IFC International Finance Corporation
World Bank Group

A SURVEY OF CORPORATE GOVERNANCE PRACTICES IN PAKISTAN 2007

COMPILED AND DRAFTED BY ACCA PAKISTAN
COMMISSIONED AND EDITED BY THE
INTERNATIONAL FINANCE CORPORATION,
SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN AND
PAKISTAN INSTITUTE OF CORPORATE GOVERNANCE

IFC International Finance Corporation
World Bank Group

A SURVEY OF CORPORATE GOVERNANCE PRACTICES IN PAKISTAN 2007

DISCLAIMER AND LIMITATIONS TO THE REPORT

This survey has been prepared as a reference document and is not intended to be exhaustive. While the utmost care has been taken in the preparation of this publication, it should not be relied upon as a substitute for legal advice or as a basis for formulating business decisions.

Any views expressed in this survey are those of the business community and do not necessarily represent the views of: (i) the Securities and Exchange Commission of Pakistan; (ii) the Pakistan Institute of Corporate Governance; (iii) the International Finance Corporation and World Bank Group; and/or (iv) the Association of Chartered Certified Accountants.

The following limitations apply to the information contained in this report.

- The scope of work did not include conducting an 'audit' of corporate governance practices of the surveyed financial sector institutions and companies in Pakistan. As such, no tests have been carried out to confirm companies' and financial sector institutions' responses.
- The survey is unable to 'look beyond the numbers'. For example, while the survey can capture quantitative data on the number of respondents that have established audit committees, it is unable to comment on whether these audit committees and their members are properly fulfilling their roles and responsibilities. Hence, the survey's authors have included qualitative data, notably comments made by respondents during the interview process, to support the survey's key findings or to highlight issues.
- The information presented in this report was obtained as a result of analysis of questionnaires received and interviews conducted with responding companies and financial sector institutions between November 2006 and February 2007. Any subsequent developments were not taken into consideration in the analysis of the survey findings.
- The surveyed sample was divided into two broad categories: financial sector institutions and companies. Although the report outlines the practices of the surveyed sample according to these categories, it is pertinent to mention that the objective of this survey was not to highlight and comment on the differences across these categories. It was to provide an accurate representation of corporate governance practices in Pakistan as a whole.
- Two roundtable discussions with stakeholders were held on 24 and 27 July 2007. Recommendations emanating from these discussions have been incorporated.

This publication should not be reproduced in whole or in part without the written permission of the copyright holder.

© 2006 International Finance Corporation
2121 Pennsylvania Ave.
NW Washington DC, 20433
United States of America
A Member of the World Bank Group

ACKNOWLEDGEMENTS

The SECP, PICG, IFC and ACCA would like to thank all the survey participants for the considerable time spent preparing their responses to the survey questionnaire and for their participation in the interview process. We are also grateful to the participants of the two roundtable events for providing valuable comments. The information we received from the respondents was indispensable for the conduct of the survey, and for developing the resulting conclusions and recommendations.

We hope that this survey and the recommendations contained in this report prove to be useful in improving corporate governance practices in Pakistan. Each participating company is entitled to receive bound copies of this report, which we hope will be helpful for improving their own corporate governance practices.

The report will also be posted on the websites of the SECP <www.secp.gov.pk>, PICG <www.picg.org.pk>, IFC <www.ifc.org/ifcext/mena.nsf/Content/CorporateGovernance> and *ACCA Pakistan* <www.accaglobal.com/pakistan/publicinterest>.

ABOUT THE SURVEY'S SPONSORS AND AUTHORS

About the Survey's Sponsors

About the SECP and Corporate Governance

Since its inception in 1999, the Securities and Exchange Commission of Pakistan (SECP) has focused its regulatory measures on fostering investor confidence. The SECP has been particularly keen to encourage good corporate governance to ensure transparency and accountability in the corporate sector and safeguard the interests of all stakeholders, especially those of minority shareholders. It has been empirically tested that jurisdictions that have implemented good governance measures are able to attract more capital.

In March 2002, the first Code of Corporate Governance for Pakistan was finalised and issued by the SECP. It was subsequently incorporated in the listing regulations of the three stock exchanges and is now applicable to all public listed companies. The Code is the first institutional effort of its kind in Pakistan.

The primary aim of the Code is to establish a system whereby a company is directed and controlled by its directors in compliance with the best practices, so as to safeguard the interests of diversified stakeholders. It proposes the restructuring of the board of directors to introduce broad-based representation by minority shareholders and by executive and non-executive directors. The Code emphasises openness and transparency in corporate affairs and the decision-making process and requires directors to discharge their fiduciary responsibilities in the larger interest of all stakeholders in a transparent, informed, diligent and timely manner.

In 2004, the SECP took the initiative to establish the Pakistan Institute of Corporate Governance in public-private partnership. The establishment of the Institute fulfils the need for an institutional arrangement where all major stakeholders jointly study governance practices and identify the problems, remain responsive to the external environment and initiate a combination of legislation, facilitation, cultural change, social values and changes in their respective roles, where necessary.

About IFC and Corporate Governance

The mission of the International Finance Corporation (IFC), the private sector arm of the World Bank Group, is to promote sustainable private sector investment in developing and transition countries in order to reduce poverty and improve people's lives. IFC finances private sector investments in the developing world, mobilises capital in the international financial markets, helps clients improve social and environmental sustainability, and provides advisory services to governments and businesses.

In 2006, IFC launched the Pakistan Corporate Governance Project (PCGP) to improve corporate governance practices in Pakistan. This goal is supported by three objectives, namely:

i. to build the business case for good corporate governance among banks and corporations, thus improving access to affordable capital, increasing strategic decision-making capacity and performance, and enhancing the reputations of banks and corporations among their stakeholders

ii. to assist investors, particularly banks, in improving the corporate governance practices of their investee companies, thus helping to create demand for good corporate governance across Pakistan, and

iii. to help develop sustainable institutional capacity for corporate governance reforms in Pakistan through, for instance, the Pakistan Institute of Corporate Governance.

About PICG and Corporate Governance

The Pakistan Institute of Corporate Governance (PICG) was established in 2004 as a not-for-profit company with a brief to promote awareness and encourage good corporate governance practices in Pakistan. The main objective of the PICG is to engender sound corporate governance practices and provide an enabling environment for the implementation of the Code of Corporate Governance issued by the SECP. This is being achieved by creation of awareness about corporate governance through conferences, seminars and lectures, and by training board directors. The Institute will also provide a platform for research and development work relating to corporate governance.

About the Survey's Authors

ACCA Pakistan, a not-for-profit organisation incorporated under Section 42 of the Companies Ordinance 1984, is part of ACCA (the Association of Chartered Certified Accountants), the largest and fastest-growing global professional accountancy body, with 296,000 students and 115,000 members in 170 countries. ACCA aims to offer the first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management. ACCA works to achieve and promote the highest professional, ethical and governance standards and advance the public interest.

ACCA has been involved globally in the development of best corporate governance practices through delivery of workshops, orientations, conferences, seminars, roundtables and production of technical publications. *ACCA Pakistan* strongly supported the adoption of Code of Corporate Governance in Pakistan and has been actively involved in arranging seminars and workshops to create awareness of best practices of corporate governance in Pakistan.

TABLE OF CONTENTS

SECTION 1 – INTRODUCTION 1
A. THE DEFINITION OF AND RATIONALE FOR IMPROVED CORPORATE GOVERNANCE 2
1. WHAT IS CORPORATE GOVERNANCE? 2
2. WHY CORPORATE GOVERNANCE MATTERS 2
B. RECENT TRENDS AND DEVELOPMENTS IN CORPORATE GOVERNANCE IN PAKISTAN 4
C. PURPOSE , METHODOLOGY AND STRUCTURE OF THE SURVEY 5
1. PURPOSE OF THE SURVEY 5
2. SURVEY METHODOLOGY 5
3. SURVEY STRUCTURE 6

SECTION 2 – EXECUTIVE SUMMARY 7
A. OVERVIEW - KEY FINDINGS 7
1. AWARENESS OF AND COMMITMENT TO GOOD CORPORATE GOVERNANCE PRACTICES 7
2. BOARD PRACTICES 9
3. CONTROL ENVIRONMENT AND PROCESSES 11
4. INFORMATION DISCLOSURE AND TRANSPARENCY 12
5. SHAREHOLDERS' RIGHTS 13
B. OVERVIEW – RECOMMENDATIONS 14
1. AWARENESS OF AND COMMITMENT TO GOOD CORPORATE GOVERNANCE PRACTICES 14
2. BOARD PRACTICES 16
3. CONTROL ENVIRONMENT AND PROCESSES 18
4. INFORMATION DISCLOSURE AND TRANSPARENCY 19
5. SHAREHOLDERS' RIGHTS 20

SECTION 3 – SURVEY RESULTS – KEY FINDINGS AND RECOMMENDATIONS 21
A. COMMITMENT TO AND AWARENESS OF CORPORATE GOVERNANCE PRACTICES - KEY FINDINGS 21
1. IMPORTANCE OF IMPLEMENTING CORPORATE GOVERNANCE PRACTICES 22
2. UNDERSTANDING CORPORATE GOVERNANCE AND ITS MAIN GOALS 23
3. BENEFITS OF IMPLEMENTING CORPORATE GOVERNANCE PRACTICES 25
4. DEMONSTRATING COMMITMENT TO REFORMS 27
5. DEFINING AND CODIFYING KEY POLICIES, PROCESSES AND PROCEDURES 31
6. COMMITMENT TO CORPORATE GOVERNANCE IMPROVEMENT PLANNING 37
7. COMMITMENT AND AWARENESS OF CORPORATE GOVERNANCE PRACTICES - RECOMMENDATIONS 40
B. BOARD PRACTICES – KEY FINDINGS 43
1. ROLE OF THE BOARD 45
2. BOARD COMPOSITION 54
3. BOARD STRUCTURE AND COMMITTEES 57
4. BOARD WORKING PROCEDURES 60
5. BOARD PERFORMANCE EVALUATION AND TRAINING 67
6. DUTIES AND RESPONSIBILITIES OF THE BOARD 68
7. ROLE OF CEO/CHAIRMAN 71
8. BOARD PRACTICES - RECOMMENDATIONS 72
C. CONTROL ENVIRONMENT AND PROCESSESS - KEY FINDINGS 76
1. INTERNAL AUDIT 77
2. AUDIT COMMITTEE 79
3. EXTERNAL AUDIT 81
4. CONTROL ENVIRONMENT AND PROCESSESS - RECOMMENDATIONS 85

D. INFORMATION DISCLOSURE AND TRANSPARENCY - KEY FINDINGS 86
1. SOURCES OF INFORMATION FOR INVESTORS 87

2. INFORMATION IN THE ANNUAL REPORTS 91
3. INFORMATION DISCLOSURE AND TRANSPARENCY - RECOMMENDATIONS 95
E. SHAREHOLDER'S RIGHTS 96
1. THE GENERAL SHAREHOLDER MEETING 97
2. SPECIAL MINORITY SHAREHOLDER PROTECTION MECHANISMS 100
3. DIVIDENDS 101
4. DISCLOSURE OF CONFLICTS OF INTEREST AND RELATED-PARTY TRANSACTIONS 103
5. RELATED-PARTY AND MATERIAL TRANSACTIONS 104
6. SHAREHOLDER'S RIGHTS - RECOMMENDATIONS 107

ANNEXE ONE: COMPOSITION OF THE SAMPLE IN TERMS OF SECTORS 108

LIST OF ACRONYMS

ACCA	Association of Chartered Certified Accountants
AGM	Annual General Meeting
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CO	Companies Ordinance
DFI	Development Finance Institution
IAS	International Accounting Standard
ICAP	Institute of Chartered Accountants of Pakistan
IFC	International Finance Corporation
IFRS	International Financial Reporting Standard
KSE	Karachi Stock Exchange
OECD	Organisation for Economic Co-operation and Development
PICG	Pakistan Institute of Corporate Governance
ROSC	Reports on the Observance of Standards and Codes
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan

SECTION I – INTRODUCTION

If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company's practices may be – suffer the consequences. Markets must now honour what they perhaps, too often, have failed to recognise. Markets exist by the grace of investors. And it is today's more empowered investors who will determine which companies and which markets will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investors' capital. [1]

There is growing interest in the concept of corporate governance in Pakistan, mainly because corporate governance is a key to developing a market economy and civil society in transitioning economies such as Pakistan. Suggestions for the need for enhanced standards of corporate governance are reverberating throughout the country. Globalisation, the need to attract foreign investment to ensure the sustainable development of Pakistan, maintaining the performance excellence of the Stock Exchanges, recent corporate scandals such as the Crescent Standard Bank, greater transparency in financial reporting and shareholders' rights protection – to name a few, are among the incentives for enhanced standards of corporate governance. Nonetheless, even though corporate governance is now a frequent topic of conversation for directors of large companies and in government circles in Pakistan, there is a notable lack of consensus about why corporate governance is important. It is therefore not surprising that, for some, corporate governance is seen as a passing fad, a necessary evil to put up with, while for others it is fundamental to what a company does, how it achieves its objectives and how it works in the interests of its shareholders. This survey aims to outline corporate governance practices in Pakistan and offer a select number of recommendations for reforms.

[1] Arthur Levitt, former chairman of the US Securities and Exchange Commission in December 2000 at a Manhattan conference sponsored by the Federal Reserve.

A. THE DEFINITION OF AND RATIONALE FOR IMPROVED CORPORATE GOVERNANCE

> *Everywhere shareholders are re-examining their relationships with company bosses – what is known as their system of 'corporate governance'. Every country has its own, distinct brand of corporate governance, reflecting its legal, regulatory and tax regimes…The problem of how to make bosses accountable has been around ever since the public limited company was invented in the 19th century, for the first time separating the owners of firms from the managers who run them.* [2]

1. What is corporate governance?

Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the boards, managers, shareholders and other stakeholders, and spells out the rules and procedures or making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.[3]

A company committed to good corporate governance has well-defined and protected shareholder rights, a solid control environment, high levels of transparency and disclosure, and an empowered board. The interests of the company and those of all shareholders are aligned.

2. Why corporate governance matters

> *The aim of corporate governance is to align as nearly as possible the interests of individuals, corporations and society.*[4]

Corporate governance ensures fairness, transparency, accountability, sustainable financial performance, increased shareholder confidence, access to external finance and foreign investment, fair treatment of the stakeholders in a company, maximisation of shareholders' value and the enhanced reputation of a company, nation and economy.[5] Efficient corporate governance practices lead to higher return on capital employed, attraction of long-term capital, mitigation of systematic risk, higher return for shareholders, improvement in the confidence of domestic and foreign investors, reduction in the cost of capital, stable flow of finance, availability of international capital, and greater productivity. An effective and efficient corporate governance framework depends on the legal, regulatory, business and institutional environment.

a. Corporate Governance and Investors

Corporate governance is becoming increasingly important to investors, because well-governed companies have lower risk and fewer unexpected events. Well-governed companies are better at protecting shareholders'

---

[2] Corporate Governance : 'Watching the Boss', *The Economist*, Jan 29, 1994

[3] OECD, 2004. The Organisation for Economic Co-operation and Development (OECD) is a grouping of 30 developed countries that share a commitment to democratic government and the market economy. The OECD plays a prominent role in fostering good public- and private-sector governance. The OECD published the Principles of Corporate Governance in 1999 and revised them in 2004.

[4] Sir Adrian Cadbury speaking at 'Global Corporate Governance Forum', World Bank, 2000.

[5] Shleifer, A and Vishny, R.W. (1997), 'A Survey of Corporate Governance', *The Journal of Finance*, June, 52/2.

rights and providing better assurance that management will act in the best interest of the company and of all its shareholders.

Did You Know That...?

- Well-governed firms in Korea have been found to trade at a premium of 160% to poorly governed firms.[6]
- A worst-to-best improvement in corporate governance predicted an astronomical 700-fold increase in firm value among Russian firms.[7]
- A study of S&P 500 firms showed that companies with strong or improving corporate governance practices outperformed those with poor or deteriorating governance practices by about 19% over a two-year period.[8]
- Institutional investors will pay premiums to own well-governed companies. Premiums averaged 30% in Eastern Europe and Africa and 22% in Asia and Latin America.[9]

b. Corporate Governance and other Stakeholders

Stakeholders such as banks, suppliers and employees will prefer to enter into business relationships with well-governed companies, since the resulting relationships are likely to be more prosperous, fairer and longer lasting compared with relationships with companies where corporate governance practices are deficient. They will also benefit from reduced risk and the increased wealth creation of the company.

Did You Know That...?

Romania's Banca Comerciala Romana (BCR) was upgraded by FitchRatings (individual rating to C/D from D) and S&P (long-term counterparty rating to BB- from B+); the agencies cited improvements in corporate governance and risk management as the main reasons for the upgrades. [10]

c. Corporate Governance and the Country

From the perspective of the country, corporate governance is important as it facilitates the development of stronger capital markets, reduces risk, and improves a country's ability to mobilise, allocate and monitor investments, which ultimately fosters economic growth.

d. Corporate Governance and Enterprises

Good corporate governance is an essential aspect of risk management as the corporate governance practices of enterprises affect market confidence as well as company performance. Good corporate governance practices

---

[6] Black, B. S., Jang, H., Kim, W. (2004), 'Predicting Firms' Corporate Governance Choices: Evidence from Korea', University of Texas Law School Working Paper No. 39, August.

[7] Black, B. (2001), 'The Corporate Governance Behavior and Market Value of Russian Firms', *Emerging Markets Review*, vol. 2, March.

[8] Grandmont, R., Grant, G., and Silva, F. (2004), *Beyond the Numbers – Corporate Governance: Implications for Investors*, (Deutsche Bank, April 1).

[9] McKinsey's Global Investor Opinion Survey, 2002.

[10] IFC (2006), *The Irresistible Case for Corporate Governance* (IFC, March).

may correlate with superior share price growth, ensure sustainable economic prosperity of enterprises, facilitate access to cheaper capital, enable efficient running of the enterprise, attract investors, ensure investors' confidence, protect minority shareholders' rights, increase wealth creation and reduce reputation risk. Poor corporate governance, on the other hand, weakens a company's potential and may pave the way for financial difficulties and even fraud.

B. RECENT TRENDS AND DEVELOPMENTS IN CORPORATE GOVERNANCE IN PAKISTAN

Since 2002, a number of corporate governance reforms, including legislative reforms, corporate governance guidance and principles, and stock exchange governance rules have been initiated globally. The most important have been the OECD Principles of Corporate Governance,[11] the Basel Committee on Banking Supervision (BCBS)[12] Guidance on Enhancing Corporate Governance for Banking Organizations, and the Sarbanes–Oxley Act[13] in the United States. These have inspired countries such as Pakistan to adopt corporate governance codes, which are frequently based on such best practices yet tailored to fit local regulations and circumstances.

Pakistan is a common law country. The relevant legislation includes the 1969 Securities and Exchange Ordinance (SEO),[14] the 1984 Companies Ordinance (CO),[15] and the 1997 Securities and Exchange Commission of Pakistan Act,[16] as a result of which the SECP became the principal regulator of securities markets and non-bank companies, including non-listed ones. Since its establishment, the Securities and Exchange Commission of Pakistan has worked towards creating transparency and accountability in the corporate and financial sectors. It has initiated a number of reforms aimed at improving corporate governance policies, structures and frameworks in Pakistan. The most important reform was the implementation of the Code of Corporate Governance[17] in Pakistan in 2002. This Code has been made part of the listing regulations of the Karachi, Lahore and Islamabad stock exchanges and all listed companies are required to give a statement of compliance with the Code of Corporate Governance in their annual reports. The Code is an extension of the requirements of the Companies Ordinance, 1984 and a number of amendments have been made in the Companies Ordinance, 1984 for greater harmonisation between the provisions of the Code and the Companies Ordinance. The Companies Ordinance Review is also in process. The Securities and Exchange Commission of Pakistan (SECP) has reinforced the Code with other publications designed to enhance the quality of corporate governance within Pakistan, for example FAQs and the *Manual of Corporate Governance*.[18]

According to the State Bank of Pakistan Prudential Regulations[19] (G1–G3), all listed and non-listed commercial banks and Development Finance Institutions (DFIs) in the country are also required to comply with this Code of Corporate Governance.

The World Bank ROSC Corporate Governance Country Assessment for Pakistan[20] (2005)(hereafter 'the ROSC report') concludes that, despite initial resistance to the Code from issuers and market participants, compliance with it has been improving. Market leaders such as multinational companies, leading banks and notable family-controlled corporations are creating more transparent and modern corporate governance structures. Companies are arranging orientation seminars for their boards. The establishment of PICG and

---

11 www.oecd.org/dataoecd/32/18/31557724.pdf
12 www.bis.org/bcbs/
13 news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf
14 www.secp.gov.pk/corporatelaws/sep_08_00.htm
15 www.secp.gov.pk/corporatelaws/pdf/CompOrd1984(Nov2006).pdf
16 www.secp.gov.pk/corporatelaws/dec_26_98.htm
17 www.secp.gov.pk/corporatelaws/pdf/CodeofCorporateGovernance.pdf
18 www.secp.gov.pk/divisions/Portal_CS/PDF/manual-CG.pdf
19 www.sbp.gov.pk/publications/prudential/PRs-Corporate.pdf
20 www.worldbank.org/ifa/rosc_cg_pak.pdf

the increasing role of IFC in enhancing and inculcating good corporate governance practices in the country were identified by the ROSC report as positive steps towards universalising the growing awareness among market participants and making the business case for corporate governance, thus encouraging companies to improve their corporate culture. The ROSC report also acknowledges the increasingly active role of the SECP in enforcing its relatively strong authority under the law. Although the ROSC report encourages consistent application of regulatory enforcement to close the gap between law and practice, it does indicate that companies are considering delisting from the exchanges for a number of reasons, including stricter corporate governance requirements.

C. Purpose, Methodology and Structure of the Survey

1. Purpose of the survey

The primary objectives of the survey were the following.

- To allow all stakeholders to gain an understanding of the extent to which financial institutions and companies in Pakistan follow good corporate governance practices, in line with Pakistan's Code of Corporate Governance and internationally recognised best practice, such as the OECD Principles of Corporate Governance and Basel Committee's recent guidance on enhancing corporate governance for banking organisations.

- To assist both the private and public sectors to close any gaps between best and current practice, by identifying areas for improvement.

- To provide the PICG and IFC's Pakistan Corporate Governance Project with a baseline on which to focus its corporate governance reform activities.

2. Survey methodology

The survey targeted local listed and large[21] local non-listed companies and financial sector institutions of Pakistan. A questionnaire was initially designed by IFC and then customised to adapt it to Pakistan's financial and corporate sector environment.

The questionnaire was dispatched in hard and soft copies to a statistically relevant sample of local listed and large local non-listed companies and financial sector institutions of Pakistan. Respondents were given the option of either completing the questionnaire or having it completed in a one-to-one semi-structured interview. After the dispatch of the questionnaires, follow-up phone calls were made and interview dates set up with those companies/financial institutions that wanted to be interviewed.

The response rate to the questionnaire was as shown in Table 1.1.

[21] A company is defined as 'large' if it has a paid up capital of PKR 500 million and above.

Table 1.1: Response rate to the questionnaire

Response from	Total questionnaires sent	Total questionnaires received	Response rate
Local financial sector institutions	111	55	50%
Local companies	260	56	22%
Total	371	111	30%

(See Annexe 1 for details of the composition of the sample). The non-responding companies and financial sector institutions explained that they did not have the human resources and time for completing the questionnaire.

a. Timeline

The survey was launched at the end of November 2006 and completed by January 2007.

b. Survey questionnaires and interviews

All the meetings and interviews were conducted with directors and executives of the surveyed financial sector institutions and company boards of directors, including the chairman/chief executive officer (CEO), chief financial officer (CFO), and company secretaries. The questionnaires were also completed by either the CFO or the company secretary.

3. Survey Structure

In addition to this introductory Section 1, the survey report includes the following three sections.

Section II – Executive summary. The executive summary highlights the major findings for the different corporate governance areas covered in the survey, namely: (i) awareness of and commitment to good corporate governance practices (ii) board practices (iii) control environment and processes (iv) information disclosure and transparency, and (v) shareholders' rights.

Section III – Survey findings and recommendations. This section outlines leading practices in corporate governance, presents the survey findings in detail, and makes some recommendations for regulators and for the improvement of corporate governance practices in Pakistan.

Section IV – Annexe. The annexe to this report contains additional brief information on the survey sample.

SECTION II – EXECUTIVE SUMMARY

Not corporate governance but the Code of Corporate Governance is important: I have to follow each and every word of the Code. I do not understand why independent directors, audit committees, internal audit and company secretaries are important but the Code wants them and I need to have them. For me the profitability of the company is important. I think the Code has not increased the profitability of my company even though we do have four meetings of the board, we have non-executive directors, we follow the Code but having all this has decreased my profits, not increased my profits. When I should be concentrating on business matters, I am concentrating on internal audit reports. So why do I follow the Code? Because I am the owner of a listed company and have to follow the Code because the SECP wants us to follow the Code. (Chairman of a local listed company)

A. OVERVIEW – KEY FINDINGS

1. Awareness of and commitment to good corporate governance practices

Corporate governance is important because we have to follow the Code of Corporate Governance… benefits like the ones outlined by you relating to access to foreign capital, institutional investors, increased reputation of the business, all this does not matter to my company. What matters to the company is the survival of the business and we need money for that. We can take a loan from the bank at any time and they are not worried about our corporate governance practices so why do we need to think of foreign capital or increased reputation or better governance? I only consider corporate governance important because the SECP wants me to consider it important. (Company secretary of a local listed firm)

1.1 Compliance with the Code of Corporate Governance

Generally, there is awareness of good corporate governance practices, with 92% of respondents stating that they considered implementation of corporate governance practices to be very important or important, primarily because the Code of Corporate Governance requires adoption of these practices. Even though 98% of the respondents stated that they comply with the Code of Corporate Governance, 89% stated that the main reason for compliance was that the Code of Corporate Governance was mandatory. Thus 81% of the respondents published a statement of compliance with the Code of Corporate Governance in their annual reports simply to demonstrate their compliance with the Code.

1.2 Benefits of adopting corporate governance practices

For an overwhelming majority (82%) of the respondents, the most important benefit of adoption of corporate governance practices was compliance with legal and regulatory requirements. There was no sufficient evidence of appreciation or comprehension of other significant benefits, such as protecting shareholders' rights; building/enhancing the company's/bank's reputation; improving strategic decision making; gaining better access to external capital or to foreign institutional investment, or to international markets; effective risk management; or transparency in the governance of companies.

1.3 Corporate governance improvements

Companies had adopted such corporate governance improvements as were required by the Code of Corporate Governance; for example, 65% had established corporate secretary positions and 59% had

started training board members on corporate governance issues. Respondents were not very keen to adopt other corporate governance improvements that are not considered mandatory by the Code of Corporate Governance but are advocated by the OECD Principles of Corporate Governance. For example, 50% of the respondents have not introduced independent non-executive directors to the board of directors or established general shareholder meeting procedures, 54% have not established conflict of interest and related-party transactions administration procedures, 53% have not implemented a formal remuneration system for executives and 55% did not have a corporate governance improvement plan. Interviewees were asked about board committees, but even though a large number had audit committees the majority did not appreciate the reason for establishing board committees other than audit committees, for instance for remuneration and nomination, mainly because they were not mandatory under the Code of Corporate Governance.

1.4 Corporate governance documents

As required by the Code of Corporate Governance, 92% prepared and circulated annually a 'Statement of Ethics and Business Practices' and 48% had a vision/mission statement. None of the companies have developed their own code of corporate governance, as in their opinion this was not required by the Code of Corporate Governance of Pakistan.

1.5 Barriers to improving corporate governance practices

31% of the respondents did not identify any barrier to improving corporate governance in the company as they believed that because they have to comply with the Code of Corporate Governance, every barrier has to be overcome and resistance is futile. Of the 69% of respondents who identified barriers, 42% mentioned unavailability of qualified staff to help with implementation of corporate governance practices and lack of information/know-how relating to corporate governance principles and practices as the barrier to improving corporate governance practices in the company. The other main obstacle identified (mentioned by 21% of respondents) was that corporate governance produces commercially sensitive information that cannot be shared with competitors. Even though none of the respondents considered corporate governance to be unimportant or irrelevant, 14% asserted that the main obstacle to improvement of corporate governance practices was that they did not see any benefit in adopting such practices.

2. Board practices

We follow the Code of Corporate Governance in terms of board composition and our board of directors do all that the Code requires…we have to do this. We have board meetings, we have a separate CEO and chairman. We have non-executive directors who may be considered independent but there is no compulsion to have non-executive directors who are independent. …The Code wants the board to approve annual reports, remuneration, strategy, etc. Thus most of the board's time is spent in approvals. The board hardly gets any time to think of vision, succession planning, long-term strategy, new business opportunities, going global. The board has human beings not robots who can comply with the Code and also think of succession planning and vision. The Code is more important than anything else. (CFO of a listed company)

2.1 The role of the board of directors

It can be concluded from the survey that the board, as envisaged by the Code of Corporate Governance, is a powerful centre of authority and control in terms of the functions it performs. The board of directors is responsible for the election, appointment and dismissal of the chief executive (88%); approving the remuneration of the members of the board (62%); the election, appointment and removal of the chairman of the board (91%); setting corporate strategy (86%); setting the remuneration of the CEO (82%); approving risk management policy (74%); approving transactions (98%); reviewing annual reports (81%); and creating disclosure policies (89%) and succession planning (32%).

2.2 Role of institutional investors

It was observed from the interviews conducted that key executives of responding companies were unhappy with the duties and functions performed by institutional investors as members of the board of directors. They asserted that representatives of institutional investors are overworked because each one is on more than ten different boards and they do not generally come prepared for board meetings.

2.3 Board composition

88% of the responding organisations had more than seven directors. Contrary to the common belief that the majority of boards comprise wives, daughters and daughters-in-law, 69% of the boards did not have any female directors.

2.4 Independent non-executive directors

There is general resistance to the idea of having independent non-executive directors on the board. Respondents were content with having non-executive directors, whom they defined as those directors who do not work full time in the company and can be distant relatives and friends, but were averse to the idea of an independent non-executive director, mainly because they could not appreciate the value of having outside independent directors.

2.5 Board committees

As recommended by the Code of Corporate Governance, 95% of the respondents had an audit committee but only 34% had a majority of non-executive directors as required by the Code. The OECD Principles of Corporate Governance encourage establishment of other board committees, for example a corporate governance committee and a remuneration committee. As the Code does not

require these, 88% of the respondents did not have a corporate governance committee and 73% did not have a remuneration committee.

2.6 Chairman/CEO position

As recommended by the Code of Corporate Governance, 85% of the respondents stated that the positions of CEO and chairman were held by different persons.

2.7 Board meetings

The board of directors met on average three to five times a year, as required by the Code of Corporate Governance, in 73% of the surveyed sample, while 91% stated that the directors are furnished with background material one week before the meeting, as required by the Code.

2.8 Fiduciary duties

For 75% of the respondents, duty of care meant that in all their decisions the company's/bank's directors acted in the best interest of the company and all its shareholders. 46% of the surveyed sample stated that the duty of loyalty meant that the company's/bank's directors do not participate in a competing company or other company in the same sector. It is worth mentioning that when interviewees were asked whether non-executive directors also fulfilled the duty of care and especially the duty of loyalty, they replied that (contrary to sound corporate governance) only executive directors were required to fulfil the duty of care and loyalty.

2.9 Remuneration

29% of respondents did not reply to the question about the amount of payment made to the non-executive board members for attending board meetings, while 71% of those respondents who did reply stated that the average such payment was in the range of PKR 500–5,000 (approximately US $8–$82[22]). Generally, there was not much evidence of performance-related salaries for executive directors and senior managers.

2.10 Orientations and evaluation

As recommended by the Code of Corporate Governance, 77% of the respondents stated that they were organising Code of Corporate Governance orientations for board members where they could discuss the various provisions of the Code. Because the Code does not require a formal evaluation of the board's performance in the previous two years, 70% of the respondents had not done so.

[22] 1 US$ = PKR 60.65 (The News, 20 September 2007)

3. Control environment and processes

I remember the time when an external auditor could do everything, now we have an internal auditor and an audit committee because it is good corporate governance. Did Enron not happen with all the internal auditors and audit committees? All these committees are a drain on our time and money. Then they say change the auditor after every five years. We had one auditor for 25 years and he knew the business. Our new auditor cannot understand the business quickly and that is an added cost. (CFO of a listed company)

3.1 Internal and external auditor

96% of the respondents had an internal auditor/audit department and 97% had an external auditor.

3.2 Roles and responsibilities of internal auditor, external auditor and audit committee

In general, the internal auditor, audit committee and external auditor were performing the roles and responsibilities assigned to them by the Companies Ordinance and the Code of Corporate Governance. Majority of the respondents stated that a whistle-blowing policy was not in place and use of insider information was not investigated by the audit committee, the internal auditor or the external auditor.

3.3 Rotation of external auditors

Even though the Code of Corporate Governance states that all listed companies in the financial sector should change their external auditors every five years, 30% of the financial institutions surveyed had not done so. A number of respondents queried the rationale for rotation of auditors/audit partners because in their opinion competent auditors work only for the big four auditing firms.

4. Information disclosure and transparency

4.1 Transparency in information disclosure

As transparency in information disclosure enables the financial markets, depositors and other stakeholders to have a fair understanding of a company's value, as well as helping to develop trust in the quality of the company and its management, the OECD Principles of Corporate Governance encourage transparency in information disclosure. It was observed that the majority of the respondents achieved transparency in information disclosure by fulfilling the requirements of the Code of Corporate Governance and the Companies Ordinance 1984.

Thus even though annual reports prepared by the majority of the respondents complied with the provisions of Fourth and Fifth Schedules of the Companies Ordinance, responding companies were reluctant to provide voluntary information relating to their articles of association (92% failed to do so), remuneration of the board as individuals (53% failed to do so), market share, sales and marketing (57% failed to do so), environment and social responsibility (58% failed to do so), biographies of the members of the board (86% failed to do so), stock options policy (90% failed to do so) or to provide a 'management discussion and analysis' section (72% failed to do so) in their annual reports, mainly because 83% of the respondents asserted that there was no legal requirement to disclose such information in the annual reports.

4.2 Compliance with IAS/IFRS

61% of the respondents complied with IAS/IFRS.

4.3 Annual reports on the company website

80% of the responding companies had a website and 67% of these made their annual reports available on their website. The remainder stated that as annual reports contain commercially sensitive information they did not want to post them on the website.

5. Shareholders' rights

The OECD Principles of Corporate Governance state that the corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. The Code of Corporate Governance also encourages the protection of shareholders' rights.

5.1 Attendance at last AGM

61% of the respondents stated that more than 50% of their company's total shareholders attended the last AGM.

5.2 Notice for the AGM

As required by the Companies Ordinance, 86% of the respondents had published the notice of their AGM in the press and 82% had also informed their shareholders via registered mail. As it is not required by the Companies Ordinance or the Code of Corporate Governance, 95% of the respondents had not used e-mail to send the notice of AGM to the shareholders. In accordance with the Companies Ordinance, 98% of the respondents stated that they give adequate notice (21 days) of their AGM.

5.3 Voting mechanisms at the AGM

Under the Companies Ordinance, voting at a general meeting of a company may take place by a show of hands, by standing vote, by ballot, by poll and by proxy. In the surveyed sample, 67% stated that voting at the AGM takes place by means of a show of hands, and 52% stated that a proxy voting mechanism was also available to shareholders. An electronic voting mechanism had not been used by any of the respondents.

5.4 Special minority protection mechanisms

The OECD Principles of Corporate Governance state that shareholders should have the opportunity to participate effectively and vote in the general shareholder meetings and should be informed of the rules, including the voting procedures that govern such meetings.

As the Code of Corporate Governance has not specifically stated any special minority protection mechanisms, 45% of the respondents declared that they did not have a clause relating to equal treatment with respect to voting rights and subscription rights in their articles, 81% did not have cumulative voting as a special minority protection mechanism, 91% did not have clear policies with respect to treatment of shareholders when changes of control occur, and none of them had block voting mechanisms.

