Corporate Governance in Pakistan

By:

Syed Kashif Saeed
Umer Faiz

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The discussion about governance is very much prevalent in Pakistan now a days. The discipline of corporate governance started with Code of Corporate Governance in 2002. Later on, it was revised in 2012. SECP further presented governance rules for Public Sector companies in 2013. This is a book about corporate governance in Pakistan, written from an academic perspective. It is intended for students of business, finance, and aspiring practitioners who are interested in understanding governance system.

We believe this book provides the information to the people who are interested in learning corporate governance from every field.
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Syed Kashif Saeed
Umer Faiz
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>ARCCGOR</td>
<td>Amsterdam Research Centre for Corporate Governance Regulation</td>
</tr>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>BMC</td>
<td>banking and managerial control</td>
</tr>
<tr>
<td>CAG</td>
<td>Competitiveness Advisory Group</td>
</tr>
<tr>
<td>CAPM</td>
<td>Capital Asset Pricing Model</td>
</tr>
<tr>
<td>CCP</td>
<td>Competition Commission of Pakistan</td>
</tr>
<tr>
<td>CEEC</td>
<td>Central and East European countries</td>
</tr>
<tr>
<td>CEO</td>
<td>chief executive officer</td>
</tr>
<tr>
<td>CFO</td>
<td>chief financial officer</td>
</tr>
<tr>
<td>CIS</td>
<td>Commonwealth of Independent States</td>
</tr>
<tr>
<td>CME</td>
<td>Co-ordinated Market Economy</td>
</tr>
<tr>
<td>CNC</td>
<td>National Accounting Council (Conseil National de la Comptabilité)</td>
</tr>
<tr>
<td>COIC</td>
<td>control by an outsider–insider coalition</td>
</tr>
<tr>
<td>DG (EC)</td>
<td>Directorate-General</td>
</tr>
<tr>
<td>DoJ (US)</td>
<td>Department of Justice</td>
</tr>
<tr>
<td>DRSC</td>
<td>Deutsches Rechnungslegungs Standards Committee</td>
</tr>
<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>EC</td>
<td>European Community</td>
</tr>
<tr>
<td>ECE</td>
<td>East Central Europe ECJ European Court of Justice</td>
</tr>
<tr>
<td>ECN</td>
<td>European Competition Network</td>
</tr>
<tr>
<td>EEC</td>
<td>European Economic Community</td>
</tr>
<tr>
<td>EMU</td>
<td>European Monetary Union</td>
</tr>
<tr>
<td>EP</td>
<td>European Parliament</td>
</tr>
<tr>
<td>EVA</td>
<td>economic value added</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FCC</td>
<td>foreign corporate control</td>
</tr>
<tr>
<td>FDI</td>
<td>foreign direct investment</td>
</tr>
<tr>
<td>FIG</td>
<td>financial-industrial group</td>
</tr>
<tr>
<td>FTC US</td>
<td>Federal Trade Commission</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>IAASB</td>
<td>International Auditing and Assurance Standards Board</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
<tr>
<td>IASC</td>
<td>Foundation International Accounting Standards Committee Foundation</td>
</tr>
<tr>
<td>IFAC</td>
<td>International Federation of Accountants</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Association of Securities Supervisors</td>
</tr>
<tr>
<td>IPE</td>
<td>international political economy</td>
</tr>
<tr>
<td>ISAs</td>
<td>International Standards on Auditing</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>mergers and acquisitions</td>
</tr>
<tr>
<td>MBO</td>
<td>management buy-out</td>
</tr>
<tr>
<td>NGO</td>
<td>non-governmental organization NSA non-state actor</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Co-operation and Development</td>
</tr>
<tr>
<td>PCAOB (US)</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>QCL</td>
<td>quality of corporate law</td>
</tr>
<tr>
<td>RA</td>
<td>regulation approach</td>
</tr>
<tr>
<td>R&amp;D</td>
<td>research and development</td>
</tr>
</tbody>
</table>
ROA
return on asset
ROE
return on equity
SECP
Securities and Exchange Commission of Pakistan
S&P
Standard & Poor’s SEC (US) Securities and Exchange Commission
SME
small and medium-sized enterprise
SOA (US)
Sarbanes-Oxley Act 2002
SOE
state-owned enterprise
SPE
special purpose entity
UNCTAD
United Nations Conference on Trade and Development
US GAAP
US Generally Accepted Accounting Principles
USGAO
United States General Accounting Office
VBM
value based management
WACC
Weighted average cost of capital
WB
World Bank
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Introduction
After fall of Russia, the supremacy of capitalism over socialism became evident. World realized that the importance of competition and right to hold private property, among others, are source of development and progress. However, the western societies also were aware of the drawbacks of ruthless competition, therefore, in majority of countries the idea of welfare state, the essence of communism, was also introduced, however, the economic system remained primarily as capitalism.

One of the prime instruments through which capitalism operates is corporations. The progress of corporations can be seen through Fortune 500. In year 2015, Fortune 500 marks the 61st running of the list. In total, the Fortune 500 companies account for $12.5 trillion in revenues, $945 billion in profits, $17 trillion in market value and employ 26.8 million people worldwide. Despite so much growth in corporations, late 19th century and early 20th century, world witnessed gigantic financial crimes where shareholder’s money was robbed.

Energy giant, ENRON, tried to hide its problematic accounts receivable through Special Purpose Entities. Higher management earned millions of dollars by selling stock while advising others to buy at the same time. WorldCom overstated profits by falsely capitalizing expenses amounting to $3.8 billion. The list of such frauds is too long. United Kingdom was already having mechanism for corporate governance. The collapse of ENRON created huge pressure on authorities and Sarbanes-Oxley Act came into force.

Governance fraud are not restricted to developed world only. Pakistan has evidenced various corporate frauds as well. The famous Cooperative Scandals and Taj Quran Company happened in the history. It has been observed that religious basis is also used in Pakistan to attract people into various Ponzi Schemes. Ponzi scheme is defined as a fraudulent investment operation where the operator generates returns for older investors through revenue paid by new investors, rather than from legitimate business activities or profit of financial trading. Such schemes can be managed by either individuals or corporations, and grab the attention of new investors by offering short-term returns that are either abnormally high or unusually consistent.

In recent history of corporation in Pakistan, such Ponzi scheme are offered using the title of Islamic Financial instrument known as Modaraba. In year 2014, National Accountability Bureau (NAB) approved more than two reference in multi-billion Modaraba Scams against various accused persons on the charges of corruption and corrupt practices and cheating the public at large in the ploy of Islamic mode of investment.

One reference was against Mezban Trading Company (Pvt) Ltd where National Accountability Bureau (NAB) received more than 2800 complaints from general public involving Rs.3 billion. Ghulam Rasool Ayubi, Chief Executive of the said company, was accused of collecting huge investments in the name of Modaraba (Islamic mode of business) from general public under the garb of business in the name of Mezban Stores. The company promised attractive monthly profits @ 30% to 50% of the total profit earned on the investment. The complainants reported that the accused paid profit to them for a few months but defaulted later on and neither the accused persons are paying back the capital investment nor are they paying monthly profit.

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1 Daily DAWN, July 21, 2014
2 www.nab.gov.pk
Another similar Modaraba scam is reported involving Rs 446 Million. The principle accused is Mufti Ehsanul Haq running Fayyazi Industries. Initially it seems a scam involving Rs 550 Million, according to the NAB, however later the estimated scam reached over Rs 31 billion. Most of the affected people are said to be madrassah students and members of their families, widows and retired government employees and the accused included over 40 prayer leaders.

1.1 Defining Corporate Governance

Corporate governance provides a mechanism by which companies are directed and managed. It starts with setting up the objectives and defining mechanisms for achieving these objectives, devising a control process and continuous monitoring to optimize performance. Academia defines corporate governance as dealing with issues that result from separation of owner and management. Good corporate practices provide an impetus for value creation through entrepreneurship, creativity, innovation, research and development.

In literature, the concept of corporate governance has been approach in various contexts. The UK's Cadbury Committee on corporate governance as “(It is) the system by which companies are directed and controlled.” In 2004, the definition from Organization for Economic Cooperation and Development (OECD) gives us an insight into the philosophy of corporate governance.

“Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.” (OECD 2004)

The World Bank (1992) defined Governance as:

“Governance is a method through which power is exercised in the management of a country’s political, economic, and social resources for development.”

The Asian Development Bank, in 1995, is defined Governance as:

Governance is the manner in which power is exercised in the management of a country's social and economic resources for development.

UNDP defined it as:

Governance is the exercise of economic, political, and administrative authority to manage a country's affairs at all levels. It comprises the mechanisms, processes, and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences. UNDP (1997)

The comprehensive definition of Corporate Governance is presented by Sir Adrian Cadbury, which states as, "Corporate Governance is defined as holding the balance between economic and social goals and also between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of the resources. The aim is to align as nearly as possible the interest of individuals, corporations and society. The incentive for states is to strengthen their economies and discourage fraud and mismanagement."

Broader concept of corporate governance involves a set of relationships amongst the organization’s stakeholders. A stakeholder is any person, organization, social group, or society at large that has a stake in the business. The stakeholders can be internal or external to the business. Stakeholders may affect a business, or that they may be affected by a business. A stake is a primary interest in the business or its activities. It can include ownership and property interests, legal interests and obligations, moral rights and social implications. A legal obligation includes the duty to pay for
wages or to honor contacts. A moral right may include the right of a consumer not to be intentionally harmed by business activities. Corporate governance is not restricted to these relationships but it holds may other dimensions to this subject. Rather, corporate governance provides you an increased transparency into the structure, business operations, business ethics and corporate social responsibility and across the board accountability.

It is important to differentiate between corporate governance and corporate management. Corporate governance operates at a higher level in a focused direction to ensure that the organization is managed and controlled that maximizes the interests of its stakeholders. Corporate management, on the other hand, focuses on the tools required to operate the business. The overlapping areas are strategy which is steered by the corporate management and is of instrumental value on corporate governance.

1.2 Broader Perspective of Corporate Governance
Contrary to the belief that the importance of corporate governance for organizations is solely confined to effective financial discipline, it adds value to their operational performance at different levels

- At the organization level, it nurtures a culture of strategic thinking by inducting independent directors. It provides for a convergence of experience, knowledge and innovative approaches. By exercising the transparency in the decision making process, it limits the liability of top management and directors. The adoption of food governance practices brings stability and growth in the organization.

- At the stakeholder's level, it provides the right reasons for the management to pursue objectives that are beneficial for the organization and stakeholders in the longer run. Adoption of good corporate governance practices, builds confidence amongst stakeholders as well as prospective stakeholders. Investors are willing to pay higher price to the corporate demonstrating strict adherence to internationally accepted norms of corporate governance. With an effective corporate governance system in place, stakeholders are taken into confidence regarding change and revision of polices and statutes that govern the business of the organization with the promise to deliver well on wealth maximization and safeguard of their interests.

- At the national level, good corporate governance practices help an organization to survive in an increasingly competitive environment through mergers, acquisitions, strategic partnerships, high value ventures and risk reduction through asset diversification. Corporate governance provides long-term sustenance and provides leverage in the competitive market.

Good corporate governance ensures that the business environment is fair and transparent and that companies can be held accountable for their actions. Conversely, weak corporate governance leads to waste, mismanagement, and corruption.

1.3 From Management towards Governance
The corporate history is full of reported events of financial misappropriation and frauds. A need was realized soon to regulate the corporate discipline and increased accountability of the management. The governments, stakeholders, and investors were equivocal in their demand for adopting better governance practices and policies. It eventually led to concerted efforts to develop recommendations, codes and guidelines on corporate governance. The buildup of the momentum led to a metamorphosis in corporate circles that realized that investors and society are serious about corporate governance.

The Watergate scandal in the United States, that jolted the government of Richard Nixon at that time, probably led to the need for an effective governance and control to run organizations. It was
found that several organizations were involved in making illegal political contributions and used funds to bribe government officials. While developments in the United States stimulated a debate in the UK, a spate of scandals and collapses in that country in the late 1980s and early 1990’s led the Shareholders and Banks to worry about their investments. These also led the Government in UK to recognize that the then existing legislation and self-regulation were not working.

A major development was the promulgation of Foreign and Corrupt Practices Act of 1977 in USA that contained specific provisions regarding the establishment, maintenance and review of systems of internal control. In 1979, the Securities and Exchange Commission of USA’s submitted proposals for mandatory reporting on internal financial controls.

The concept of good governance emerged at the end of the 1980s, at a time of unprecedented political changes. The collapse of the Berlin in 1989 set off the disintegration of the Soviet Union. It also led to the decay of the political and economic alliances of the Eastern bloc. It triggered off a serious discussion on how a state has to be designed in order to achieve development, i.e. a discussion on good governance.

In 1989 study the term “governance” was first used to describe the need for institutional reform and a better and more efficient public sector in Sub-Saharan countries. The former World Bank president Conable used the term “good governance”, referring to it as a “public service that is efficient, a judicial system that is reliable, and an administration that is accountable to its public”.3

In 1985 Treadway commission was constituted to identify the causes of financial indiscipline and measure to prevent misrepresentation in financial reports. The Treadway Commission stressed the need for a proper control environment, independent audit committees and an objective internal audit function. It called for a record-keeping of documents of evidence on the effectiveness of internal control. The most important outcome of the Treadway Commission was the recommendation to develop an integrated set of internal control criteria to enable organizations to improve their controls.

Pursuant to the recommendations of the Treadway Commission, Committee of Sponsoring Organizations (COSO) was born. The report produced by it in 1992 stipulated a control framework, which has been endorsed and reviewed in the four subsequent UK reports: Cadbury, Rutteman, Hampel and Turnbull.

The Cadbury Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance. Its chairman was Sir Adrian Cadbury.

