *et al.*, 2000). It suggests that when outsiders are legally powerless to remove entrenched managers because of the latter's predominance in voting rights, they would still seek ways to enhance their protection from potential expropriation by the predominant shareholders.

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**APPENDIX 1: SUMMARY OF THE MANDATORY DISCLOSURE REQUIREMENTS AND THE
RECOMMENDED DISCLOSURE OF THE CORPORATE GOVERNANCE REPORT AS PER
APPENDIX 23, LISTING RULES, HKEX, EFFECTIVE 2005:**

Mandatory disclosure requirements:

1. *Corporate governance practices*: whether a statement is given by the issuer stating that the principles in the Model Code Provisions has been applied, and if there is any deviation, whether the issuer provides details and reasons for such deviations.
2. *Directors' securities transactions*: whether the issuer has adopted a code of conduct regarding directors' securities transactions on terms no less exacting than the required standard set out in the Model Code.
3. *Board of directors*: whether the issuer has disclosed the composition of the board, the number of board meetings held during the financial year, the individual attendance of each director, the relationship among the members of the board, a statement of how the board operates, and the reasons why an INED is considered to be independent.
4. *Chairman and chief executive officer*: whether the issuer has identified the chairman and CEO, and their roles are segregated and are not exercised by the same individual.
5. *Non-executive directors*: whether the term of appointment of non-executive directors is disclosed.
6. *Remuneration of directors*: whether the issuer has disclosed the role and function, the composition, the number of meetings, and a summary of the work of the remuneration committee.
7. *Nomination of directors*: whether the issuer has disclosed the role and function, the composition, the number of meetings, the procedures, process, and criteria adopted in selecting directors, and a summary of the work of the nomination committee.
8. *Auditors' remuneration*: whether the issuer has provided an analysis of remuneration in respect of audit and non-audit services provided by the auditors, and details of the nature of each significant non-audit service assignment and the fees paid.
9. *Audit Committee*: whether the issuer has disclosed the role, function, and composition, the number of meetings, a report on the work of the audit committee and any details of non-compliance.

Recommended disclosures:

1. *Share interests of senior management*: whether the issuer has disclosed the number of shares held by senior management.
2. *Shareholders' rights*: whether the issuer has disclosed the ways shareholders can convene an extraordinary general meeting, the procedures to put enquires to the board, and the procedures to put forward proposals at shareholders' meetings with sufficient contact details.
3. *Investor relations*: whether the issuer has disclosed any significant changes in the issuer's articles of association, details of shareholders by type and aggregate holdings, details of the last shareholders' meeting, indication of important shareholders' dates in the next financial year, and the public float capitalisation as at the end of the fiscal year.
4. *Internal controls*: whether the issuer has disclosed a definition of its internal control system, the procedures and criteria for handling price sensitive information, how often internal controls are reviewed, the outcome of the review, and how the code provisions on internal control are complied.
5. *Management functions*: whether the issuer has made a distinction between the responsibility of the board and management.

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10/04 – Dr Ronnie Lo, Prof. Jo Danbolt & Prof. Kwaku Opong
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