5.5 Conflict of interest disclosure and related party transactions

The OECD Principles of Corporate Governance encourage disclosure of conflicts of interest. The Companies Ordinance 1984 and the State Bank of Pakistan Prudential Regulations also have requirements relating to conflict of interest and related-party transactions. In the survey, 67% of the respondents stated that their company's/bank's governing documents require the board members and management to disclose, and abstain from voting on, issues where there is a conflict of interest.

There was evidence of increasing related-party transactions among responding companies, with 80% of the respondents stating that under a governing document or law it was mandatory to disclose related-party transactions. Even though there is currently no requirement to have the related-party transactions certified by the external auditors, 67% of the respondents stated that they should be verified by the external auditors.

B. OVERVIEW – RECOMMENDATIONS

The recommendations given below follow the same groupings as the key findings above.

1. Awareness of and commitment to good corporate governance practices

1.1 A task force should be established to review the Code of Corporate Governance.

Over the last five years, the Code of Corporate Governance, built upon a sound framework of company law, has developed a culture of compliance with corporate governance practices. Our overall recommendation is thus that even though Pakistan must continue to press forward with the enhancement of its corporate governance – while taking care not to stifle the nation's entrepreneurial flair with a burgeoning volume of counterproductive regulation – the country should nevertheless follow the practice elsewhere across the world and establish a task force to review its Code of Corporate Governance. This may be necessary so that the code more effectively represents some of the emerging corporate governance practice issues, such as independent non-executive directors, whistle-blowing procedures and remuneration committees, as well as to ensure that the Code is in line with international changes in corporate governance codes and principles.

1.2 The business community should be made aware of the business case for implementation of corporate governance practices through awareness raising seminars.

The majority of the respondents had adopted a box-ticking and compliance approach to implementing the provisions of the Code of Corporate Governance. They were unable to understand the business case for corporate governance, presumably because for them the main objective was compliance with the Code; expanding their horizons beyond this did not occur to them. It is important that the business community appreciates the business case for good corporate governance. In this context the chambers of commerce, trade associations, PICG, IFC and other professional bodies need to make companies aware of the business case for corporate governance by making them appreciate the advantages beyond compliance with legal and regulatory requirements. These advantages include improving access to external capital, making possible sustainable business growth, protecting shareholders' rights, building reputation, achieving improved transparency in the governance of a business, and attracting investment by institutional investors such as Hermes and CalPERS. At present Pakistan has none of the three-trillion-dollar investment by Hermes and CalPERS in Asia. This business case should be promoted by conducting awareness-raising seminars.

1.3 The review of the Code of Corporate Governance should emphasis the principles that underpin the specific mandatory requirements already included within the Code so as to make companies appreciate the rationale for implementing corporate governance improvements.

It was observed that even though respondents were implementing corporate governance improvements required by the Code of Corporate Governance, such as establishing audit committees and a corporate secretary position, and producing a statement of compliance with the Code and statements of ethics and business practices, their approach was one of box ticking. A revised Code should focus on underlying principles and explaining the rationale for corporate governance. This may help in developing a business case for corporate governance and implementing the true spirit of corporate governance practices, rather than the current, narrower, application. The spirit of corporate governance itself has to be understood by companies in Pakistan before they will implement fully committed corporate governance practices.

1.4 There should be a sharpening up of the current statement of compliance with the Code of Corporate Governance so that the narrative statement provides sufficient explanation to enable shareholders to evaluate how the principles of corporate governance have been applied.

The compliance statement should be a narrative statement, providing sufficient explanation to enable shareholders to evaluate how the principles of corporate governance have been applied. There should also be a statement as to whether or not the company has complied, throughout the accounting period, with the specific requirements of the Code. A company that had not complied with the Code requirements, or complied with only some of them, or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, would be required to specify the requirements with which it had not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for this non-compliance.

1.5 The SECP should consider inclusion of guidance notes for companies on preparation of Statement of Ethics and Business Practices in the revised Code of Corporate Governance.

The SECP should consider developing a guidance note for companies on how to prepare a Statement of Ethics and Business Practices, or it could include a template Statement of Ethics and Business Practices in the revised Code of Corporate Governance.

1.6 Pakistan's resource of competence in corporate governance should be developed.

Lack of qualified staff to implement corporate governance practices and lack of information/know-how about corporate governance were identified as the main barriers to the implementation of corporate governance practices. It is suggested that corporate governance as a subject should be taught at universities to develop qualified staff able to implement corporate governance practices effectively. There is also a need to further strengthen the PICG so that it becomes a centre of excellence in terms of corporate governance research and professional development programmes.

1.7 The roles of regulators, stock exchanges and courts need to be strengthened.

In order to ensure effective implementation of corporate governance practices in Pakistan, along with the SECP, the stock exchanges and the courts have to play a critical and more active role. The stock exchanges have to be stricter in enforcing the listing rules relating to corporate governance. The courts also have to play a key role in enforcement of corporate governance practices. There may also be a need for refreshing the skills and knowledge of regulators, courts and stock exchanges personnel so that they may effectively monitor the implementation of the code of corporate governance.

2. Board practices

2.1 Fiduciary duties of directors should be strengthened.

The fiduciary duties of directors should be strengthened by describing them specifically in the Code of Corporate Governance and then, over time, incorporating them in the Companies Ordinance. It is important that the responsibilities of boards and of directors are codified within statute law, rather than relying on common law.

2.2 The difference between 'non-executive' and 'independent' directors needs to be better understood within companies. The revised Code of Corporate Governance should adopt a 'comply and explain' approach towards the inclusion of independent non-executive directors.

The difference between 'non-executive' and 'independent' is insufficiently understood within companies. Inclusion of independent non-executive directors on the board of directors should be encouraged, with a 'comply or explain' policy incorporated in the revised Code of Corporate Governance.

2.3 The composition of boards should be balanced and there should be representation of independent, qualified and experienced directors.

There may be a case for encouraging a better mix of skills among board directors, and different types of director, ie a mix of executive, non-executive and independent directors, as well as a greater diversity of qualified and experienced individuals, including women.

2.4 Research should be conducted on assessing the effectiveness of board meetings in setting the strategic directions and oversight of management.

Further research would be useful to determine whether boards in Pakistan are effective at determining the strategic direction of the entity and overseeing management on behalf of shareholders. Research thus needs to be conducted on the range and content of board meetings.

2.5 Establishment of board committees, for example remuneration committees, should be encouraged by the SECP.

The SECP Code should progressively come into line with other leading codes in influencing the more general establishment of corporate governance, nomination and/or remuneration committees.

2.6 The SECP should play an important role in ensuring more effective audit committees by stipulating the inclusion of a majority of independent non-executive directors in audit committees.

The SECP Code and other guidance on audit committees should be kept under review, with the intention of making audit committees progressively more effective, commensurate with the constraints that apply in Pakistan. The composition of audit committees needs to be reconsidered and the chairman or a majority of the members should be independent non-executive directors.

2.7 Guidance on directors' remuneration should be developed.

There is a need to develop best practice guidance on directors' remuneration.

2.8 Modern and interactive training courses for directors and company secretaries should be developed.

There is an urgent need to have more modern and interactive training courses for directors, company secretaries and those entrusted with implementing corporate governance. The Board Development Series initiated by PICG and IFC is a promising initiative in this area.

2.9 Board and director evaluations should be addressed in the Code.

The Code is silent on board and director evaluation. There is thus a marked lack in the present Code, which the review of the code of corporate governance should address.

2.10 The role of institutional investors needs to be reviewed so as to make these investors aware of their duties and responsibilities.

The SECP should incorporate in the Code a section on a revised role for institutional investors. This is essential to make the institutional institutions aware of their duties and responsibilities. It may also be helpful in ensuring that the institutional investors and their nominee directors play a pivotal role in effective implementation of corporate governance practices.

3. Control environment and processes

3.1 The concept of the whistle-blower needs to be developed in Pakistan and whistle blowing policies should be developed by companies and financial sector institutions.

Developing the concept of the whistle-blower will ensure that there are channels for reporting fraud and other unethical activities that can be detrimental to the reputation and sustainability of the organisation. A whistle-blower policy should be developed by companies and financial sector institutions, in addition to protection mechanisms for whistle-blowers.

3.2 Professional accounting bodies need to cultivate and nurture a large number of skilled and knowledgeable accountants.

More accountants with modern skills and knowledge are needed. The Institute of Chartered Accountants, ACCA and other professional accounting bodies can play a fundamental role in training these.

3.3 The functions and duties of Internal audit need to be clarified.

The internal audit function needs to be more clearly defined, as it is observed that internal audit departments are performing wide-ranging functions and even overseeing the implementation of internal controls on a daily basis, which is usually a management function.

3.4 The revised Code of Corporate Governance should clarify the role of the audit committee in overseeing risk management and internal controls policies and procedures.

The role of audit committees in overseeing risk management and internal controls policies and procedures needs to be better understood by the enterprises. The revised Code of Corporate Governance in its annexe should give guidance on the role of audit committees in overseeing risk management and internal controls policies and procedures. The importance of risk management and internal controls needs to be emphasised through awareness seminars and workshops.

4. Information disclosure and transparency

4.1 Guidance on narrative reporting should be developed. Transparency in information disclosure can be achieved by inclusion of narrative reports encompassing balanced and relevant information about sustainable development of business, corporate governance, forward-looking information and risk management.

Balanced, comparable and relevant narrative reports, similar to the 'Management Discussion and Analysis' section of US reports or the 'Operating and Financial Review' of the UK, need to be encouraged. Guidance about narrative reporting is needed. This guidance should also specifically focus on encouraging detailed disclosure of corporate governance practices, for example board composition, board remuneration, functions of board committee and the control environment, including, internal audit.

4.2 Research needs to be conducted to explore challenges faced in compliance with IAS/IFRS by local companies. Local guidance on IFRS should also be developed.

Research should investigate those areas where there is a lack of compliance with IFRS, determine ways of mitigating obstacles, and result in the development of specific local guidance on IFRS.

5. Shareholder’s rights

5.1 Minority shareholders’ protection rights need to be monitored.

The Code of Corporate Governance should clearly specify special mechanisms for protecting minority shareholders, such as the inclusion of a clause in the articles of association covering a policy of minority shareholder protection and setting out minority shareholders’ voting rights, or a recommendation for companies to provide their shareholders with an information note on their rights as shareholders. The minority protection rights should be monitored.

5.2 Related-party transactions and conflict of interest situations should be monitored.

Even though respondents stated that there were effective procedures relating to monitoring related-party transactions, in view of the increasing number of such transactions there is a need to monitor them. There is also a need to monitor the procedures being implemented by companies and financial sector institutions to deal with conflicts of interest.

SECTION 3 – SURVEY RESULTS – KEY FINDINGS AND RECOMMENDATIONS

A. COMMITMENT TO AND AWARENESS OF CORPORATE GOVERNANCE PRACTICES

Key Findings

- In general, corporate governance practices are being implemented because of the Code of Corporate Governance; for 82% of the respondents the main benefit of implementing corporate governance practices was compliance with the legal and regulatory requirements.
- Almost all respondents (98%) stated that they complied with the Code of Corporate Governance.
- The majority (81%) of the respondents published a statement of compliance with the Code of Corporate Governance in the annual reports, as required by the Code.
- Corporate governance improvements required by the Code of Corporate Governance have generally been implemented. On the other hand, there was little evidence of corporate governance improvements not required by the Code of Corporate Governance, such as the introduction of independent non-executive directors on the board of directors and establishment of any board committees other than audit committees.
- None of the respondents have developed their own code of corporate governance.
- A significant barrier in implementing good corporate governance was the unavailability of qualified staff and a lack of information/know-how about corporate governance principles and practices.

The success of corporate governance reforms depends upon the awareness of and commitment to good corporate governance practices among the business community and financial sector of Pakistan.

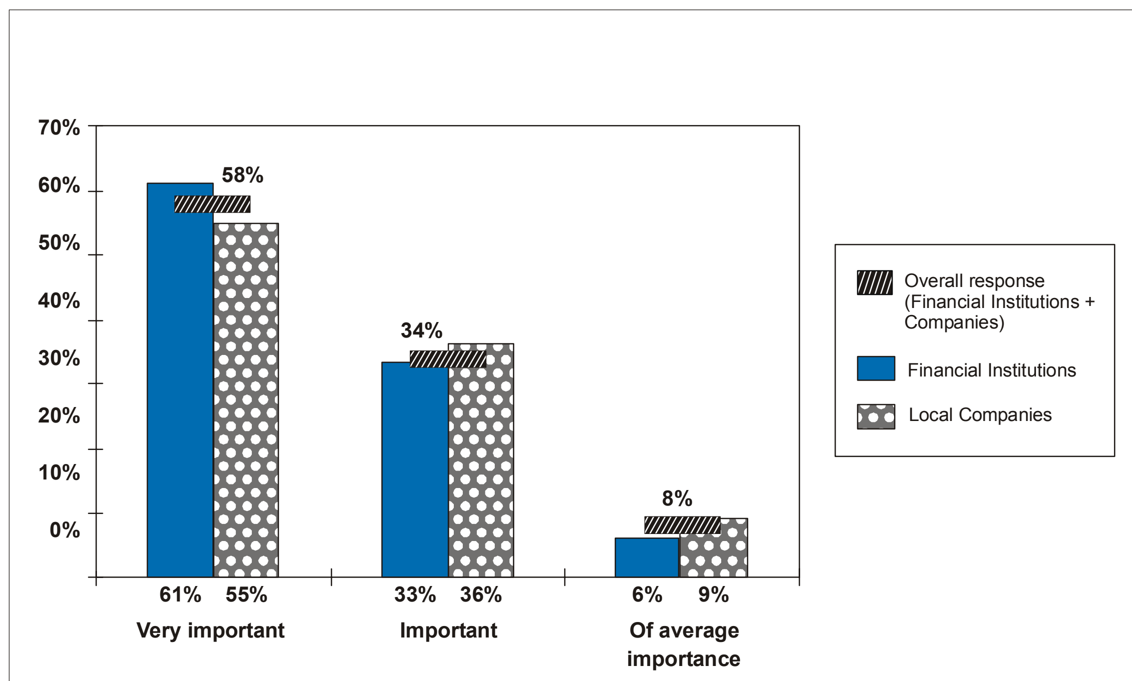
1. Importance of Implementing Corporate Governance Practices

The concept of corporate governance will become popular only if the business community and the financial sector consider it to be important. 58% of the respondents considered corporate governance to be very important, 34% considered it important and only 8% considered it to be of average importance.

Even though the questionnaire offered the options of 'not important at all' or 'irrelevant', none of the respondents considered corporate governance to be irrelevant or not important at all.

> *Do I have an option but to consider corporate governance very important? The SECP wants it to be very important. If I do not think corporate governance is important I might end up in jail and my company will be de-listed and I will go out of business.* (Chief executive of a family-owned business)

Figure 3.1 The importance of the implementation of corporate governance



2. Understanding Corporate Governance and its Main Goals

Corporate governance is the Code of Corporate Governance – whatever is in the Code is corporate governance. (CFO of a listed company)

Did You Know That...?

Corporate governance is a system of structures and processes for the direction and control of corporations.[23] It should not be confused with compliance with legislation or regulations, daily management of the business, corporate citizenship, corporate social responsibility or business ethics. Good corporate governance will certainly reinforce these important concepts but corporate governance is a distinct concept.

In an ACCA survey of chairs and finance directors of the top 1,000 listed companies in the UK (ranked by market value), 62% of the respondents considered corporate governance to be a system by which companies are directed and controlled. Only 1% of the respondents considered corporate governance to be compliance with legal and regulatory requirements. None of the respondents confused corporate governance with corporate social responsibility (CSR).[24]

35% of the respondents were of the opinion that corporate governance is a system by which companies are directed and controlled. This is in line with the OECD definition of corporate governance, which uses the same definition.

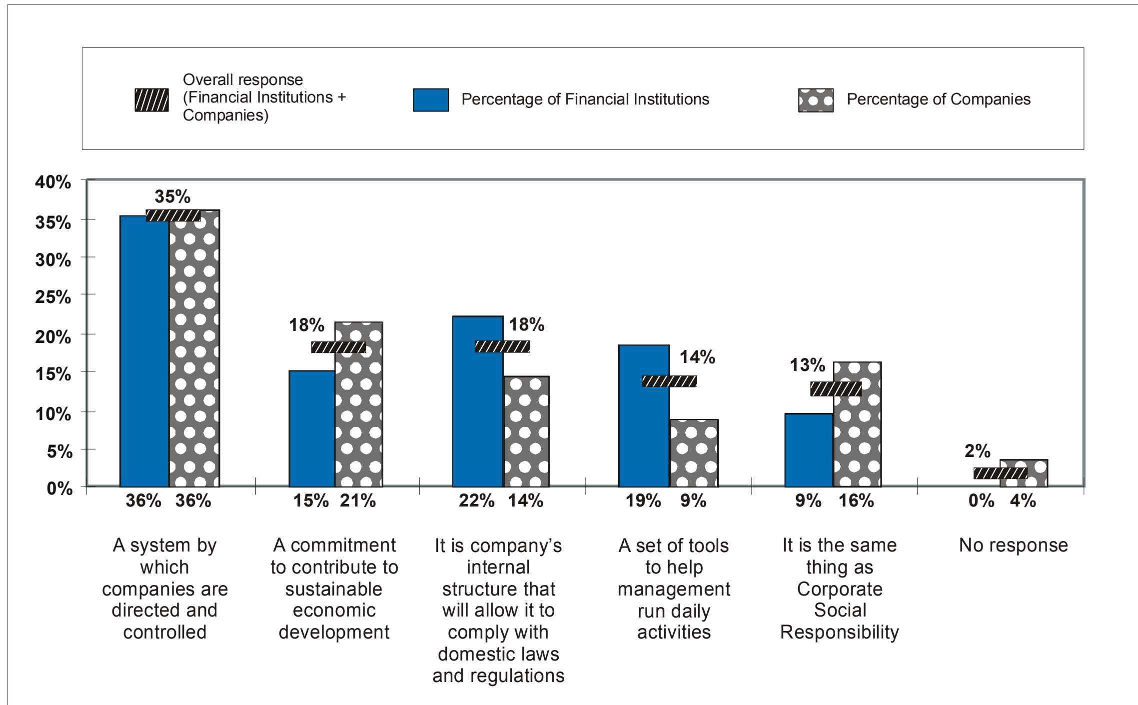
The remaining 65% gave various definitions of corporate governance. Around 18% of the respondents identified corporate governance as a company's internal structure that allows it to comply with domestic laws and regulations, such as the Code of Corporate Governance. They perceived corporate governance to be a legislative and regulatory burden that has been imposed on them by the SECP; 31% of the respondents believed that corporate governance is the same as corporate social responsibility or sustainable economic development. In their opinion, corporate governance is about ethics and a company is ethical if it fulfils its corporate social responsibility. 14% equated corporate governance to corporate management.

[23] OECD Principles of Corporate Governance.

[24] Moxey, P. (2004) *Corporate Governance and Wealth Creation*, ACCA Occasional Research Paper No. 37.

Figure. 3.2 highlights variations in response between companies and financial sector institutions.

Figure 3.2 What is corporate governance?



3. Benefits of Implementing Corporate Governance Practices

Why is corporate governance important – because the Code of Corporate Governance wants corporate governance to be considered important? If you follow the Code, all the other benefits do not matter. (Company secretary of a listed company)

As shown in figure 3.3, for 82% of the respondents, compliance with legal and regulatory requirements was the main benefit of implementing corporate governance practices. This may be because, for a majority of the respondents, the main reason for adopting such practices was compliance with the Code of Corporate Governance; they thus found it hard to find value in other benefits of corporate governance.

Whereas 52% of the respondents considered implementing corporate governance important because it improves operational efficiency, only 40% of the respondents considered corporate governance to be important for improving strategic decision making. This may be due to the perception that existed among the respondents that, in complying with the Code of Corporate Governance, they were improving their daily operations relating to internal controls and risk management.

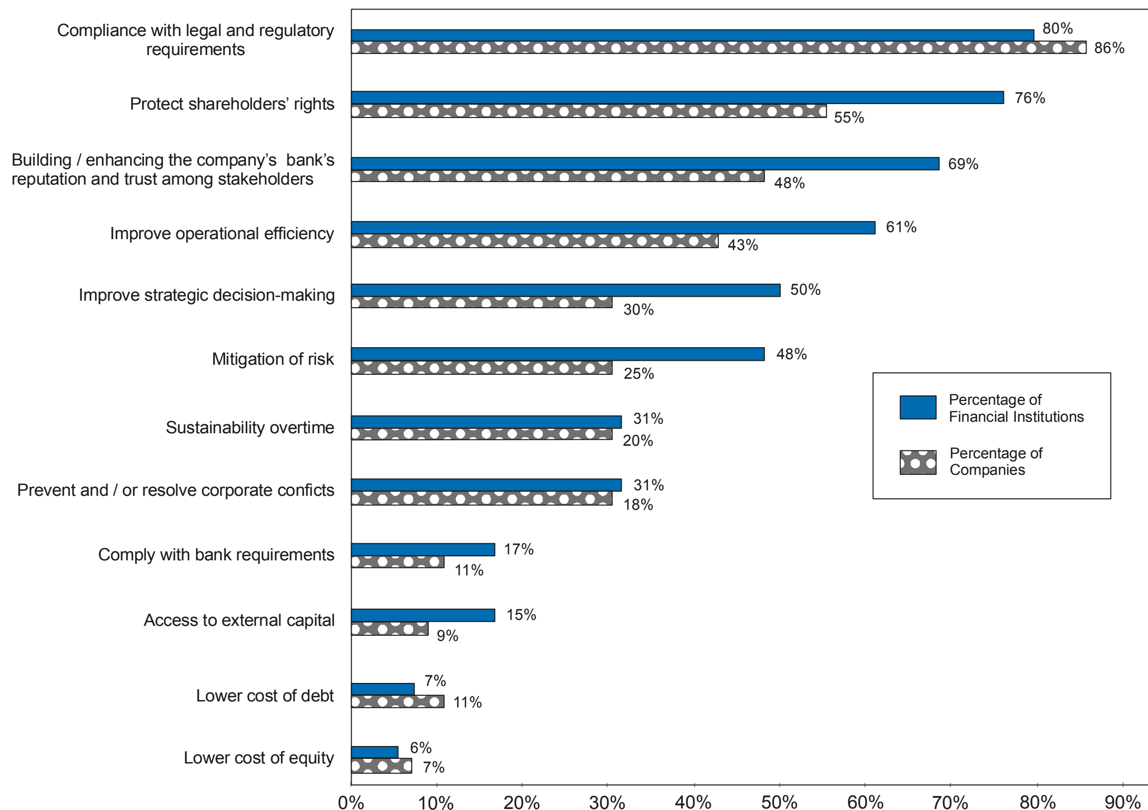
Before the Code of Corporate Governance, life was easy. Now on a daily basis I have to look after the controls. I receive circulars relating to corporate governance and I need to review them, so I do not have time for strategy and vision but yes, I have to take out time daily to look into the controls and risk management – maybe this is what the Code is for? (Company secretary of a bank)

Given the importance of corporate governance in improving access to external capital, and lowering the cost of equity and debt financing, it was surprising that a small percentage of the respondents considered these benefits important.

When I need money, I go to the bank. My bank does not care about my corporate governance practices. We have institutional investors on our board but they never ask any questions about corporate governance, so I think it does not matter to them. (Company secretary of a family-owned business)

Figure. 3.3 outlines the different perceptions of the benefits of implementing corporate governance practices**.**

Figure 3.3 Perceived benefits of implementing corporate governance (multiple answers)



Did You Know That…?

In an ACCA survey, 95% of the chairs and finance directors of the top 1000 listed UK firms opined that one of the main benefits of implementing corporate governance was protecting shareholders' rights; 88% also emphasised improved access to external capital while 85% gave low cost of debt and equity as an important benefit. Only 1% of the respondents stated compliance with regulations as a major benefit of implementing corporate governance practices.[25]

In another ACCA survey, of CFOs of 40 leading companies in Argentina, 70% considered improving reputation to be an important benefit, 67% stated contribution to strategic decision making and 60% stated improved access to external capital in the form of investment from institutional investors. Only 2% stated compliance with legal and regulatory requirements as a significant benefit of implementing corporate governance practices.[26]

---

[25] Moxey, P. (2004), *Corporate Governance and Wealth Creation*, ACCA Occasional Research Paper No. 37.

[26] ACCA (2006), *Corporate Governance Past, Present and Future in Argentina*, ACCA Research Paper.

Whereas globally, owing to the increasing size of firms and the growing role of financial intermediaries, the mobilisation of capital has become increasingly removed from the principal owner, in Pakistan this trend still has to develop. The role of institutional investors is growing in many countries. Institutional investors such as CalPERS in the US and Hermes in the UK are investing in other countries. International financial integration has increased, and trade and investment flows are increasing. A majority of the respondents, however, were unaware of any external source of financing other than bank finance or raising money through a stock exchange. There is no indication that local institutional investors or banks reward companies that have better corporate governance practices. It is thus difficult for the companies to identify any benefits, such as low cost of equity or low cost of debt.

4. Demonstrating Commitment to Reforms

4.1 Adherence to recognised corporate governance codes/principles

One of the ways to demonstrate commitment to corporate governance is to adhere to corporate governance codes and principles. The OECD Principles of Corporate Governance have become an international corporate governance benchmark for policy makers, investors, corporations and other stakeholders. The Financial Stability Forum has designated the OECD Principles of Corporate Governance as 12 key standards for ensuring sound financial systems. Even though compliance with the OECD Principles of Corporate Governance is not mandatory in Pakistan, familiarity with the Principles might indicate a commitment to gaining understanding of good corporate governance principles. Results (Figure 3.4) show that 98% of the respondents did not follow the OECD Principles of Corporate Governance.[27]

The Basel Committee on Banking Supervision has also issued a guidance document *Enhancing Corporate Governance for Banking Organizations,*[28] which encompasses principles of corporate governance for banks and aims to promote the adoption and implementation of sound corporate governance practices by banking organisations. In fact, 96% of the respondents (Figure 3.4) did not follow the Basel Committee Guidelines on Corporate Governance.

The Commonwealth Business Council has also published corporate governance principles in association with the Commonwealth Association for Corporate Governance.[29] None of the respondents said they followed the Commonwealth Corporate Governance Principles.

The Securities and Exchange Commission of Pakistan issued a Code of Corporate Governance in 2002 with which compliance is mandatory for listed companies, and 98% of the respondents complied with this. The 2% of respondents who did not comply with the Code were unlisted firms for which compliance is not required. As shown in figure 3.5, an overwhelming majority (89%) complied with the code of corporate governance only because it is mandatory.

---

[27] www.oecd.org/dataoecd/32/18/31557724.pdf

[28] www.bis.org/publ/bcbs56.pdf

[29] www.ecseonline.com/PDF/CACG%20Guidelines%20-%20Principles%20for%20Corporate%20Governance%20in%20the%20Commonwealth.pdf

Why will I comply with the code of corporate governance? Because I have to comply with it. Do I have an option? It is my business, my father and grandfather have worked hard to establish it and now I am told that I should have independent directors, have an audit committee, separate the post of chief executive and chairman and if I do not do it then I am de-listed? Do I have an option but to do as they [the regulators] *order? You need to understand I run a company in a country where the cost of doing business is very high. The code has only added to my costs and that is compulsory cost. I cannot evade or avoid this cost but if it was voluntary I would not have complied with it for I see no value in compliance with the Code.* (Chief executive of a family-owned listed company)

The high compliance with the Code of Corporate Governance and almost non-existent adherence to the OECD Principles, Recommendations of the Basel Committee on Banking Supervision and Commonwealth Principles of Corporate Governance among the sample may be an indication of the wider attitude towards corporate governance in Pakistan. There is generally no inclination to move beyond the mandatory requirement to comply with the Code of Corporate Governance, to embrace other global best practices and standards of corporate governance.

Did You Know That…?

A ‘check the box’ approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to an array of inhibiting, ‘politically correct’ dictates. If this was the case, ultimately corporations would not strive to meet higher standards, they would only strain under new costs, associated with fulfilling a mandated process that could produce little of the desired effect. They would lose the freedom to make innovative decisions that an ethically sound entrepreneurial culture requires.[30]

Figure. 3.4 outlines responses regarding non-compliance with the different principles and the Code of Corporate Governance while Figure. 3.5 outlines the reasons for compliance with the Code of Corporate Governance.

Figure 3.4 Non-compliance with corporate governance codes and principles

[30] William Donaldson, ex-Chairman of the US Securities and Exchange Commission

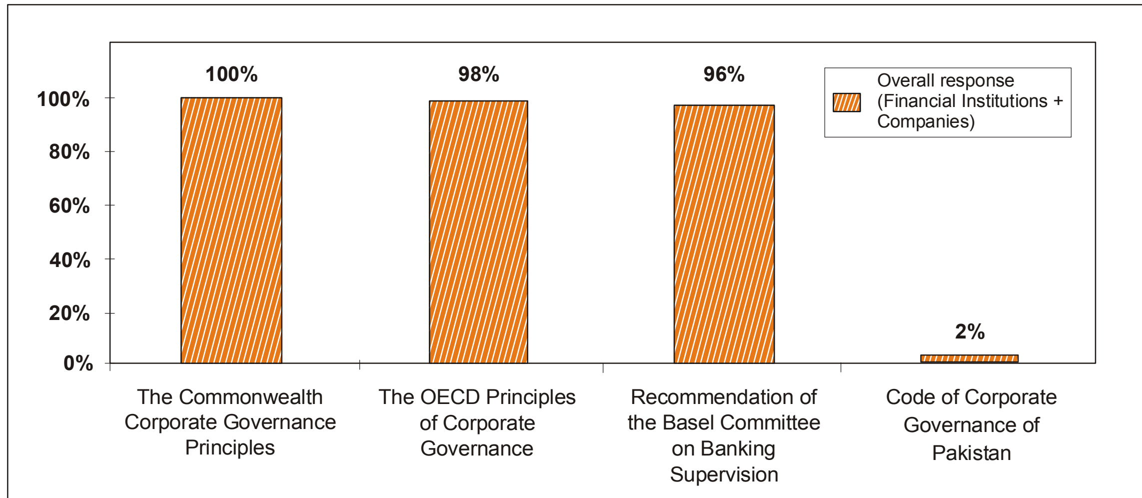
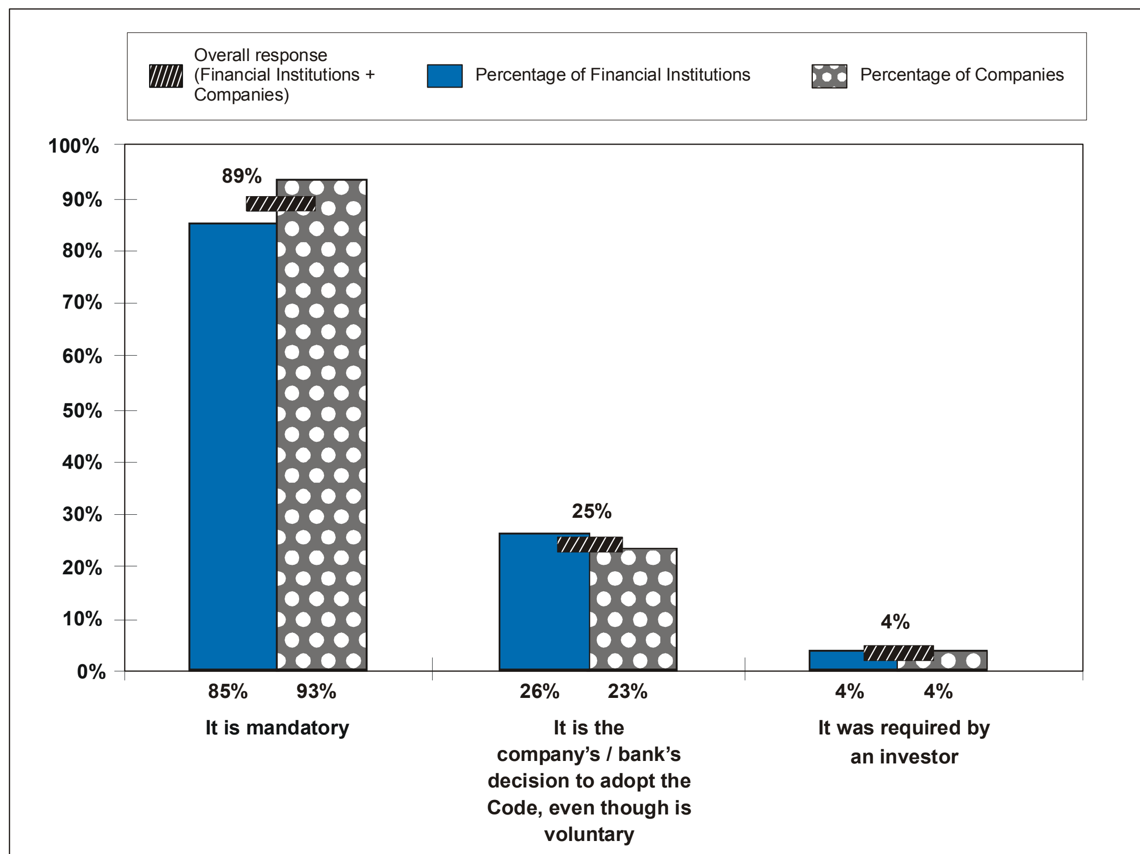


Figure 3.5 Reasons for compliance with the Code of Corporate Governance of Pakistan (multiple answers)

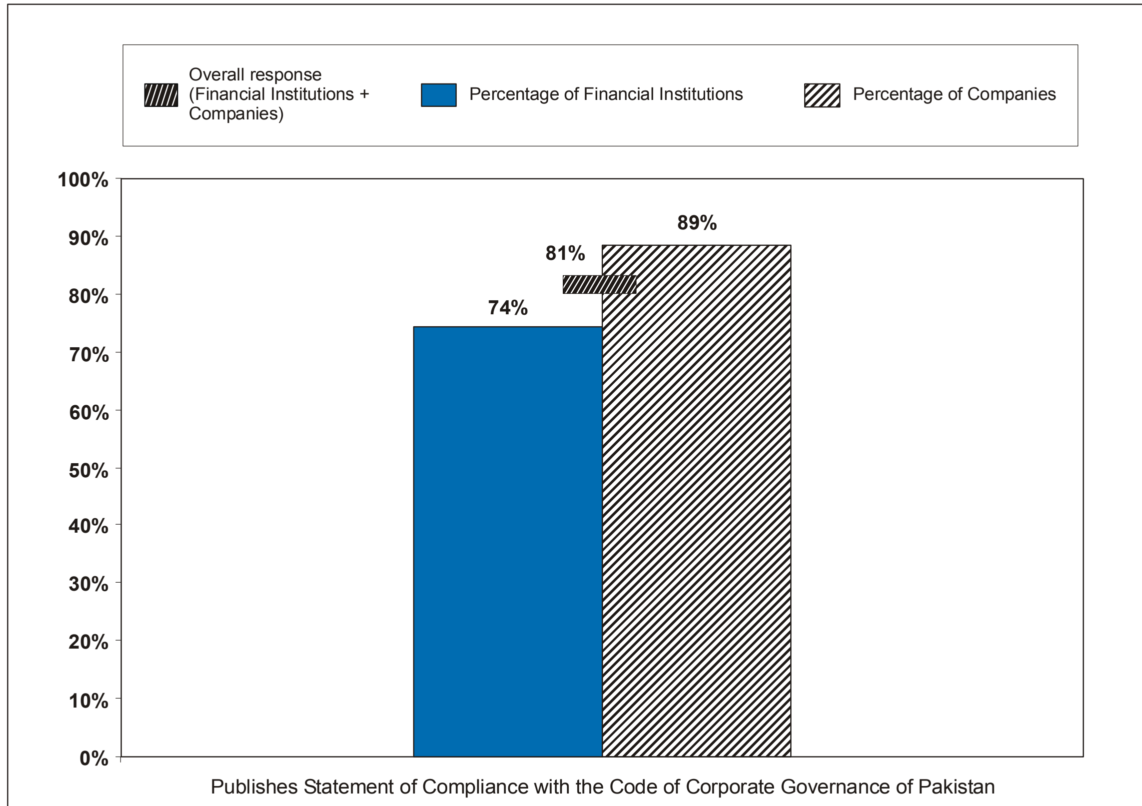


4.2 Statement of compliance with the Code of Corporate Governance

The survey found that 74% of the financial institutions and 89% of the companies claimed to publish a statement of compliance with the Code of Corporate Governance. A cursory review of the annual reports of some of the surveyed companies revealed that almost all the companies had

used a standardised statement of compliance which satisfied the bare minimum requirement of the Code of Corporate Governance.[31] They had not outlined corporate governance policies, procedures or practices.