The concept of governance was further developed in the Bank’s 1992 publication “Governance and Development”. In this publication, governance was defined as “the manner in which power is exercised in the management of a country’s economic and social resources for development”.4 Two years later, the Bank substantiated this definition:

“Governance is epitomized by predictable, open, and enlightened policymaking (that is, transparent processes); a bureaucracy imbued with a professional ethos; an executive arm of government accountable for its actions; and a strong civil society participating in public affairs; and all behaving under the rule of law”.

More than 20 years later, these definitions still represent the basis of the Bank’s perception of good governance.

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3 World Bank 1989, p. xii.
Corporate Governance Theory

2.1 Governance
The concept of governance is as old as human civilization. However, recently the usage of this term has increased manifold. The term Governance and Good governance are being used interchangeably. Governance is defined as the process of decision making and the process by which decisions are implemented. In today's world, the term governance is being used in various contexts such as corporate governance, academic governance, political governance etc. In the process of governance, various agents perform their role, therefore, to analyze governance, formal and informal agent included in decision making process need to be analyzed. One important formal actor is the State. In the perspective of Corporate Governance, the role of State is taken by the regulatory authority.

2.2 Characteristics of Good Governance
United Nation Economic and Social Commission explain that Good Governance has eight major distinguishable features. These are accountability, transparency, follow rule of law, responsiveness, equitable and inclusive, participation, efficient and effective, and consensus oriented.

a) Good Governance is accountable. Accountability is the key to governance. In corporate governance, shareholders elect directors to run the affairs of organization. It has been witnessed that lack of accountability of directors has resulted in failure of various big organization like ENRON etc.

b) Good Governance believes in transparency. In corporate governance framework, transparency is being enforced through financial disclosure and audit requirements.

c) Following rule of law is essential for good governance

d) Good Governance is responsive. A timely and reasonable response is required and expected from institution to all stakeholders. Such responsiveness is less available from public sector organization in Pakistan.

e) Good Governance exhibits equity and inclusiveness

f) Good Governance is participatory

g) Good Governance is efficient and effective

h) Governance process consist of various formal and informal economic agents therefore good Governance demands the mediation of various interest groups therefore it is believed that good governance is consensus oriented

2.3 Corporate Governance Systems
Recognizing the importance of corporate governance, most of the countries in the world have developed their own corporate governance mechanism known as corporate governance models. The mechanism of corporate governance depends upon various indigenous factors such as legal framework, regulatory framework, pattern of shareholding, breadth and depth of financial markets etc. Irrespective of dissimilarities of corporate governance in various counties, majority of de facto and de jure factors affect corporate sector in reasonably analogous way. Taking advantage of such similarity, academia and policy maker have outline corporate governance models for various group of countries. Two broad categories of corporate governance models are outsider model and insider model. Outsider model can be referred as Shareholder oriented model. Such mechanism generally exists in Anglo-Saxon counties like USA, UK etc. On the contrary, Insider model, also referred as
Stakeholder oriented model, can be further categorized into three sub-models known as German model, Japanese model and Family/State based model.

**Outsider Model:**
Outsider model also known as Shareholder model or Anglo-Saxon model is based on unitary board model approach where all directors contribute in decision making process while in single board. The idea behind this model is that shareholders are the rightful owner of the company and therefore the ultimate objective of corporation should be maximization of their (i.e. Shareholders’) wealth. In this model, the idea of Principal-Agent relationship exists, being shareholders as Principal whereas directors perform their services as Agent of the shareholders. One distinguishing characteristics of this model is investors, in highly dispersed ownership pattern, who are not affiliated with the corporation. The day-to-day operations of the corporation are run by professional and the board generally does not interfere in management. This situation depicts the separation of ownership and control.

Source: Survey on Corporate Governance, Shleifer and Vishny (1997)

This model operates under well-developed legal framework wherein the duties and responsibilities of key players, i.e. shareholder, directors and executives have been properly defined in relatively less complicated environment.
Such corporate model generally can be seen in United States, United Kingdom, Canada, Australia, New Zealand etc. The corporate structure of certain Asian counties, being part of colonial regime, essentially resembles with Anglo-Saxon model.

**Insider Model:**

Insider model is also known as Stakeholder model. The fundamental rationale behind this model lies in the belief that corporation must ensure the benefits accrue to other stakeholders as well in addition to shareholders. This approach considers that stakeholders (i.e. creditors, employees, unions etc.) participate in production process and corporation is socially responsible towards them. This model can be further categorized into three types: German model, family/State based model, and Japanese model. The distinguishing characteristic of such model include less-dispersed ownership structure, relatively less strong capital markets, interlocking structure and directorship, less disclosure in financial reporting, high leverage firms etc.
The term insiders, here, include family interest, institutional interest, banking interest, and holding companies interest. Contrary to Anglo-Saxon model, insider play a dominant role in governance of firm in this arrangement and agency cost is significantly reduced. Controlling shareholders (i.e. family, the state, or institutions etc.) manage the corporations, thus the agency cost under such model is almost irrelevant. However, the conflict of interest between controlling interest holders and minority shareholder, i.e. expropriation problem, is very much relevant in this corporate arrangement. The basic characteristic of both models have been presented in table 1.

Table: Insider versus Outsider Corporate Governance Model

<table>
<thead>
<tr>
<th>Essentials of CG</th>
<th>Outsider Model</th>
<th>Insider Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing sources</td>
<td>Equity based financing (Generally)</td>
<td>Debt based financing (Generally)</td>
</tr>
<tr>
<td>Corporation strive for</td>
<td>Maximize shareholder’s wealth</td>
<td>Considering interest of all stakeholders</td>
</tr>
<tr>
<td>Status of Capital markets</td>
<td>Large and very liquid market</td>
<td>Relatively small and less liquid market</td>
</tr>
<tr>
<td>Ratio of publicly traded firms in economy</td>
<td>High ratio</td>
<td>Low ratio</td>
</tr>
<tr>
<td>Ownership structure</td>
<td>Block holding by any types of shareholding doesn’t exist.</td>
<td>Block holding (i.e. family, state or institutional) of shareholders exist</td>
</tr>
<tr>
<td>Dominant Agency Problem</td>
<td>Agency problem exist because of principal-Agent relationship</td>
<td>Expropriation Problem exist because of Controlling and Non-controlling shareholders</td>
</tr>
<tr>
<td>Minority Shareholder Rights</td>
<td>Strong</td>
<td>Weak</td>
</tr>
<tr>
<td>Board Type</td>
<td>Unitary Board Model</td>
<td>Two-tier board model</td>
</tr>
<tr>
<td>Board Compositions</td>
<td>Majority director are Non-executive directors. Corporations are run by professionals.</td>
<td>Majority director are from block holders, coming from families etc.</td>
</tr>
<tr>
<td>--------------------</td>
<td>---------------------------------------------------------------------------------------</td>
<td>--------------------------------------------------------</td>
</tr>
<tr>
<td>Financial Institution Role</td>
<td>No significant defined role of banks exist.</td>
<td>Significant role of banks exist.</td>
</tr>
</tbody>
</table>

**German model**

German model is based on two-tier board model. In this model, banks hold long-term stakes and their representatives are elected to sit in boards. Large German banks, both private and public sector, play a major role being a key shareholders in corporation and their existence in the board is the reason of relatively less agency problems.

The German corporate governance exhibits certain significant dissimilarities from, both, the Anglo-US and the Japanese model. This model is prevalent in Germany and Austria. Due to its unique characteristics, some corporations in the Netherlands, Scandinavia, France and Belgium are also incorporating some elements of this model.

In German model, two tier board mechanisms consist of Supervisory Board and Management Board. Supervisory Board consists of shareholders representatives, union representatives and the bank obviously. Management Board consists of executives of the organization, i.e. insiders only. Compulsory presence of employees; representative on supervisory board in German firms is one of the most differentiating characteristics of this model in comparison with Anglo-Saxon and Japanese model. An important characteristic of this two tier mechanism is that no one is allowed to serve in both boards simultaneously. Another distinguishing fact is that size of board is fixed according to law of the land and cannot be changed by shareholders. Voting right restrictions, irrespective of percentage of shareholding are also part of legal framework. These restrictions limit a shareholder to voting a certain percentage of the corporation’s total share capital.
Family/State based model
Family based or State based model can be mainly observed in East Asian economies and in some emerging economies including Pakistan. Family business is defined as a form of enterprise in which both management and ownership are controlled by a family kinship group, either nuclear or extended, and the fruits that which remain inside that group, being distributed in some way among its members”. Suehiro (1993)

Adam Smith, in his book Wealth of Nation (1776) implicitly stresses the importance of family business in following words.

"[B]eing the managers of other people's money than of their own, it cannot well be expected that [the managers of widely held corporations] should watch over [public investors' wealth] with the same anxious vigilance with which partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they ... consider attention to small matters as not for their master's honour and very easily give themselves a dispensation from having it. Negligence and profusion therefore must prevail more or less in the management of such a company."

Family or State based models exhibits following characteristics:

- Ownership concentrations
- Prominent shareholding within families
- Pyramid structure or cross holdings in various corporations
- Institutions based on relationship
- Lack of transparency, less financial reporting disclosure
- Conflict of interest within controlling shareholder and minority shareholder

Irrespective of certain problems, this model of corporate governance bears certain advantages as well. Some of advantages include stable ownership, less agency cost, long term commitment of shareholders etc.

Japanese model
The Japanese model is also known as business network model, having predominantly stockholder from affiliated banks and corporations. In this model, board of directors is generally insiders and executives. Two important characteristic of this model are existence of a Main bank and “keiretsu”. In this model, a strong, long term relationship exists between banks and corporations which is vital in case of financial distress.

A keiretsu (mean agrouping of enterprises or order of succession) is a set of companies with interlocking or cross shareholdings and corporate relationships. This method was established by Article 280 of Commerce Law. According to this method, the member companies held a small shareholding stake in each other's companies and on a core bank. This arrangement provides comfort each company from hostile takeovers and unnecessary fluctuations in stock markets. Thus, unnecessary pressure on management to achieve short-term goals at the expense of long-term growth is also reduced. keiretsu is equally beneficial as a tool for monitoring and disciplining the group’s firms due to its inter-locking nature. The level of group orientation or strength between the member companies is determined by the "interlocking shares ratio" (the ratio of shares owned by other group firms to total shares issued) and the "intragroup loans ratio" (the ratio of loans received from financial institutions in the group to total loans received). The keiretsu maintained dominance over the Japanese economy for the second half of the 20th century.

The existence of main banks does not mean absence of equity financing, as it is important for Japanese corporations as well. However, insiders and their affiliates are the major shareholders in
most Japanese corporations. Consequently, they play a major role in individual corporations and in the system as a whole. Conversely, the interests of outside shareholders are marginal. The percentage of foreign ownership of Japanese stocks is small, but it may become an important factor in making the model more responsive to outside shareholders.

The Japanese Model

After elaborating various corporate governance models, it is pertinent to mention here that the said process is dynamic in nature. It is not possible to define model that apply on every company in given country. With globalization phenomenon, this process is becoming even more complex and defining the limits is becoming more impossible.
Contemporary Issues in Corporate Governance

3.1 Introduction

The concept of corporate governance sounds simple and unambiguous, when one attempts to define it and scan available literature to look for precedence, one comes across a bewildering variety of perception behind available definition. The definition varies according to the sensitivity of the analyst, the context of varying degrees of development and from the standpoint of academics versus corporate managements. Still, there seems an underlying uniformity in the thinking of all he analysts that there is definite need to eradicate corporate misgovernance and promote corporate governance at all costs.

Different governance practices exist in the today's corporate world reflection the business reality. Although natural goal for all markets, whether developed or developing, is same still it is almost evident that "one size does not fit all". Various researchers view corporate governance from little broader views. They see it encompassing the corporate strategy as key element. Other want the inclusion of management discipline, business ethics, corporate social responsibility and stakeholder participation in the corporate governance discussion. Mayer (XXXX) argues that "corporate governance is not only concerned with the efficiency with which companies are operated in the interest of shareholders. It is also related to company strategy and life cycle development. Thus governance is more than shareholder and management alignment, it is about who is in control, for how long and over what critical important activities".

Corporate governance has been defined in different ways by different writers and originations. It has been seen by some in narrow perspective whereas some see it using broader perspective. Narrow perspective focuses only on shareholder’s approach where only shareholder face loses from corporate misgovernance. Broader perspective include stakeholders and argues that due to misgovernance almost every section of society face loses.

Corporate governance is a discipline which has emerged from business realities. Business realities show us that corporate governance have not been in true practice. The notorious cases of Barings Bank, BCCI, and ENRON etc. are recorded history of corporate world now. Every corporate history provides another dimension to corporate ethics and social responsibility. Every case study described governance from a different perspective. Some talk about accounting malpractices whereas some explain the root cause of misgovernance in BoD composition. But all seems to converge at one point that corporate governance is a means to an end which is shareholder’s value and more importantly stakeholder’s value. Throughout history of governance in corporation, some important dimension and issues have been identified which ultimately contribute to governance or misgovernance. These issues are the following:

3.2 Role of Board and Management

"There is no institution better placed to ensure good governance of corporations than the board of directors. But a board consist of people and a good board consist of god people with the integrity to do what's right with the competence to contribute with the stature to stand up to management when necessary, and with sense of responsibility to all shareholders regardless of their size. It is this people factor that has seen most codes left as guidelines rather than being formulated as rules." 

5 The Corporate Governance, Landscape of Pakistan
To distinguish the role of Board with Management we must have to know about what is the Board? It is an organized group consists of many people having collective responsibility to control or supervise the affairs of the corporation. Generally, the board comes into existence through an election of numerous shareholders. Thus shareholders, through election, elect directors as their agents to control and supervise the affairs of the corporation. The group of director is collectively known as Board of directors and assume collective responsibly. Later on, the board delegates the responsibility of managing the company to CEO who in turns delegate this responsibility to other senior executives. Thus, the board assume a pivotal role between shareholders and management of the company.

The management and Board have their separate responsibilities to perform within the interest of the shareholders because the board of directors elected from the shareholders and every shareholder has votes as he has its shares.

The board has many responsibilities to perform in the favor of shareholders and also have some authorities to perform its responsibilities well.

Arnwine (2002) explain the three major roles of the board i.e. to establish policies, to make strategic decision and to oversee the activities of the organization. The board’s focus is on long term policies in the business. They must have to present a broader vision and also a competitive mission for the business. The appointment of CEO and its remuneration is also one of the major responsibility of the board and the board has the authority to change the CEO. The major decisions and policies of the company require ratification by the board. The board also served as the external advocate and also oversees (indirectly) the performance of the company and if they found any negligence by the management then the board has the authority to take action against it. The board is also responsible to render the advice to the top management and counseling too. One very significant responsibility of the board is to ensure that applicable laws, regulation, and standards, international or national, are being complied with. The board is not responsible of the operations of the business but if they found any problem in operations then the board takes appropriate action. This means that if there is a matter have the negative impact on the business then the board must be informed about the matter to take action; otherwise the board cannot take any action directly in the operations of the management.

Now we must have to discuss the responsibilities of the Management in the business. The board and the management have the open working relationship and the board should have to cooperate with the main person i.e. CEO. The CEO is the top manager of the company who watch every matter of the company directly or indirectly. The CEO is responsible all the operations of the company and also overlook downstairs executives and oversees all the operations of the company carefully. All the operation decisions are taken by the CEO of the company and also make the policies for the company and inform to the board about all the updated operational information. The management is also responsible to take decision to change needed to the adoption of internal and external factors that has some impacts on business operations.

It is extremely important to emphasize that, performing their respective roles, both board and management, is critical to the success of organization. In fact, performing their respective roles is the governance. If the board and the management perform their duties and responsibilities then the company or the business can easily grow up. It can be said that Effective governance assists the organization to grow whereas Ineffective governance compromises the ability of the management to thrive. Allowing the discussion of diverse ideas at board is one critical symbol of effective governance. It is simple, efficient, focused, synergistic, and become steward for the organizational resources.

Corporate governance mechanism specifies certain important dimension where every board is supposed to invest its energies. Following are the dimension where board, collectively, are supposed to invest their time and energies:
It is the responsibility of the board to develop a code of conduct consisting of professional standards and corporate values which help to promote integrity for the board, senior management and other employees. Such a code of conduct should explicitly define the acceptable and unacceptable behaviors i.e. sexual harassment, etc. It is also the responsibility of the board to take appropriate steps to disseminate the Code of Conduct throughout the company along with supporting policies and procedures.

Board responsibility includes the placement of an adequate system for identification and redress of grievances arising from unethical practices.

The creation of vision and mission statement and inculcating overall corporate strategy for the listed company is one of the important responsibilities of the board.

The board should further ensure that the significant policies, including but not limited to, governance, risk management, and compliance issues, human resource management, procurement of goods and services, determination and delegation of financial powers, transactions or contracts with associated companies and related parties, the corporate social responsibility (CSR), and the whistleblower policy, etc., have been formulated.

One very important responsibility of the board, mentioned in Cadbury committee’s recommendation, is to establish a system of sound internal control, need to be implemented effectively and evaluated periodically for improvement at all levels within the company;

### 3.3 Composition and Diversity in Boards

Board of directors is defined as “committee elected by shareholders” who are responsible for providing vision and overall supervision to a limited company. Apart from elected, sometimes, full-time directors are also appointed as well.

Keeping in view the importance of board of directors, its composition is of critical importance. Board composition normally issues related to board independence (including independence of board committees), diversity (firm and industry experience, functional backgrounds, etc.) of board members, and CEO duality. In general, board director can be classified into two categories, i.e. Executive Directors and Non-Executive Directors. Executive director are those directors who are involved in day-to-day operations, receive salaries from the company and also sits in the board of directors. While Non-Executive Directors are not involved in daily operations of the company. Their role is only restricted to supervisory duty. Non-executive directors can be further classified into three types. Firstly, Non-executive directors can be elected through election by shareholder and want them to assume only supervisory role. Secondly; Non-executive directors can be nominee directors having some pre-existing relationship with the firm or company management, such as family relatives, link with major supplier or customer of the firm or company, or may provide professional services to the company, or may be a retired top management professional of the company. Sometimes, institutional shareholders and lending financial institutions also include the provision of their representative in the board as nominee director to ensure safeguard of their interest in the company. Thirdly, Non-executive director can be an independent director who have no personal connections or business dealing with the company or firm.

Governance literature around the globe stresses the need of having a reasonable combination of various types of directors in the board, also known as board independence. Code of Corporate Governance 2012 states that “the board of directors is encouraged to have a balance of executive and non-executive directors, including independent directors and those representing minority interests with the requisite skills, competence, knowledge and experience so that the board as a group includes core competencies and diversity, including gender, considered relevant in the context of the company’s operations”.

Board independence refers to a corporate board having a significant number of independent directors on the board. Compared to executive directors-dominated board, a non-executive directors-dominated board is believed to be more vigilant in monitoring managerial behaviors and decision-making of the firm.

The idea of diversity in the board is as important as independence in the board. Diversity being a broad term, not only include diverse experience and qualification but diversity in gender and in race etc. is also important. A large contributory literature is there to justify this claim.

3.4 Duality concept in CEO and Chair position
Separation of the role of the CEO and chairperson till a date is a big issue of corporate governance. Board being a supervisory body is link between the management and shareholders.

Responsibility of the Chairperson is to ensure that the policies are efficiently applied by CEO. He also ensures that the board communication with shareholder is effective. Chairperson is responsible to clarify that the meetings are planned and conduct through the constitution and efficiently. Key role of chairperson is to lead the board. One duty of chairperson is to ensure that all the member of boards are receiving clear and accurate information. CEO is consider as a leader of the company. CEO is the one who is responsible for the performance and progress of company he is also responsible for the protection of company reputation. One job of the CEO is to implement the policies to achieve the target. Key role of the CEO is to leading the management to manage company day to day operation. So, Chairperson chairs the board of directors whereas CEO is the ultimate manager who run the show. Thus, CEO and Chairperson have two different role in a company.

When one person play the dual role of CEO as well as the role of chairperson then who will check or analyze the performance(activity) of executives. It also has been realized from various corporate failures that due to combining the role of CEO and chairperson, concentration of power increases and results in untoward consequences. Another drawback of combining the role of CEO and Chairperson is to putting a lot of pressure on one person so maybe one shall not be able to take such pressure and unable to deliver one’s duties effectively, competently and efficiently. Due to this some corporate bodies mentioned that the role of chairman and CEO not to be combined. Chairman play an independent role in the company and who will independently check the performance of the executive without any pressure.

3.5 Role of Board committee
Evidence from corporate sector indicate that dearth of board meetings. Even after implementation of governance mechanism, minimum requirements of board meeting are generally restricted to four. Keeping in view the actual time available for deliberation and decision making while keeping in view the required composition and diversity in the board, it becomes evident that board members have dearth of time. Therefore, governance mechanism stresses the need for committees. Committees, in the context of corporate governance, refers small groups among board members with specified sets of duties.

Board committees constitute an important element of the governance process and should be established with clearly agreed reporting procedures and a written scope of authority. One thing is very important to understand here that establishing committee does not exonerate the board of complying with its legal fiduciary responsibilities. Governance literature generally discuss about four types of committees. These are audit committee, risk management committee, the nominations committee and the compensations committee.

History of board committees is not recent and these have been recognized constituents of the board of directors. In United States, the Securities and Exchange Commission (SEC) directed the companies to establish audit committees comprised of outside (independent) directors (Birkett,
Later on, firms were asked to disclose the composition of audit committees as well, to ensure the reasonable presence of independent directors (Reeb and Upadhyay, 2010).

Despite the central role of boards in corporate governance, literature suggest that these are committee meetings, and not the board meetings, where most board activity actually takes place (please see Kesner (1988) and Klein (1998)). Understanding how board committees are structured, therefore, allows us to gain deeper insights into the role of boards and their optimal design.

The Sarbanes-Oxley Act (SOX) requires that the three required committees i.e. audit, compensation, and governance committees be composed solely of outside directors. The audit committee is responsible to ensure the integrity of the firm’s financial reporting. The compensation committee mostly focuses on whether the compensation of top executives are in line with the market competitiveness and with the performance of executives as well. The assignments like recommending new candidates to the board along with filling the top executives positions comes into the preview of the governance committee (De Kuyver, 2009). Research argue that find that 52% of board activity in S&P 1500 firms takes place at the committee level after the implementation of Sarbanes-Oxley (Adams et al., 2015).

In Pakistan, Code of Corporate governance 2012, requires listed companies to have at least two board committees namely audit committee and Human Resource and Remuneration (HR&R) Committee. Audit committee should be have at least of three members comprising of non-executive directors and at least one independent director. The chairman of the committee shall preferably be an independent director. Whereas Human Resource and Remuneration (HR&R) Committee should have at least of three members comprising a majority of non-executive directors, including preferably an independent director. Governance literature further encourages corporations to establish committees for performing specific tasks that take place within board. For example Morgan Stanley has a technology committee that advises the board and management team on Big Data tools and systems that control stock trading.

### 3.6 Executive Compensation

Executives’ compensations has been one of the pivotal point in almost every corporate failure saga. Behind various earning management scheme, the motivating factor has been executive compensation. Directors and executives’ compensation packages used to include retainers, meeting fees, chairmanship fees, stock or option grants and retirement plans. Directors and executives are the people who are actually running the show. They need to be paid for their services and also for retaining them. It is very difficult to decide whether directors and executives are getting reasonable compensation or not. However, Cadbury report in 1991 provided the punch line about it. “The overriding principle in respect of board remuneration is that shareholders are entitled to a full and clear statement of directors’ present and future benefits, and how they are determined.”

Cadbury report recommended that, separate figures of total emoluments of directors and chairman, should be given for their salary and performance-related Elements. Emoluments include the salary and other benefits inclusive of stock options, stock appreciation rights, and pension contributions should also be given. It was also recommended to disclose the criteria for performance appraisal.

Directors and executives are paid very gigantic amount which also include non-monetary benefits as well. They also had the benefit of getting discounts on whatever the business produces such as retail company directors getting free merchandise or discounts, General Motors used to give its directors a new car every 90 days and they also get to use company properties for free such as the corporate jets. They also used to get business from the companies for their law, consulting or investment banking firms. These payments and benefits used not to be dependent on the performance of the company or the performance of the director. And whenever they are paid in stocks, they were paid in such a way that does not align their interest with those of shareholders.
Another guiding principle for executive compensation in Cadbury report is about remuneration committees. Report recommended that there should be a committee consisting wholly or mainly of non-executive directors and chaired by a non-executive director, to recommend to the board the remuneration of the executive directors in all its forms, drawing on outside advice as necessary. Executive directors should play no part in decisions on their own remuneration.

But after the many corporate scandals, the remuneration of directors and executives became a very vexed issue. After shareholder’s activism, more directors are now paid in stock or stock options that more closely align their interests with the interests of the shareholders. And also most companies have stopped offering directors retirement plans. Directors are now paid solely in stock or stock options and cash and other kinds of benefits are being eliminated including side payments through consulting or legal fees. Companies are now expected to make comprehensive disclosure of the process and content of director compensations. This is mostly done by reporting the director’s pay as part of the notes to the annual financial statements.

Directors and executives’ pay is now to be based strictly on performance of the company and their performance. That is why equity-based remuneration (EBR) including stock options is now considered the most effective way to match remuneration with performance. This is based on the belief that a well thought out EBR would more effectively deal with the “agency cost” of the interests of directors and executives not working in the best interest of shareholders. This is because when the directors and executives own shares they have no choice other than working in the interest of the shareholders since they would now have the same financial interest and risk as the shareholders. So they would be encouraged to make decisions that maximize shareholder wealth. The EBR also deals with the problem of directors being too risk-averse. This is because directors, who do not receive benefits for the good performance of the firm, get blamed for their poor performance. This makes directors risks averse which affect the performance of the company. So when company’s performance is linked to directors remuneration this would be eliminated.

3.7 Shareholders’ Elections

Normally in corporate sector directors are elected by the shareholders. In corporations, directors are also selected or appointed by the board of directors, among senior employees, because of their relative competence, importance and for their retention. If the organization do not appoint very senior employees in board of directors, there are chances of their switching to other organization. Even if they not switch to other organization they might feel internally demotivated. As we know that de-motivation of seniors level management directly impact on the profitability and growth of the organization. According to these situations organization must have to sometime select or appoint board of directors from senior’s level management. Simply, institutional shareholders nominate their representative in the board of directors as well. Also, as per corporate governance mechanism, there need to be independent directors on the board as well.

Theoretically, directors are elected through election process. However, in large companies’ especially, the process of election becomes time consuming and expensive process due to scatteredness of shareholders. That’s why, the process of selecting and appointing directors generally happen through constituted committees and later on, in annual general meeting some formalities are met. Shareholders generally just ratify the directors who are nominated by board and rarely happens otherwise. This issue of election and automatic re-appointment after expiry of term is one the critical area where corporate governance discipline is focusing now days.

3.8 Financial Disclosure and Audit

“Disclosure is the act of releasing all relevant information pertaining to a company that may influence an investment decision.” All listed companies, in Pakistan, are required to follow International Financial Reporting Standards (IFRS) which demand thorough financial disclosures in annual reports. Same is the case with almost all emerging and developed economies. In Europe, all listed companies are also required to prepare their financial statements according to IFRS.
The world economy is going to be stable, investment in capital markets also becoming strong. This uplifting aspect of the markets lying confidence of the investors in the business and this can only be possible through clear and fair presentation of the financial statements. External audit of the companies is an important contributor to this confidence although this external audit not provides the guarantee of investing in the business. The key goal of this external audit is to provide the fair not the absolute presentation of the financial statement.