Figure 3.6 Statement of compliance with Code of Corporate Governance of Pakistan



5. Defining and Codifying Key Policies, Processes and Procedures

Did You Know That…?

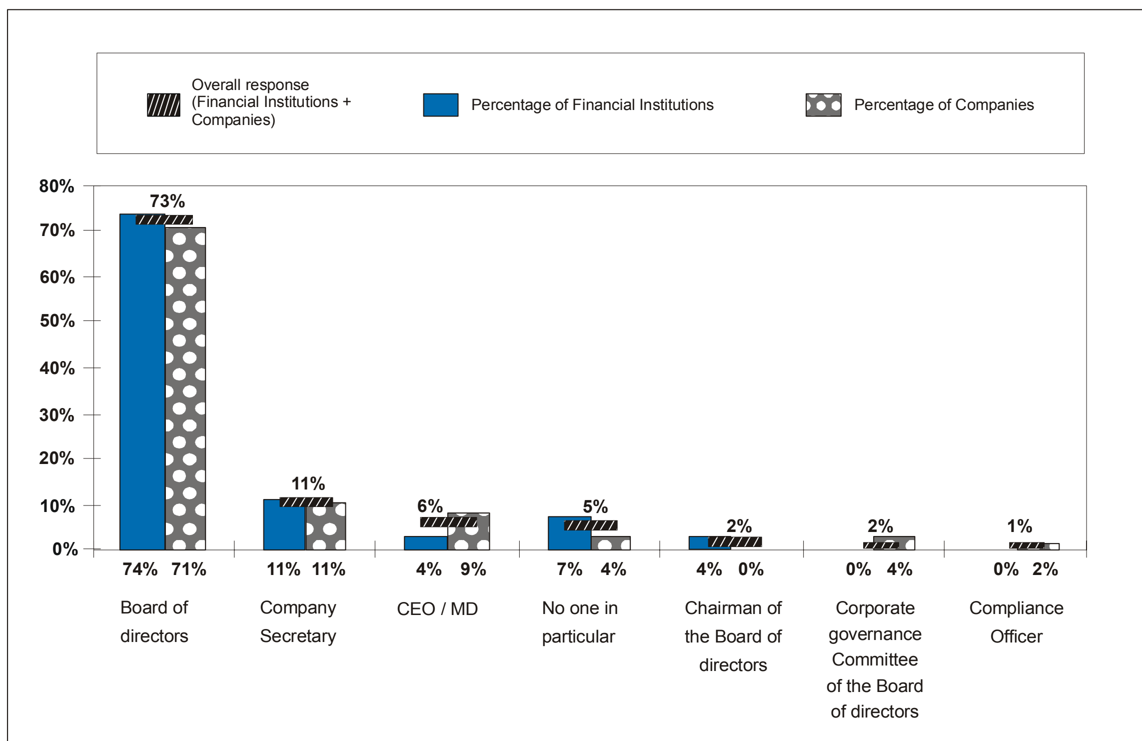
[31] Section xlv of the Code of Corporate Governance of Pakistan: 'all listed companies shall publish and circulate a statement along with their annual reports to set out the status of their compliance with the best practices of corporate governance.'

The board should ensure that management develops, implements and periodically reviews an appropriate set of policies and procedures in line with international best practice. All key corporate documents should be codified, current, complete and practical.

5.1 Assigning responsibility for corporate governance

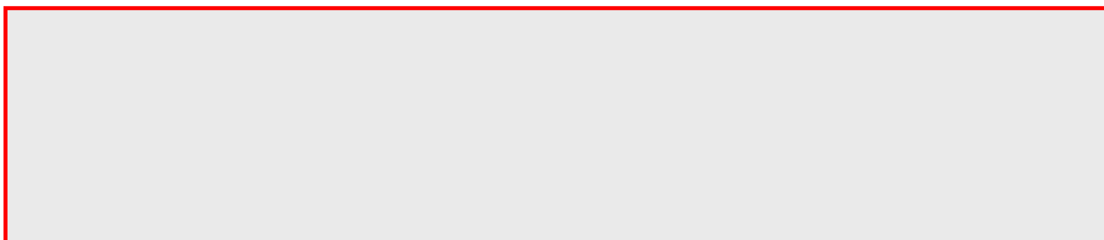
Mainly because of resource constraints, 98% of the respondents did not have a dedicated corporate governance committee and so 73% stated that the board of directors itself was responsible for developing corporate governance policies. Best practice would call for the corporate secretary or other designated officer to develop such corporate governance policies and for the board – ideally through a board-level corporate governance committee – to approve these.

Figure 3.7 Responsibility for developing corporate governance policies



5.2 Corporate governance codes

As the Code of Corporate Governance does not require companies to develop their own corporate governance code, none of the respondents had such a code and only 5% intended to develop one.



Did You Know That…?

A company-level corporate governance code is a principle-based statement that should go well beyond the minimum mandatory requirements of the SECP Code of Corporate Governance.

A corporate governance code usually comprises:

1) the role of the board of directors, chair and CEO

2) the policy on director independence

3) board membership criteria and board size

4) procedures for the election of directors and their term of office

5) number and composition of board committees

6) required standard of business conduct

7) succession planning information

8) directors' compensation package information

9) guidelines for director orientation and education

10) guidelines for evaluation of board and committee performance

11) chief executive officer performance review and succession plan

12) share ownership guidelines for directors

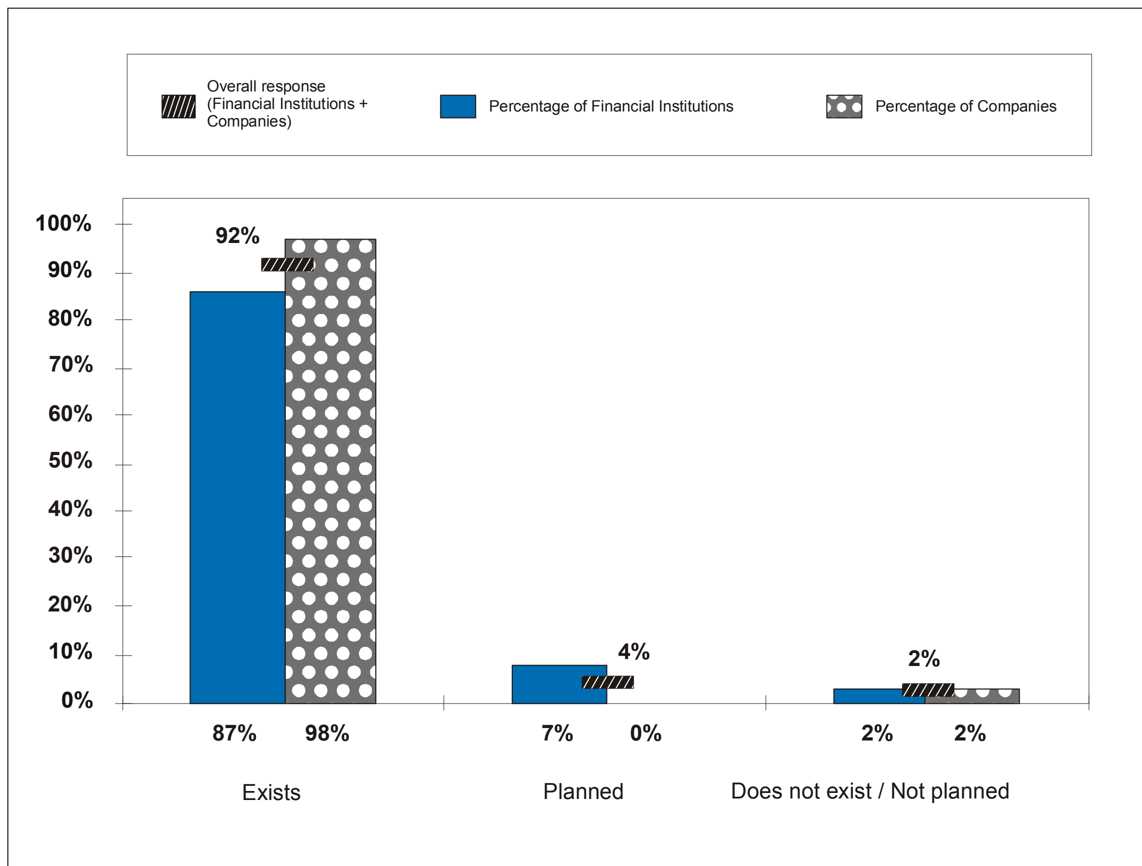
13) guidelines for communications with stakeholders.

5.3 Statement of Ethics and Business Practices

> *We have always believed in ethics, now we have to come up with a statement of ethics and business practices. So we have developed a book of rules that mainly states what is to be done and what is not to be done. We have it on our reception and all the employees have it. As the Code of Corporate Governance is in English, the Statement is in English also. 70% of our employees do not understand English and do not understand the Statement of Ethics and Business Practices but we comply with the Code.* (Director of a family-owned company)

The survey shows that 87% of the financial sector institutions and 98% of the companies had a Statement of Ethics and Business Practices.[32] A number of respondents were of the opinion that the SECP should produce guidance on developing a Statement of Ethics and Business Practices and on disseminating this Statement among employees.

Figure 3.8 Statement of Ethics and Business Practices



[32] Section 'viii (a) of the Code of Corporate Governance of Pakistan: [Every listed company should] ensure that a 'Statement of Ethics and Business Practices' is prepared and circulated annually by its Board of Directors to establish a standard of conduct for directors and employees, which Statement shall be signed by each director and employee in acknowledgement of his understanding and acceptance of the standard of conduct.'

Did You Know That…?

Ethical lapses have led to some of Europe's biggest business failures. Ethical breaches by management or employees have caused 37% of high-profile business failures in Europe. A recent study of 60 European cases of formal bankruptcy or stock price free fall shows this remarkable impact of ethical lapses. In a large number of these cases, a dominant shareholder or manager with big ambitions was acting unethically, and his/her actions went unchallenged by the company and by the Board.[33] Corporate governance codes of ethics can help guard against unethical behaviour in companies. A performance review of the CEO by the board of directors can also help root out ethical problems before they lead to business failures.

Indeed, a statement of ethics and business practices is not a rule book but a statement of core value, a basic guide to conduct and behaviour that imposes duties and responsibilities on the company, its directors, officers and employees. It should be used as a toolkit by management and employees to resolve daily ethical problems and issues. It should reflect the differences in business culture and values in ethically sensitive operational areas.

In an ACCA survey of the top 20 business leaders of Australia and New Zealand, all the business leaders were of the opinion that a statement of ethics has to be a living document supported by an appropriate organisational culture and value system.

In the words of one interviewee, 'investors can have faith in a statement of ethics, but only to the extent that the statement of ethics reflects the culture of an organisation. Having a code of ethics that just tells a person not to lie or cheat is naive'.[34]

---

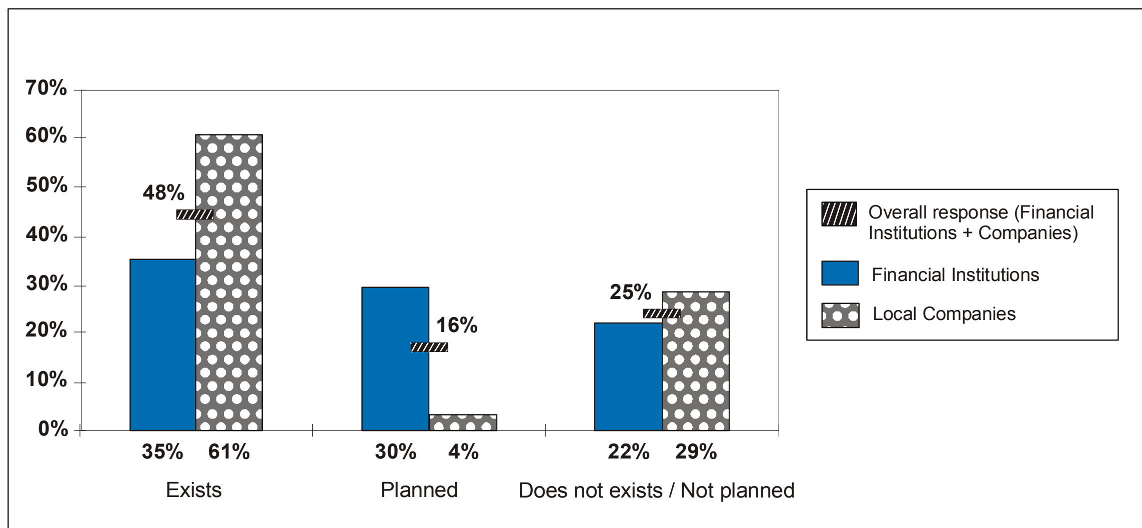
33 'Classification and Analysis of Major European Business Failures', Maastricht Accounting, Auditing & Information Management Research Center, RSM Erasmus University. October 2005

34 ACCA (2004), *Where the Buck Stops: A Snapshot of Responsibility in Business*, ACCA Occasional Research Paper.

5.4 Charter of the board of directors

The charter of the board of directors was interpreted as the vision/mission statement of the board.[35] 48% of the surveyed sample had a vision/mission statement and 16% planned to have a vision/mission statement within the next year. According to best practice, a board charter sets out and defines the role of the board, the duties and responsibilities of its directors, and also establishes its composition, structure and working procedures. The board charter may also touch upon board remuneration policies as well as board evaluations and director training.

Figure 3.9 The charter of the board of directors



5.5 Components of the articles of association[36]

Articles of association can be used to give clear outlines for a company's corporate governance framework, policies and procedures. The majority of respondents had provisions relating to the authority of the board; this was expressly mentioned and the board was clearly distinguished from the management. The articles specified the necessary qualifications for the candidates to the board of directors, the duties and functions of CEO and chairman, and the general principles of shareholders' rights protection. There is room for improvement in terms of the definition of an independent director, prohibition or restriction on sale of shares, and the possibility of establishing board committees.

---

[35] Section 'viii (b) of the Code of Corporate Governance of Pakistan: [Every listed company should ensure that] 'the Board of Directors adopt a vision/ mission statement and overall corporate strategy for the listed company.'

[36] The articles of association should set out the guiding principles under which the internal management of the company is to operate. The Companies Ordinance requires companies to have articles relating to appointments, powers, duties, qualifications, remuneration of directors and chief executives as well as procedures of convening, holding and conducting various company meetings (First Schedule Companies Ordinance 1984).

Table 3.1 outlines the components of the articles of association of the responding companies.

Table 3.1: Components of articles of association

Company/Bank's articles of association provide for:	Financial Sector Institutions	Companies
A definition of an independent director	15%	18%
Prohibition or restrictions on the sale of shares	20%	25%
Requirements for the rotation of the external auditors' lead partner	31%	25%
The possibility of establishing board committees	54%	41%
General principles of shareholders' rights protection	59%	48%
Duties and functions of the chairman	67%	73%
The qualification requirements for candidates to be on the board of directors	72%	71%
Duties and functions of the CEO	85%	75%
The authority of the board of directors is expressly mentioned and clearly distinguishable from that of management	89%	95%

6. Commitment to corporate governance improvement planning

6.1 Implemented corporate governance improvement measures

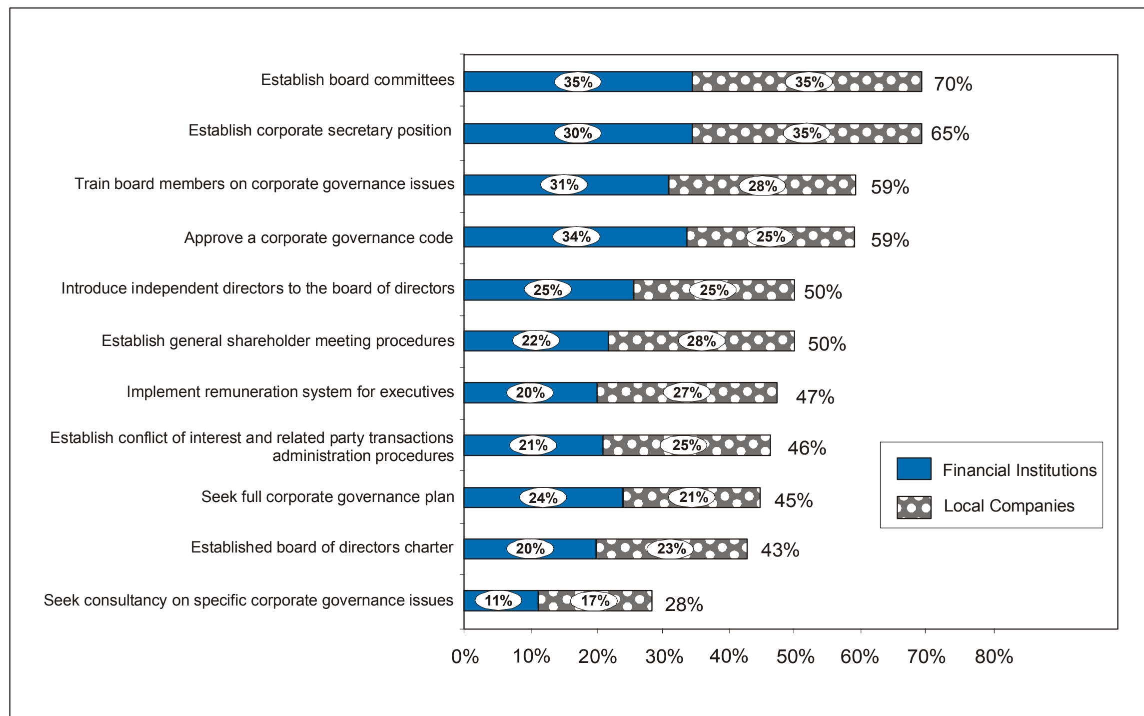
Almost all the financial sector institutions and companies surveyed had implemented measures to improve corporate governance. The majority of the survey sample had focused on compliance with the requirements of the Code of Corporate Governance and had thus implemented improvements such as establishing a position of corporate secretary,[37] establishing board committees (only audit committees[38]) and initiating training programmes[39] on the Code for their board of directors.

A more dynamic approach may be necessary for implementing further corporate governance measures, for example establishing procedures for related-party transactions, introducing independent directors onto the board, establishing board committees (other than audit committees), creating a board charter and seeking full corporate governance improvement plans.

Point to ponder

Not one of the respondents in the entire sample had implemented all the improvements.

Figure 3.10 Corporate governance improvements already implemented (multiple answers)



[37] Para. xv – Code of Corporate Governance of Pakistan.

[38] Para. xxx – Code of Corporate Governance of Pakistan.

[39] Para. xiv – Code of Corporate Governance of Pakistan.

6.2 Barriers to improving corporate governance

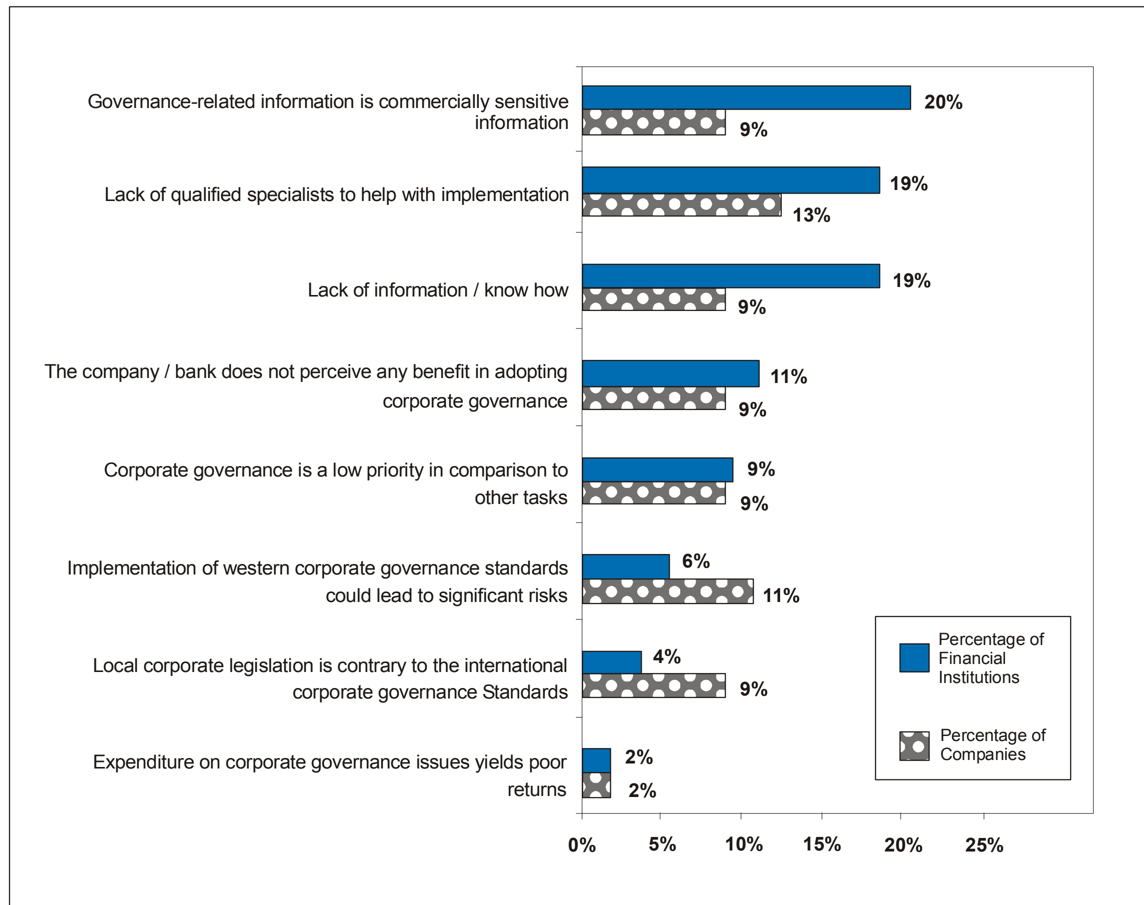
How can there be any barrier to corporate governance? We just have to adopt it because the Code of Corporate Governance wants us to adopt it. The SECP wants us to adopt it. An order has to be obeyed whatever the difficulties. (Chief financial officer of a listed company)

31% of the respondents did not identify any barrier to improving corporate governance in the company because they believed that they have to comply with the Code of Corporate Governance. Of the 69% respondents who identified barriers, 42% considered the unavailability of qualified staff, especially accounting and finance staff, to help with the implementation of corporate governance practices, as well as lack of information/know-how about corporate governance principles and practices, to be important barriers to improving corporate governance practices in the company.

Point to ponder

Even though none of the respondents considered corporate governance to be 'not important' or 'irrelevant', 14% of the respondents stated that the main obstacle to improving corporate governance practices was that they did not see any benefit in adopting such practices. It is possible that they considered a code of corporate governance to be important and they might be able to foresee benefit in its adoption, as it is mandatory, but could not appreciate the benefit of implementing corporate governance practices other than those required by the Code.

Figure 3.11 Barriers to improving corporate governance (multiple answers)



Synopsis: Commitment to good corporate governance

It can be concluded that even though there is strong commitment to adopting the rules and regulations of corporate governance in a 'tick-the-box' manner, especially those spelled out by the Code of Corporate Governance, there is not much evidence of an attempt to understand the underlying business case for good corporate governance. The main benefit of implementing corporate governance measures is considered to be compliance with legal and regulatory requirements. Other benefits, such as lower cost of equity or debt, or better access to external capital, strong long-term growth, development of the enterprise and strong and consistently high-performing share prices, are not understood. Corporate governance documents that are required by the Code of Corporate Governance are being developed but the quality of these documents needs to be monitored. Only those corporate governance improvements have been implemented that are required by regulations. Other best practices, for example implementing a transparent remuneration system for executives, having independent directors on the board, or establishing conflict of interest and related-party transactions procedures are not considered important enough to be implemented by a majority of the respondents. Corporate governance is thus being viewed as a burden rather than an opportunity to improve business practices and attract investment and stakeholders' confidence. The regulator is seen as an enforcer rather than a facilitator or benefactor. Corporate governance needs to move beyond legal compliance and this can be done only once the business community understands the business case for it.

7. Commitment and Awareness of Corporate Governance Practices – Recommendations

7.1 Establishment of a Task Force to carry out a Review of the Code of Corporate Governance, and development and communication of a business case for corporate governance

It can be concluded from the results of the survey that, being built upon a sound framework of company law, Pakistan's 2002 Code of Corporate Governance has had a significant influence upon company practices. There are, however, areas indicated by the survey results and discussed in later sections of this report where improvement in the Code of Corporate Governance in line with practices elsewhere across the world would stand to further strengthen the current Code. A task force comprising all stakeholders should be established to review the Code of Corporate Governance. This is necessary because, since 2002, the business world has changed. It faces a number of new challenges, for example the increasing importance of independent non-executive directors, the role of audit committees, convergence with IFRS, increasing emphasis on ethics and the importance of whistle-blowers and board committees. Corporate Governance principles and codes have also been revised. Thus the Code of Corporate Governance of Pakistan should be reviewed by a task force that should also have representation from the business community. Future corporate governance reforms should be made with care to avoid stifling the nation's entrepreneurial flair with a burgeoning volume of counterproductive regulation.

For most respondents the main benefit of 'implementing corporate governance' was compliance with legal and regulatory requirements, and not the benefits outlined earlier in this report. Organisations in the surveyed sample were thus developing only mandatory corporate governance documents. Limited vision and a reactionary approach by the majority of the business community in Pakistan mean that corporate governance is considered a burden rather than a business enhancement opportunity.

Corporate governance needs to move beyond legal and regulatory requirements. It needs to be understood as an idea, particularly by family-owned businesses. This will happen only once the business community understands the business case for the highest standards of corporate governance. To help inculcate good corporate governance within the 'DNA' of Pakistan's companies, so that they optimise the potential benefits rather than merely incurring the overhead costs, we recommend that a future revision of the SECP's Code of Corporate Governance should set out the fundamental principles of corporate governance that underpin the existing specific mandatory requirements. This will help build the business case for good corporate governance. This approach characterises the UK Combined Code, for example. Awareness seminars could be used to develop the business case and achieve greater support from the business community for strengthening the Pakistan Institute of Corporate Governance, a major focus of IFC's Pakistan Corporate Governance Project.

7.2 The roles of regulators, stock exchanges and courts need to be strengthened

> *Clearly the balance between these governance forces varies between countries. Where the opinions of shareholders and of the public cannot make themselves sufficiently felt, the gap needs to be filled by the law and appropriate regulations. This is why each country has to devise its own governance framework. But how effective is this framework of governance? The legal rules are clear-cut and carry known penalties if boards of directors contravene them. Regulations are equally straightforward; if quoted companies do not abide by the rules of the London Stock Exchange, they risk de-listing.* [40]

This sub-section outlines evidence of the compliance approach being adopted by companies to implement corporate governance practices. It shows that corporate governance in Pakistan is currently being implemented in form but not substance. Furthermore, the Pakistan capital markets are not efficient and may be described as insiders' markets, ie they are clearly still dominated by owner-driven listed companies, resulting in a lack of shares being traded; and therefore shares are not being held by institutional investors such as pension funds, insurance companies and investment funds. In these circumstances the role of the government and regulators is to ensure a level playing field in areas where voluntary regulation cannot be expected to be effective.

The SECP's Code of Corporate Governance is included in the listing regulations of all Pakistan's stock exchanges, with almost all the clauses being mandatory. It is clear even from this survey that there is a high level of compliance with the Code but that the majority of the companies surveyed comply primarily because of the Code's legal underpinning. Thus the mandatory character of the Code should not be relaxed to become just a requirement to 'comply or explain'. On the other hand, some of the more controversial issues that may be included in a future version of the Code could well be implemented on a 'comply or explain' basis, lest companies are once again reduced to implementing reforms by 'ticking the box'. As recommended by the World Bank's ROSC report, enforcement needs to be strengthened. The SECP is playing a positive role but the stock exchanges and even the courts have to be more stringent in their enforcement.

Under the law there is no penalty for non-compliance with the Code of Corporate Governance. Even the Stock Exchange Listing Rules are silent over the issue of non-compliance. In these circumstances, the impact that the Code of Corporate Governance has had is commendable.

Just as there is a need for professional development workshops and seminars for those entrusted with implementing corporate governance practices, there is also a need to consider the professional development and refreshing of skills/knowledge of those entrusted with monitoring the implementation of the Code of Corporate Governance, ie courts, stock exchanges and regulators. This will help in strengthening the role of the regulators, stock exchanges and courts.

7.3 Sharpening up the 'Statement of Compliance with the Code of Corporate Governance' so that it provides sufficient explanation to enable shareholders to evaluate how the principles set out in the Code have been applied

The SECP's Code of Corporate Governance requires all listed companies to publish and circulate a statement along with their annual reports to show the status of their compliance with the best practices of corporate governance, as set out in the Code. It is recommended that the revised SECP Code should require a more rigorous compliance statement incorporating a narrative statement of how the company has applied the principles set out in the Code. This should provide sufficient

[40] *Sir Adrian Cadbury, 1998*

explanation to enable shareholders to evaluate how the principles have been applied, as well as a statement as to whether or not the company has complied throughout the accounting period with the specific requirements of the Code. A company that had not complied with the Code requirements, or had complied with only some of them or (in the case of provisions whose requirements are of a continuing nature) complied for only part of an accounting period, would be required to specify the requirements with which it has not complied, and (where relevant) for what part of the period such non-compliance continued, and give reasons for any such non-compliance.[41]

7.4 Guidelines for preparing a Statement of Ethics and Business Practices should be prepared, and company-specific codes and corporate governance charters should be encouraged through orientation seminars and workshops

Professional bodies or academic institutions may develop corporate governance charters and models for company-specific codes to provide guidance to companies to develop these documents.

The SECP should consider developing guidelines for preparation of the Statement of Ethics and Business Practices, or including a template Statement of Ethics and Business Practices in the revised Code of Corporate Governance. It is important that the Statement of Ethics and Business Practices is translated into Urdu so that all employees can understand it properly.

7.5 There is a need to develop Pakistan's resource of competence in corporate governance

A lack of qualified staff to implement corporate governance practices and lack of information/know-how about corporate governance were identified as the main barriers to implementation of such practices. It is suggested that corporate governance as a subject should be taught at universities to overcome this barrier over the long term. In the short term, board directors and company officers should attend the director training programmes already being offered, such as by the PICG, ICAP, ACCA and LUMS. Academia–business linkages need to be developed where the business community could identify the challenges that it faces in implementing corporate governance practices and academia could suggest solutions in the form of guidance notes or case studies that can stimulate discussion. This is also an area on which IFC's Pakistan Corporate Governance Project is focusing.

7.6 Corporate governance guidelines for state-owned and unlisted large and medium-sized enterprises should be developed

During the course of the project, a number of respondents observed that there is a need for developing corporate governance guidelines for the state-owned and unlisted enterprises. State-owned and large and medium-sized enterprises are an important part of the economy. Research into corporate governance practices among state-owned and family-owned enterprises could enable corporate governance guidelines to be developed specifically for these enterprises. We suggest the PICG should take a lead on this.

---

41 This is similar to the present UK Listing Rule 9.8.6. In the UK the specific requirements are termed 'provisions'.

B. BOARD PRACTICES – KEY FINDINGS

Every time directors sit down at the boardroom table, thousands of shareholders sit down alongside them. So we must have a system that gives directors timely information, to help them represent those shareholders. Every time directors ask a tough disclosure or financial question, thousands of shareholders will benefit. So we must have an atmosphere that encourages directors to be active – to avoid the trap of believing that they must 'go along to get along'. Every time directors stand up for what's right – even if they think they might be alone – thousands of shareholders stand with them. Directors must remember: Protecting the interests of shareholders is the goal of corporate governance. The task of upholding the integrity of our entire corporate system begins with the work of directors. When our system lives up to the highest standard of integrity, it inspires deeper public faith that our marketplace is sound. Maintaining the integrity of our system is the director's legal mandate – and it must become a fundamental part of every director's mission.[42]

[42] Arthur Levitt, 1998

Key Findings

- The board, as envisaged by the Code of Corporate Governance, is a powerful centre of authority and control in terms of the functions it performs.

- Even though the boards of directors are performing a number of functions required by the Code of Corporate Governance, such as approving budgets and remuneration of executives, issues such as succession planning and exploring business opportunities are not considered important matters that need to be overseen by the board.

- Key executives of responding companies were generally not happy with the duties and functions performed by institutional investors as board members.

- Contrary to the common belief that the majority of boards comprise wives, daughters and daughters-in-law, 69% of the boards did not have any female director.

- 31% of the respondents did not have a single independent non-executive director on their board of directors.

- Respondents generally struggled to define the word 'independent'.

- 95% of the respondents had an audit committee but only 34% of them had a majority of non-executive directors as audit committee members.

- There was no corporate governance committee in 88% of the responding firms and 73% did not have a remuneration committee.

- The board of directors met on average three to five times a year in 73% of the surveyed sample.

- 29% of respondents did not reply to the question about the amount of payment made to non-executive board members for attending board meetings, while 71% of those who replied stated that the average payment made to board members for attending board meetings was in the range of PKR500–5,000 (approximately US$8–$84) .

- Code of Corporate Governance orientation sessions for board members, to discuss the various provisions of the Code, were being organised by 77% of the respondents.

- No formal evaluation of the board performance had been conducted in the previous two years by 70% of the respondents.

1. The Role of the Board

Did You Know That…?

The board is mainly responsible for setting corporate strategy, setting ethical standards, monitoring managerial performance and achieving an adequate return for shareholders, while preventing conflicts of interest and balancing competing demands on the corporation. Boards need to exercise objective and independent judgement. It is the board's responsibility to oversee systems designed to ensure that the corporation obeys applicable laws, including tax, competition, labour, environmental, equal opportunity, health and safety laws. The board is not only accountable to the company and its shareholders but also has a duty to act in their best interests. In addition, boards are expected to have due regard for, and deal fairly with, other stakeholder interests and to observe environmental and social standards.[43] Boards should also set and enforce clear lines of responsibility and accountability throughout the organisation. The board must understand the control environment over all significant business risks. [44]

The board of directors is responsible for implementing the corporate governance of the company. [45]

The principal role of the board thus is to:

(i) provide strategic guidance

(ii) provide material oversight

(iii) ensure the right corporate governance frameworks, policies and procedures are in place.

Our board of directors meets every quarter and most of their time is taken up approving decisions and financial plans and salaries. We only have four meetings and in these four meetings our board does not have the time to approve everything and then to think of tomorrow as well. (Company secretary of a listed company)

---

43 OECD Principles of Corporate Governance.

44 *Enhancing Corporate Governance for Banking Organizations*, Basel Committee on Banking Supervision, February 2006.

45 Code of Corporate Governance of Pakistan.

1.1 Strategic guidance and material oversight

> **Did You Know That…?**
> An effective, efficient, successful and focused board in one that directs and does not manage. The board guides strategic direction but the management develops and implements strategies and business plans under the board supervision. The role of the board is to oversee management but not to be part of the management. Independence and vigilance are essential characteristics of boards of directors.

An overwhelming majority (83% of financial sector institutions and 89% of the companies) stated that the board was responsible for setting the corporate strategy as required by the Code of Corporate Governance.[46]

Under the Code, the annual budget of a listed company is classified as a significant issue that shall be placed before the board for information, consideration and decision making.[47] In 91% of the financial sectors institutions and 75% of the companies surveyed, respondents stated that the board of directors approved the budgets.

Under the Companies Ordinance and the Code of Corporate Governance, the annual reports, including the financial statements, are to be approved by the directors of the company, [48]and 81% of the surveyed sample claimed that the board of directors did approve these documents.

In addition, 59% of the surveyed sample stated that placing additional shares and increasing authorised share capital were the responsibility of the board of directors.