It is very important to explain the process of audit along with its various types. Listed companies are normally subject to two types of audits i.e. External versus Internal audit. External audit is also known as statutory audit as it is one of the legal and mandatory requirement. This audit is conducted through an independent body external to the organisation that is why it is also called external audit. This audit focuses on the financial accounts or risks associated with finance and auditors are appointed by the company shareholders. The main responsibility of external audit is to perform the annual statutory audit of the financial accounts, providing an opinion on whether financial statements represents true and fair view of the company's financial position and free from ant material misstatements. As part of this, external auditors often examine and evaluate internal controls put in place to manage the risks which could affect the financial accounts, to determine if they are working as intended.

Internal audit is a function that, although operating independently from other departments and reports directly to the audit committee, resides within an organization (i.e. they are company employees). It is responsible for performing audits (both financial and non-financial) within a wide range of areas within a business, as directed by the annual audit plan. Internal audit look at key risks facing the business and what is being done to manage those risks effectively, to help the organization achieve its objectives. For example, they may look at risks to the company's reputation such as the use of cheap labor in foreign countries, or strategic risks such as producing too many products in comparison to resources available etc.

There are number of reasons for the disclosure and explanation of the “key elements” of the business entity to its owners (shareholders). According to the Cadbury Report, annual audit is the backbone of the corporate governance. Audit is the source of providing authenticity to every collaborator of the company. Governance literature and corporate laws across the globe consider board of Directors liable to explain the true and fair value judgment of financial statement. Corporate laws and governance stress that management is responsible for preparation of financial statements where auditor role is to draw an opinion on financial statements based on audit evidence through audit procedures.

The role of audit committee is to observing the tasks of the internal and external auditors. It also keeps an eye on the execution of the management policies. There are so many queries and questions in accordance to audit having effect on corporate governance. Some of them are here as a sample,

1. Either the Board has enacted an audit committee?
2. If the answer is yes then how the board has formed this committee?
3. How can the Board maintain the assurance of independent audit?
4. What are the measures have been taken or what are the situations related to the non-audited services by the auditors?
5. Should Board have established performance standards?

Code of Corporate Governance 2012 place some additional restriction on auditing, auditors and disclosure requirements to ensure governance. For example, external auditors will only be selected having a satisfactory rating under the Quality Control Review program of the Institute of Chartered Accountants of Pakistan.
Disclosure and audit are the key terms used in corporate business. Research suggest that complete disclosure and audit by reputable auditors tend to increase the market value of the firm as well. It also ensure that proper governance mechanisms are in place in organization which in turn signals the prospective investors that their funds are safe here.

3.9 Corporate Social Responsibility

Corporate social responsibility (CSR) is the idea that companies should look beyond the basics of profit making and integrate social and environmental concerns in their integral business operations and interaction with stakeholders on a voluntary basis. The stakeholders are generally the diverse groups of organizations and individuals who have interest in the company's existence. This includes customers, suppliers, communities where the business operate, non-governmental organizations, social and environmental pressure groups and different levels of government officials etc. Alternative contradicting idea is that companies should work towards maximization of shareholders wealth and don’t waste shareholders’ funds in CSR.

There are several models of CSR which includes the American philanthropic model where companies make unhindered profits and are expected to donate a portion of their profits to charitable goals. This is based on the classical economic model of Adam Smith who believed that the invisible hand promoted the public welfare and that the public interest was best served through the pursuit of self-interests. This was why Milton Friedman said “there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it engages in open and free competition without deception or fraud.”

The European model or the socioeconomic model is about businesses operating their core business in a socially responsible way complemented by investing in communities for concrete business motivated reasons. So the business recognizes that it has stakeholders other than just shareholders and responds to the demands of all its stakeholders while pursuing its profit.

It is in the implementation of CSR that brings about conflict. There is the school of thought that CSR activities increases the cost of doing business and reduces profit and hence potential dividends of shareholders. This view is no doubt based upon the classical economic model which prioritizes the views of shareholders/investors on CSR. If they want it then the management must carry it out otherwise they must avoid such activities that reduce shareholder’s value.

But there is the school of thought based on the socioeconomic model that counters that CSR activities do not necessarily reduce profit. And there are lots of research to back it up such as a Harvard University study that concluded that "stakeholder balanced" companies exhibited four times the growth rate and eight times the employment generation compared to companies only focused on shareholders and profit maximization. It is also posited that CSR can in fact reduce operating cost such as companies that recycle their waste and sell it at a profit as compared to just paying for the waste disposal and the reduction is regulatory cost of compliance with environment regulations due to reduced oversight etc. It has also been argued that CSR facilitates easier access to capital with some estimates that there are more than US$ 2 trillion worth of assets to be invested in socially conscious firms.

Irrespective of the school of thought on this issue of who has the final say in CSR, it is usually decided by the court whenever conflicts arise between management and shareholders. There have been times when the court ruled in favor of the shareholders such as the 1919 case between Dodge brothers and Ford Motor Co. The case arose when Ford Motor Co ceased paying out a special annual dividend due to it arguing that it wanted to help the people through the Depression by lowering the price of cars and also expanding by building a second plant to be able to employ people. Both arguments can be considered to be forms of CSR but the court ruled in favor of the shareholders saying "there should be no confusion…of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to protesting minority stockholders. A business corporation is organized and carried
on primarily for the profit of the stockholders”. There also have been cases when the court ruled against the shareholders such as the 1968 case between the Wrigley Corporation (WC) and some of its shareholders. The WC management refused to install lights on Chicago’s Wrigley baseball field arguing that baseball is a daytime sport and that night games would lead to a deterioration of the neighborhood. But some shareholders claimed that the WC’s operating losses for four years were the result of not having lights for night games whose attendance would have increased revenues. The court ruled against the shareholders saying that as long as the decision was made “without an element of fraud, illegality, or conflict of interest and if there is no showing of damage to the corporation, then such questions of policy and management are within the limits of director discretion as a matter of business judgment”.

3.10 Shareholders Rights
A shareholder is a person who put his investment to buy the shares of a particular company for the sake of profit or some financial benefit and the company collect a huge amount through this process to run the company’s financial operations. When the company performs well then pays the dividend to its shareholders according to their number of share they have and in case of loss shareholders also bear it. So there is a financial risk is involved in buying the shares of a company. Being owner of the certain part of the company, the shareholders also have the voting power to elect directors who work in the best interest of the shareholders; the directors also oversee the company’s big matters and decision makings. If the directors performs their responsibilities well then definitely the company will perform well and when the company performs well then the shareholders will enjoy dividend on their shares investment.

Protection of shareholders rights and expectations is also an important governance issue. It is discussed that the shareholders having voting right to select the directors of the company. But there are evidences that once elected directors even take very strategic decision by themselves behaving as monopoly. It is believed that for good governance shareholder needs to be taken into confidence regarding significant strategic decision like acquisitions, mergers or liquidations of the assets. One share one vote has been one important issue in the past where some type of shares were allotted more than one vote and thus creating disharmony among shareholders. Shareholder can vote on these matters only in annual meetings and shareholders have right to attend the annual general meeting and they can also vote from email, telephone if the company have these measures. It was all about the voting right of the shareholder that how can he utilize his/her voting right.

Currently shareholders are only entitled to receive annual report of the company authorized by BoD. Should the shareholders have free access to inspect the company’s financial information? Through the financial information the shareholders can easily check and understand that how the company is performing. If the company distributing profits as dividend among shareholders and every shareholder has equal right to receive its dividend equally.

The shareholders who have been wronged by their company then they have right to sue on the company. For example if the shareholders denied from the access of financial information or not received the entitled dividend they have right to sue on the company.

One of the main objectives of the corporate governance is to be fair with all the shareholders, but some corporations are issuing some dual stocks that challenging the fairness and equality of all the shareholders and the corporate governance is trying to protect. This kind of stock (Dual Stock) is no available for all shareholders and there are different level of rights are associated with this kind of stocks. For Example one type of class issued to common investors and the while the other class is available only for the executives and family members. It's is not possible that the investors who have common stocks and have less voting powers than special stock.

3.11 Institutional Shareholders
Institutional shareholders are the organizations who acquire interest in companies. The existence of institutional shareholders are very common in today’s business world. It is expected that
managers/directors might not perform their fiduciary responsibility in some cases. Individual shareholders have no specific rights and without special knowledge as well. In such case, recommendation of Cadbury committee encourages institutional shareholder to perform their role positively in a company. Institutional shareholder has experience of business so they can watch the organization in a better way. That institutional investor must watch the organization as owners of the company. If they feel something wrong in a company that institution investor can provide solution of that problem. They can also suggest the possible change in the relevant policy of the organization, which is the cause of that problem. In this way not only problem will reduce but also the performance of the organization will improved because of the experience and expertise sharing between investor and company.

Corporate mechanism encourages the institutional investment. It is a just like internal check for other individual shareholder. It can be used as tool to improve and check the performance of the management of the company. Corporate governance mechanism encourages the institutional shareholder and management of the company to be in constant dialogue for organizational performance.

3.12 Long term Fiduciary Focus

It has been generally believed that maximization of shareholder’s wealth is the ultimate responsibility of boards and managers. Governance mechanism has taken another view in recent past by identifying an error at the heart of corporate leadership. This recent alternative concept believe that board of directors should be more concerned about company’s health and not about its shareholders’ wealth. This concept may feel like insignificant change, however, it help managers to realize that focus on long term goals are more important and it could make companies less vulnerable to damaging forms of activist investing.

The idea that corporate managers should make maximizing shareholder value is rooted in agency theory. Agency theory states that shareholders own the corporation and have ultimate authority over its business. Thus the wish to conduct business as per their requirement is very legitimate. The idea of attaching ownership to shareholders is very natural and logical. However, closer look reveals that it is legally confused and, perhaps more important, involves a challenging problem of accountability. Keep in mind that shareholders have no legal duty to protect or serve the companies whose shares they own and are shielded by the doctrine of limited liability from legal responsibility for those companies’ debts and misdeeds. Moreover, they may generally buy and sell shares without restriction and are required to disclose their identities only in certain circumstances. In addition, they tend to be physically and psychologically distant from the activities of the companies they invest in. That is to say, public company shareholders have few incentives to consider, and are not generally viewed as responsible for, the effects of the actions they favor on the corporation, other parties, or society more broadly.

The effects of this omission are troubling. We are concerned that the agency-based model of governance and management is being practiced in ways that are weakening companies and—if applied even more widely, as experts predict—could be damaging to the broader economy. In particular we are concerned about the effects on corporate strategy and resource allocation. Over the past few decades the agency model has provided the rationale for a variety of changes in governance and management practices that, taken together, have increased the power and influence of certain types of shareholders over other types and further elevated the claims of shareholders over those of other important constituencies—without establishing any corresponding responsibility or accountability on the part of shareholders who exercise that power. As a result, managers are under increasing pressure to deliver ever faster and more predictable returns and to curtail riskier investments aimed at meeting future needs and finding creative solutions to the problems facing people around the world.

The agency model’s extreme version of shareholder centricity is flawed in its assumptions, confused as a matter of law, and damaging in practice. A better model would recognize the critical
role of shareholders but also take seriously the idea that corporations are independent entities serving multiple purposes and endowed by law with the potential to endure over time. And it would acknowledge accepted legal principles holding that directors and managers have duties to the corporation as well as to shareholders. In other words, a better model would be more company centered.
Evolution of Corporate Governance

4.1 Introduction
Corporate Governance is fairly a recent phenomenon which can be traced back in last two decades. Although, it can be reasonably traced from Watergate scandal, however, the Cadbury Committee recommendation can be regarded as seminal contribution towards corporate governance. Herrigel (2006) argues in similar lines and considers corporate governance arrangements as a relatively new field of inquiry for business historians. He further extends his claim by considering corporate governance evolution as the constitutive processes shaping the relationship between ownership and management of enterprises. He considers that corporate governance literature primarily focuses on the origins of dispersed (mainly Anglo-American) and concentrated ownership systems, together with the financial and political factors that shaped different development paths. It is seen in the literature that the debates about governance are although highly stimulating but have been largely unresolved. It is also noticeable that corporate governance literature and its historical evolution is not only central for understanding the historical dynamics of firm performance and economic development, but also for understanding the co-evolution of the corporation with modern ideas of political and legal order. This chapter is devoted towards explaining the historical evolution of corporate governance.

4.2 Genesis of Corporate Governance in US
The first trace of corporate governance in history can be made in 1972 when Foreign and Corrupt Practices Act of 1977 (FCPA) was promulgated in United States subsequent to Watergate Scandal. This act made it difficult to major corporations to make illegal political contributions to bribe government officials. This act led to development of establishment, maintenance and review of internal control systems in United States’ corporations.

The Watergate scandal began early in the morning of June 17, 1972, when a security guard of Watergate Hotel reported about some robbers with wiretapping phones. Evidences suggested later on that, in May 1972, members of Nixon’s Committee to Re-Elect the President (known derisively as CREEP) broke into the Democratic National Committee’s Watergate headquarters, stole copies of top-secret documents and bugged the office’s phones. However, the wiretaps failed to work properly, therefore, on June 17, a group of five men returned to the Watergate building. These men were spotted and the police arrived, just in time, to catch the spies red-handed.

In August, Nixon gave a speech in which he swore that his White House staff was not involved in the break-in. Most voters believed him, and in November 1972 the president was reelected in a landslide victory. It later came to light that Nixon was not being truthful. Nixon and his aides also hatched a plan to instruct the Central Intelligence Agency (CIA) to impede the FBI’s investigation of the crime. This was a more serious crime than the break-in: It was an abuse of presidential power and a deliberate obstruction of justice.

In the face of almost certain impeachment by Congress, Nixon resigned in disgrace on August 8, and left office the following day. His abuse of presidential power had a long-lasting effect on American political life, creating an atmosphere of cynicism and distrust. The Watergate scandal heightened the public’s sense of political morality and raised concerns about high level corruption in both the public and private sectors. The FCPA was born in this morality oriented post-Watergate atmosphere.