[46] Para. viii (b) Code of Corporate Governance of Pakistan.
[47] Para. xiii Code of Corporate Governance of Pakistan.
[48] Para. xix Code of Corporate Governance of Pakistan, section 196(2)(h) Companies Ordinance 1984.

Figure 3.12 Responsibility for setting corporate strategy (multiple answers)

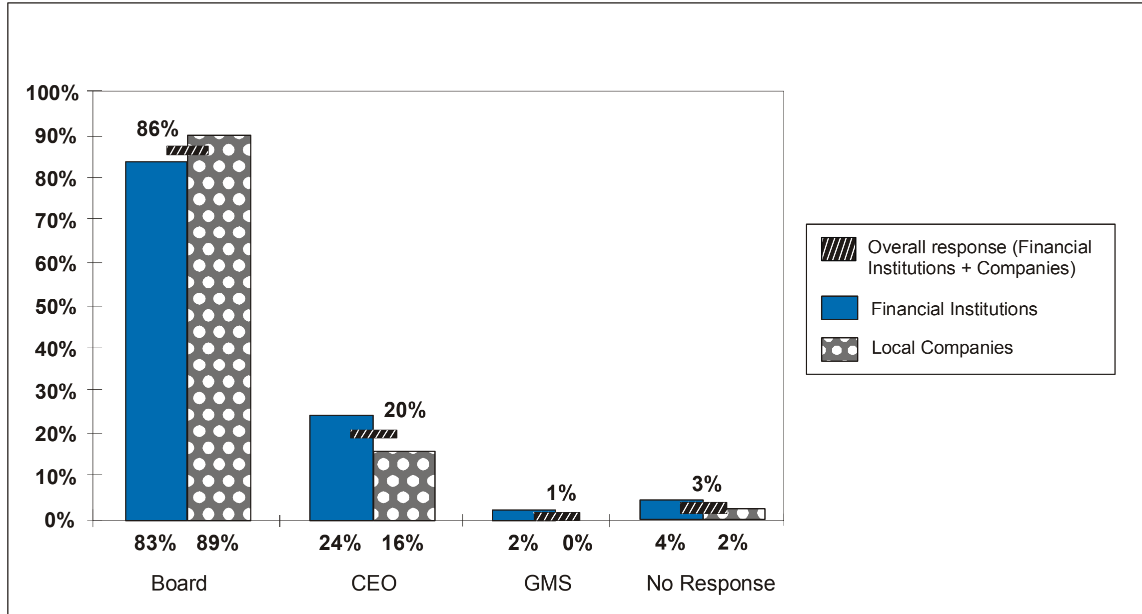


Figure 3.13 Responsibility for approving annual budgets (multiple answers)

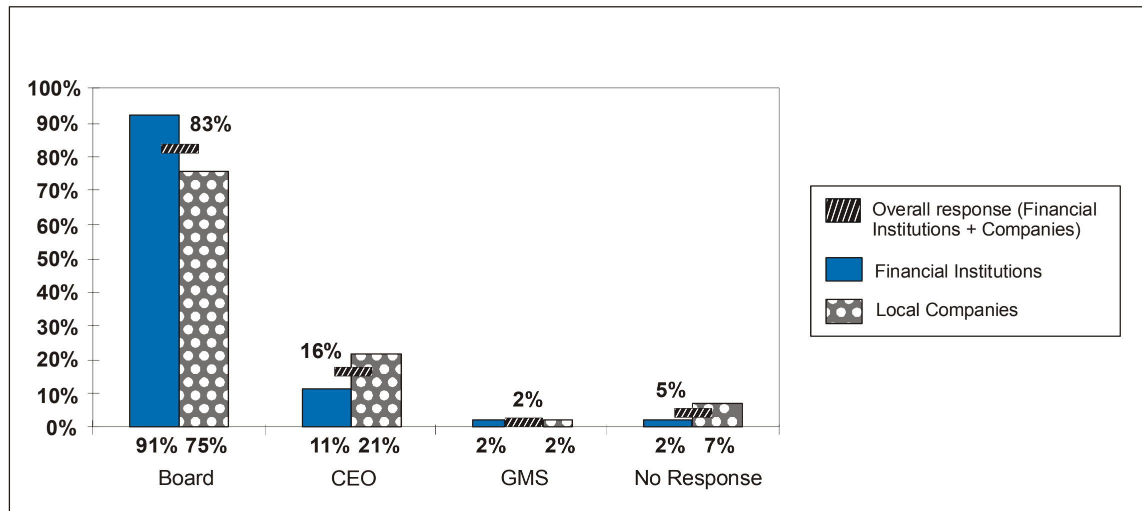


Figure 3.14 Responsibility for approving the annual report (multiple answers)

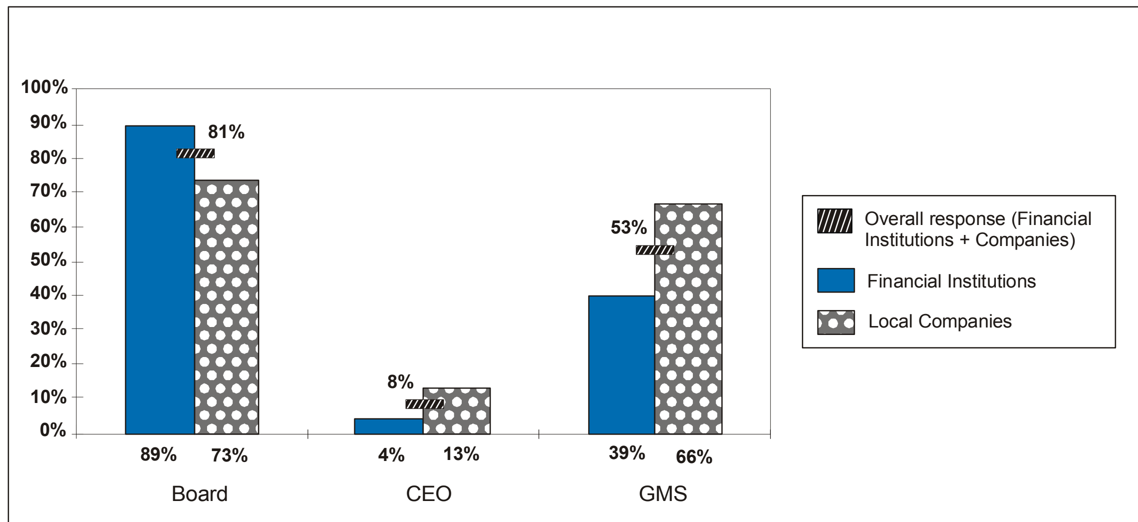
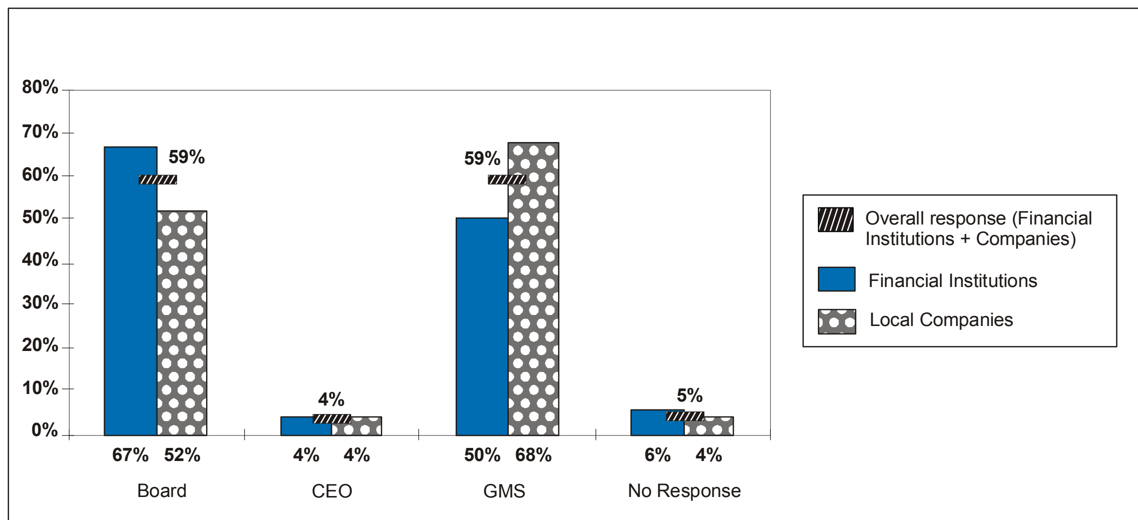


Figure 3.15 Responsibility for placing additional shares and increasing authorised capital (multiple answers)

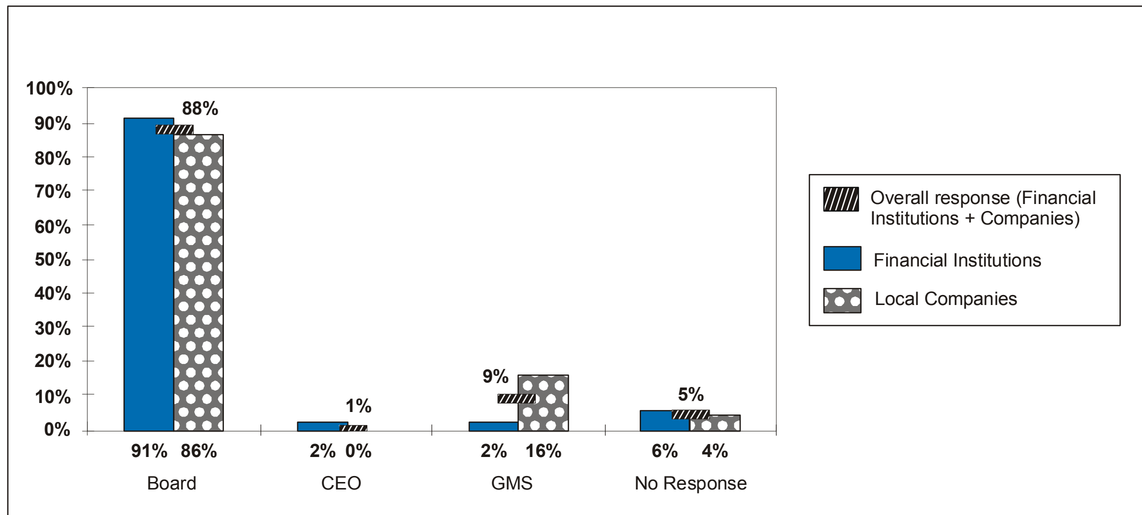


89% of the respondents stated that the board was responsible for approving disclosure policies.

1.2 Selection, appointment and dismissal of the chief executive

88% of the surveyed sample stated that the board was responsible for electing, appointing and dismissing the chief executive.

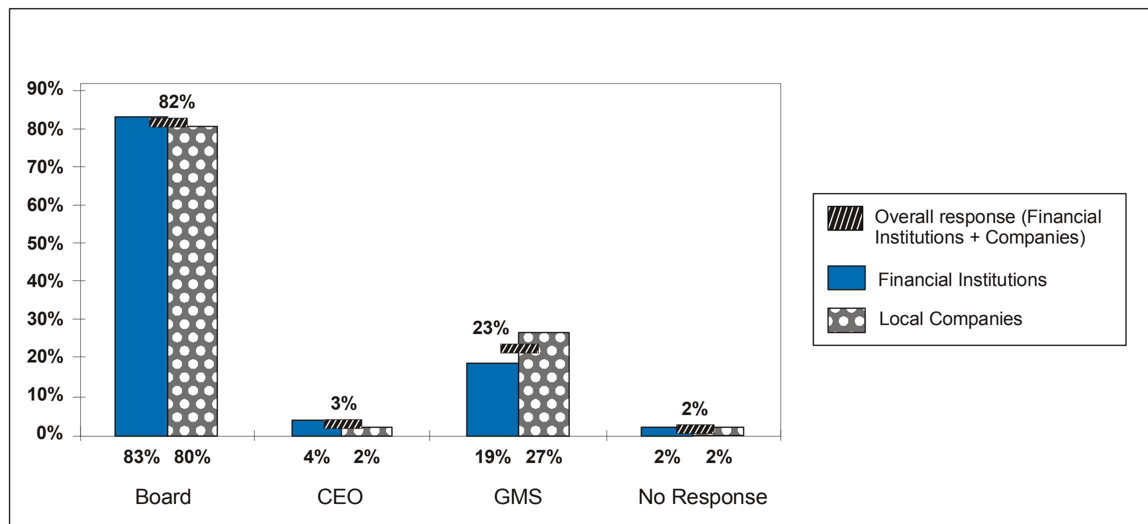
Figure 3.16 Responsibility for electing, appointing and dismissing the CEO/MD (multiple answers)



1.3 Executive remuneration

Under the Code of Corporate Governance, the board of directors is responsible for setting the remuneration of the CEO.[49] A majority (83% for financial sector institutions and 80% for companies) of the sample thus expressed the opinion that the board was responsible for approving the remuneration of the CEO.

Figure 3.17 Responsibility for approving the remuneration of the CEO/MD (multiple answers)



1.4 Internal audit and internal control systems

The board was responsible for overseeing the internal audit function in 83% of the surveyed sample.

[49] Para viii (e) Code of Corporate Governance of Pakistan.

Under the Code of Corporate Governance, the directors' report to shareholders should include a statement that the system of internal control is sound in design and has been effectively implemented and monitored.[50] 65% of the respondents stated that it was the function of the board to oversee internal control systems.

Figure 3.18 Responsibility for overseeing the internal audit function (multiple answers)

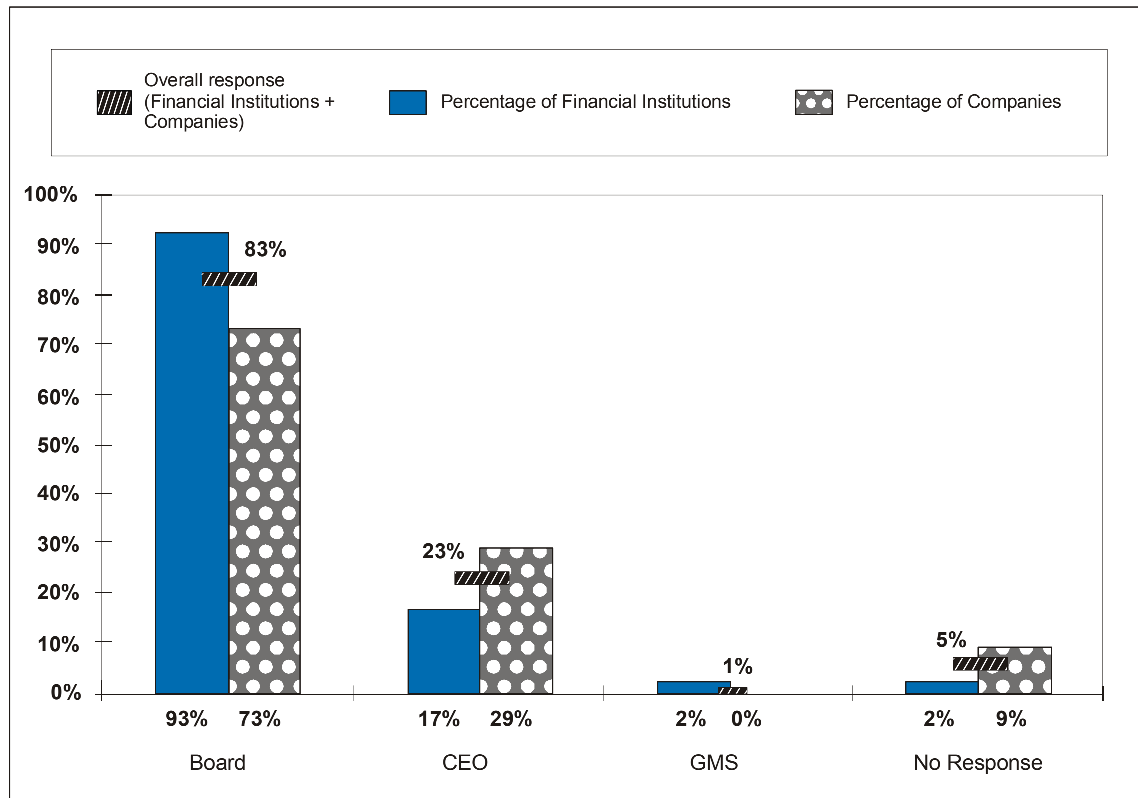
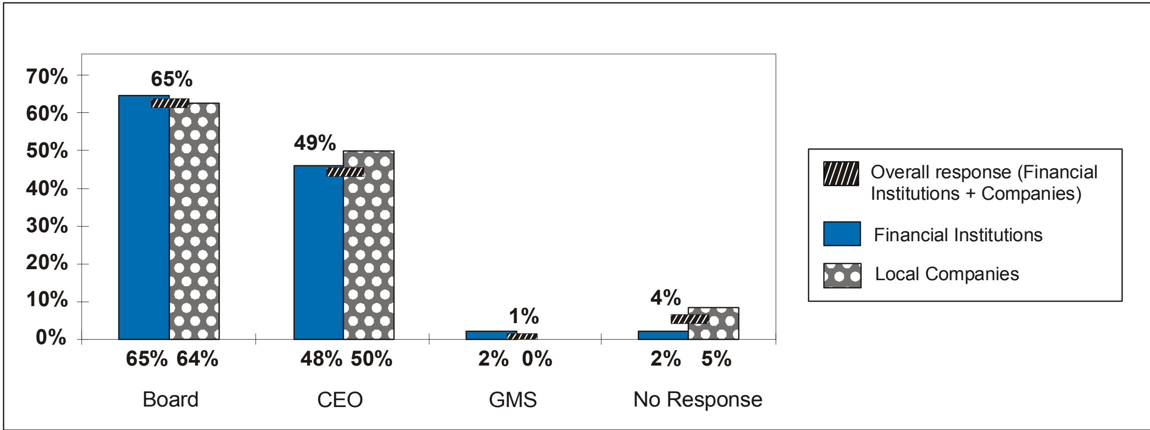


Figure 3.19 Responsibility for overseeing internal control systems (multiple answers)

[50] Para. xix (e) Code of Corporate Governance of Pakistan.


70%
60%
50%
40%
30%
20%
10%
0%
65%
49%
1%
4%
65% 64%
48% 50%
2% 0%
2% 5%
Board
CEO
GMS
No Response
Overall response (Financial Institutions + Companies)
Financial Institutions
Local Companies

1.5 Succession planning

> *This is a family-owned business – when the father dies the son takes over and that is how it has continued for generations. This is the plan, why would the board spend time discussing this plan?* (CFO of a listed company)

Did You Know That…?

Overseeing succession planning is an important function of the board of directors as it allows a company to develop and change leadership in a systematic, progressive and non-disruptive manner. There should be succession plans for all key executives, CEO and board positions.[51]

The importance of succession planning for family-owned businesses is of even greater importance. A study of inherited family firms and management practices in the UK shows that while family ownership seems to improve a company's management practices, family management of family-owned firms often leads to performance woes. The two problems with family management are that:

- selecting a potential CEO from the small group of family members severely restricts the available pool of managerial ability
- assuring family members of managerial positions later in life can lead to the 'Carnegie effect', in which family members work less hard at school and early in their careers, knowing they have a guaranteed family job.

Even worse, choosing a CEO by 'primogeniture' (selecting the eldest son to lead) tends to lead to extremely bad performance. The lack of a selection pool and the Carnegie effect become much more severe in situations of primogeniture, since the CEO position is determined from birth.[52] This is just one reason why only 5% of family-run businesses continue to add value after the third generation of ownership.

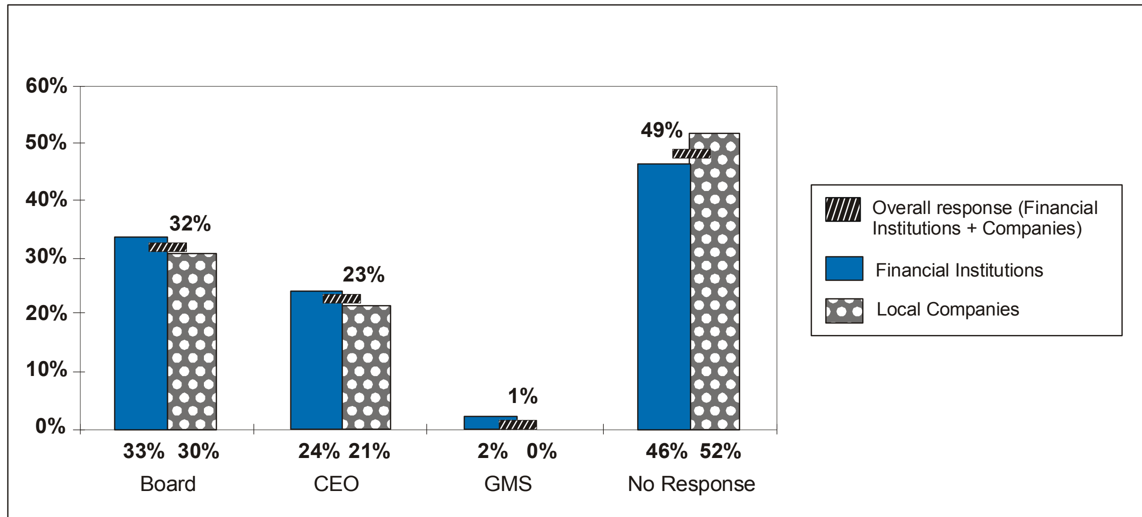
49% of the respondents did not reply to the question relating to approval of the succession plan, while 32% stated that the board was responsible for the succession plan.

---

[51] OECD Principles of Corporate Governance.

[52] *Inherited Family Firms and Management Practices: The Case for Modernising the UK's Inheritance Tax*, Centre for Economic Performance, London School of Economics.

Figure 3.20 Responsibility for approving the succession plan (multiple answers)



Synopsis

The board is strong in terms of the functions it performs, as outlined by the Code of Corporate Governance but there is significant scope for extending its concerns. Succession planning is not a key issue for the majority of boards. Considerable time is taken up by approvals and overseeing implementation of policies, thus raising a question as to when the board has time to plan strategy and develop vision.

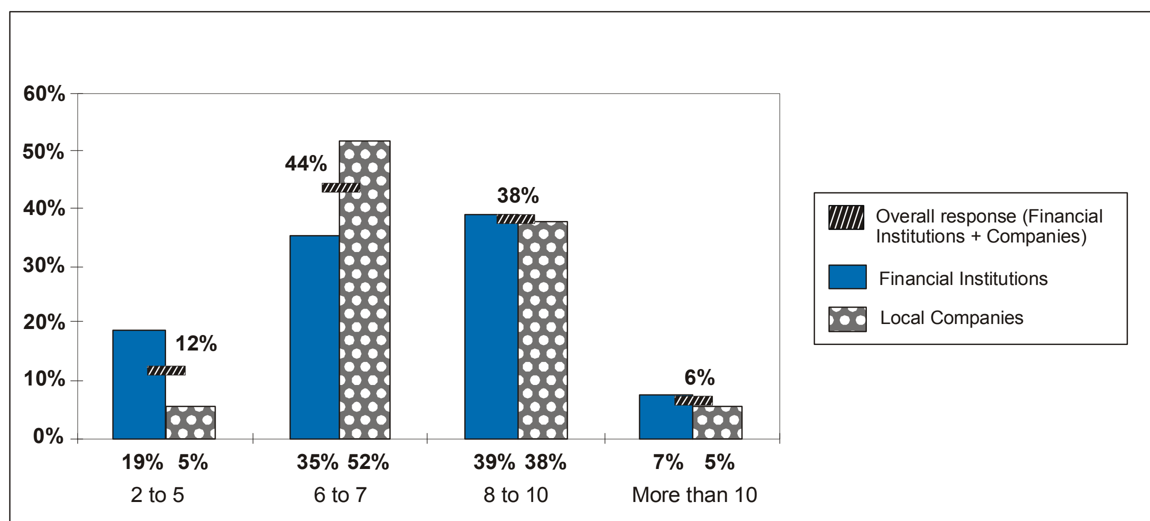
2. Board Composition

For decades my family has been running this business. Now we are told to have independent non-executive directors on our board. As an institutional investor has some investment in our company, we have them as independent non-executive directors. Honestly, they do not come prepared for the meetings. They are whimsical and not competent to do the job. They have never read the agenda and never contribute to the discussion. I have nothing against independent non-executive directors but they should be competent. The other issue is where to get these independent non-executive directors. Key executive jobs can be advertised but we cannot advertise for a director. (Chief executive of a family-owned business)

2.1 Number of board members

The Companies Ordinance requires that every listed company shall have not fewer than seven directors,[53] and 88% of respondents complied with this, saying that they had on average seven or more directors.

Figure 3.21 Number of board members



2.2 Number of executive directors

Although the Code of Corporate Governance recommends that no more than 75% of the elected directors should be executive directors, including the chief executive,[54] 48% of the respondents stated that more than 75% of the elected directors were executive directors.

[53] Section 174 (2), Companies Ordinance 1984.

[54] Para. i (c) Code of Corporate Governance of Pakistan.

Point to ponder

An independent director is a director who has no material relationship with the company beyond his or her directorship (directly or as a partner, shareholder or officer of an organisation that has a 'material' relationship with the company). An independent director should be independent in character and judgement, and there should be no relationships or circumstances which could affect, or might appear to affect, the director's independent judgement. [55]

2.3 Number of independent non-executive directors

Independent board members can contribute significantly to the decision-making of the board. They can bring an objective view to the evaluation of the performance of the board and management. In addition, they can play an important role in areas where the interests of management, the company and its shareholders may diverge, such as executive remuneration, succession planning, changes of corporate control, take-over defences, large acquisitions and the audit function. In order for them to play this key role, it is desirable that boards declare who they consider to be independent and the criteria for this judgment.[56]

Even though the definition of independent director was given in the questionnaire and explained during the process of interview, a majority of respondents did not want to understand or read the definition. For them, a non-executive director who did not work full time for a company was an independent director. A majority of the respondents expressed the opinion that it is difficult to find any non-executive directors and impossible to find independent non-executive directors. Dissatisfaction was expressed with the role and performance of institutional investors such as the National Investment Trust (NIT). The main criticism was their lack of preparation for board meetings and their uninterested attitude towards board discussions; thus they did not fulfil their responsibility as non-executive directors.

A person having a family relationship is not an independent director. Well, how do you define a family? Are nephews and great-nephews' part of the family or not? Are uncles and aunts part of the family or not? My family has run the business successfully now, all of a sudden, why should I have outsiders on the board? In my opinion if a person does not work full time for the company [he] *is an independent non-executive director and that is the end of the story of independence.* (Chief executive of a family-owned business)

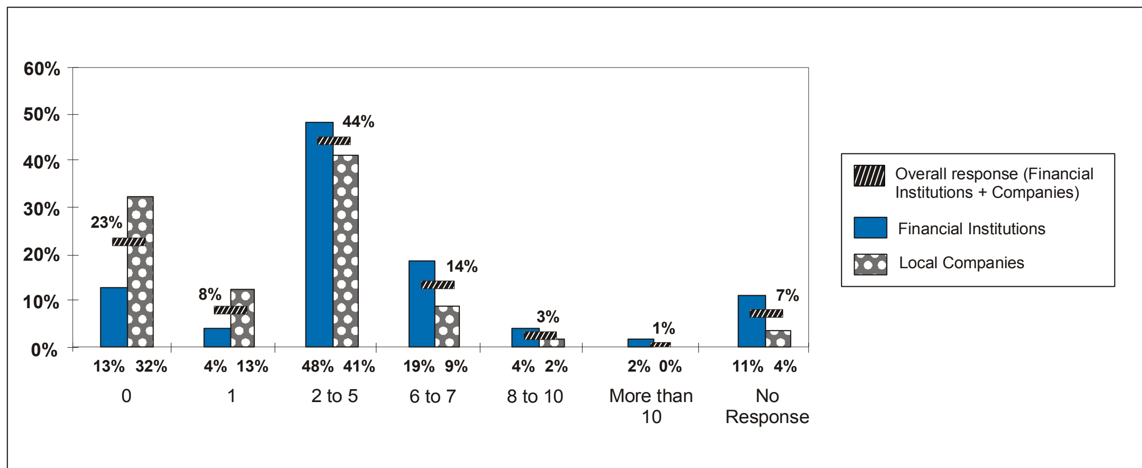
In the survey, 23% of the respondents did not have any independent non-executive directors and a further 7% did not reply to the question, while 8% had only one independent non-executive director.

---

55 IFC Guidelines for Directors. See www.ifc.org/mena

56 OECD Principles of Corporate Governance.

Figure 3.22 Number of independent non-executive directors on the board



2.4 Balancing the boards

Point to ponder

Companies that have women directors scored significantly higher in corporate governance than companies with all-male boards.[57]

69% of the respondents stated that women were not represented on their board of directors. This is contrary to a common belief that persists in Pakistan that most company boards include wives, sisters-in-law, daughters and daughters-in-law as dummy directors.

57 *The Female FTSE Report 2004*, Cranfield University School of Management. The study used 13 indicators to measure corporate governance in relation to gender diversity.

3. Board Structure and Committees

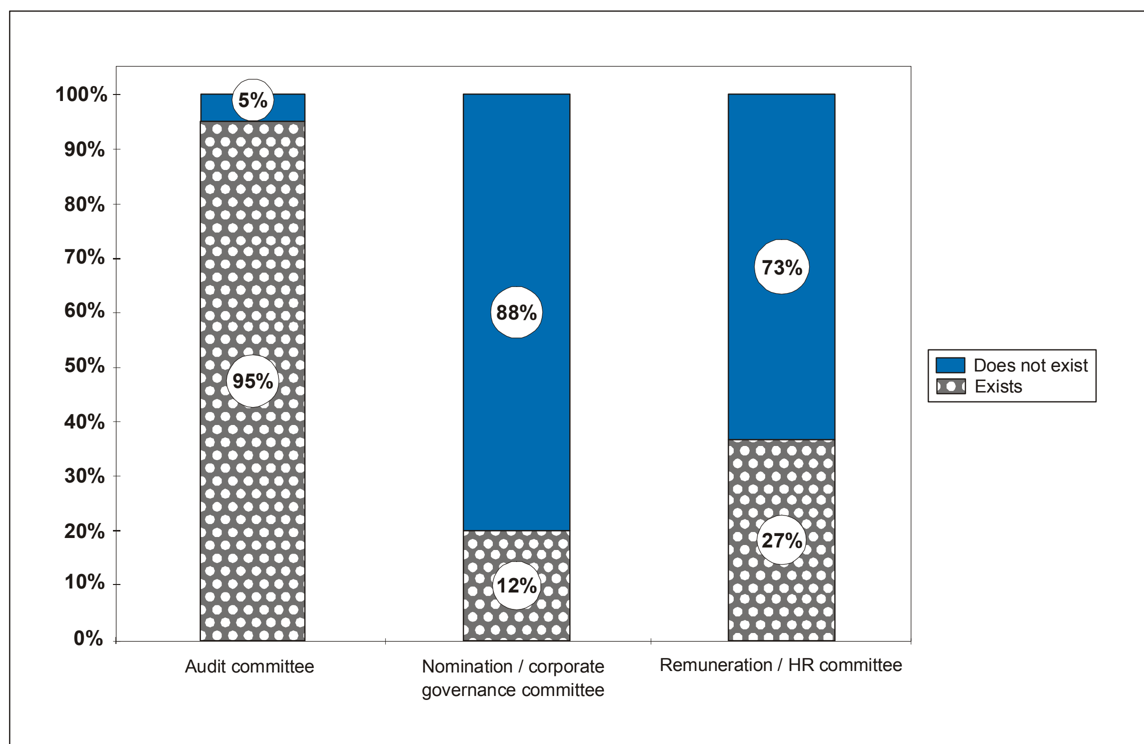
Did You Know That…?

Boards are strengthened by the presence of board committees,[58] for example an audit committee, nomination committee and remuneration committee. Board committees can help the board to:

- handle a greater number of issues in a more efficient manner by allowing experts to focus on specific areas and provide recommendations to the board as a whole
- develop subject-specific expertise on the company's operations, for example on financial reporting, risk management and internal controls, and
- enhance the objectivity and independence of the board's judgement, insulating it from potential undue influence of managers and controlling shareholders, in such key areas as remuneration, director nomination and controls oversight.

When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed in the annual reports by the board.[59]

Figure 3.23 Outline of the different committees of the boards of responding companies



[58] The UK Combined Code, the OECD Principles of Corporate Governance and the Commonwealth Principles of Corporate Governance.

[59] OECD Principles of Corporate Governance.

3.1 Audit committee

Audit committee – we have an audit committee just like the Code wants but why do we need an audit committee? I still do not know. The board can do the work that the audit committee is doing. Our non-executive directors do not have time for board meetings, now they have to take out time for audit committee meetings too and get more money. (Company secretary of a listed company)

As it is required by the Code of Corporate Governance,[60] 95% of the respondents had established an audit committee.

Only 34% of the respondents stated that they had a majority of non-executive directors (directors not working full time) as members of the audit committee and of these only 27% stated that these directors were independent.

Point to ponder

All SAP 500 boards now have an audit committee composed entirely of independent directors.[61]

3.2 Nominations committee

As most of the respondents were unaware of the possibility of having nominations committees, 88% of them did not have such a committee.

Did You Know That…?

The nominations committee is responsible for considering matters relating to the composition of the board, including the appointment of new directors. The committee reviews strategic human resource decisions and succession plans for the chairman, and other keyboard and executive positions. Where resources are limited, this committee might also review corporate governance arrangements and oversee the annual performance evaluation of the board, its committees and the individual directors. It should include a majority of independent directors.[62]

3.3 Remuneration/HR committee

As Shown in figure 3.23, 73% of the respondents did not have a remuneration/HR Committee.

---

60 Section xxx of the Code of Corporate Governance of Pakistan: 'The Board of Directors of every listed company shall establish an Audit Committee, which shall comprise not less than three members, including the chairman. Majority of the members of the Committee shall be from among the non-executive directors of the listed company and the chairman of the Audit Committee shall preferably be a non-executive director.'

61 The Spencer Stuart Board Index, 2005.

62 IFC Guidelines for Directors.

Did You Know That…?

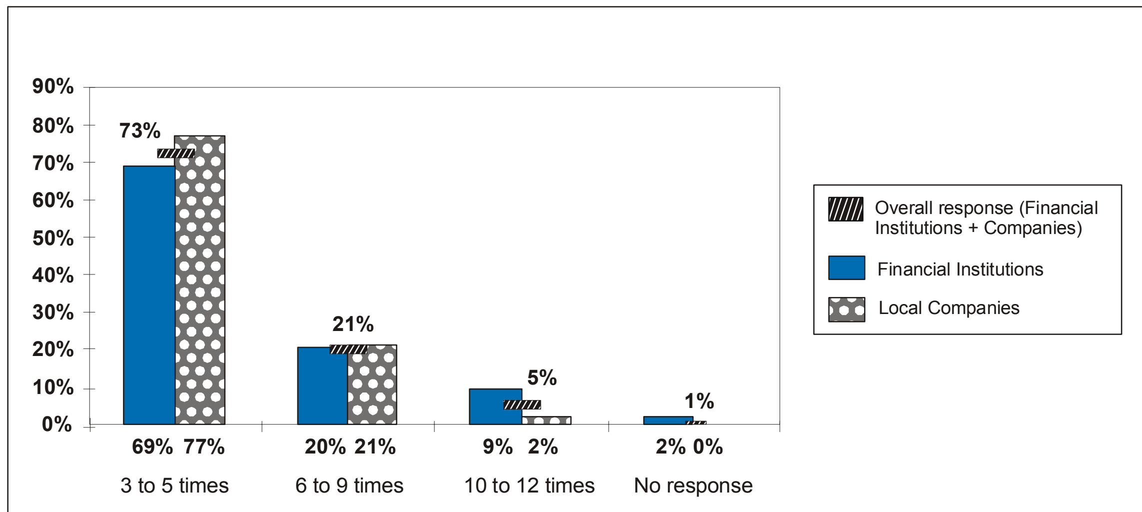
The remuneration committee considers matters relating to board and executive remuneration. The committee approves changes to incentive and benefits plans applicable to senior managers and may be involved with remuneration decisions for the company as a whole. It should ideally comprise independent directors only.

4. Board Working Procedures

4.1 Calling for a meeting

The Companies Ordinance[63] and the Code of Corporate Governance,[64] require that the directors of a public company meet at least once every quarter, and 100% of the responding surveyed sample stated that they complied with this.

Figure 3.24 Number of board meetings in a year



4.2 Meeting notification and time commitment

The Code of Corporate Governance recommends that directors are furnished with background materials one week before the meeting,[65] and as shown in the figure 3.25, 95% of the surveyed sample stated that they complied with this.

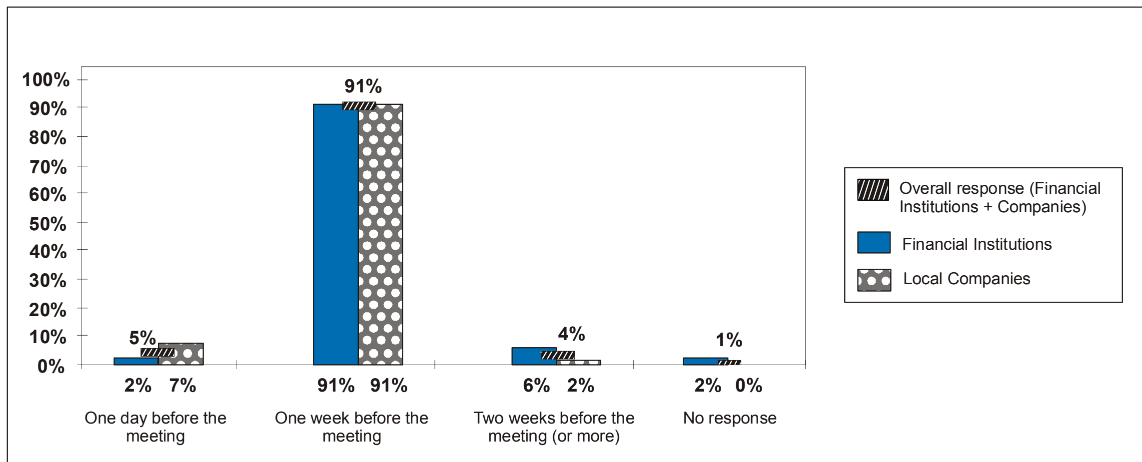
---

63 Section 193 (2) Companies Ordinance 1984.

64 Section xi of the Code of Corporate Governance of Pakistan: 'The Board of Directors of a listed company shall meet at least once in every quarter of the financial year '.

65 Section xi of the Code of Corporate Governance of Pakistan: 'Written notices (including agenda) of meetings shall be circulated not less than seven days before the meetings, except in the case of emergency meetings, where the notice period may be reduced or waived'.

Figure 3.25 When are directors supplied with background material for board meetings?



4.3 Meeting agenda, frequency and length

> *Rarely does one come across the 'right sized' agenda, which concisely outlines the issues to be discussed, their importance, and the tasks before the board for that meeting. Board meetings are usually held after lunch and that is not a very good time to concentrate on key issues.* (Director of a listed company)

The Code of Corporate Governance states that in order to strengthen and formalise the corporate decision-making process, significant issues shall be placed before the directors of listed company for their consideration, information and decision making.[66] The survey shows that the background material being provided to directors is comprehensive in terms of quantity but the quality may vary from company to company.

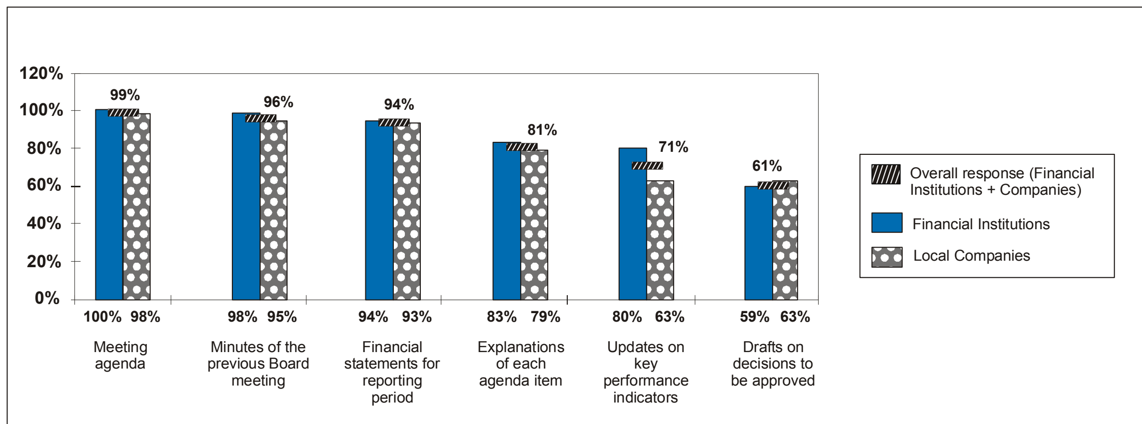
Did You Know That…?

The board agenda should itemise issues under discussion and should strike a balance between reviews of past performance and forward-looking issues. The agenda should reflect discussion time. The board should not spend much time on routine or administrative matters.[67]

66 Section viii, Code of Corporate Governance of Pakistan.

67 *Boards at work*, Ram Charan.

Figure 3.26 Materials distributed to directors for board meetings (multiple answers)



4.4 Remuneration of executive and non-executive directors

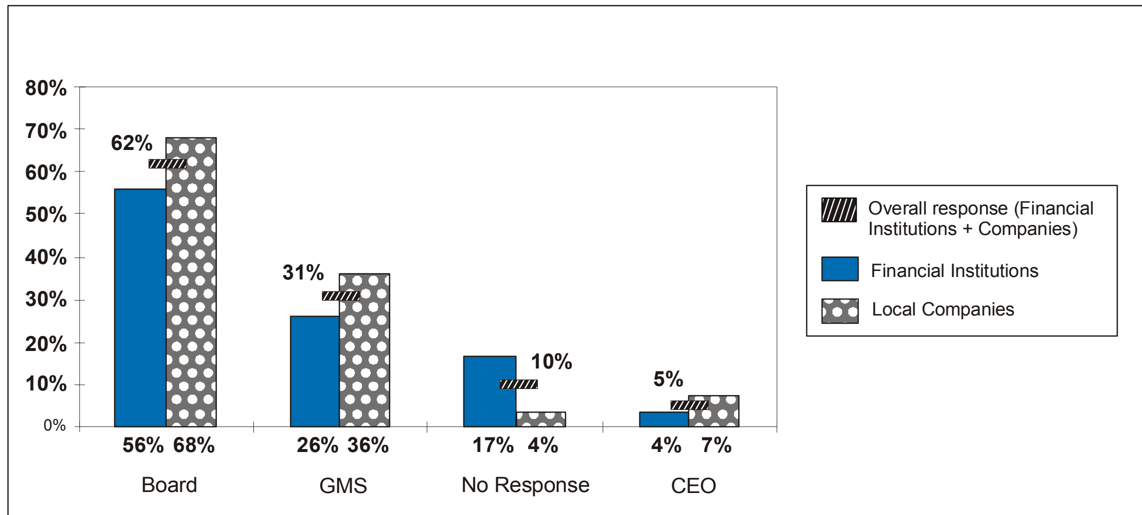
> *Non-executive directors get only PKR 500 for attending a meeting. This is just peanuts. If you pay peanuts you get monkeys. This is hardly a compensation for properly exercising fiduciary responsibilities. No competent, qualified, experienced person will want to be a director for PKR 500, especially when there is also no concept of director's liability insurance. Executive directors get a fixed salary. This is again unreasonable. Executive director's salaries need to be aligned with the short- and long-run maximisation of corporate value; companies must begin to offer a combination of commissions on net profits and stock options.* (Director of a listed company)

4.5 Remuneration of the board of directors

Under the Code of Corporate Governance, remuneration and other terms and conditions of employment of executive directors of listed companies are determined and approved by the board of directors,[68] and as shown in the figure 3.27, 62% of the respondents stated that the board was responsible for approving the remuneration of the members of the board.

[68] Section. viii (e) Code of Corporate Governance of Pakistan.

Figure 3.27 Responsibility for approving remuneration of members of the board (multiple answers)



4.6 Remuneration of key executives

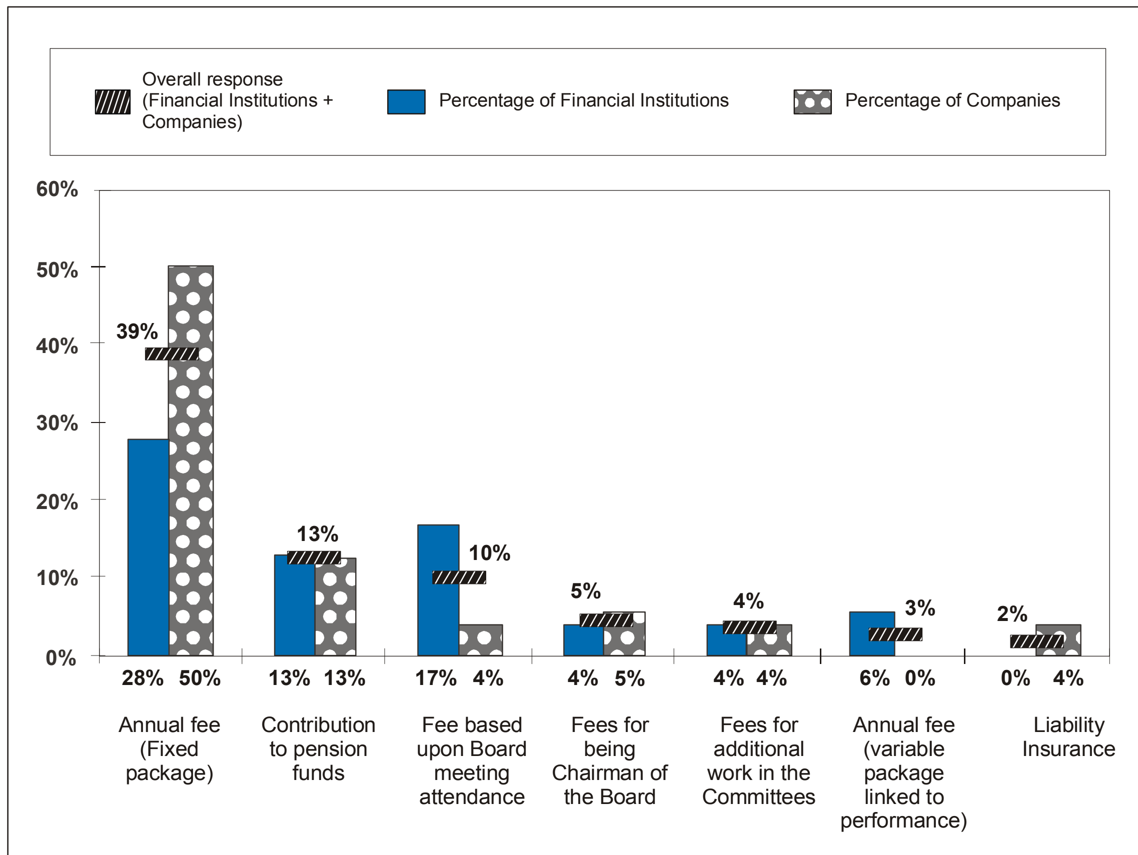
Did You Know That…?

The remuneration of executive board members should be aligned with the longer-term interest of the company and its shareholders. A remuneration policy may be developed that specifies the relationship between remuneration and performance and also includes measurable standards that are based on the company's key performance indicators.[69]

Because they believed that it was confidential, 59% of the respondents did not want to share information relating to remuneration of the executive directors; 39% of the respondents stated that a fixed annual salary was paid to executive directors. The concept of performance-related remuneration is still to develop in Pakistan.

[69] OECD Principles of Corporate Governance.

Figure 3.28 Elements of the remuneration of executive directors (multiple answers)



4.7 Remuneration of non-executive directors

Did You Know That…?

The annual fee payable to directors should be the same for all non-executive directors and should be determined by market practice. Additional fees should be paid for committee membership and for chairing the board or committees.[70]

29% of the respondents were unwilling to answer the question relating to the amount of payment for attending board meetings while 50% of the respondents stated that the average payment made to board members for attending board meetings was in the range of PKR 500–5000 (approximately US $8–$84).

[70] IFC Guidelines for Directors.

Figure 3.29 Payments to board members for attending board meetings

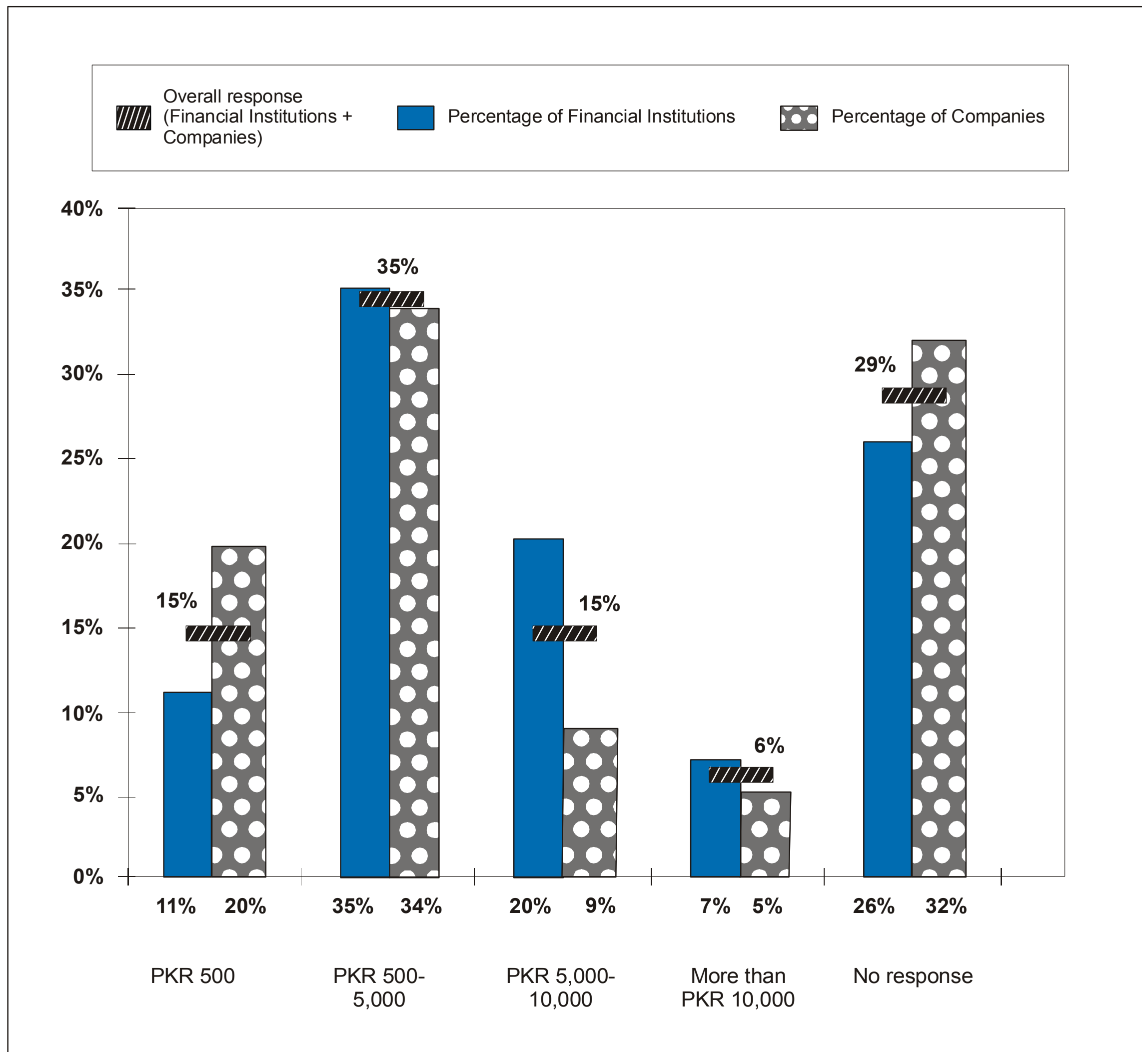
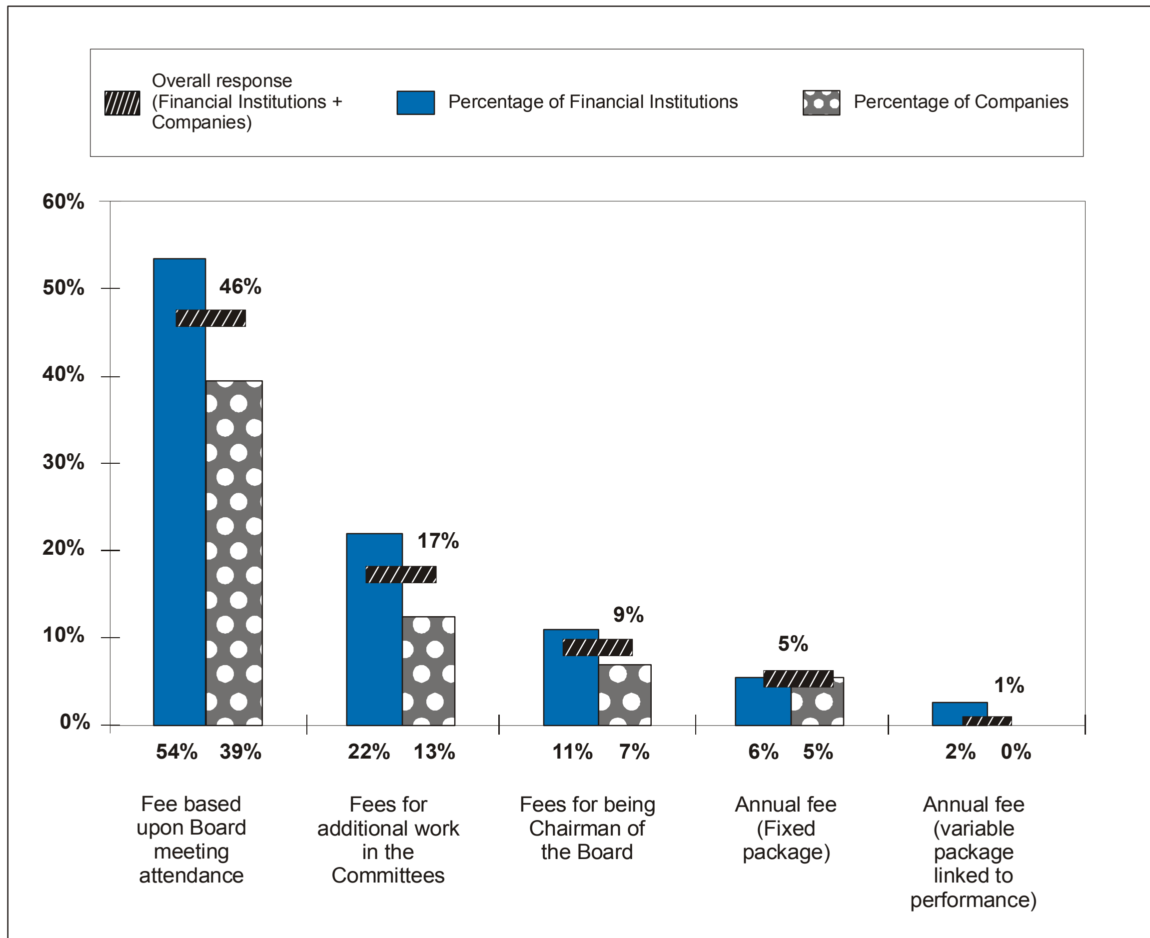


Figure. 3.30 outlines the different elements of non-executive directors' remuneration. It can be concluded from the graph that in most cases the non-executive directors are being paid for board meetings and in some cases for additional work on the committee or for chairing the boards.

Figure 3.30 Elements of remuneration for non-executive directors



Synopsis

Formal structures for board remuneration need to be set up or improved. The fees being paid to non-executive directors are well below international remuneration benchmarks. The idea of performance-related salary structures for executive directors and senior managers needs to be developed.

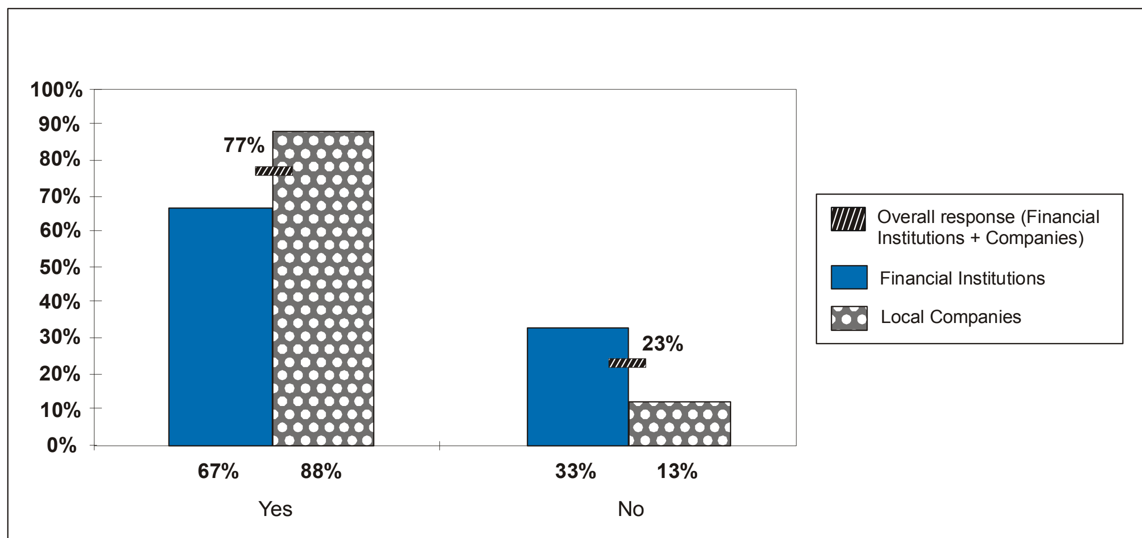
5. Board Performance Evaluation and Training

In order to improve board practices and the performance of its members, an increasing number of jurisdictions are now encouraging companies to engage in board training and voluntary self evaluation that meets the needs of the individual company. This might include that board members acquire appropriate skills upon appointment, and thereafter remain abreast of relevant new laws, regulations, and changing commercial risks through in-house training and external courses[71].

77% of the respondents stated that they were organising corporate governance orientations for board members where the provisions of the Code would be discussed.[72]

Our directors know everything. They are competent and qualified. Why should they attend orientations? But we have to comply with the Code. So we discuss the Code of Corporate Governance in a meeting, but honestly our directors do not need to be educated on corporate governance. They know it. (Company Secretary of a listed company)

Figure 3.31 Organising corporate governance orientation sessions for board members



The culture of board evaluation still has to develop, as only 30% of the respondents stated that the board had conducted a formal evaluation of its performance in the last two years. The relatively high positive response to organising orientation sessions and relatively low response to conducting evaluations indicates that companies in Pakistan are doing only what is required by the Code of Corporate Governance.

---

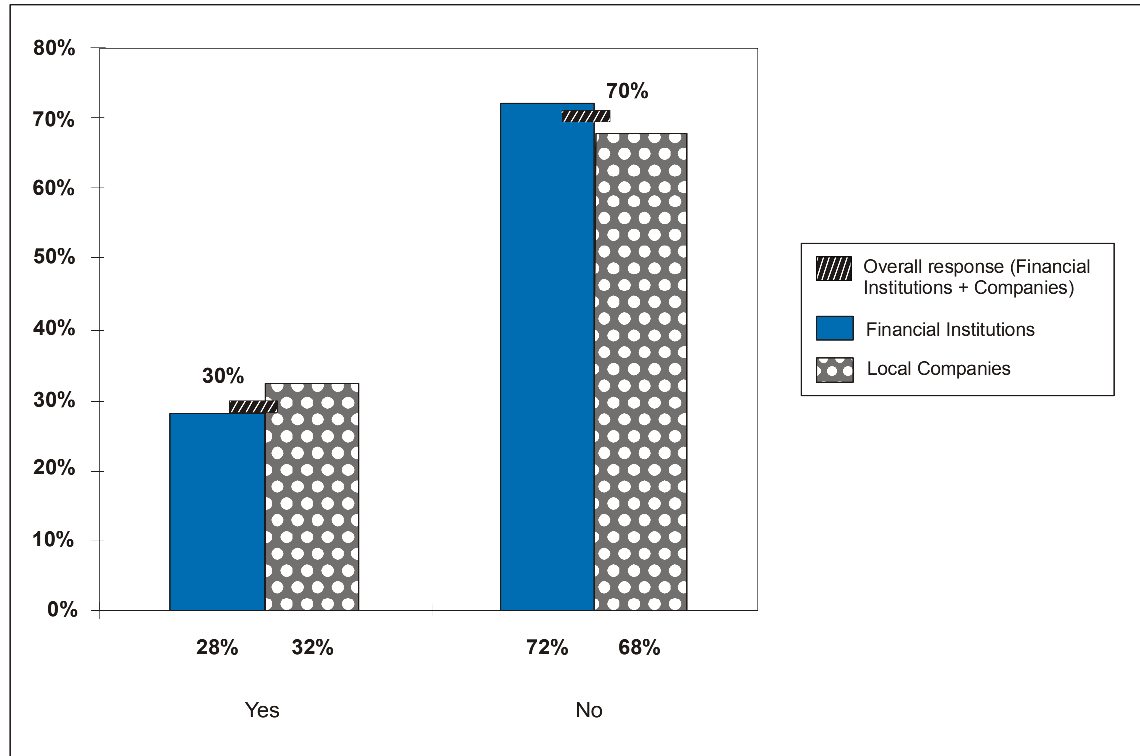
71 OECD Principles of Corporate Governance.

72 Section xiv of the Code of Corporate Governance of Pakistan requires all listed companies to make appropriate arrangements to carry out orientation courses for their directors to acquaint them with their duties and responsibilities and enable them to manage the affairs of the listed companies on behalf of shareholders.

Did You Know That…?

Directors should encourage the establishment of a board evaluation process that focuses on ways to improve the board's contribution to the company. Board evaluations are useful in identifying the weaknesses and strengths of the board, and allow the board to take action to improve itself.

Figure 3.32 Has a formal evaluation of the board been conducted in the previous two years?



6. Duties and Responsibilities of the Board

Did You Know That…?

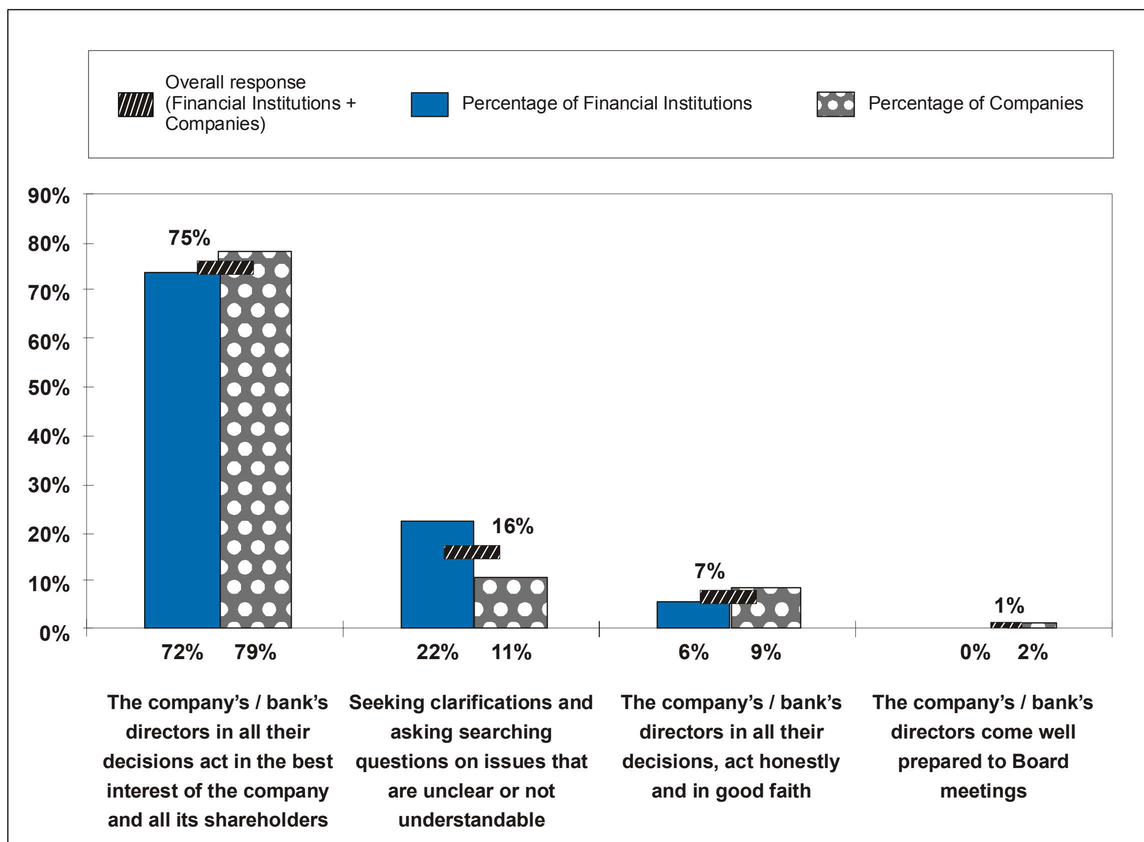
The members of the board of directors have to fulfil their fiduciary duties: the duty of care and the duty of loyalty. The duty of care requires board members to act on a fully informed basis, in good faith, with due diligence and care. The directors are required to exercise behaviour that a reasonably prudent person would exercise in similar circumstances and to act on a fully informed basis. The duty of loyalty for a board member relates to the company and all its shareholders and not only to the controlling company of the group. It underpins effective implementation of principles of corporate governance, for example the equitable treatment of shareholders, monitoring of related-party transactions and the establishment of a remuneration policy for key executives and board members.[73]

[73] OECD Principles of Corporate Governance.

The Code of Corporate Governance specifically states that it is the duty of the directors to act with an objective and independent judgement and in the best interest of the company.[74] The Code also requires directors to confirm at the time of election that they are aware of their duties under the law, company by-laws and listing rules.[75] The Companies Ordinance deals with conflict of interest situations[76] but is not very specific in terms of fiduciary duties, which are based mainly on a small body of case law.[77]

For 75% of the respondents 'duty of care' meant that in all their decisions the company's/bank's directors act in the best interest of the company and all its shareholders. For 16% it meant that the company's/bank's directors actively take part in board meetings and the work of the board committees.

Figure 3.33 Which statement about 'duty of care' is true?



---

74 Section vii Code of Corporate Governance of Pakistan.

75 Section ii Code of Corporate Governance of Pakistan.

76 Companies Ordinance 1984, ss. 214 to 217.

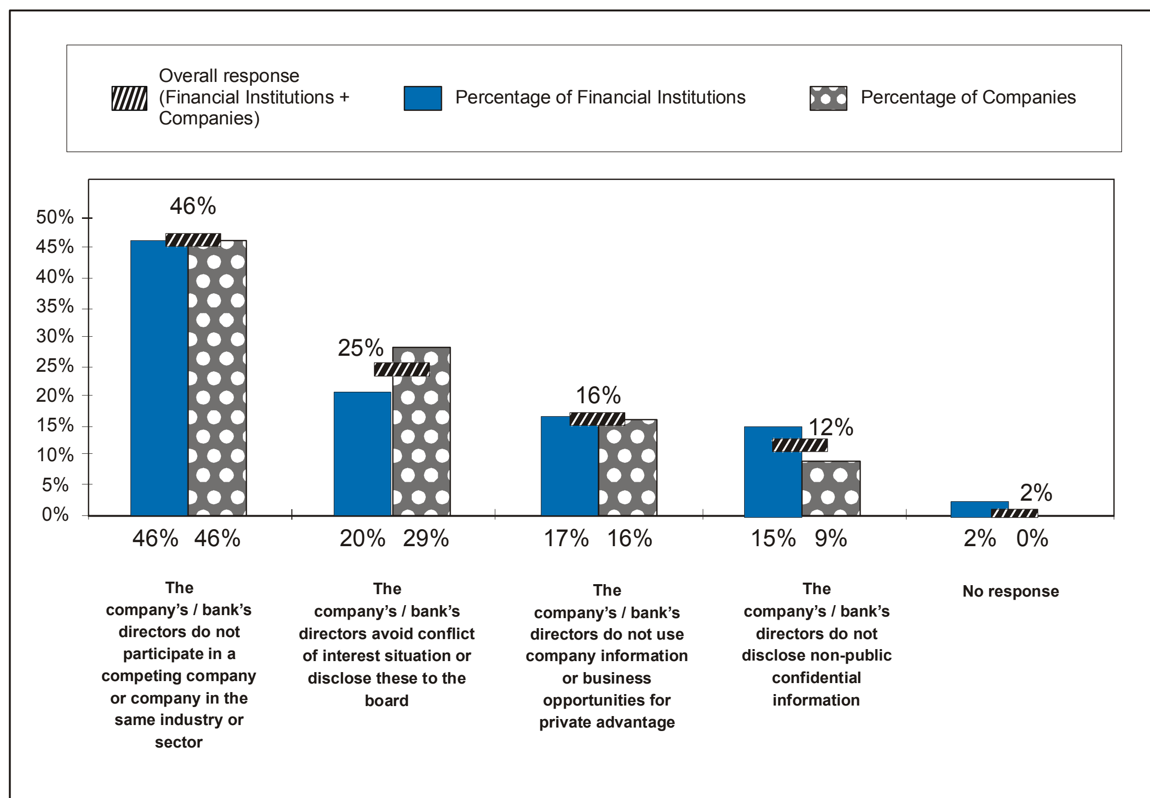
77 *Muhammad Bakhsh & Sons Ltd.* v *Azhar Wali Muhammad* 1986 MLD 1870 (Karachi), *Shahid Saigol* v *Kohinoor Mills Ltd.* PLD 1995 Lahore 264 and *Haroon Ayoob Abdul Karim* v *Sulleman Ahmad and 4 others* 1983 CLC 162 (Karachi).

Point to ponder

Generally, respondents struggled to explain the duty of care and duty of loyalty. On being asked whether the directors fulfilled the duty of care and loyalty in spirit, the answer was that they always act in the interest of the company. Asked whether non-executive directors also fulfilled the duty of care and loyalty, they replied that this was required only of executive directors. This is an important issue as non-executive directors can be on the boards of ten different listed companies at the same time, which means that they are unlikely to find the time to prepare in a professional manner in line with their duty of care.

The conclusion of 46% of the surveyed sample as outlined by Figure 3.34 was that 'duty of loyalty' means that the company´s / bank´s directors do not participate in a competing company or company in the same industry or sector, whereas 25% opined that duty of loyalty means that company's/bank's directors either avoid conflict of interest situations or disclose these to the board.

Figure 3.34 Which statement about 'duty of loyalty' is true?



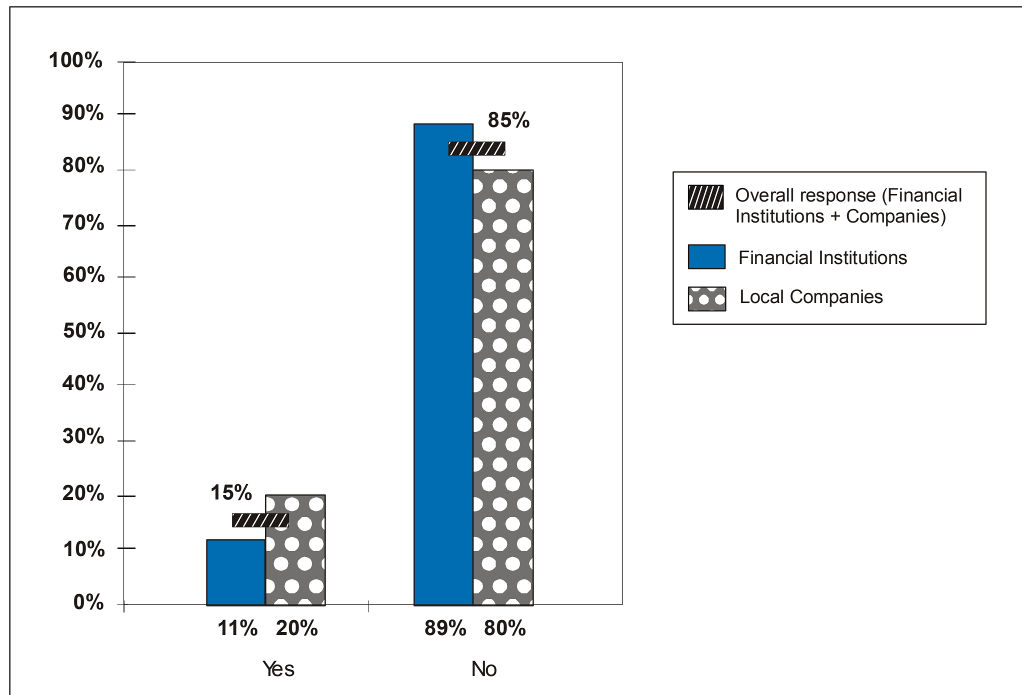
7. Role of CEO/Chairman

Did You Know That…?