The FCPA contains two major provisions: an internal accounting requirement and antibribery provisions. The former provision requires every issuer of securities to keep accurate records which
fairly reflect disposition of assets and to devise a system of internal accounting control to regulate the disposition and recording of assets. The latter provisions prohibit issuers from offering or paying anything of value to a foreign official to influence him to make any act or to use his influence to affect any government act in order to obtain or retain business. The antibribery provisions received widespread publicity. Under the FCPA antibribery provisions, payments are not illegal unless the corporation makes them "corruptly" and "to assist the issuer or domestic concern in obtaining or retaining business." The term "corruptly" means, according to the legislative history of the FCPA, "an evil motive or purpose, an intent to wrongfully influence the recipient.

4.3 Genesis of Corporate Governance in UK

The genesis of corporate governance in UK can be attributed to two major corporate failures i.e. BCCI and Barings Bank failure.

Bank of Credit and Commerce International (BCCI) was indeed an international bank. The Governor of the Bank of England, Robin Leigh-Pemberton, was quoted as saying that fraud had been perpetrated at the highest levels within BCCI. It was a large international bank, with branches in over 70 countries around the world. Planning the closure was a complex task and necessitated close co-operation by banking authorities in different countries. Shortly after BCCI was closed down, the UK Prime Minister, John Major, commissioned Lord Justice Bingham to report on events at BCCI. When the report was published in 1992, Bingham did not recommend a radical shake-up of banking supervision in the UK. Instead, some suggestions were made to improve the existing system of banking supervision. Bingham noted that the most important single lesson was that banking group structures that were deliberately made complex in order to deny supervisors a clear view of a bank's operations should be outlawed. In addition, Bingham suggested there should be improved exchange of information between international supervisors and a tougher line should be taken against financial centers that offered impenetrable secrecy.

Barings Bank was one of the oldest banks in United Kingdom. The bank had been in business for over 200 years and had been founded in the eighteenth century by Francis Baring, son of a German immigrant. Before long, Barings was highly thought of in financial circles, as shown by the fact that in 1803 Barings were involved in negotiations on behalf of the USA to purchase Louisiana from France. As the capital markets became bigger and more complex during the 1970s and 1980s, Barings responded by setting up Baring Securities to take advantage of new and profitable opportunities in the increasingly sophisticated financial markets. Later on, in 1995, Barings Bank failure became evident and its total losses eventually amounted to £830m. Barings was taken over by ING and restructured. On 19 July 1995 in London, the Board of Banking Supervision issued a report referring to 'a failure of controls of management and other internal controls of the most basic kind'. Much of the blame was attributed to Norris and Baker, and Baker told investigators 'There is no doubt in my mind that my lack of experience in the area was a contributing factor to what happened'.3 In addition Coopers and Lybrand were criticized for failing to detect Leeson’s fraud. The Bank of England report concluded that Barings’ collapse was due to the unauthorized activities of one individual, Nick Leeson, but these activities had not been detected by management due to internal control failures of a most basic kind.

4.4 Cadbury Committee in 1992

The mega corporate failures in UK convinced policy makers about serious flaws in regulatory mechanism. Therefore, the Corporate Governance Committee was set up in May 1991 by the Financial Reporting Council, the Stock Exchange and the accountancy profession to suggest mechanism for accounting disclosures, financial reporting and accountability. Basic concerns of stakeholders included lack of confidence both in financial reporting and in the auditors’ report. Cadbury Report mentioned that “the underlying factors were due to the slackness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business, and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards.”
The explicitly stated objective of the Committee was to suggest mechanism “to raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them.”

Cadbury report states the basis of code of corporate governance rests on openness, integrity and accountability and these three principles should go together. Openness refers to disclosure of material information for all stakeholders. It will be the basis of confidence between business and stakeholders, within the limits set by their competitive position. An open approach to the disclosure of information contributes to the efficient working of the market economy, prompts boards to take effective action and allows shareholders and others to scrutinize companies more thoroughly.

Integrity, as explained by Cadbury report, relates to straightforwardness and completeness. It is about presenting a balanced and honest picture of the company’s affairs. This integrity of financial reports largely depends on management of the company. And the third aspect of accountability relates to boards of directors who are accountable to their shareholders about their fiduciary responsibilities.

The Cadbury report is still regarded as seminal contribution in the discipline of corporate governance. It has nineteen recommendations relating to boards of directors, directors and Reporting and auditing.

The recommendations about boards of directors, in the exact words of Cadbury Report, are as follows:

1. The board should meet regularly, retain full and effective control over the company and monitor the executive management.
2. There should be a clearly accepted division of responsibilities at the head of a company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. Where the chairman is also the chief executive, it is essential that there should be a strong and independent element on the board, with a recognized senior member.
3. The board should include non-executive directors of sufficient caliber and number for their views to carry significant weight in the board’s decisions.
4. The board should have a formal schedule of matters specifically reserved to it for decision to ensure that the direction and control of the company is firmly in its hands.
5. There should be an agreed procedure for directors in the furtherance of their duties to take independent professional advice if necessary, at the company's expense.
6. All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring that board procedures are followed and that applicable rules and regulations are complied with. Any question of the removal of the company secretary should be a matter for the board as a whole.

The recommendations about directors, in the exact words of Cadbury Report, are as follows:

7. Non-executive directors should bring an independent judgment to bear on issues of strategy, performance, resources, including key appointments, and standards of conduct.
8. The majority should be independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding. Their fees should reflect the time which they commit to the company.
9. Non-executive directors should be appointed for specified terms and reappointment should not be automatic.
10. Non-executive directors should be selected through a formal process and both this process and their appointment should be a matter for the board as a whole.
11. Directors’ service contracts should not exceed three years without shareholders’ approval.
12. There should be full and clear disclosure of directors’ total emoluments and those of the chairman and highest-paid UK director, including pension contributions and stock options. Separate figures should be given for salary and performance-related elements and the basis on which performance is measured should be explained.

13. Executive directors’ pay should be subject to the recommendations of a remuneration committee made up wholly or mainly of non-executive directors.

The recommendations about reporting and auditing are as follows:

14. It is the board’s duty to present a balanced and understandable assessment of the company’s position.

15. The board should ensure that an objective and professional relationship is maintained with the auditors.

16. The board should establish an audit committee of at least three non-executive directors with written terms of reference which deal clearly with its authority and duties.

17. The directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities.

18. The directors should report on the effectiveness of the company’s system of internal control.

19. The directors should report that the business is a going concern, with supporting assumptions or qualifications as necessary.

Other miscellaneous recommendations in Cadbury Report are as follows:

20. Companies should expand their interim reports to include balance sheet information. If full audit is not feasible for interim reports, but these must be reviewed by the auditors and the Auditing Practices Board should develop appropriate guidance.

21. Fees paid to audit firms for non-audit work should be fully disclosed. The essential principle is that disclosure should enable the relative significance of the company’s audit and non-audit fees to the audit firm to be assessed.

22. The accountancy profession should draw up guidelines on the rotation of audit partners to ensure reasonable independence.

4.5 Other committees

One of the very important recommendation of Cadbury report was to appoint a new Committee by the end of June 1995 to examine how far compliance with the Code has progressed, how far recommendations have been implemented, and whether the Code needs updating in line with emerging issues. Such step ensured establishing a continuing process of governance. Cadbury in its report also denied the idea of “one size fits all” for corporate governance. Keeping in view this concept, the Listing Rules of the London Stock Exchange, stipulated, in the start, that if companies do not comply with these governance principles, they had to mention the reason for not doing so.

Later on, to examine the issue of executive compensations, another committee was established headed by Sir Greenbury. The recommendations of Greenbury committee included the mandatory implementation of corporate governance principles along with annual compliance statement, to the full extent in United Kingdom. The formation of remuneration committee comprising of non-executive directors and long term performance related compensation of directors along with full disclosure in financial statements are the most important recommendations of the Greenbury Report.

Another committee chaired by Sir Ronald Hampel presented its report in January 1998. The summary presented in this report consisted of 56 recommendations. Some important are the following:
1) Hampel committee rejected the idea of two-tier board by arguing that they have found overwhelming support for the unitary board of the type common in the UK and it offers considerable flexibility. There was little enthusiasm for a two tier framework.

2) Boards should establish a remuneration committee, made up of independent non-executive directors, to develop policy on remuneration and devise remuneration packages. All types of remuneration including facilities and pensions should be properly disclosed in annual financial statements.

3) We see no objection to paying a non-executive director's remuneration in the company's shares, but do not recommend this as universal practice. The board should itself devise remuneration packages for non-executive directors.

4) The Chairman of the board should be seen as the "leader" of the non-executive directors.

5) Separation of the roles of chairman and chief executive officer is to be preferred, other things being equal, and companies should justify a decision to combine their roles.

6) The majority of non-executive directors should be independent, and boards should disclose in the annual report which of the non-executive director-s are considered to be independent.

4.6 Combined Code of Corporate Governance in UK

Later on, on the recommendations of Hampel report, Combined Code of Corporate Governance has been introduced by combining various recommendations of Cadbury Committee, Greenbury committee and Hampel committee in 1998. This combined code is appended in listing rules of London Stock Exchange and combined Code is mandatory for all listed companies.

The journey towards governance is not static rather than dynamic. The Turnbull Committee, in 1999, was another step towards better governance in corporate sector. It further recommended that directors should be held accountable and responsible for effective internal controls mechanism in the companies.

Combined Code of Corporate Governance was later revised in 2003. This revision was based on three important reports, i.e. Higgs Report, Smith Report and Turnbull Review report. Higgs report was focused on non-executive directors and their possible role in governance mechanism. One important report about institutional investors, in 2000, were prepared by Paul Myners for UK treasury. This Report looked at institutional investment with a view to provide a best practice approach to investment decision making for pension funds.

David Walker presented his report in 2009 which was focused to examine corporate governance in the UK banking industry. Terms of reference included to examine the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively; the balance of skills, experience and independence required on the boards of UK banking institutions; the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees; the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and whether the UK approach is consistent with international practice and how national and international best practice can be promulgated.

In 2010, a new Stewardship Code was issued by the Financial Reporting Council, along with a new version of the UK Corporate Governance Code, hence separating the issues from one another. Combined Code of Corporate Governance 2016

Economy is in evolution so corporate sector is. Similarly, the governance mechanism also needs to be revisited. The fitness of governance paradigm, in a permanently changing environment, requires its evaluation at appropriate intervals. Recently, another version of code of corporate governance 2016 has been issue. The new Code applies to accounting periods beginning on or after 17 June 2016 and applies to all companies with a Premium listing of equity shares regardless of whether they are incorporated in the UK or elsewhere.
The “comply or explain” approach is the trademark of corporate governance in the UK. The Code is not a rigid set of rules. It consists of principles (main and supporting) and provisions. The Listing Rules require companies to apply the Main Principles and report to shareholders on how they have done so. If companies believe that governance can be achieved by not applying provision or by amending it, an alternative to following a provision may be justified in particular circumstances. However, proper and detailed justification need to be conveyed to shareholders.

Combined Code 2016 revolves around five pillars of governance. These pillars are leadership, effectiveness, Accountability, Remuneration and Relations with Shareholders.

**Leadership:** Every company should be headed by an effective board which is collectively responsible for the long-term success of the company. There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company’s business. No one individual should have unfettered powers of decision. The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role. As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy.

**Effectiveness:** The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. There should be a formal, rigorous and transparent procedure for the appointment of new directors to the board. All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. All directors should be submitted for re-election at regular intervals, subject to continued satisfactory performance.

**Accountability:** The board should present a balanced and understandable assessment of the company’s position and prospects. The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems. The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company’s auditor.

**Remuneration:** Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance. There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

**Relations with Shareholders:** There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should use the AGM to communicate with investors and to encourage their participation.

Corporate sector is still evolving therefore its governance mechanism need to evolve. New challenges in economic environment always keep on pushing policy maker and regulator to work towards better regulation.
4.7 OECD principles for Corporate Governance

The Organization for Economic Cooperation and Development (OECD) is one of the earliest organization to work on governance principle in corporate sector. OECD in its report recognizes that good corporate governance is not an end in itself, rather, It is a means to create integration in businesses across markets and thus confidence. This market trust is essential for companies that need access to equity capital for long term investment.

OECD presented the first version of governance principles in 1999 and later on it was updated in 2004. The current review has been carried out under the auspices of the OECD Corporate Governance Committee in 2016. This review was benefited from experts from key international institutions, notably the Basel Committee, the FSB, and the World Bank Group have also participated actively in the review.

Although the recent version maintain many of the governance recommendations from earlier versions, however they also introduce some new issues and bring greater emphasis or additional clarity. One size does not fit to all therefore some of the recommendations may not be more appropriate for all size of organizations. OECD Principles provide guidance about following six elements:

Ensuring the basis for an effective corporate governance framework: OECD principles considers the role of corporate governance framework very critical factor in promoting transparent and fair markets, and the efficient allocation of resources. These focus on the quality and consistency the different elements of regulations that influence corporate governance practices and the division of responsibilities between authorities, along with the quality of supervision and enforcement.

The rights and equitable treatment of shareholders and key ownership functions: OECD principles gives prime importance to the rights of shareholder, their right to have information and active participation in strategi decisions. OECD also gives critical consideration to disclosure of control structures through different voting rights, participation of shareholders in various meeting using information technology, the procedures for approval of related party transactions and shareholder participation in decisions on executive remuneration.

Institutional investors, stock markets and other intermediaries: This element addresses the need for sound economic incentives throughout the investment chain, with a particular focus on institutional investors acting in a fiduciary capacity. The importance to disclose and minimize conflicts of interest that may compromise the integrity of proxy advisors, analysts, brokers, rating agencies and others that provide analysis and advice that is relevant to investors is also emphasized in these principles. OECD provides new principles with respect to cross border listings and the importance of fair and effective price discovery in stock markets.

The role of stakeholders in corporate governance: The OECD Principles encourage active co-operation between corporations and stakeholders and underline the importance of recognizing the rights of stakeholders established by law or through mutual agreements. Timely access to information on regular basis and shareholders right to obtain redress for violations of their rights are also emphasized.

Disclosure and transparency: Key areas to ensure transparency and accountability such as disclosure of financial and operating results, company objectives, major share ownership, remuneration, related party transactions, risk factors, board members have critical importance in these principles.

The responsibilities of the board: the performance of board largely depends upon the collective understanding of board regarding their responsibilities. These principles provide guidance with respect to key functions of the board of directors, including the review of corporate strategy,
selecting and compensating management, overseeing major corporate acquisitions and
divestitures, and ensuring the integrity of the corporation’s accounting and financial reporting
systems. The emerging issues such as the role of the board of directors in risk management, board
training, and evaluation of the board, tax planning and internal audit have also been introduced.

OECD principles talk about inclusiveness. Because millions of households around the world have
their savings in the stock market, directly or indirectly. And publicly listed companies provide for
more than 200 million jobs. In this scenario, the Principles rightly address the rights of various
stakeholders and their ability to participate in corporate wealth creation.

4.8 ENRON and Corporate Governance in USA

In the start of 2001, the front-page of newspapers were filled with corporate scandals that erupted
in the U.S. economy, the corporations like Enron, HealthSouth, WorldCom, Tyco, Adelphia, and
others – have totally shattered the confidence of providers of funds in the financial system of United
States. These scandals put big questions question marks on the effectiveness of corporate
governance in the United States.

In this critical time, Sarbanes-Oxley Act 2002 (i.e. SoX Act 2002) was enacted as a reaction to
mega financial scandals like Enron and WorldCom. SoX Act 2002 consist of eleven elements,
covering responsibilities of board of directors, auditors responsibilities, establishing mechanism to
check public accounting firms, adding criminal penalties for directors misconduct, and required the
SECP to create further regulations to define how public corporations are to comply with the law.
SoX Act 2002 is one of the toughest law in governance history. The words of US President George
W. Bush while signing it are very interesting. He stated SoX as “the most far-reaching reforms of
American business practices since the time of Franklin D. Roosevelt. The era of low standards and
false profit is over; no boardroom in America is above or beyond the law."

4.9 Sarbanes-Oxley Act 2002

The Sarbanes–Oxley Act of 2002 is also known as the ‘Public Company Accounting Reform and
Investor Protection Act’. It is named after two U.S. lawmakers Senator Paul Sarbanes and Michael
Oxley. This law was law makers’ reaction to a number of mega financial scandals which shattered
the confidence of almost everyone in US governance mechanism.

SOX Act 2002 only applies to publically held companies. The act consists of eleven elements
covering all important area of corporate governance. Main points in every section has been
summarized below:

Establishing Public Company Accounting Oversight Board (PCAOB):

This element establishes the Public Company Accounting Oversight Board, to oversight the
activities of public accounting firms providing audit services. It also creates a central oversight
board tasked with registering auditors, defining the specific processes and procedures for
compliance audits, inspecting and policing conduct and quality control, and enforcing compliance
with the specific mandates of SOX.

Auditor Independence: The objective of this element is to ensure independence of external auditor
and to minimize conflict of interest. These objectives are achieved through rotation of audit partner,
new auditor approval requirements, and auditor reporting requirements. It also restricts auditing
companies from providing non-audit services (e.g., consulting) for the same clients.

Corporate Responsibility: SOX Act 2002 stresses that senior executives should take individual
responsibility for the accuracy and completeness of corporate financial reports. It defines the
interaction of external auditors and corporate audit committees, and specifies the responsibility of
corporate officers for the accuracy and validity of corporate financial reports. It enumerates specific
limits on the behaviors of corporate officers and describes specific forfeitures of benefits and civil
penalties for non-compliance. It requires that the company's "principal officers" (typically the Chief Executive Officer and Chief Financial Officer) certify and approve the integrity of their company financial reports quarterly.

Enhanced Financial Disclosures: To ensure financial disclosures at appropriate level, this act describes enhanced reporting requirements for financial transactions, including off-balance-sheet transactions, pro-forma figures and stock transactions of corporate officers. It requires internal controls for assuring the accuracy of financial reports and disclosures, and mandates both audits and reports on those controls. It also requires timely reporting of material changes in financial condition and specific enhanced reviews by the SEC or its agents of corporate reports.

Analyst Conflicts of Interest: Some important section have been included in SOX Act regarding security analyst, their independence and to restore investors’ confidence in in securities analysts. It defines the codes of conduct for securities analysts and requires disclosure of knowable conflicts of interest. It also defines the SEC’s authority to censure or bar securities professionals from practice and defines conditions under which a person can be barred from practicing as a broker, advisor, or dealer.

Studies and Reports: SOX Act requires the Security and Exchange Commission and Comptroller General to conduct various studies and report their findings. Studies and reports include the effects of consolidation of public accounting firms, the role of credit rating agencies in the operation of securities markets, securities violations and enforcement actions, and whether investment banks assisted Enron, Global Crossing and others to manipulate earnings and obfuscate true financial conditions.

Corporate and Criminal Fraud Accountability: SOX Act has one special section related to ensure accountability known as the “Corporate and Criminal Fraud Accountability Act of 2002”. It describes specific criminal penalties for manipulation, destruction or alteration of financial records or other interference with investigations, while providing certain protections for whistle-blowers. For example, any CEO or CFO providing any invalid certificate knowingly may be fined up to one million dollar and/or imprisonment up to 10 years. In certain cases, this fines can be up to five million dollars and/or 20 years imprisonment.

White Collar Crime Penalty Enhancement: SOX Act have established penalties for white collar crimes and has special section known as “White Collar Crime Penalty Enhancement Act of 2002.” This section increases the criminal penalties associated with white-collar crimes and conspiracies. It recommends stronger sentencing guidelines and specifically adds failure to certify corporate financial reports as a criminal offense.

Corporate Tax Returns: SOX Act states that Income tax returns of the company should be signed by the Chief Executive Officer.

Corporate Fraud Accountability: Title XI consists of seven sections. Section 1101 recommends a name for this title. SOX Act identifies corporate fraud and records tampering as criminal offenses and joins those offenses to specific penalties. Section dealing with this area is known as “Corporate Fraud Accountability Act of 2002” It also revises sentencing guidelines and strengthens their penalties. This enables the SEC the resort to temporarily freeze transactions or payments that have been deemed "large" or "unusual”.

It is expected that SOX Act will help in strengthening accountability and transparency mechanism in corporations thus restoring the confidence of investor. Although, the compliance cost of SOX has increased many times but policy makers are of the view that such cost in compulsory to ensure any harmful effect to economy as evidenced in the past. The most important aspect of SOX Act is to make directors, auditors and CEO responsible for disclosure, internal control and reporting.
4.10 International Corporate Governance network (ICGN)

The International Corporate Governance Network (ICGN), is a Non-governmental organization founded in 1995. ICGN is the result of concern of major institutional investors, companies, financial intermediaries, academics, and other parties interested in the development of global corporate governance practices. The stated objectives of ICGN include to facilitate international dialogue on how to achieve high standards of corporate governance. The ICGN believes that effective dialogue between companies and their shareholders are a prerequisite for companies to compete effectively and for economies to prosper.

The ICGN has developed Governance Principles earlier as well. ICGN states that the aim of these Principles is to assert standards of corporate governance to which we believe that all companies should aspire. By seeking to live up to high quality corporate governance standards, companies will be better able to take the decisions which will protect and enhance value for their long-term shareholders. Boards with high standards of corporate governance will be better able to make robust strategic decisions, to challenge and promote the effectiveness of management’s operational oversight of the business and to oversee the approach to risk management. The corporate governance principles provided by ICGN includes the following areas:

a) The major objective of corporation should be Sustainable value creation.

b) Corporate boards plays the most important role in governance. ICGN principles discuss almost every aspect of board including composition of board, time commitment, independence, election and appointment of directors. It emphasizes on directors’ conflict of interest and disclosure of related party transactions. Two important principles of ICGN includes the evaluation of board and Lead Independent director. Companies should appoint an independent deputy chair or lead independent director. Where the chair is the CEO or former CEO or is otherwise not independent on appointment, the role of the lead independent director is of particular importance in providing independent leadership of the board. The lead independent director in such a context will have a key role in agreeing the agenda for board meetings and should have powers to call board meetings and otherwise act as a spokesperson for the independent element of the board.

c) Corporate culture of openness and integrity where corruption is discouraged and compliance with laws is encouraged is very important for better governance. ICGN stresses the need to have fair whistle blower policy as well to ensure healthy corporate culture in organizations.

d) To ensure sustainable value creation, risk taking is essential. However, boards need to understand and ensure that proper risk management is put in place for all material and relevant risks that the company faces. ICGN principles focus on board oversight, reasonable disclosure and comprehensive approach towards risk management.

e) Remuneration structures for senior management has been considered as one of the important area of corporate governance. ICGN principle states that remunerations should be appropriately linked with the value-creation over long term horizon.

f) Audit and financial disclosure through financial reporting is an important pillar of transparency and contribute to better governance. These principles stress the need for internal audit along with external audit with the coordination of audit committee comprises of independent directors. Similarly to ensure transparent communication, these principles suggest the need of affirmation of financial statement by the directors and disclosure of ownerships in the annual reports.

g) ICGN is very conscious about shareholders rights and their responsibilities. Boards should treat all the company’s shareholders equitably and should respect and not prejudice the rights of all investors. ICGN suggests that shareholder approval must be there in case of every significant decision is going be made especially if nature of business is expected to be amended. Pre-emptive basis must be used on issuance of new share so that shareholding pattern may not be changed without consent of shareholders. In similar way, governance mechanism expects responsible behavior of shareholders as well. Institutional shareholders must recognize their responsibility to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working.
The ICGN believes that for effective governance dialogue between board members (including executives) and shareholders is a compulsory. The most important pillars of corporate governance includes the accountability of board members to shareholders and alignment between the interests of management and investors. The network believes that change toward better governance can also be fostered with amendment in legislation, regulation or guidance in particular markets and particularly where such change will facilitate dialogue and accountability.

4.11 Code of Corporate Governance in Pakistan

In Pakistan, the idea of code of corporate governance was presented in Fifth All Pakistan Chartered Accountants Conference on December 1998. It was an appropriate move by accounting profession to ensure a vibrant corporate sector. To translate vision into reality, a committee consisting of representative from Institute of Chartered Accountant of Pakistan (ICAP), Institute of Cost and Management Accountants of Pakistan (ICMAP), Securities and Exchange Commission of Pakistan (SECP) and stock exchanges. The Terms of Reference (ToR) of this Committee were determined as follows:-

1. To consider and make recommendations for evolving a Code of best practices on the financial aspects, including financial reporting and accountability, in relation to corporate governance in Pakistan.
2. To identify principal issues, having regard to the economic and corporate environment prevailing in Pakistan, impacting:
   a. Interests of various stakeholders in corporate enterprises in Pakistan.
   b. Development of healthy and ethical corporate governance practices in Pakistan.
3. To consider and recommend, in the light of the issues identified:
   a. Principles for constitution of an effective Board of Directors:
      - To have due representation of non-executive directors.
      - To determine the role and responsibilities of the executive and non-executive directors in relation to financial aspects, reporting and accountability.
   b. Need for Audit Committees of the Board, including their composition and role.
4. To consider the expectation gap regarding the role of external auditors, the manner of their appointment, their powers and duties including determination of scope of statutory audit and reporting convention.
5. To consider and identify and other material issue having a bearing on corporate governance in Pakistan.

It was also agreed that one important task of the committee will be to identify the various types of corporate entities in Pakistan to whom the good practices of corporate governance shall apply.

The committee, in its first few meetings, discussed a few fundamental matters and finally decided that for a more focused attention, a smaller group could best serve the purpose. Hence a sub-committee of five persons was nominated. After due process of deliberations, the committee decided the following major issues which needed to be discussed in corporate governance in Pakistan:

1) The composition of board of directors
2) Roles, Duties and obligations of directors
3) Director’s remuneration
4) Corporate ownership structure
5) Auditors
6) Other issues including role of regulator, government policies etc.

4.12 Code of Corporate Governance 2002

After thorough deliberation within the committee, the first draft of the CCG surfaced in March 2000. It is always important to have the necessary input from the stakeholders. Therefore, the first draft
was very widely circulated to over sixty trade bodies, association and institutions, besides many individuals who were in their own right considered to be knowledgeable on the subject. The list included all the three stock exchanges in the country, Overseas Investors Chambers of Commerce and Industry, Management Association of Pakistan, State Bank of Pakistan, Pakistan Bankers Association, Insurance Association of Pakistan, Leasing Association of Pakistan, Modaraba Association of Pakistan, Mutual Fund Association of Pakistan, National Investment (Unit) Trust, various Chamber of Commerce, certain academics and leading professional firms.

After incorporating important feedback into code, the draft was presented as the Revised Draft of the CCG in May 2000 to the committee. A presentation was given in August 2000 to the SECP on the Second Revised Draft after incorporating changes deemed necessary in the light of the committee's deliberation. Our discussions with the SECP provided thoughtful insight to enable us to further modify the draft and fine-tune the same which was later circulated to the members of ICAP for their comments and observations. This process of discussion, seminars and workshops continued for next six months. During this entire process, a vigorous discussion ensued and the final draft of the CCG 2002 was submitted by us to the SECP in January 2002. After final vetting and publication of the draft, the SECP notified the final version of the CCG 2002 in March 2002. Accordingly, a direction was issued to all the three stock exchange of the country to enforce the same by incorporating the Code in their respective Listing Regulations. Pakistan got its first version of the Code of Corporate Governance in 2002.

4.13 Code of Corporate Governance 2012

Code of corporate governance was new experience for family based corporate sector in Pakistan. This family based corporate sector looked at CCG 2002 as cost based law. Therefore, in the start, there was superficial compliance in several cases but there were also many who complied with the spirit of the code. Another problem was less response from public sector organizations working in corporate sector. In spite of working in corporate sector, these entities used to consider them as government organization and often don’t care about certain regulations. In any case, it was a very good beginning and Pakistan was in the forefront among emerging markets. An important development in Pakistan was the setting up of the Pakistan Institute of Corporate Governance (PICG). Inspired by SECP, this institute since its inception in 2006 has played an important role in the education and promotion of good corporate governance practices.