The separation of the posts of chairman and CEO is a prerequisite for improving the objectivity of the board and strengthening the board's independence from the management. This also facilitates an appropriate balance of power, improves accountability and enables the board to make decisions independently of the management. [78]

A big majority (85%) of the respondents stated that the position of CEO and chairman were held by different persons. Only 15% stated that the positions of CEO and chairman were held by the same person.

Figure 3.35 Are the positions of CEO and chairman held by the same person?



Synopsis: Board practices

The majority of boards are in compliance with the legal and regulatory requirements laid down in the Companies Ordinance 1984 and the Code of Corporate Governance. The role of the board of directors has evolved into a powerful centre of decision making and approvals but the composition of boards of directors needs to be reviewed critically. Improvements are needed in terms of more representation of independent directors and professional women on boards. The idea of independent non-executive directors needs to develop in its true spirit in Pakistan. The institutional investors can play a key role in developing corporate governance in Pakistan.

[78] OECD Principles of Corporate Governance.

8. Board Practices – Recommendations

8.1 Strengthening of fiduciary duties by inclusion in the Code of Corporate Governance and through the Companies Ordinance.

In line with the World Bank Group's ROSC report, it is recommended that fiduciary duties need to be strengthened, first through newly introduced provisions in the Code of Corporate Governance and eventually through the Companies Ordinance. The suggested approach is to codify within statute law the responsibilities of boards and of executive and non-executive directors, rather than relying on common law. The UK has done this, for the first time, in its 2006 Companies Act.[79]

8.2 Independent non-executive directors should be included in the board of directors.

It is suggested that the difference between 'non-executive' and 'independent' needs to be clarified. There is considerable resistance to the idea that a non-executive director is not necessarily independent, but nevertheless this is an important distinction.[80] In the revised Code of Corporate Governance, a 'comply or explain' approach needs to be adopted to encourage the inclusion of independent non-executive directors in accordance with good corporate governance practice. If companies find it hard to recruit independent directors then they should explain the reasons for this and these reasons should be addressed. This approach will ultimately lead to a situation where the inclusion of independent non-executive directors can be made mandatory.

There were no women members on 69% of the boards surveyed. This indicates that women are a largely untapped source of talent for boards, not least as non-executive and independent directors. In an environment of a shortage of directors with appropriate skills, Pakistan must diligently tap this source and encourage competent and qualified women to join the boards.

There may also be a case for representation of banks and lending institutions on boards to ensure that effective corporate governance practices are being adopted by the businesses to which they have provided loans.

The Pakistan Institute of Corporate Governance with the assistance of IFC has initiated a Board Development Series, a training programme for directors. It is suggested that when PICG has trained a pool of skilled independent directors it should develop a database of such directors from which companies can choose.

8.3 Research on board meetings and board behaviour should be conducted.

In terms of the agenda, frequency and notice of the board meetings, compliance with the Code of Corporate Governance is common. It is recommended, however, that further research would be useful to determine whether Pakistan boards are effective at determining the direction of the entity, overseeing management, and accounting effectively to their owners. These research studies should concentrate on reviewing board meeting practices and assessing the effectiveness of board meetings, the quality of discussions at these meetings and the appropriateness of their agendas.

8.4 Independent non-executive directors should be included in the audit committee of the board.

The survey results indicate that considerable progress has been made in establishing effective audit committees in Pakistan companies. This is undoubtedly a consequence of the emphasis that the

---

79 www.opsi.gov.uk/ACTS/acts2006/ukpga_20060046_en.pdf

80 See sub-section 2 (Board composition)

SECP Code places on audit committees – which potentially augers well for any future initiative to establish other board committees in Pakistan companies.

The SECP Code does not prescribe that any member of the committee need be an independent director, only that the majority of members should be non-executive directors. We noted, however, that only about a third of the surveyed audit committees have so far succeeded in achieving a majority of non-executive directors as committee members – as the Code sets out. Best practice, however, calls for an audit committee to be exclusively composed of independent directors; in most emerging markets, an argument can be made to aim for audit committees that are exclusively composed of non-executive directors. The inclusion of executives as members of the audit committee runs counter to good corporate governance practices. Thus there is a need to encourage companies to include non-executive directors as members of the audit committee. In this context the SECP will have to play a key role in monitoring the composition of the audit committees. Furthermore, in accordance with good principles of corporate governance, inclusion of independent directors as members of audit committees needs to be encouraged. A 'comply or explain' approach may have to be adopted whereby if companies do not include independent directors, reasons for their non-inclusion need to be given. It might also be worth exploring why many companies do not have a majority of non-executive directors as members of the audit committee.

Having particular regard to the issues raised above, we recommend that that the SECP Code and other guidance on audit committees in Pakistan is kept under review, with the intention of making audit committees progressively more effective, commensurate with the constraints that apply in Pakistan.

8.5 Establishment of Remuneration (or Compensation) Committee of the Board should be encouraged.

It is encouraging that almost one-third of the companies surveyed have some form of remuneration or HR committee, since this is not a stipulation of the SECP Code and has therefore come about as a consequence of genuine, perceived value. Nevertheless, the remuneration systems of companies, as they relate to director remuneration, have considerable scope for improvement. The idea of a remuneration committee still has to develop in Pakistan and even when the remuneration committee exists, very rarely does it comprise exclusively independent directors, in line with best practice.

The fundamental, generally accepted principle is that no executive director or manager should participate in the determination of his or her own remuneration. So it is conventional, across the world, that boards have remuneration (or 'compensation') committees comprising exclusively non-executive directors who are independent of management.

It is the role of the board's remuneration committee to introduce remuneration schemes that provide adequate incentives for the top executives of the company and align their interests with those of the owners. It would not be unusual elsewhere for 60% or more of total top executive remuneration to be performance-related.

Remuneration schemes can be highly technical and, typically, remuneration committees will take advice from specialist remuneration consultants. The perceived lack of technical expertise on remuneration matters is not a good reason for the absence of remuneration committees in many Pakistani companies.

The survey reveals that non-executive directors' fees are based on their attendance at board and board committee meetings, and sometimes on their additional responsibility for chairing a board committee. Before taking on a non-executive director role, the anticipated time demands should be clearly established and accepted. Persistent non-attendance should lead to removal from the board.

With, typically, few board meetings each year, fees based on attendance should be significant.[81] Time commitment varies considerably between countries. Non-executive directors' fees tend to be equivalent to the mean earnings of the executive directors but in proportion to their required time commitment. Thus, if being a non-executive director is expected to take about 25 days per annum of time, including preparation time, etc. then a non-executive director's fee would be approximately one-eighth of the average earnings of an executive director (taking into account the executive's remuneration for his or her managerial responsibilities as well as for his or her board responsibilities).

It is recommended that best practice guidance on directors' remuneration and on remuneration committees of the board is formulated; and that in due course the SECP Code should include coverage of this subject equivalent to its present treatment of audit committees.

The UK's Combined Code includes relevant guidance on remuneration committees, as do the NYSE corporate governance rules.

8.6 Establishment of a nominations committee of the board should be considered.

32% of the respondents were of the opinion that the board is responsible for succession planning, as indeed it is in an overall sense. The board can set up a nominations committee largely comprising independent directors, to come up with a policy for board succession and search for new directors. For public companies, even those with a significant or majority family shareholding, this is important. 49% of the survey's respondents did not reply to the question relating to approval of the succession plan. A majority of these non-responders were family-owned businesses where, arguably, the need for a succession plan is much higher. Many family businesses fail in the third or fourth generation owing to their reluctance to open up the boardroom and senior executive roles to outside competition.

It is recommended that Pakistan develop best practice guidance on nominations committees of the board; and that in due course this subject is covered within the SECP Code to an equivalent extent to the present treatment on audit committees.

8.7 Pakistan's resources of competence in corporate governance should be developed.

It can be concluded from the survey that there is a dearth of appropriate skills to exploit best practice in corporate governance. PICG has already introduced an internationally accredited directors' training programme, the Board Development Series (with IFC assistance), and all companies should be encouraged to send their directors/managers to this course, as well as to other programmes being offered by institutions such as ACCA, ICAP and LUMS.

Although as many as 77% of the respondents stated that they organise corporate governance orientations for their board members, continuing update training is also required.

---

[81] 46% of the respondents stated that non-executive directors were paid fees based upon board meeting attendance; 50% stated that the average payment made to board members for attending board meeting was in the range of PKR500–5,000.

It is also suggested that the principles of corporate governance are taught as a subject at academic institutions. In this context, case studies need to be developed and industry–academia linkages encouraged so that, at both undergraduate and postgraduate levels, students are made aware of practical aspects of corporate governance. This will, in the medium to long term, help in developing the competence of corporate governance resources in Pakistan.

8.8 Board and director evaluation should be covered in the revised SECP Code of Corporate Governance.

Only 30% of the respondents stated that the board had conducted a formal evaluation of its performance in the previous two years. Best practice suggests that the performance of the board, of the board committees, of individual directors and board committee members, and of the chairs of boards and their committees should all be assessed at least annually. The SECP Code is silent on this at the moment and we consider that this should be addressed as soon as possible.

8.9 Institutional investors should play an active role in implementation of corporate governance practices.

Our survey noted a level of unease on the part of companies about the role of institutional investors. Successful corporate governance addresses the behaviour of stakeholders with respect to the companies in which they have stakes. The UK Combined Code has a section relating to institutional investors. We suggest that SECP considers incorporating a similar section in the next edition of the Code. In addition, institutional investors such as the National Investment Trust (NIT) should try to emulate international best practice relating to shareholder activism and to realise their responsibilities for ensuring the highest standards of corporate governance in companies.

C. CONTROL ENVIRONMENT AND PROCESSES – KEY FINDINGS

Internal auditor, external auditor, audit committee – how many audits do we need and why do we need them? Is external audit not supposed to audit every thing? (CFO of a listed company)

Key Findings

1. Overall the respondents are complying with the control processes outlined by the Code of Corporate Governance.

2. In terms of the understanding of the roles, responsibilities and functions of the internal auditor, audit committee and external auditor, there is a clear understanding of what is required under the Companies Ordinance 1984 and the Code of Corporate Governance. Because whistle-blowing and investigation of insider information are not identified as functions or responsibilities of the audit committee, internal auditor or external auditor by either the Code or the Companies Ordinance, respondents did not generally expect the audit committee or the internal or the external auditor to perform these roles. Nonetheless, while management is responsible for ensuring that fraud and insiders dealing do not take place, the audit committee, supported by the internal and external auditors, should ensure that the necessary controls are robust and defensible.

3. The idea of auditor rotation or rotation of audit partners was not very popular among the respondents, mainly because quality auditors are not available in abundance: 30% of the financial institutions surveyed had not changed their external auditor in the previous five years.

4. 46% of the respondents stated that their audit committees were responsible for overseeing internal controls and risk management procedures and only 18% stated that the audit committees were responsible for overseeing whistle-blowing policies.

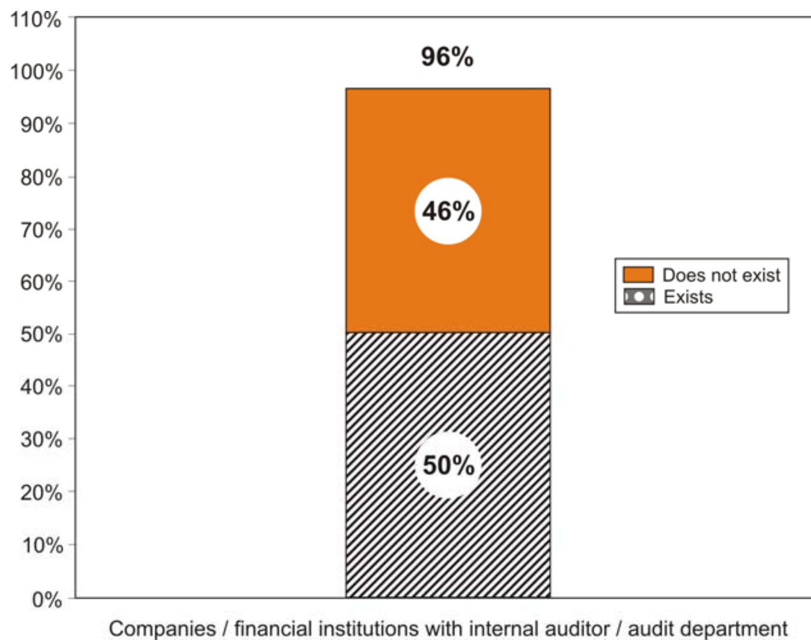
Did You Know that…?

The control environment and processes should facilitate compliance with applicable laws and regulations, enhance the efficiency and effectiveness of activities and ensure the availability of reliable, complete and timely financial and management information.

1. Internal Audit

The Code of Corporate Governance recommends that every listed company shall have an internal audit function,[82] and in fact 96% of the respondents had an internal auditor/audit department.

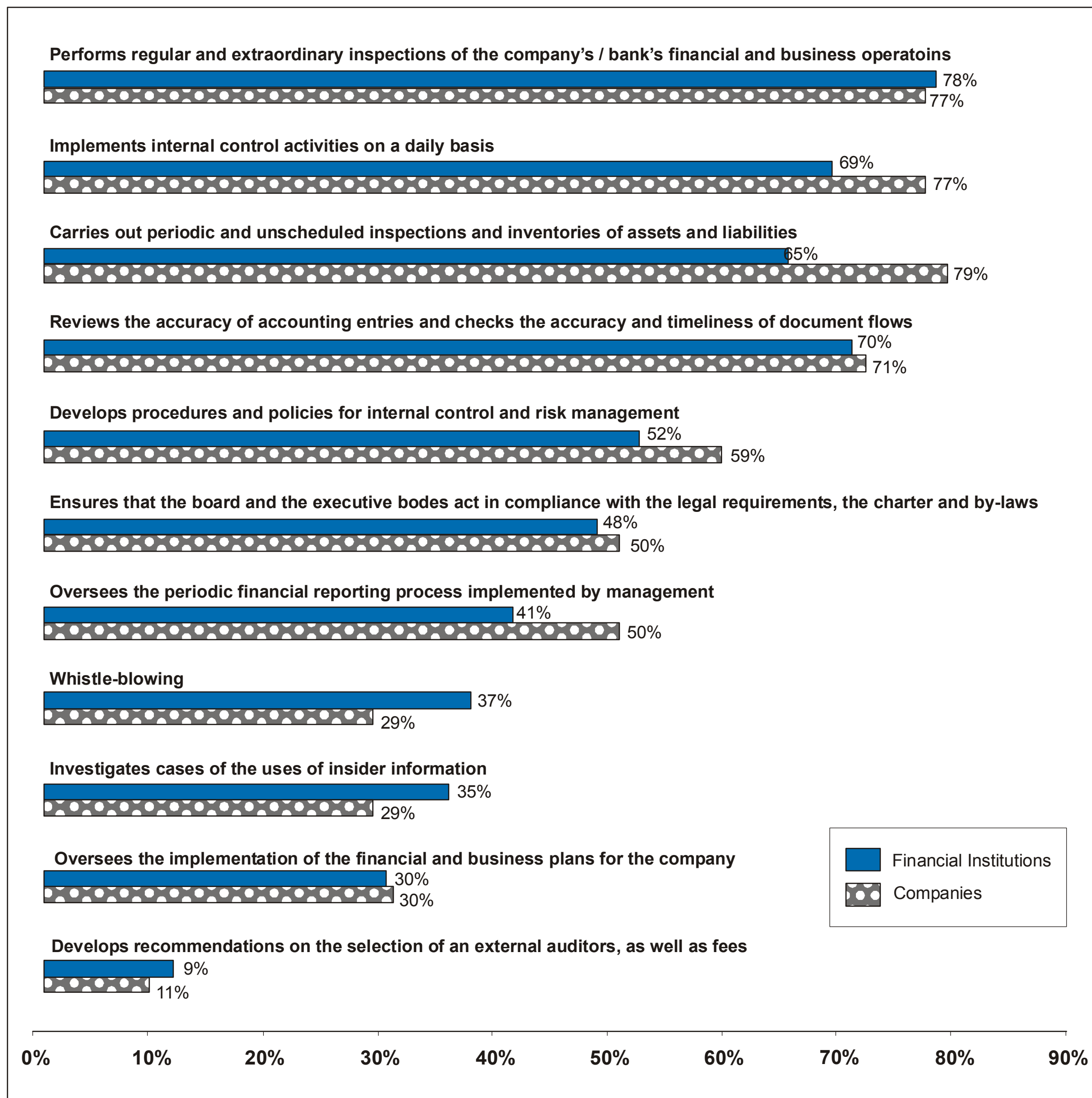
Figure 3.36 Percentage of companies/financial institutions with internal auditor/audit department



[82] 'There shall be an internal audit function in every listed company' (Code of Corporate Governance).

It can be concluded from Figure. 3.37 that the internal auditor of the responding companies performs a number of functions, the most common being to perform regular and extraordinary inspections of the company's/bank's financial and business operations, to ensure compliance of the board of directors and executive bodies with legal requirements, charters and by-laws, and to develop policies and procedures for internal control and risk management.

Figure 3.37 Functions performed by internal auditor/audit department (multiple answers)



Did You Know That…?

Internal auditing is an independent, objective assurance and consulting activity designed to add value to and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and corporate governance processes. [83]

2. Audit Committee

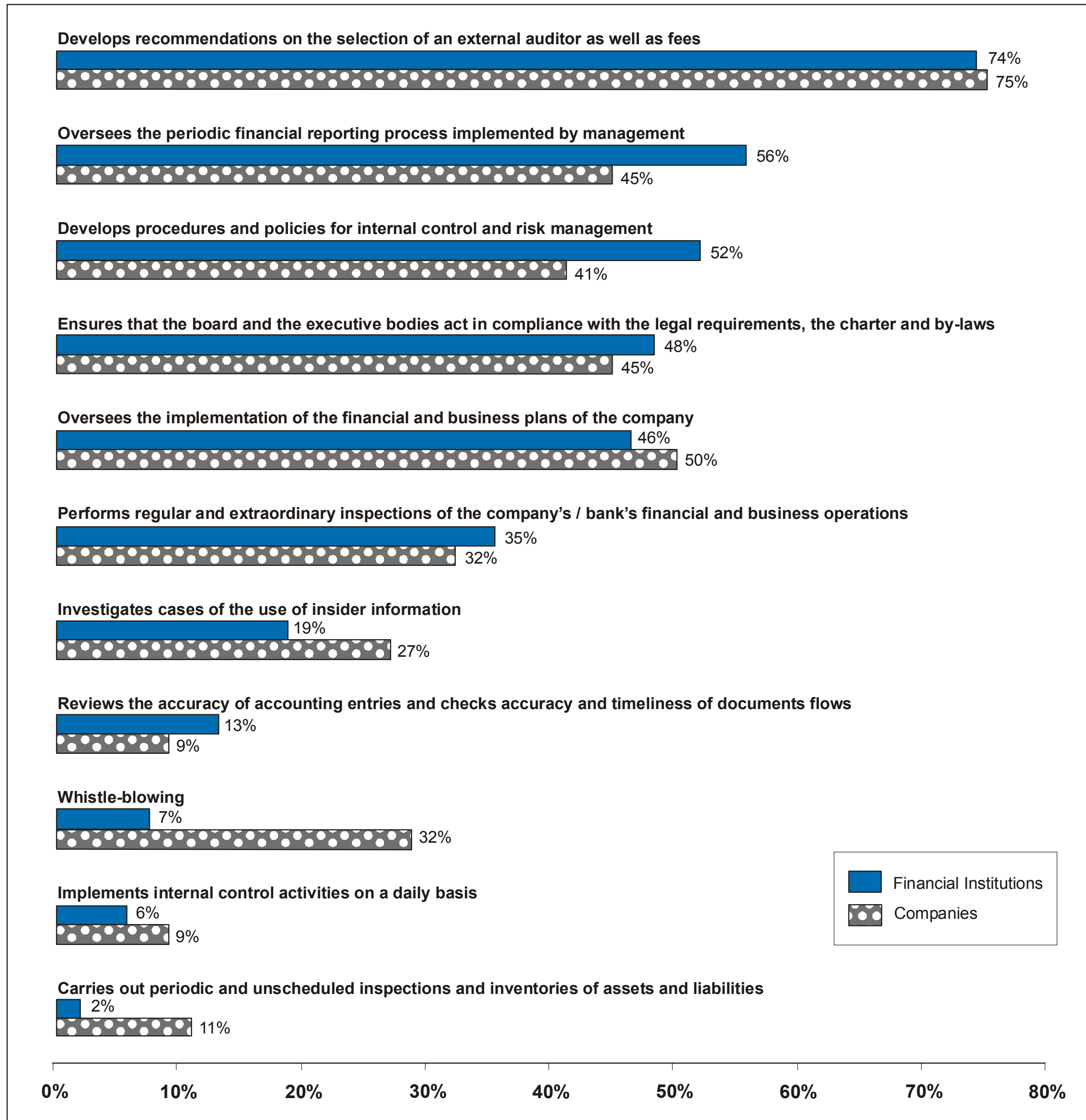
Every listed company should have an audit committee that shall, among other things, be responsible for recommending to the board of directors the appointment of external auditors by the listed company's shareholders and shall consider any questions of resignation or removal of external auditors, audit fees and provision by external auditors of any service to the listed company, in addition to audit of its financial statements. The Code outlines the terms of reference of the audit committee.[84]

---

[83] www.theiia.org

[84] Section xxxiii of Code of Corporate Governance of Pakistan

Figure 3.38 Functions performed by the audit committee (multiple answers)



It can be concluded from Fig 3.38 that audit committees are generally performing the functions specified by the Code of Corporate Governance in its terms of reference for the audit committee.

Did You Know That…?

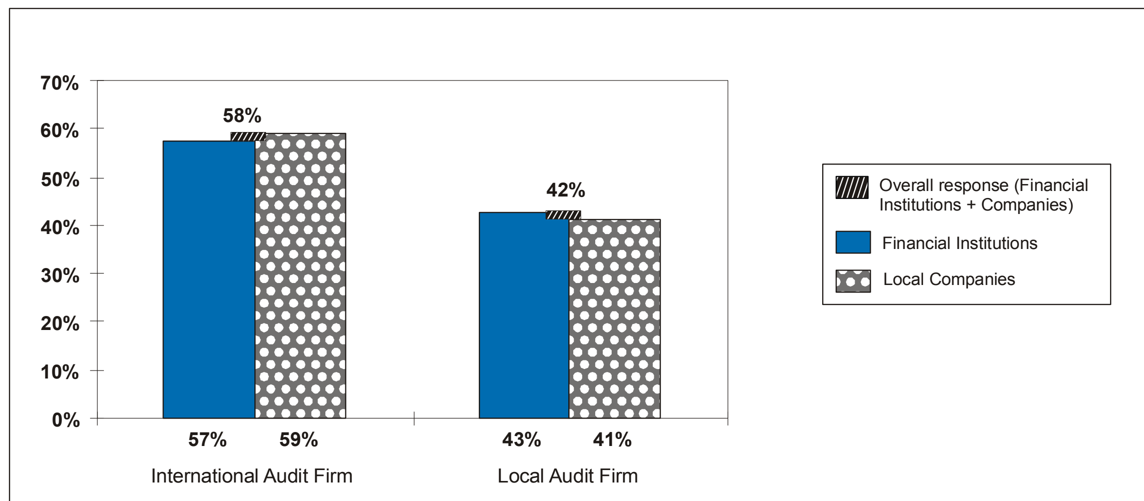
The key functions of an audit committee are financial supervision, evaluating the adequacy of internal audit and controls, auditor selection and monitoring, overseeing compliance and ensuring risk management. [85]

3. External Audit

An annual audit should be conducted by an independent, competent and qualified auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit. [86]

In accordance with the Code of Corporate Governance and the Companies Ordinance,[87] 97% of respondents had an external auditor. In the majority of the cases it was an international audit firm.

Figure 3.39 Characteristics of an external auditor



Error!

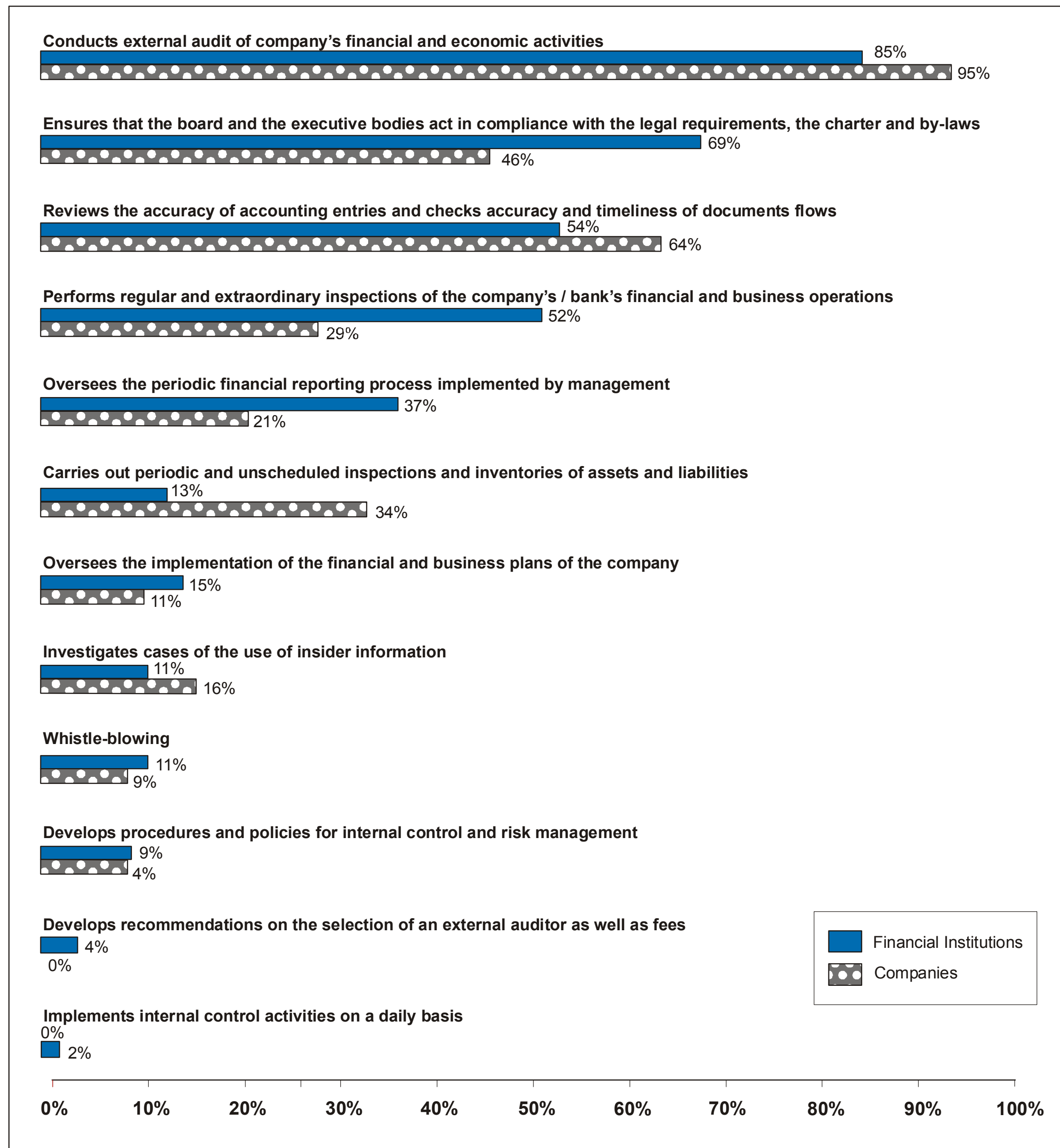
3.1 The role of the external auditor

In the surveyed firms, one of the major functions of the external auditor was performing external audit and ensuring that the boards of directors acted in compliance with the law, charter and other regulations.

---

[85] OECD Principles of Corporate Governance.
[86] OECD Principles of Corporate Governance.
[87] Section 252 (1), Companies Ordinance 1984.

Figure 3.40 Functions performed by external auditors (multiple answers)

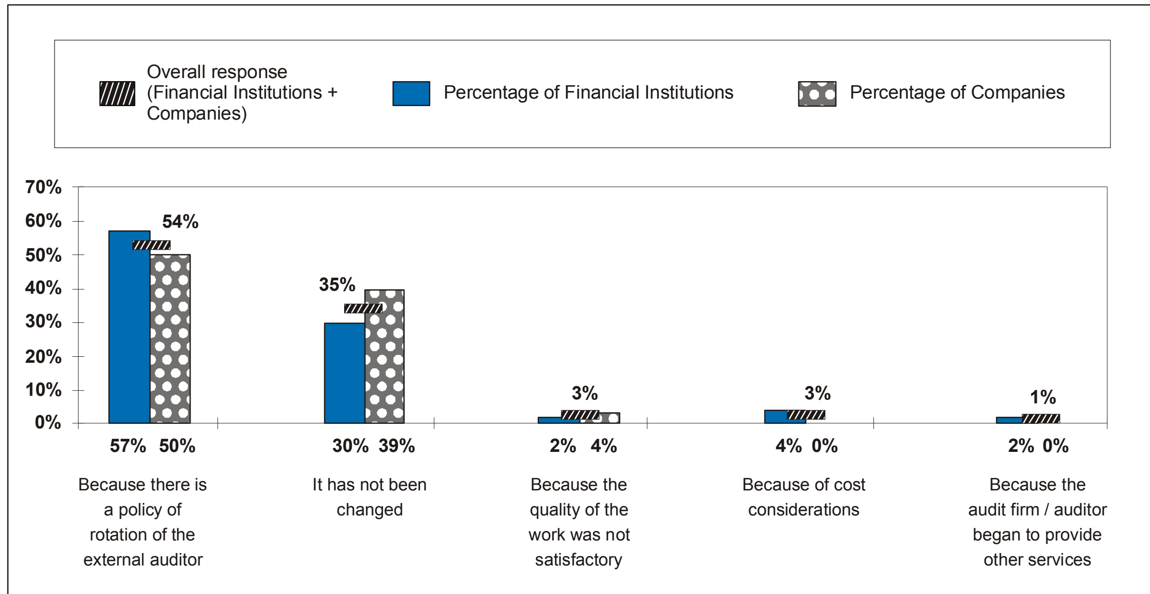


3.2 Rotation of external auditor

Under the Code of Corporate Governance all listed companies in the financial sector should change their external auditors every five years,[88] but 30% of the financial sector institutions surveyed and 39% of the companies had not changed their external auditors in the previous five years. Respondents were generally averse to the idea of rotation of external auditors as in their opinion there is a shortage of quality auditors.

[88] Section. (xli) (a) Code of Corporate Governance of Pakistan.

Figure 3.41 Reasons for change of external auditor



Did You Know That…?

Auditor independence may be improved by the rotation of either audit partners or the audit firm. Rotation is important because it prevents the external auditor from developing an excessively close relationship with the client, which may eventually compromise the auditor's independence.[89]

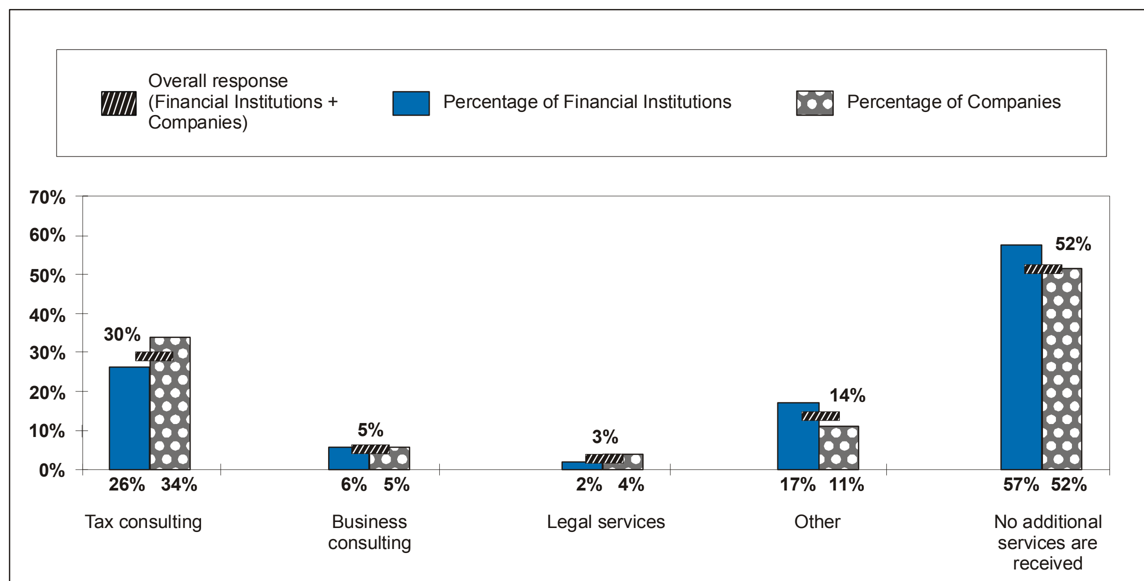
[89] OECD Principles of Corporate Governance, 2004 and *Enhancing Corporate Governance for Banking Organizations*, Basel Committee on Banking Supervision, February 2006.

3.3 Provision of non-audit services

> **Did You Know That…?**
>
> The provision of non-audit services by the external auditor to an audit client could impair their independence, particularly if the fees earned for other services are significant compared with audit fees or if auditors are involved in auditing their own work. [90]

The Code of Corporate Governance states that no listed company shall appoint its auditors to provide other services, in addition to audit;[91] 52% of the respondents stated that no such additional services were being received from the external auditors.

Figure 3.42 Additional services provided by external auditor (multiple answers)



> **Synopsis: Control environment and processes**
>
> A vast majority of the companies and financial sector institutions have an external auditor, audit committee and an internal audit function as recommended by the Code of Corporate Governance and the Companies Ordinance. They perform a number of functions, all within the terms of reference outlined by the Code and the Companies Ordinance 1984.

---

[90] Ibid.

[91] Section xl Code of Corporate Governance of Pakistan.

4. Control Environment and Processes – Recommendations

4.1 The role of the audit committee in overseeing internal controls and risk management needs to be strengthened.

It can be observed from the survey that audit committees should oversee internal controls and risk management more rigorously. In this context, the revised Code of Corporate Governance should clearly specify the role of audit committees in such oversight. Guidance should be developed clearly outlining how the audit committees can carry out these tasks. While companies may wish to combine the risk function within the audit committee, banks should consider establishing separate risk committees, owing to the importance of risk to financial institutions.

4.2 The idea of 'whistle-blowing' should be introduced in the revised Code of Corporate Governance and companies should be encouraged to have whistle-blowing policies or protection mechanisms.

The survey indicated that the idea of whistle-blowing has still to develop in Pakistan. Many respondents were apprehensive and cautious when discussing the concept and did not have a whistle-blowing policy or protection mechanisms for whistle-blowers in place. It is thus suggested that the revised Code of Corporate Governance should address the concept of whistle-blowing and encourage enterprises to have whistle-blowing policies and protection mechanisms. It should also identify overseeing whistle-blowing policies as one of the functions of the audit committee.