A decade is a reasonable period of time to review and take stock of the impact of any policy initiative, in this case the introduction of the 2002 Code of Corporate Governance. Whereas many of the beneficial features were becoming apparent, there were areas being talked about that could bring about further improvements. To take the next step in the development of the Code, PICG in consultation with SECP put together a 12-membdr task force in December 2007. The mandate for the task force was to review the existing Code and recommended changes that would further enhance good corporate governance in Pakistan. The team met 22 times and approached the task by reviewing the 2002 Code clause by clause. The task team had a few members who had framed the first Code and so could provide the rationale that prevailed at that time. The team had many more new members who challenged some of the earlier assumptions and provided fresh insights. The debate necessitated review of other global codes as well as identifying best practices that could be applied to our local situation. Through this process the task force evolved its recommendations and then held winder stakeholder consultations in Karachi, Lahore, and Islamabad. The recommendations thus evolved were forwarded to the SECP for adoption. Not all the recommendations were accepted as the SECP decided to undertake another round of consultations under its own supervision where a few of the task force recommendations were modified to accommodate the view point of the participants of these round table consultations. Looking back, the task force found the 2002. Code was well put together and substantially relevant in 2012 as well. However, about a dozen new recommendation were proposed and finally incorporated with some modifications into the new 2012 Code.
4.14 Public Sector Companies (Governance) Rules 2013
The very first draft of Code of Corporate Governance was envisioned to apply to all listed companies, Asset Management Companies, modaraba, Development Financial institution, Non-banking Finance Institutions, banks, insurance companies and undertakings in which federal or provincial governments directly or indirectly own or hold a majority interest. The implicit purpose was to send out a signal to everyone in the economic circle.

There are almost more than 200 Public sector companies (PSC) which are fully or partially owned by state. The governance and performance of these PSC came under serious attack after 2008. These PSCs were called white elephant for Pakistan economy. PSCs like Pakistan Steel, Pakistan International Airlines, and Pakistan Railway are draining almost 200 billion rupees annually. According to estimates, almost 1.5 percent of GDP is lost annually due to inappropriate governance, corruption and inefficiencies of PSCs.

Government of Pakistan does not have any consolidated data bank about public sector companies, therefore comprehensive analysis about operational and financial efficiencies cannot be made. Ministries under which these PSC are operating often lack either understanding of how to run public owned enterprises or lack political will towards effective governance.

After code of corporate governance, the need for a separate code for Public sector companies (PSC) was realized as these PSC were not deemed serious about CCG 2012. Keeping in view these factor, SECP through deliberation and consultation process of stakeholders, presented first set of governance rules, on March 08, 2013, for public sector companies known as Public Sector Companies (Governance) Rules 2013.

4.15 Code of Corporate Governance for Insurers 2016
After CCG 2012 and Public Sector Companies (Governance) Rules 2013, SECP decided to move further and to ensure effective governance in another important financial sector i.e. Insurance Companies. In February 2016, SECP issued governance principle for insurance companies known as Code of Corporate Governance for Insurers 2016. Important provisions of this code include better financial reporting requirement, rules about directors and their meeting and appointment of compliance officer.

Corporate sector is dynamic in its nature. Due to globalization, the regulator is in continuous process of learning new ways to mitigate the effects of internal and external prospective shocks. Due to this never ending circle, the evolution of corporate governance is also non-static.
CHAPTER-5

Corporate Law in Pakistan

5.1 History of Corporate Law
The history of corporate law can be traced back to several centuries in sub-continent. During the era of Queen Elizabeth I, the famous East India Company was incorporated in 16th century. In United Kingdom, Royal Charter or by Special Acts of Parliament were used to incorporate business organizations till 1844. Later on, in 1844, business organizations were allowed to incorporate without a Royal Charter or Special Act of Parliament. The Limited Liability Act 1855 was an Act of the Parliament of the United Kingdom that first allowed limited liability for corporations that could be established by the general public in the UK. Later, this law kept on amended keeping in view the requirements of the economy. However, in 1908, Companies (Consolidation) Act, 1908 was enacted by consolidating all amendments made during the period 1862 to 1908.

Under British rule, English Companies Act, 1844 was used in Sub-continent to run the affairs of the companies. In 1850, this act was further enhanced and said to be the core legislation around which subsequent Companies Acts further developed. In 1857, to incorporate the Joint Stock Companies, with or without limited liability, an act was passed. However, the companies formed for the purpose of banking or insurance were not allowed use limited liability shelter under this act. After various amendments in 1860 and in 1862, a comprehensive Act, in 1866, was enacted for consolidating and amending the laws relating to the incorporation, regulation and winding up of Trading Companies and other Associations.

Following the English Companies (Consolidated) Act, 1908, the Companies Act, 1913 was passed in the sub-continent, which was almost the reproduction of the English Act. However, some amendments were made in this Act in 1914, 1915, 1920, 1926, 1930 and 1932. Companies (Amendment) Act, 1936 came into operation on 15th January 1937.

5.2 Legal Frame for Companies in Pakistan
After gaining independence from British Raj in 1947, Pakistan adopted the Companies Law by an order in 1947, by making amendments in various sections of the Act and finally Ordinance Order, 1949 came into force on 26th March 1949. In January 1972, the President's Order No. 2 of 1972 was issued, which abolished the system of managing agents in company administration and introduced a sort of corporate democracy, directing the election of directors by cumulative system of voting. On 26th September 1973, the Companies (Amendment) Act, 1973 was passed to conform to the new constitutional pattern and also made some amendments in Section 248 and 277. On 1st March 1974, the Companies (Appointment of Legal Advisors) Act, 1974 was passed, which made it compulsory for every company to appoint one legal advisor on retainership basis.

The Companies Act, 1913 was further amended by the Companies (Amendment) Ordinance LXII of 1979.

To have corporate law in order to cater the needs of Pakistan economy, a Company Law Commission was established in 1959. The commission kept on working but no significant result can be seen till 1980. The recommendations of the commission were not implemented and the Companies Act, 1913 continued till the enforcement of Companies Ordinance, 1984. On December 20, 1980, first draft for companies' ordinance was published for eliciting the views of stakeholders. Finally, the Corporate law having nomenclature of “The Companies Ordinance, 1984 (XLVII of 1984)” was issued on 8th October 1984.
Companies Ordinance 1984 was the first corporate law of Pakistan still it has long rooted stems from British law. Although some amendments were made from time to time. The establishment of The Securities and Exchange Commission of Pakistan (SECP), in pursuance of the Securities and Exchange Commission of Pakistan Act, 1997 was an important step in order to strengthen the role of regulator of corporate sector. SECP was an improved and restructured version of earlier Corporate Law Authority. SECP became operational on January 1, 1999, and It has been given large investigative and enforcement powers, including the Supervision and regulation of corporate sector, capital market, regulation of insurance companies, non-banking finance companies and private pensions schemes. Oversight of various external service providers to the corporate and financial sectors, including chartered accountants, credit rating agencies, corporate secretaries, brokers, surveyors etc. also included in the mandate of SECP.

5.3 Companies Act 2017
Due to vibrant nature of economy, the responsibility of regulator is to keep on improvement rules and regulation so that various external and internal shocks can be mitigated in the start. Companies Ordinance 1984 was first corporate law of Pakistan and more than thirty years have passed. This period was enough and economy of Pakistan was significantly changed. This amended dynamics of economy was demanding new and improved version of corporate law. Keeping this in view, the regulator i.e. SECP started working on new companies’ law. At last, Companies Law 2017 was enacted on May 31, 2017.

5.4 Defining a Company
The prosperity and growth of today’s world is contributed to capitalism by many. The most important tool of capitalism is corporation. Corporation, also known as Joint Stock Company or company, is the nucleus of all business activities in modern economies. The list of fortune 100 tell us about first one hundred biggest corporation of the world which are employing more 27 million people and having US $12.5 trillion sales. The net sales of Walmart for the year 478 billion dollars which is almost 12 times bigger than annual budget of Pakistan.

There are various ways to define a corporation. Justice Lindlay defined company as “an association of many persons who contribute money or money’s worth to a common stock and invest it in some trade or business, and who share the profit and loss arising therefrom. The common stock so contributed is denoted in money and is capital of the company. The person who contribute it or to whom it belongs are members. The proportion of capital to which each member is entitled is his share. Shares are always transferable, although the right to transfer them is often more or less restricted.”

According to Chief Justice John Marshall, a corporation is an artificial being, invisible, intangible and existing only in the contemplation of the law. Being the mere creature of law, it possess only those properties which the charter of its creation confers on it, either expressly or as incidental to its very existence. These acts are supposedly best calculated to effect the object for which it was created. Among the most important properties are immortality and if the expression be allowed, individuality; which a perpetual succession of many persons are considered the same, and may act as a single individual.”

Throughout this book the term of corporation, company or body corporate is used interchangeably. The Companies Act 2017 defines corporation as follows:

A body corporate or corporation is an entity incorporated under this Companies Act 2017 or company law; or a statutory body declared as body corporate in the relevant statute, but does not include a co-operative society registered under any law relating to cooperative societies. The definition of company in this Act also include any other entity, not being a company as defined in this Act or any other law for the time being, which the concerned Minister-in-Charge of the Federal Government may, by notification, specify in this behalf. However, the word company has specifically defined in this Act as “company means a company formed and registered under this
Act or the company law”. It is again important to explain the word company law here. Company law means the repealed Companies Act, 1913 (VII of 1913), Companies Ordinance, 1984 (XLVII of 1984), Companies Ordinance, 2016 (VI of 2016) and also includes this Act.

From numerous definitions of company, the following important characteristics of a corporations emerges:

Incorporated Association: A company comes into being only after getting incorporated (registered) under relevant companies’ law, e.g. Companies Act 2017 or Companies Ordinance 1984.

Artificial legal existence: In the eyes of law, a company is an artificial person although not natural one. It can acquire assets, hold liabilities can sue or can be sued like a normal person. It does not have any civil or political rights. It is also important to understand that the liability of members and shareholders is limited to the capital invested by them. On the similar grounds, the creditors of shareholders and members have no right on assets of corporation.

Perpetual existence: Company has unlimited life as it is not dependent on lives of its shareholders. The perpetual existence of corporation is preserved through transferability of shares. Corporation continues to exist until it is not liquidated through a rigorous process under relevant laws.

Common seal: Company being an artificial entity cannot sign the official documents for itself. Directors do it on behalf of the company. To fulfill certain legal requirements about signature of the company, the seal of the company is used. The signature of at least two directors (including CEO) along with seal is binding legally on the company.

Separation of management from ownership: This aspect of separation of management from ownership is unique for corporations. The shareholders have no rights in routine operations of business. Rather, they elect directors for this purpose. Although this separation also results in agency problem and lead to governance problem, still this separation is also important in many aspects.

Limited liability: the idea of limited liability is another most important aspect of corporation. This idea was initiated in 1855 in United Kingdom. Limited liability implies that liability of shareholders is limited to the amount of unpaid on their share irrespective of the obligations of the company. It simply mean that if a corporation suffers heavy losses and its capital fades away, the shareholder’s maximum loss could be the loss of amount they have already invested or to the extent of any unpaid amount on its share. This limited liability minimizes the risk for shareholders but at the same time, in the absence of governance and accountability mechanism, it leads to serious financial crimes as well.

Extensive Membership: Company law does not restrict on the number of shares or shareholders, especially in public limited companies. A company has as many members as possible.

Transferability of share: in corporation, transfer of ownership is very easy through sale and purchase of share from stock exchanges. There is no need for seeking permission from company or other regulator. This freedom leads to liquidity which is considered as one important characteristics of good investment.

### 5.5 Types of Companies

Companies can be classified according to liability and also according to ownership. Companies can be classified into two types as per liability, i.e. company limited by shares and company limited by guarantee. Company limited by shares means a company; having the liability of its members limited by the memorandum to the extent of amount, if any, remaining unpaid on the shares respectively held by them. Whereas company limited by guarantee means a company having the liability of its
members limited by the memorandum to such amount as the members may respectively thereby undertake to contribute to the assets of the company in the event of its being wound up.

Companies can be classified into two types as per ownership, i.e. private limited company and public limited company. Private company means a company which, by its articles, restricts the right to transfer its shares, limits the number of its members to fifty and prohibits any invitation to the public to subscribe for the shares or debentures or redeemable capital of the company. It simply mean that private company cannot offer its shares to general public. The shares are expected to be within friends, family and known circle. Whereas a public company mean 'not a private company’. It simply mean that a company where there is no restriction on transfer its shares, no limitation on the extent of number of its members. A public company can offer its shares, or debentures or redeemable capital of the company to general public. And the same may be sold or purchased through stock exchange.

It is important to differentiate public company with Public Sector Company. According to Companies Act 2017, a public sector company means a company, whether public or private, which is directly or indirectly controlled, beneficially owned or not less than fifty-one percent of the voting securities or voting power of which are held by the Government or any agency of the Government or a statutory body, or in respect of which the Government or any agency of the Government or a statutory body, has otherwise power to elect, nominate or appoint majority of its directors. It also includes a public sector association not for profit, licensed under section 42 of Companies Act 2017.

5.6 Directors, Appointment and Qualifications
The concept of separation between owner and management is of prime importance in corporation. Shareholders cannot interfere in operations of business. They elect directors as their representatives. Director work like agent of the shareholders and the relation of Principal-Agent comes into existence. The combination of all directors is known as Board of Directors. This board of directors assumes the supervisory role in running the operation of the corporation. Some of the directors can also assume the responsibility of running day to day operation in the company as well. Board can also appoint the expert in the field to run the operation of corporations.

Being agent of shareholder, directors have lots of power and responsibility. The board is the nucleus of the organization. Because of such importance, Companies Act 2017, defines the selection and qualification of directors.