4.3 The role of internal audit needs to be clarified.

Internal auditing is mandatory for Pakistani listed companies – as it is in the US but not in the UK. In neither the US nor Pakistan is there a mandatory requirement for the scope of internal audit to cover all the activities of the organisation. The survey results reveal that, in practice, internal auditors in Pakistan have an appropriately broad remit, covering much more than accounting and financial matters and providing both assurance and consulting services. Internal auditors are implementing internal control activities on a daily basis – it is usually the responsibility of line management to use their own staff resources to do this, leaving internal audit in a position to audit these matters in an independent, objective manner.

4.4 There is a need to cultivate and nurture more accountants equipped with modern knowledge and skills.

The professional accounting bodies of Pakistan need to train and develop more accountants in up-to-date methods and theory.

D. INFORMATION DISCLOSURE AND TRANSPARENCY – KEY FINDINGS

Key Findings

1) Respondents are generally fulfilling the requirements of the Code of Corporate Governance and the Companies Ordinance 1984 with regard to information disclosure and transparency.

2) There is, however, reluctance to provide voluntary information relating to articles of association, remuneration of the board as individuals, market share, sales and marketing data, environment and social responsibility, biographies of the members of the board, and stock options policy, or to add a 'Management discussion and analysis' section in the annual report, mainly because the respondents were of the opinion that there was no legal requirement to disclose such information in the annual reports.

3) 61% of the respondents complied with IAS/IFRS but lack of know-how or unavailability of human resources to implement IAS/IFRS were identified as barriers.

4) 33% of the respondents did not make their annual reports available on their websites.

Did You Know That…?

Disclosure should cover the material matters of the corporation including:

1. *major share ownership and voting rights.*
2. *material foreseeable risks factors.*
3. *material issues regarding employees and other stakeholders, and governance structures and policies.*

Transparency in disclosure enables the financial markets, depositors and other stakeholder to have a fair understanding of a company's value as well as help develop trust in the quality of the company and its management.[92] Regular, timely, accurate, comprehensive, comparable, reliable and relevant disclosure enables the users of annual reports to evaluate the company's position and performance and thus facilitate informed decision making. In a survey, 69% of institutional investors (95 of 137) in charge of some of the world's largest portfolios in 16 countries identified transparency as the top priority in considering an initial investment.[93]

92 OECD Principles of Corporate Governance.
93 Ernst and Young, 1995.

1. Sources of Information for Investors

Investor information is provided through multiple channels (general meetings of shareholders (GMS), local press, e-mail, website, annual report), although the annual report remains the most commonly used means to provide information to shareholders about financial statements, operating results, major shareholders, material information and governance issues. Even though a majority of the respondents were willing to include financial statements in their annual reports, there was a general reluctance to disclose information on corporate governance, operating results and information about the company's shareholding structure, as these matters were considered to be commercially sensitive (see Figs 3.43 to 3.47).

Figure 3.43 How shareholders obtain information about financial statements (multiple answers)

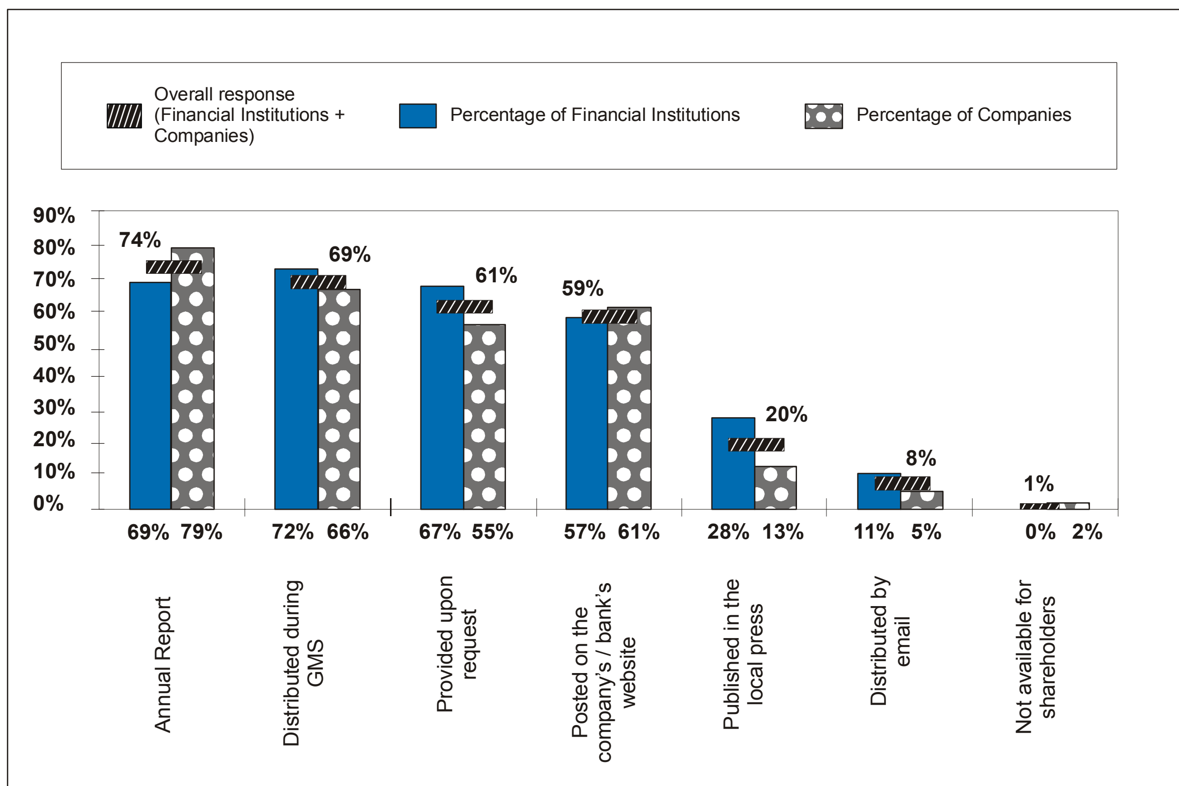


Figure 3.44 How shareholders obtain information about major shareholders (multiple answers)

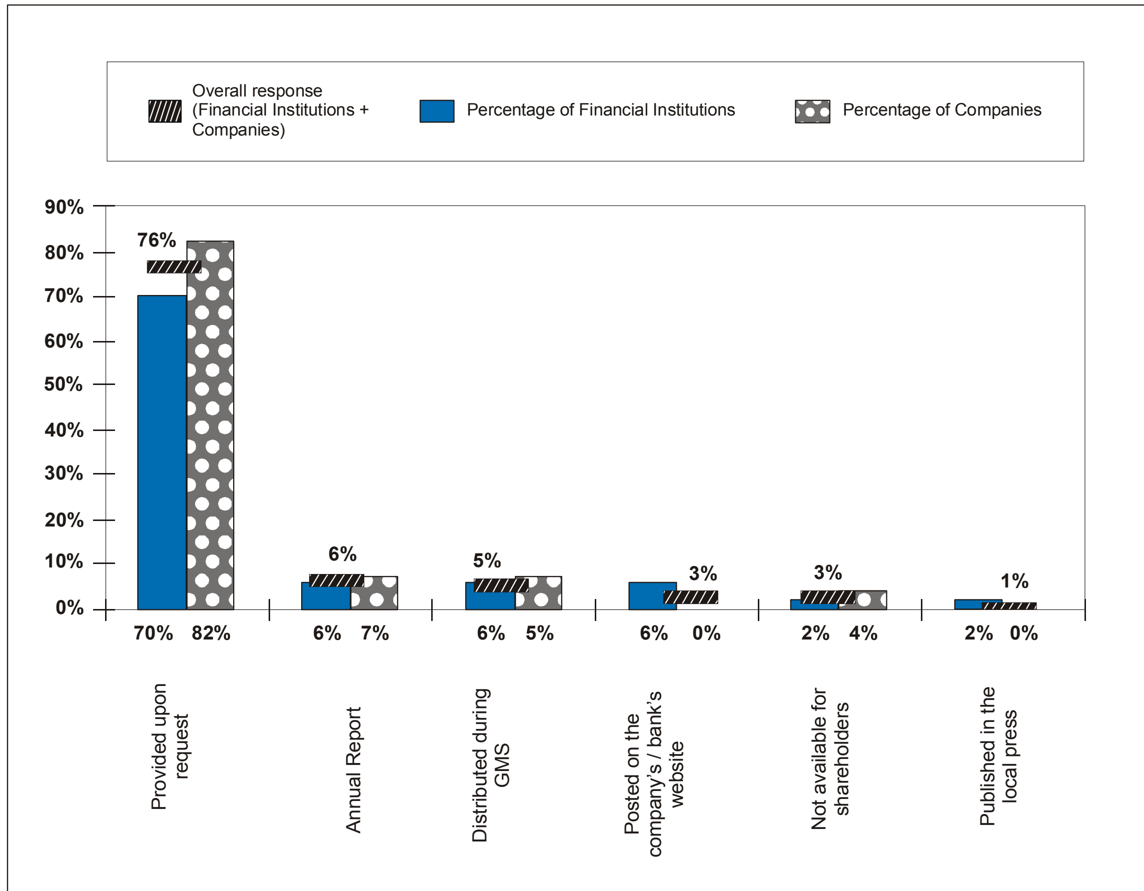


Figure 3.45 How shareholders obtain information about articles of association and by-laws (multiple answers)

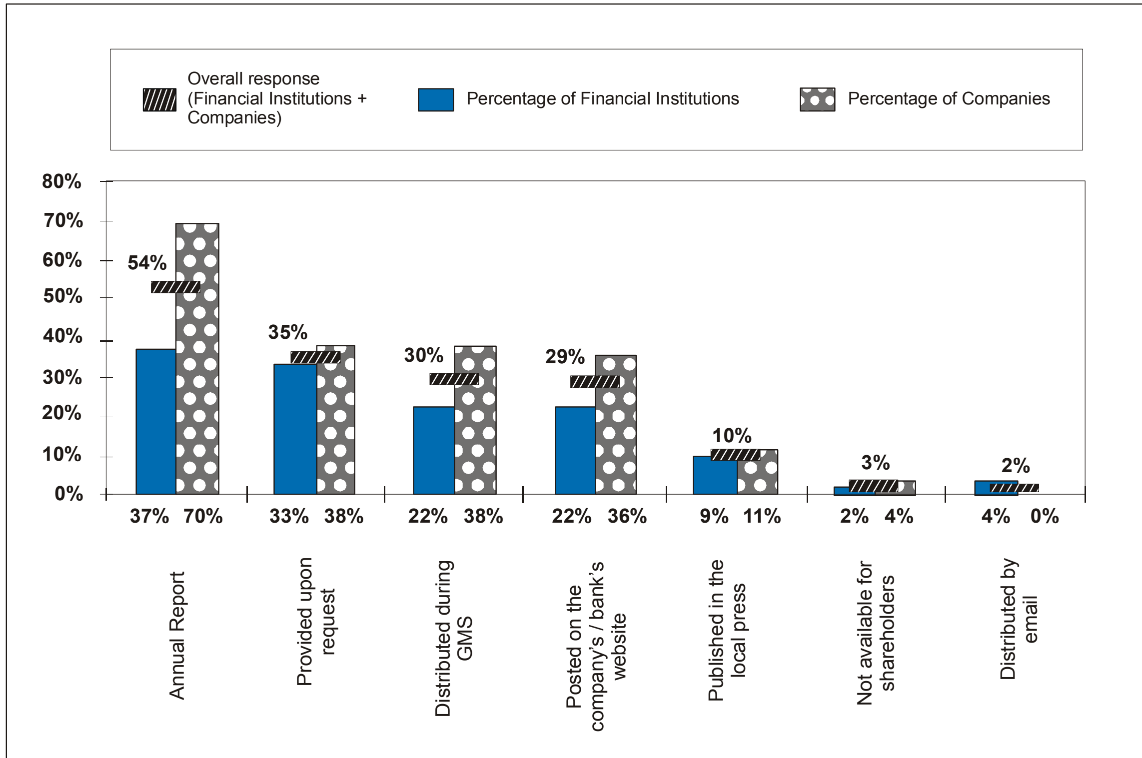


Figure 3.46 How shareholders obtain material information (multiple answers)

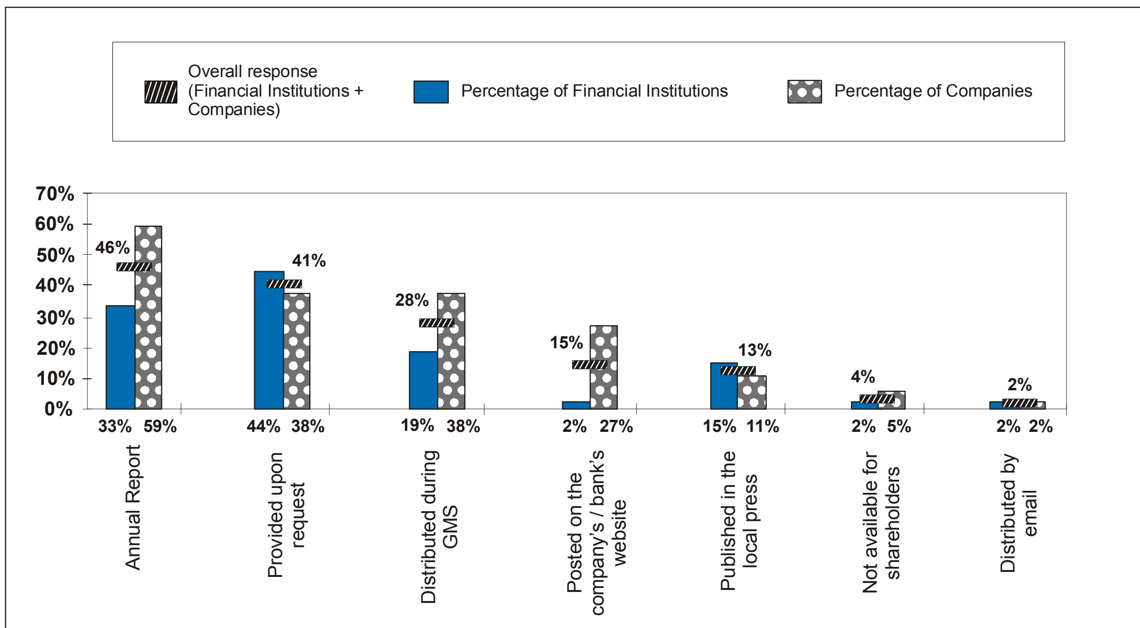
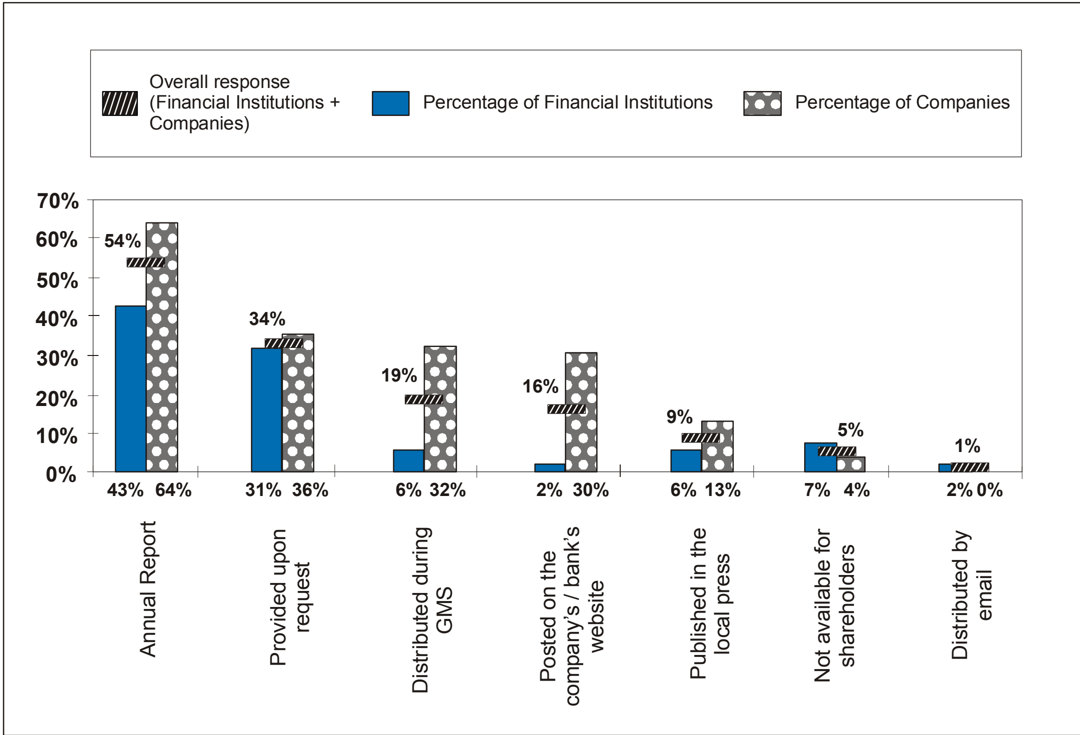


Figure 3.47 How shareholders obtain information about governance issues (multiple answers)


Overall response (Financial Institutions + Companies)
Percentage of Financial Institutions
Percentage of Companies
70%
60%
50%
40%
30%
20%
10%
0%
54%
34%
19%
16%
9%
5%
1%
43% 64%
31% 36%
6% 32%
2% 30%
6% 13%
7% 4%
2% 0%
Annual Report
Provided upon request
Distributed during GMS
Posted on the company's / bank's website
Published in the local press
Not available for shareholders
Distributed by email

2. Information in the Annual Reports

We comply with the Companies Ordinance requirements and have fairly standardised annual reports, ie only financial statements, notes to financial statements and a brief Director's Report. These days I come across reports of multi-nationals that have information about directors, committees, environment, social responsibility, risk management, and I am perplexed. Investors only need financial information, why will they be interested in directors, human resources or environment? Annual reports are being used as marketing documents. Some of this information is proprietary information and should not be shared with external stakeholders. Then in addition, the information is not audited so how reliable is it? Furthermore, why have qualitative information in the annual reports? (CFO of a listed company)

2.1 Compliance with IAS/IFRS

Did You Know That…?

The application of high-quality reporting standards is expected to improve significantly the ability of investors to monitor the company, by providing increased reliability and comparability of reporting, and improved insight into company performance. [94]

Under the Companies Ordinance it is obligatory for all listed companies to present their financial statements in accordance with all those IAS/IFRS that the SECP has published in the government gazette.[95] In most cases, the transition to IAS and IFRS is completed only within the scope required by the SECP and ICAP, which does not include all international financial reporting standards. Pakistani companies have made significant progress in the transition to IAS/IFRS, as 61% of the companies and financial sector institutions surveyed publish their financial statements in accordance with the internationally recognised financial reporting standards.

Yes, we comply with IAS and IFRS but only because we have to do it. These standards are made for the developed world, not for a country such as Pakistan where we do not have the human capital to implements such standards. (CFO of a listed company)

2.2 Disclosure in the annual reports

The survey respondents generally complied with minimum legal[96] and regulatory requirements for disclosure of information in their annual reports but were generally reluctant to volunteer information about the sustainable development of the business, or biographies of directors and future plans, or to include narrative statements on financial and non-financial performance, such as a 'Management discussion and analysis' section, mainly because they were unable to appreciate the value or relevance of such disclosures.

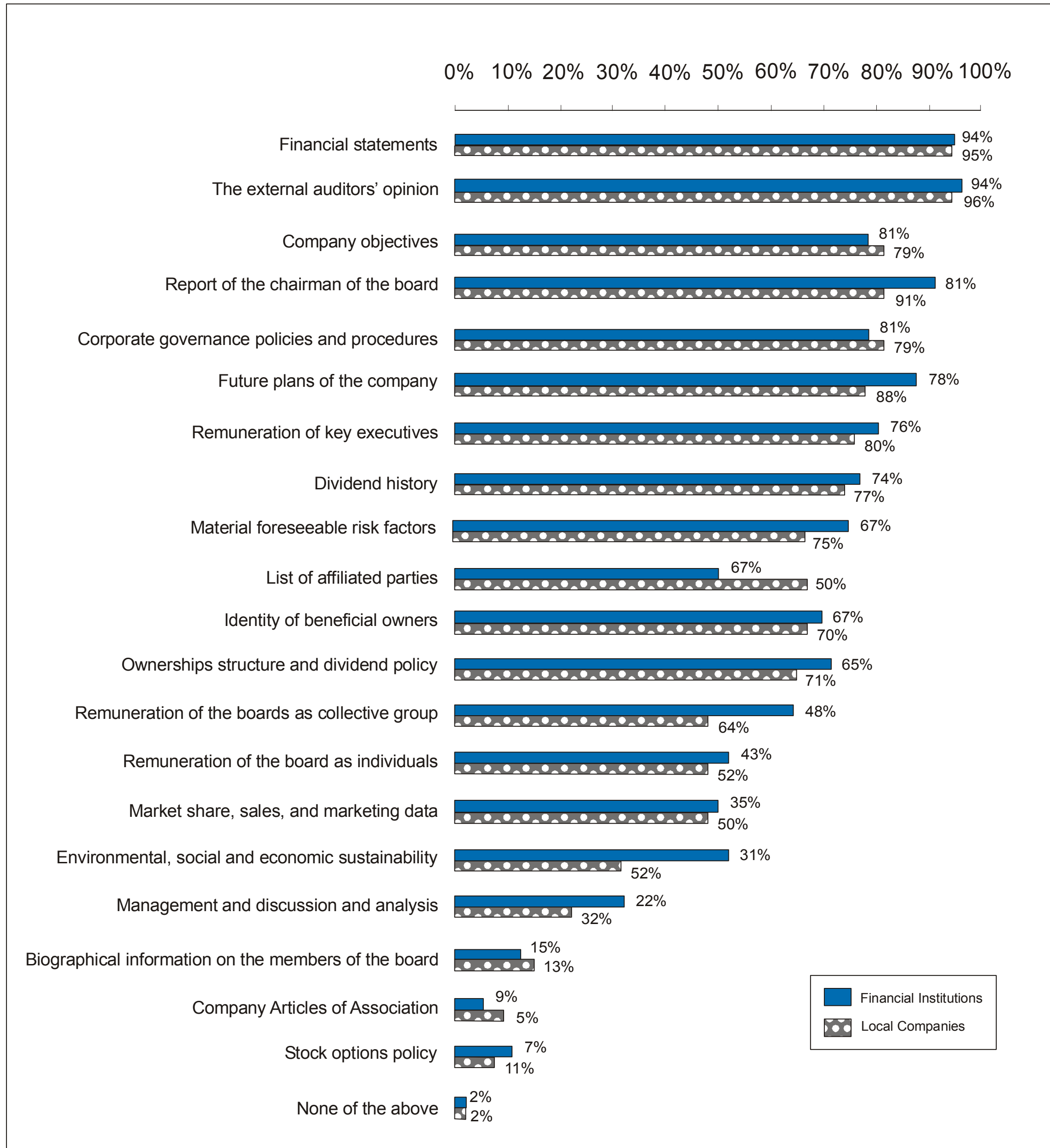
---

94 Basel II Guidelines for Corporate Governance.

95 Section 234 (3)(i), Companies Ordinance 1984.

96 In addition to the various provisions pertaining to financial reporting, the Fourth Schedule of the Companies Ordinance lays down the form, content and certain disclosure requirements for preparing financial statements for listed companies, while the Fifth Schedule outlines the same for non-listed companies.

Figure 3.48 Information given in last annual report (multiple answers)



2.3 Factors preventing disclosure

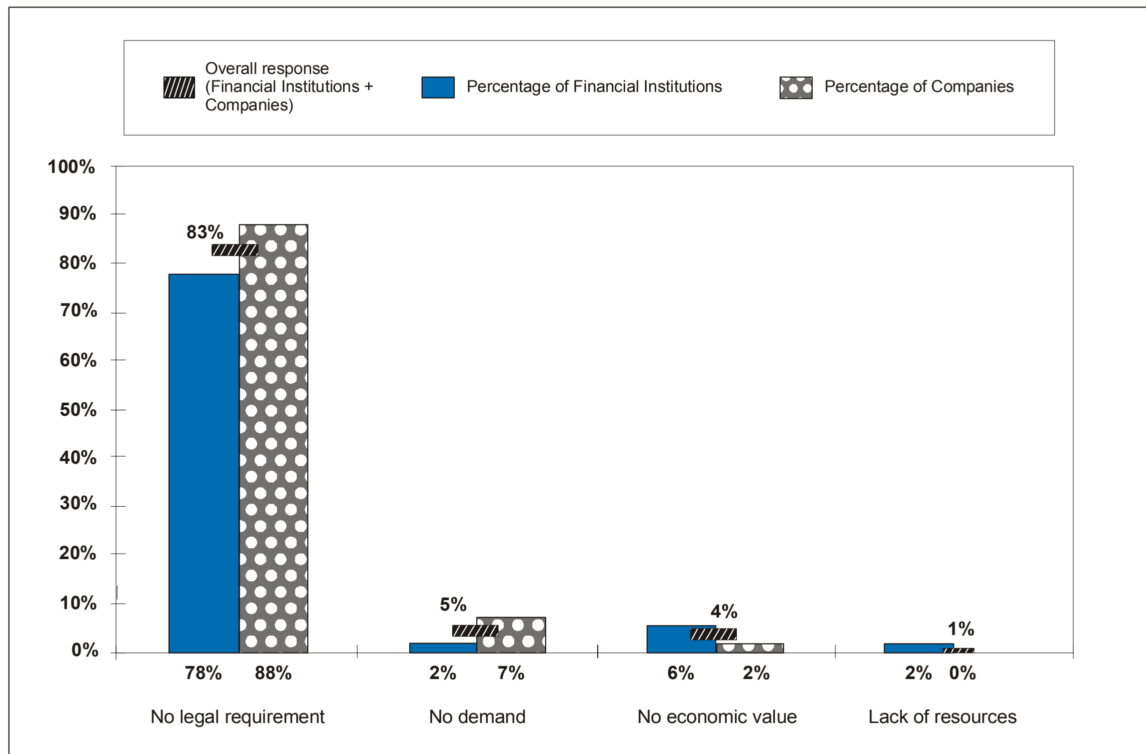
> *Why should I disclose information about directors or our future plans, thus giving sensitive information to our competitors and regulators? There is no legal requirement to give such information in the annual reports.* (Company secretary of a listed firm)

The main reason provided by 83% of the respondents for non-disclosure of the voluntary information outlined above or for not publishing a 'Management discussion and analysis' section, was the absence of any legal requirement to do so.

Point to ponder

Only 1% of the companies identified lack of resources as the reason for non-inclusion of information relating to directors, future plans, the environment and social responsibility in the annual reports.

Figure 3.49 Reasons for non-inclusion of information in annual reports

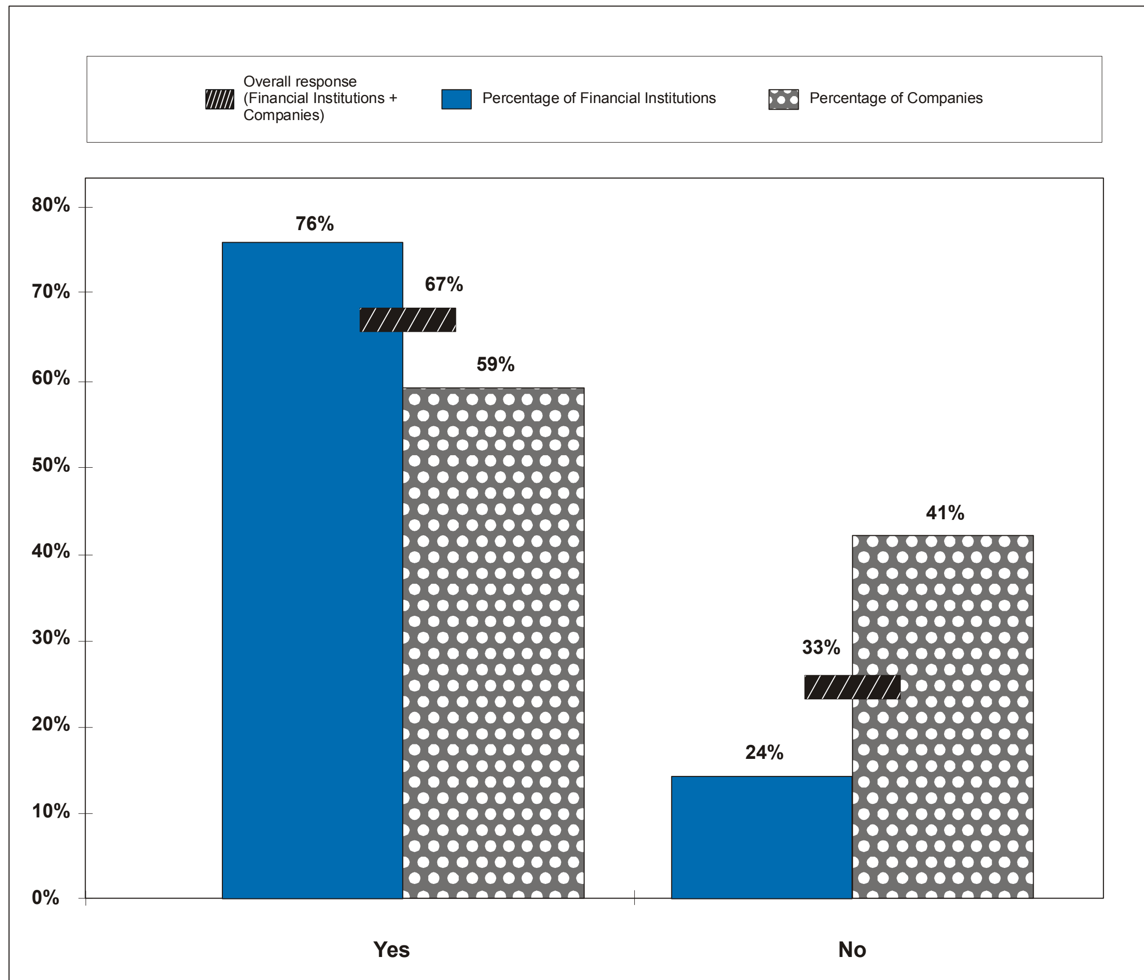


2.4 Disclosure of financial information on the website

There is an increasing trend internationally to use companies' websites to disclose financial and non-financial information. In the survey, 76% for financial sector institutions and 59% of the

companies reported that their annual reports were on their websites, but 20% of the responding companies did not have a website.

Figure 3.50 Annual Report on websites



Synopsis: Information disclosure and transparency

A vast majority of the companies comply with the basic legal and regulatory requirements for disclosure of information in the annual reports by including financial statements, external auditor's opinion, the report of the chairman of the board and information about material foreseeable risk factors. Information about the environment and social responsibility, and a 'Management discussion and analysis' section are generally excluded, mainly because there is no legal requirement to include this information in the annual reports. A vast majority of the companies surveyed complied with the International Financial Reporting Standards. A number of interviewees did, however, express their concerns about the lack of human resources for fulfilling the requirements of compliance with these Standards.

3. Information Disclosure and Transparency – Recommendations

Disclosure is the lifeblood of governance… Openness by companies is the basis of public confidence in the corporate system and enables external governance forces to function as they should...Investors, lenders, employees and the public can only play their governance roles provided they have the information.[97]

3.1 There should be more voluntary narrative disclosure of information relating to sustainable development, corporate governance and risk management in annual reports

As we have seen, the main reason for non-disclosure of voluntary information was an absence of any legal requirement for it. As the business environment moves from being producer-driven to consumer-driven and reputation-oriented, the information needs of investors are changing. Today's investor wants information about intangible assets, relationships with stakeholders, the environment, social responsibility, risk management, corporate governance, and the future prospects and strategies of a company.[98] These factors are not recognised in the financial statements, resulting in an information gap. Contemporary financial reporting has developed narrative reporting to bridge the gap between financial statements and additional information that might be useful to the users of annual reports. Forward-looking information as well as information about intangible assets, relationships, risk management, corporate governance, the environment and social responsibility may be disclosed in narrative reports such as the 'Director's report', 'Corporate governance statement', 'Operating and financial review', 'Management discussion and analysis' or the 'Management commentary'. A discussion paper on narrative reporting has been issued by the International Accounting Standards Board and there are indications that a standard on narrative reporting is being developed.[99] Narrative reporting facilitates transparency in disclosure in annual reports. Companies need to be encouraged by the SECP and other professional accounting bodies to be more transparent in their disclosure of voluntary information that may be relevant to investors. Guidance should be developed on narrative reporting.

3.2 Research should be carried out to identify challenges faced by local companies in complying with IAS/IFRS and local guidance on IAS/IFRS should be developed.

A high level of compliance with IAS/IFRS was observed but the concerns relating to a lack of know-how or of resources to implement the standards need to be addressed. Research could explore the obstacles and challenges faced by accountants and the business community in implementing IAS/IFRS. The challenges need to be overcome and local guidance on IAS/IFRS should be developed to facilitate this.

E. SHAREHOLDERS' RIGHTS – KEY FINDINGS

---

[97] Sir Adrian Cadbury,1998.

[98] Jenkins Report, AICPA, 1994.

[99] 'Discussion Paper on Management Commentary', International Accounting Standards Board, 2006

Key Findings

1) 61% of the respondents stated that more than 50% of all shareholders attended the last AGM.

2) 86% of the respondents stated that they published the notice of the AGM in the press and 82% also informed the shareholders via registered mail.[100]

3) Nearly all (98%) of the respondents stated that they gave adequate notice (21 days) of the AGM.[101]

4) Electronic voting mechanisms are not used by any of the respondents; 67% of the sample stated that voting at their AGM takes place by means of a show of hands.

5) 45% of the respondents stated that they did not have a clause relating to equal treatment with respect to voting rights and subscription rights in their articles of association.

6) With respect to treatment of shareholders when changes of control occur, 91% did not have clear policies and none had block-voting mechanisms.

7) In 50% of the responding organisations, minority shareholders did not have the right to join the transaction and sell their minority stakes in the company if a majority shareholder sold their stake in the company.

8) 67% of the respondents stated that company's/bank's governing documents require the board members and management to disclose, and abstain from voting on, issues where there is a conflict of interest situation.

9) Evidence was found of an increasing number of related-party transactions among responding companies, with 80% of the respondents stating that under a governing document or law it was mandatory to disclose related-party transactions. In addition, 67% stated that the related-party transactions should be verified by the external auditors.

[100] Section 158 (3), Companies Ordinance 1984.
[101] Section158 (3), Companies Ordinance 1984.

Did You Know That…?

Corporate governance frameworks should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. Minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress. Votes should be cast by custodians or nominees in a manner agreed upon with the beneficial owner of the shares. Processes and procedures for general shareholder meetings should allow for equitable treatment of all shareholders. Members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation.[102]

A large number of firms in Pakistan are dominated by single families. Even prominent, publicly listed firms are parts of networks of firms, each supervised by a family-owned holding company. Public investors in such companies are, in effect, minority shareholders in the family's business undertakings. Issues that may arise within these family-owned businesses are conflicts of interest between majority and minority shareholders. In some family-owned businesses the controlling shareholder may expropriate profits that would have otherwise gone to outside investors. In family-owned companies and family-dominated enterprise networks, a sense of privacy about the business and a possessive feeling of entitlement to unquestioned and unfettered discretion in decision making naturally arise. Under these psychological conditions, changes in corporate governance are resisted. The family may aspire to 'have their cake and eat it too', thereafter running the company broadly as if it were still a family business. Outside shareholders' interests may not be paramount. The composition of the board may still be dominated by members of the family or by directors sourced by the family.

Concentrated control limits the influence that non-controlling shareholders can have on the company, and effectively reduces their protection from abuse. When families dominate the shareholder meetings and the board, director accountability to other shareholders becomes critical. Currently in Pakistan this accountability is absent in many companies. We noted that in only half of Pakistani companies surveyed do the minority shareholders have the right to join the transaction and sell their minority stakes in the company if a majority shareholder sells their own stake in the company. Protection of shareholders rights is thus an important challenge to enforcement of corporate governance in its true spirit.

1. The General Shareholder Meeting

It was observed that companies were generally following the provisions of the Companies Ordinance in respect of the AGM.[103]

1.1 Attendance at the last AGM

The quorum for a General Meeting is a minimum of 25% of all shareholders, and at least 10 voting shareholders.[104] In the surveyed sample, 36% stated that fewer than 50% of the total shareholders had attended their last AGM while 19% stated that more than 86% of the total shareholders had done so.

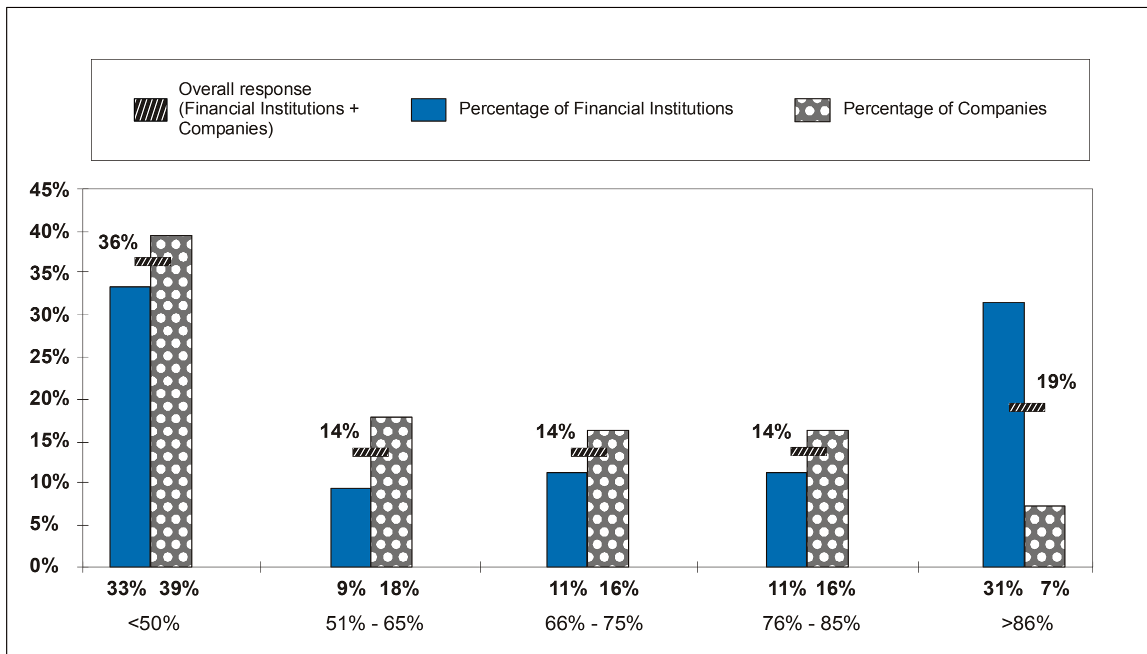
---

[102] OECD Principles of Corporate Governance.

[103] Section 158, Companies Ordinance 1984.

[104] Section 160 (2)(a), Companies Ordinance 1984.

Figure 3.51 Percentage of shareholders attending last AGM



1.2 Giving notice of the AGM to shareholders

The notice of AGM must be sent to the shareholders at least 21 days before the date of the meeting. In the case of a listed company, such notices must also be published in at least one issue of both daily a daily English and Urdu newspaper of the province in which the stock exchange of the listed company is situated.[105]

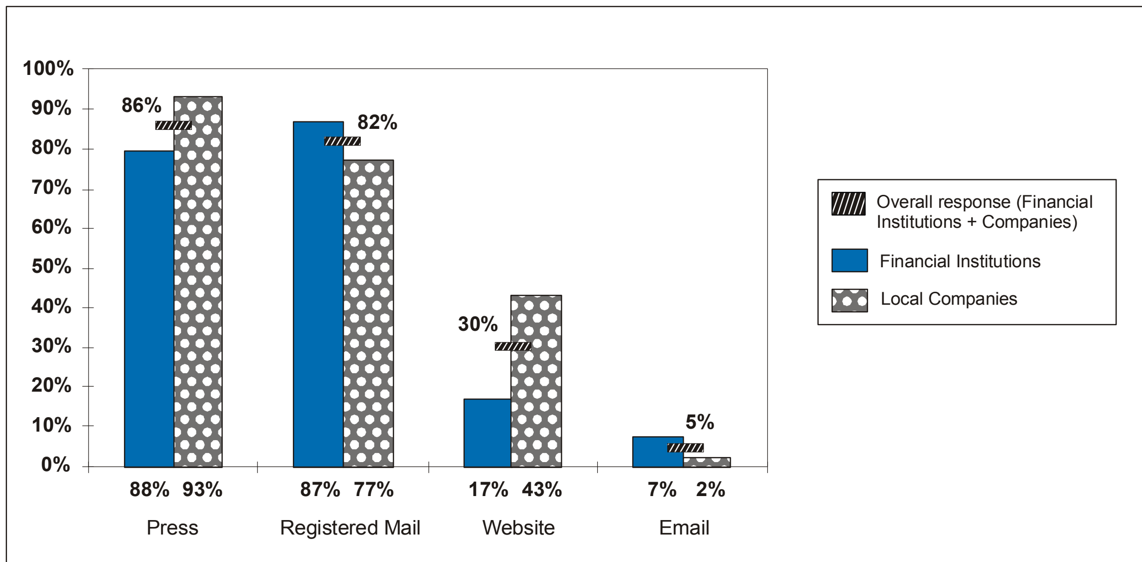
Did You Know That…?

Shareholders should be furnished with sufficient and timely information concerning the date, location and agenda of general meetings, as well as full and timely information regarding the issues to be decided at the meeting.[106]

It can be concluded from Figure. 3.52 that in compliance with the Companies Ordinance, 86% of the respondents published the notice of the meeting in the press and 82% also informed the shareholders via registered mail. Only 5% respondents informed the shareholders via e-mail and 30% informed the shareholders via their website.

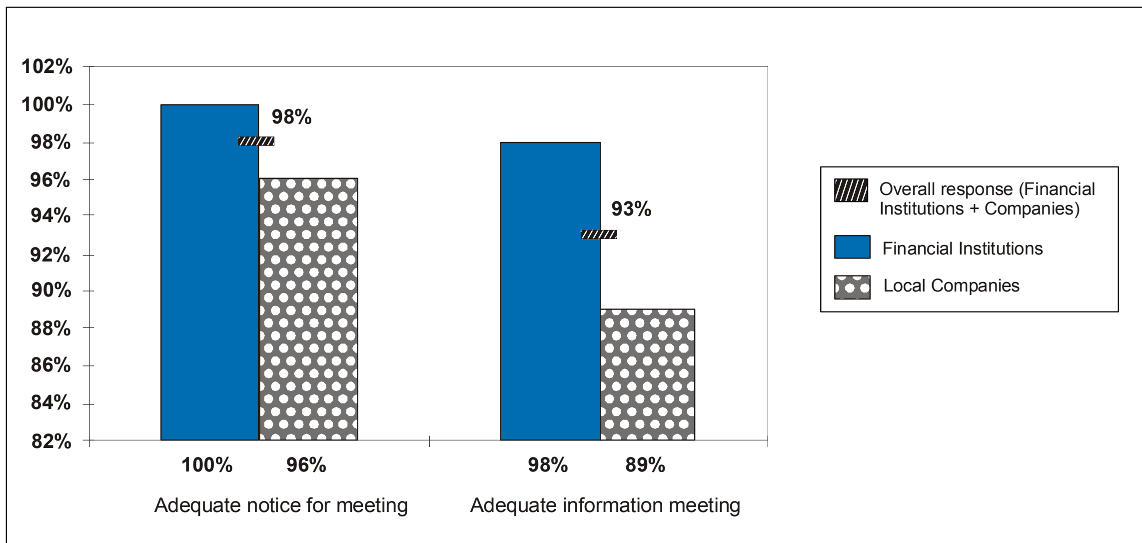
105 Section158 (3), Companies Ordinance 1984.
106 OECD Principles of Corporate Governance.

Figure 3.52 How shareholders are informed of the AGM (multiple answers)



Almost all (98%) of the respondents gave adequate notice of the AGM to the shareholders, as specified by the Companies Ordinance, and 93% gave adequate information to the shareholders for AGM.

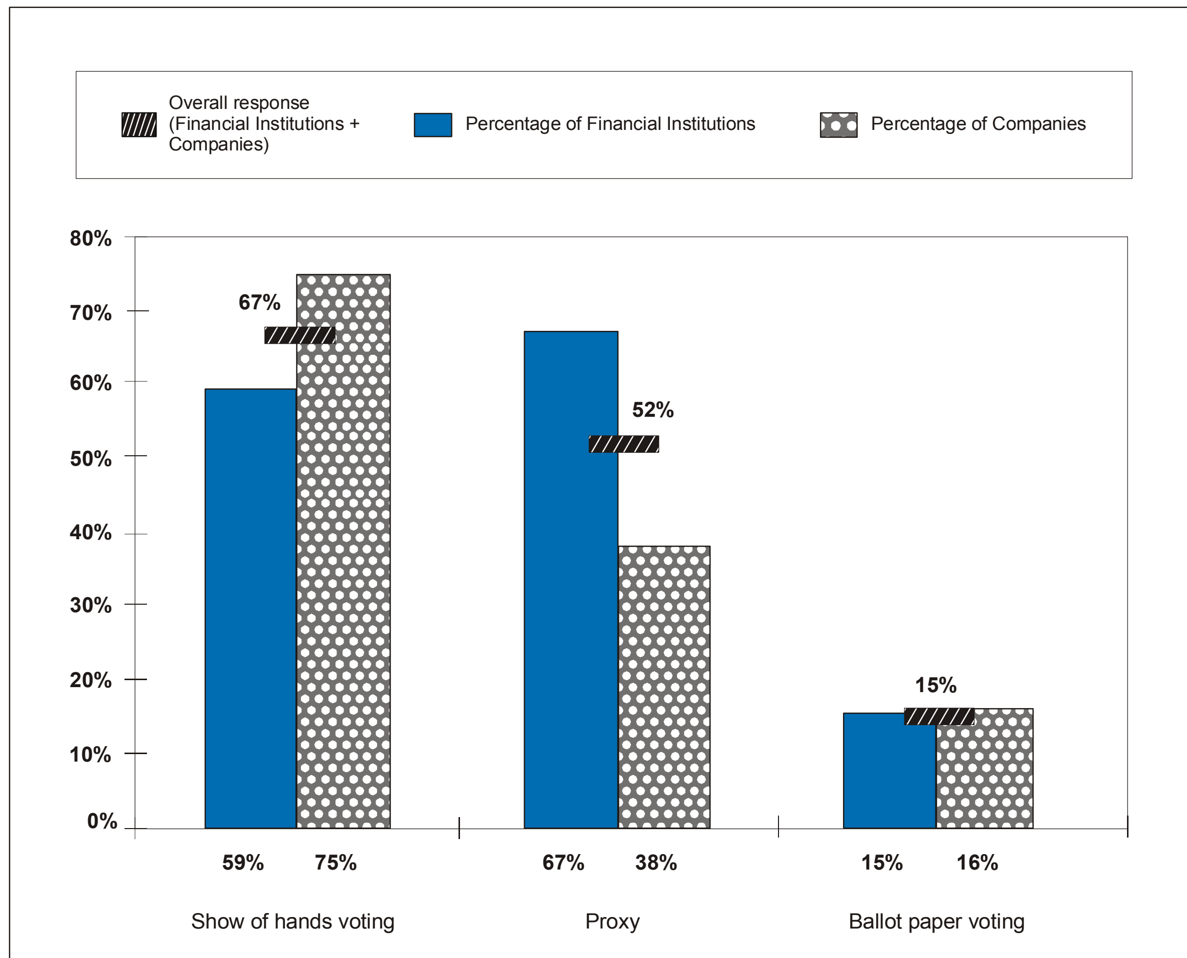
Figure 3.53 Companies providing adequate notice and information for the AGM



1.3 Voting mechanisms at AGMs

The Companies Ordinance has specific provisions in relation to voting[107] and proxies.[108] 67% of the surveyed sample stated that voting at AGMs took place by means of a show of hands while 52% stated that a proxy voting mechanism was also available to shareholders. An electronic voting mechanism was not used by any of the respondents.

Figure 3.54 Voting mechanisms used in the last AGM (multiple answers)



2. Special Minority Shareholder Protection Mechanisms

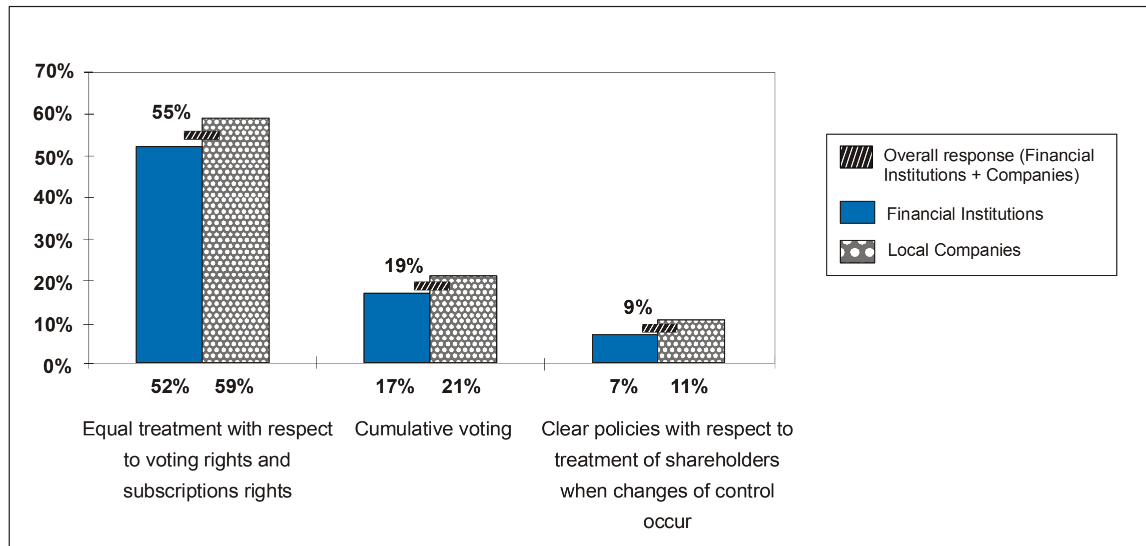
55% of the surveyed sample claimed that they had a clause relating to equal treatment with respect to voting rights and subscription rights in their articles of association, while only 19% had cumulative voting as a special minority protection mechanism.

---

107 Section 160, Companies Ordinance 1984.

108 Section161, Companies Ordinance 1984.

Figure 3.55 Formalised voting mechanisms in articles of association (multiple answers)



3. Dividends

Under the Companies Ordinance a company has no implied authority to distribute dividends even if it has earned a profit. The directors have the power to recommend the dividend to the general meeting.[109] Dividends can be declared only at the AGM when the company has divisible profits[110] and its financial position is such as to permit it to distribute such a dividend. Under the listing rules dividends are to be paid at least once in every five years. Companies that do not meet this requirement are placed on the 'defaulters counter'.

It can be concluded from figure 3.56 and figure 3.57 that the majority of the surveyed sample have a dividend payout ratio of less than 20%.

Figure 3.56 Payout ratios for companies (2003–2005)

---

[109] Section 248, Companies Ordinance 1984.

[110] Section 249, Companies Ordinance 1984.

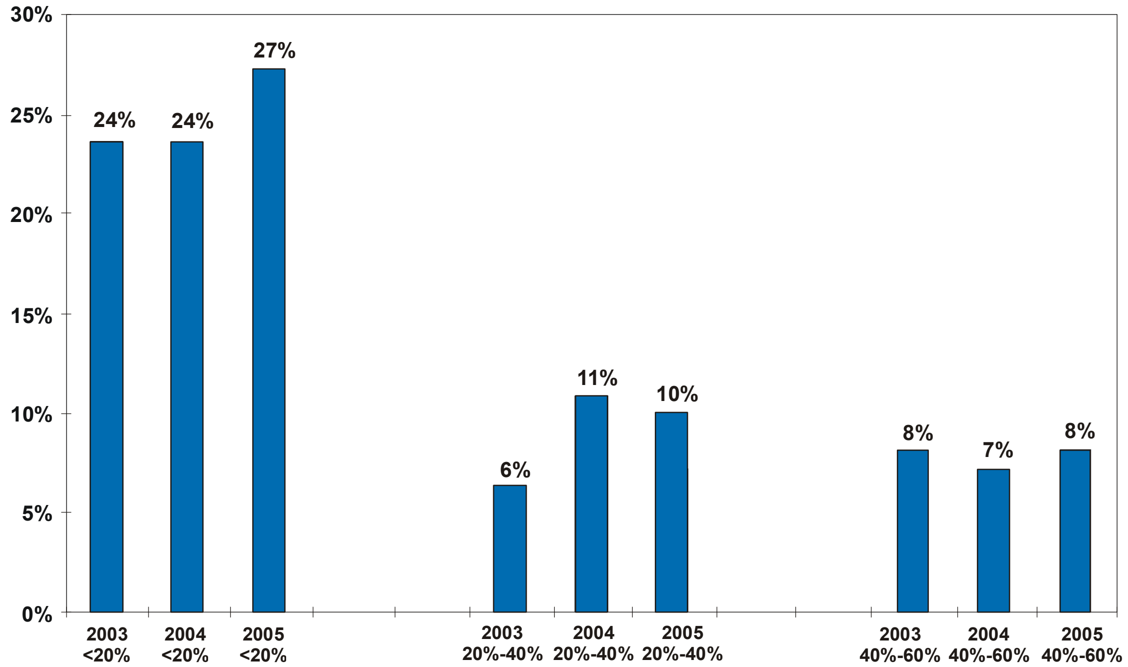
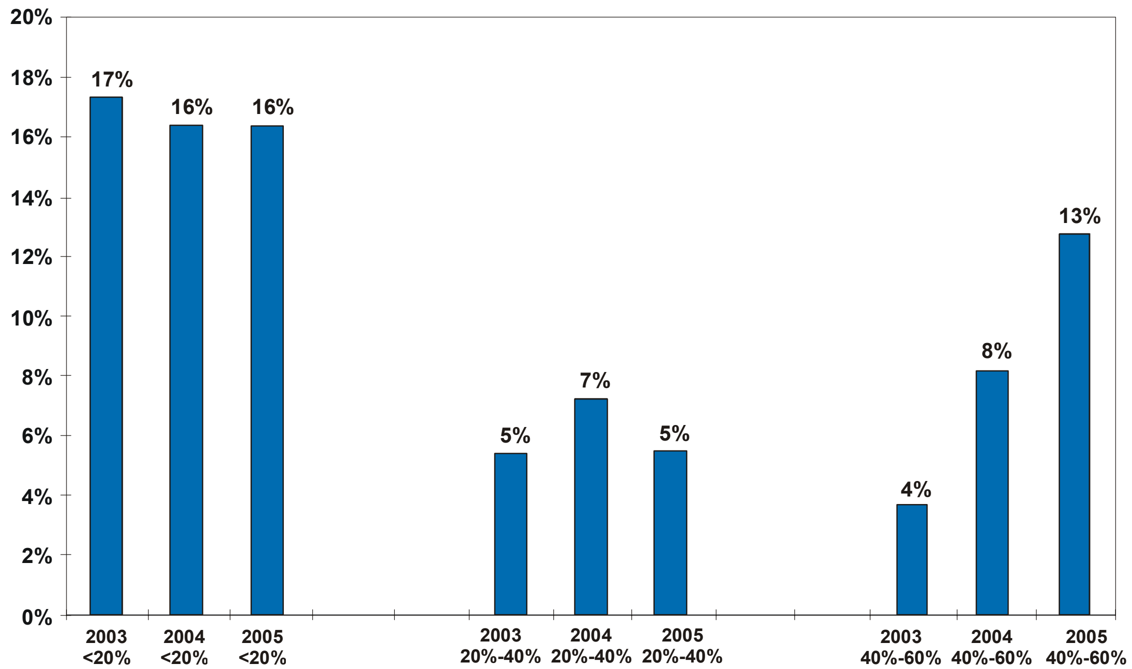


Figure 3.57 Payout ratios for financial institutions (2003–2005)



4. Disclosure of Conflicts of Interest and Related-Party Transactions

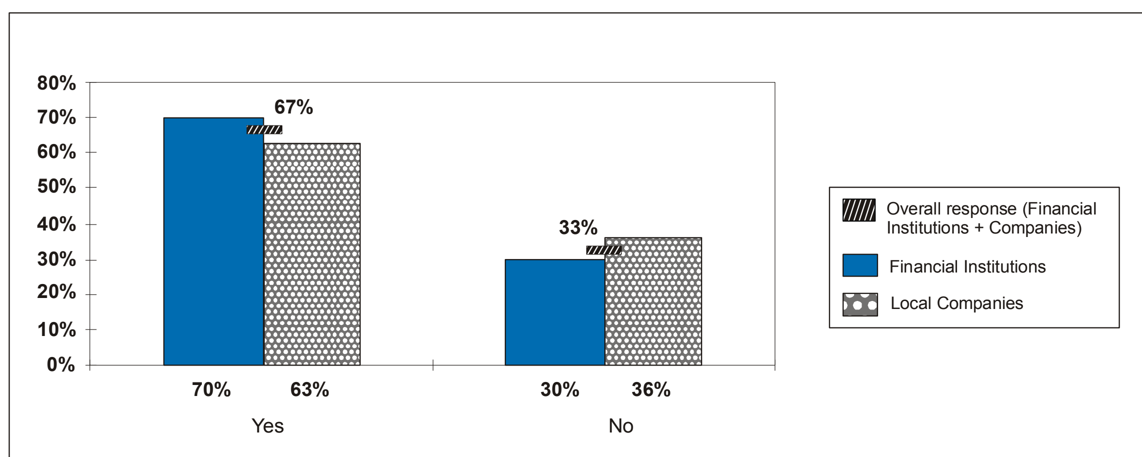
It is the responsibility of the board to monitor and manage potential conflicts of interest between management, board members and shareholders, including misuse of corporate assets and abuse in related-party transactions. Disclosure of related-party transactions and conflicts of interest help protect minority shareholders' rights as well as provide information to the market that the company is being run with due regard to the interests of all its investors. It is thus essential to fully disclose material related-party transactions to the market, including whether these transactions have been executed at arm's length and on normal market terms. Related parties can include entities that are controlled by, or are under common control with the company, significant shareholders, including members of their families, and key management personnel.[111]

The Companies Ordinance has also laid down certain requirements related to disclosure of conflict of interest and related-party transactions. The chief executive cannot engage, directly or indirectly, in a business competing with the company's business.[112] Directors and officers must disclose 'direct or indirect concerns or interests in any contract or arrangement entered into or to be entered into by or on behalf of the company'.[113] Directors who have an interest in a certain transaction are not allowed to discuss or vote on the matter in board meetings.[114] Violations of these rules could result in (small) financial penalties or a declaration by a court that a director is 'lacking fiduciary behaviour'.

Under the State Bank of Pakistan Prudential Regulations (Prudential Regulation G2), banks/DFIs cannot (without prior approval of the SBP) enter into any kind of transaction with their directors, officers, employees or persons who either individually or in concert with family members beneficially own 5% or more of the equity of the bank.

As outlined in figure 3.58, 67% of the respondents stated that their company's/bank's governing documents require the board members and management to make disclosures about, and abstain from voting on, issues affected by a conflict of interest situation.

Figure 3.58 Conflict of interest disclosure



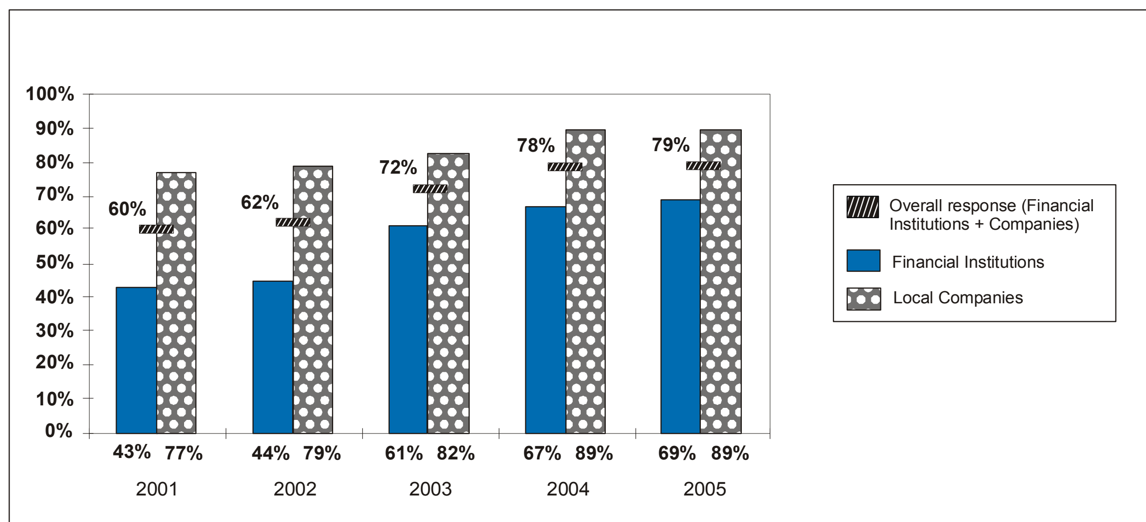
111 OECD Principles of Corporate Governance.
112 Section 203, Companies Ordinance 1984.
113 Section 214 and 215, Companies Ordinance 1984.
114 Section 216, Companies Ordinance 1984.

5. Related-party and Material Transactions

In 2006, the SECP amended the Fourth Schedule to the Companies Ordinance 1984, requiring the listed companies to disclose their accounting policy in respect of related-party transactions. The directors of listed companies are now required to formulate a transfer-pricing policy for each related-party transaction. In addition, listed companies are required to maintain a statement recording the methods employed by them for determining transfer pricing in various types of related-party transactions and to maintain a record of all related-party transactions. All companies registered under the Companies Ordinance 1984 are required to place before the board of directors all transactions with any related parties for review and approval.

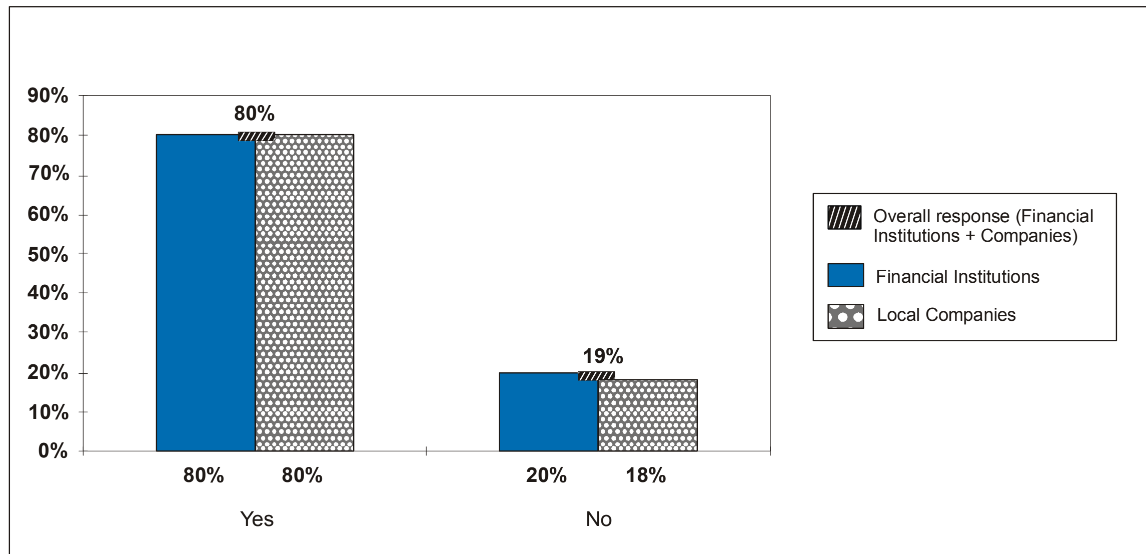
It can be concluded from Figure. 3.59 that there is evidence of substantial related-party transactions and that at the time of the survey the number of related-party transactions was increasing among the surveyed responding companies and financial sector institutions.

Figure 3.59 Related-party transactions 2001 - 2005



80% of the respondents stated that under a governing document or law it was mandatory to disclose related-party transactions, whereas 19% stated that this was not the case.

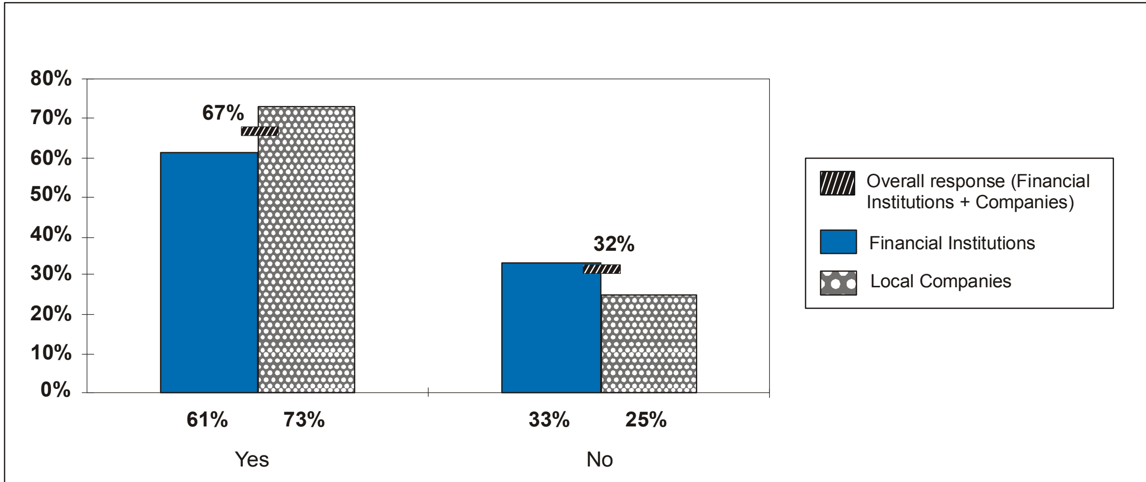
Figure 3.60 Is it mandatory to disclose related-party transactions?



Currently, under the Companies Ordinance, the external auditors are not required to certify related-party transactions. Under SRO No. 167(1)/2003 dated 14–02–2003: 'a form of audit report was prescribed for reporting by statutory auditors of compliance by the company management with transfer pricing requirements. This notification still holds ground and has neither been rescinded nor held in abeyance. However, neither compliance therewith has been insisted by SECP nor have the statutory auditors complied'. One of the recommendations of the Task Force on Transfer Pricing was that auditors should not have the capacity to verify such information.

It can be seen from Figure. 3.61 that 67% of the respondents stated that external auditors should be required to verify related-party transactions whereas 32% stated that external auditors should not be required to do this.

Figure 3.61 Should external auditors verify related-party transactions?



Synopsis: Shareholders' rights

There is compliance with legal and regulatory requirements relating to minority shareholders' rights and related-party transactions, although this compliance appears to be by the letter rather than the spirit. Minority shareholders in family-owned businesses may need more rights and more protection. Regulations for related-party transactions have been strengthened but compliance with the regulation and legislation needs to be monitored. Similarly, minority shareholders' rights and protection mechanisms need to be monitored.

6. Shareholders' Rights – Recommendations

6.1 Disclosure of conflicts of interest and related party transactions should be monitored.

This survey has noted that 67% of the respondents stated that their company's or bank's governing documents required the board members and management to disclose, and abstain from voting on, issues where there is a conflict of interest. We recommend that, in view of the importance of disclosure of conflict of interest and related-party transactions for ensuring effective corporate governance, consideration be given to monitoring conflict of interest policies and procedures. It is also suggested that in the next revision of the Code of Corporate Governance, disclosure of conflict of interest and related-party transactions be made mandatory and monitoring mechanisms be put in place for monitoring conflict of interest and related-party transactions disclosures.

6.2 Minority protection rights should be monitored.

Even though the survey outlines evidence that best practice for minority protection rights is being adopted, monitoring of these rights should be considered. The revised Code of Corporate Governance should specify mechanisms for achieving this.

6.3. The possibility of verification of related-party transactions by external auditors should be explored.

67% of the respondents stated that related-party transactions should be verified by external auditors. There is thus a need to explore the possibility of doing this.

ANNEXE I: COMPOSITION OF THE SAMPLE IN TERMS OF SECTORS

Figure A1 The composition of the final sample of local companies

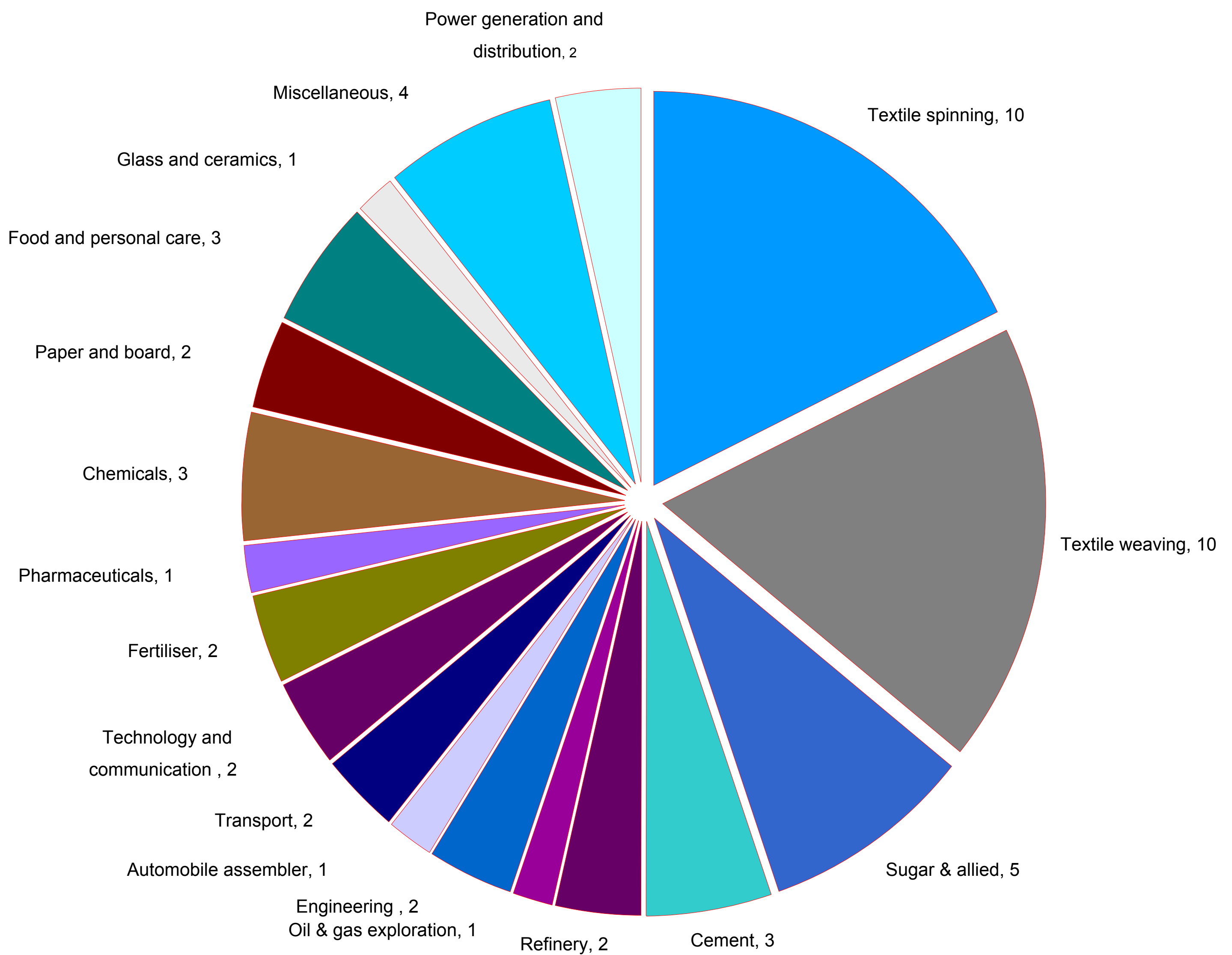


Figure A2 Composition of the final sample of local financial institutions