"An act or behavior that gravely violates the sentiment or accepted standard of the community".

Section 153 of Companies Act 2017 presents certain qualifications for being ineligible to assume the post of director. According to this section a person shall not be eligible for appointment as a director of a company, if he

a) is a minor;

b) is of unsound mind;

c) has applied to be adjudicated as an insolvent and his application is pending;

d) is an undischarged insolvent;

e) has been convicted by a court of law for an offence involving moral turpitude;

f) has been debarred from holding such office under any provision of this Act;

g) is lacking fiduciary behavior and a declaration to this effect has been made by the Court under section 212 at any time during the preceding five years;

h) does not hold National Tax Number as per the provisions of Income Tax Ordinance, 2001 (XLIX of 2001):

i) is not a member:

The condition of being member shall not apply in following cases:
a) a person representing a member which is not a natural person;
b) a whole-time director who is an employee of the company;
c) a chief executive; or
d) a person representing a creditor or other special interests by virtue of contractual arrangements;
e) has been declared by a court of competent jurisdiction as defaulter in repayment of loan to a financial institution; (only in case of listed companies)
f) is engaged in the business of brokerage, or is a spouse of such person or is a sponsor, director or officer of a corporate brokerage house (only in case of listed companies)

Moral Turpitude is legal term mean "an act or behavior that gravely violates the sentiment or accepted standard of the community".

Companies Act 2017 also places certain restrictions on number of directors for various types of companies. A single member company shall have at least one director whereas every other private company shall have not less than two directors. Law of the land also restricts a public company other than a listed company from having less than three directors, whereas a listed company shall have not less than seven directors. Law further states that only a natural person shall be a director. Companies Act 2017 also directs the public interest companies to have female representation on their board.

5.7 Audit Process and its Types
Due to separation of management and control, day to day operation and supervision is in hands of either directors or executive management. To inform shareholders and other stakeholders, about the financial position and performance of the corporation, financial statements are prepared. Annual audit involves the evaluation of this financial evidence and documentation about the economic and transaction activities of an organization. It is just like third party certification that financial statements present true picture of organization's financial position.

It is said that “the public good derived from auditing is reasonable assurance that financial statements and disclosures are free from material misstatement. Relevant users benefit from auditing of companies and organizations because auditors’ attestations lend credibility to the information disseminated by corporations and reduces the informational asymmetries that might otherwise exist between the users and issuers of financial statements”. It is important to understand that the source of this reasonable assurance is not the opinion of auditor but audit evidence. On the basis of audit evidence, auditor assures himself reasonably about his opinion. Audit report, also known as audit opinion, is classified into four types, i.e. unqualified opinion, qualified opinion, adverse opinion and disclaimer of opinion.

5.8 Auditors, Qualification and Appointment
Companies Act 2017 explain criteria for appointment and qualification of auditors in corporations. Accounting to Act 2017, a person shall not be qualified for appointment as an auditor unless such person is a chartered accountant having valid certificate of practice from the Institute of Chartered Accountants of Pakistan or a firm of chartered accountants, in the case of a public company or a private company which is subsidiary of a public company or a private company having paid up capital of three million rupees or more. In the case of a company having paid up capital of less than three million rupees, auditor should be a chartered accountant or cost and management accountant having valid certificate of practice from the respective institute or a firm of chartered accountants or cost and management accountants.

According to Companies Act 2017, following a person shall not be appointed as auditor of a company, if:

a) he or she, or at any time during the preceding three years was, a director, other officer or employee of the company;
b) he or she is a partner of, or in the employment of, a director, officer or employee of the company;
c) the spouse of a director of the company;
d) indebted to the company other than in the ordinary course of business of such entities;
e) he or she has given a guarantee or provided any security in connection with the indebtedness of any third person to the company other than in the ordinary course of business of such entities;
f) a person or a firm who, whether directly or indirectly, has business relationship with the company other than in the ordinary course of business of such entities;
g) he or she has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;
h) a body corporate;
i) he or she is ineligible to act as auditor under the code of ethics as adopted by the Institute of Chartered Accountants of Pakistan and the Institute of Cost and Management Accountants of Pakistan; and
j) a person or his spouse or minor children, or in case of a firm, all partners of such firm who hold any shares of an audit client or any of its associated companies: provided that if such a person holds shares prior to his appointment as auditor, whether as an individual or a partner in a firm the fact shall be disclosed on his appointment as auditor and such person shall disinvest such shares within ninety days of such appointment.

Companies Act 2017 further clarifies that if a person is in debt to credit card issuer for not more than one million rupees or unpaid dues to a utility company for a period not exceeding ninety days, then the person shall not be deemed to be indebted to the company.

Companies Act 2017, further states that a person shall also not be qualified for appointment as auditor of a company if he or she is disqualified for appointment as auditor of any other company which is that company's subsidiary or holding company or a subsidiary of that holding company. Even if, an auditor becomes subject to any criteria of the disqualifications, after appointment, he shall be deemed to have vacated his office as auditor with effect from the date on which he becomes so disqualified. The appointment of an unqualified person, as auditor, shall be void and if that person acts as auditor of a company shall be liable to a penalty.

5.9 Types of Meetings in Companies
Corporation is an artificial entity and decision are made in meetings of either directors or at some point meeting of shareholders is also called upon. Companies Act 201, specifies numerous condition for shareholder's meetings. There are three types of shareholders meeting as mentioned in Companies Act 2017. These are Statutory Meeting (Section 131), Annual General Meeting (Section 132) and Extraordinary General meeting (Section 133).

Statutory meeting is help once in life of every public company having a share capital. It shall be held within a period of one hundred and eighty days from the date at which the company is entitled to commence business or within nine months from the date of its incorporation whichever is earlier.

It is mandatory for company to send the notice of this meeting to the members at least twenty-one days before along-with a copy of statutory report. The statutory report shall contain information which include the total number of shares allotted, distinguishing shares allotted other than in cash, the total amount of cash received by the company, an abstract of the receipts of the company from shares and debentures and other sources, the payments made there out, and particulars concerning the balance remaining in hand, and an account or estimate of the preliminary expenses of the company, and the names, addresses and occupations of the directors, chief executive, secretary, auditors and legal advisers of the company, and other significant related information as well. This report shall also provide information about state of the company's affairs since its incorporation and the business plan, including any change or proposed change affecting the interest of shareholders and business prospects of the company. Statutory meeting held once in life of company provided, if first annual general meeting of a company is decided to be held earlier,
then statutory meeting shall not be required. All these rules will not be applicable to the public company which has been converted from private company after one year of incorporation.

Second type of shareholders meeting is known as Annual general meeting. According to Companies Act 2017, every company is required to hold a meeting of shareholders within sixteen months from the date of its incorporation and thereafter once in every calendar year within a period of one hundred and twenty days following the close of its financial year. This meeting shall be held, in case of listed company, in the town in which the registered office of the company is situate or in a nearest city.

If number of members of the corporation are in significant numbers in city other than where registered office is situated, then law provides special provision. On the demand of members residing in a city who hold at least ten percent of the total paid up capital, at least seven days prior to the date of meeting, some provision of information technology must be provided to members for their active participation. The notice of this meeting must be sent, at least twenty one days before, to everyone entitled to attend the meeting including shareholders. Companies Act 2017 further states that, in order to ensure dissemination of information, the notice shall also be published in English and Urdu languages at least in one issue each of a daily newspaper of respective language having nationwide circulation, in case of listed company.

Third type of shareholders meeting is known as Extraordinary General meeting. Section 133 of Companies Act 2017 defines extra-ordinary general meetings as all general meetings of a company, other than the annual general meeting and the statutory meeting.

An extra-ordinary general meeting can be called by the board, at any time, to consider any significant matter which requires the approval of the company in a general meeting. Board shall proceed to call an extra-ordinary general meeting if request is made by the members representing not less than one-tenth of the total voting power or not less than one-tenth of the total members.

In order to ensure to avoid the decision making in absence of significant number of shareholders, Companies Act 2017 specifies quorum of a general meeting. The quorum of the general meeting shall be, in the case of a public listed company, not less than ten members present personally, or through video-link who represent not less than twenty-five percent of the total voting power, either of their own account or as proxies. Whereas quorum shall be, for companies other than public listed company, two members present personally, or through video-link who represent not less than twenty-five percent of the total voting power, either of their own account or as proxies. It is important to note here that requirement for quorum in meeting can be increased in article of association.

5.10 Financial Disclosure and Reporting Requirements
Financial reporting is one of the most important way to make directors and executives accountable towards shareholders. That’s why, corporate law and governance mechanism put additional pressure on this aspect. According to Companies Act 2017, every company shall prepare and keep complete books of account and prepare financial statements for every financial year. Companies are also required to prepare financial statements giving a true and fair view of the state of the affairs of the company.

Companies Act 2017 restricts the companies to maintain complete books of accounts together with the vouchers relevant to any entry in such books of account shall be kept in good order for a period of not less than ten financial years.

Corporate law imposes tough penalty, if a company fails to comply, every director, including chief executive and chief financial officer, of the listed company who has by his act or omission been the cause of such default shall be punishable with imprisonment for a term which may extend to two year and with fine which shall not be less than five hundred thousand rupees nor more than five million rupees, and with a further fine which may extend to ten thousand rupees for every day after
the first during which the default continues; and in respect of any other company, be punishable with imprisonment for a term which may extend to one year and with fine which may extend to one hundred thousand rupees.

It is the responsibility of board to present Financial Statements for the period in annual general meeting. The financial statements must be presented within a period of one hundred and twenty days following the close of financial year of a company. It is the responsibility of every company to send audited financial statements together with the auditor’s report, director’s report to every person who is entitled to receive notice of general meeting.

Companies Act 2017 further directs corporations to prepare financial statements in accordance with international financial reporting standards (IFRS) issued by IASB or such other standards as may be notified by the Commission. However, this condition shall not apply to an insurance or banking company or to any other class of companies for which the separate requirements of reporting have been provided in the companies Act 2017. To ensure consistency and comparability, board of a holding company has been directed by Act to ensure that its financial year and each of its subsidiaries should be same. If financial year of holding and subsidiary company are not same then there must be some recorded good reasons for it.

Every listed company has been asked to prepare the quarterly financial statements. These statements will be presented on website of the company for information of its members and also be transmitted electronically to the Commission, securities exchange and with the registrar. These quarterly final statements must be prepared with in thirty days of the close of first and third quarters of its year of accounts; and within sixty days of the close of its second quarter. The financial statements for first and third quarters will remain unaudited whereas the second quarter financial statements are subject to limited audit review but not full-fledged audit.

This chapter has presented the short history of corporate law in Pakistan. To understand the governance mechanism, one must be conversant with the law of the land with perspective of companies. Therefore, this chapter has provided all basic definitions, understandings and laws related to corporations in Pakistan.
CHAPTER-6

Corporate Governance Mechanism in Pakistan

The need for code of corporate governance in Pakistan was presented in 1999 in Karachi at Chartered Accountant conference. The need for governance mechanism can be traced to various corporation frauds in Pakistan. Some of them include Cooperative Societies Scandal, Taj Quran Company Scandal, and Modaraba Scandal etc. Due to non-existence of credible reporting and accountability mechanism, billions of rupees were looted of this nation and no one brought to justice. In Modaraba scandal, billions of rupees were transacted without any legal cover and regulator was in sleep.

First Code of Corporate Governance in Pakistan was enforced in 2002. This code was only applicable to listed companies in Pakistan. The remaining corporate sector was supposed to be resulted through Companies ordinance 1984 which was almost 18 years old. By the time, various loopholes and disharmony was evidenced. To create a convergence, Pakistan Institute of Corporate Governance with consultation with SECP, started working towards an improved version of corporate governance. And finally Pakistan corporate sector got its amended version of code for corporate governance in 2012.

This code of corporate governance is part of listing regulations at Pakistan Stock Exchange (PSX). Every company which is listed on stock exchange is required to follow this code of corporate governance 2012.

6.1 Code of Corporate Governance 2012

The governance issues related to Composition of the Board, meetings of the board, Significant issues to be placed for decision of Board of Directors, Chief Financial Officer (CFO), Company Secretary and Head of Internal Audit, Corporate and financial reporting framework, and Responsibility for financial reporting and corporate compliance have been discussed in code of corporate governance 2012 in length.

Code requires that all listed companies to state their compliance with the requirements of this code in annual report in statement form, known as statement of compliance with the best practices of corporate governance. This statement is supposed to be very specific duly supported by the necessary evidence. Code further makes it mandatory for the listed companies to get this compliance statement reviewed and certified from external auditors. It is the responsibility of external auditors of listed company to highlight the non-compliance with the CCG requirements in their review report. Only SECP is competent to relax provisions of code, if satisfied about non-practicability, of some provision.

6.2 Composition of the Board

“There is no institution better placed to ensure good governance of a corporation that the board of directors. But board consist of people and good board consist of good people with the integrity to do what’s right, with the competence to contribute, with the stature to stand up to the management when necessary and with sense of responsibility to all shareholders regardless of their size.” Keeping in view the importance of board, CCG 2012 encourage companies to have a reasonable combination of executive and non-executive directors, including independent directors and those representing minority interests. CCG 2012 provides vision of directors having competence, experience, and knowledge with diversity including gender, race in such a way that board as a group includes core competencies in the context of the company’s operations.
To ensure the inclusion of directors representing minority interest, CCG 2012 encourages listed companies to facilitate the minority shareholders as a class. Minority shareholders are facilitated to use proxy solicitation to contest election of directors. Code states that company must annex a statement by a candidate representing his profile from among the minority shareholders who seeks to contest election to the board of directors.

CCG 2012 put restriction on corporation that each listed company shall have at least one independent director and further encourages that the number of independent director may be increased up to one third of the total members of the board. The names along with brief details about nonexecutive, executive and independent director(s) shall be presented in the annual report.

The idea of independent directors is often difficult to explain as no person can be entirely independent. Code states that if a person can be reasonably perceived as being able to exercise independent business judgment without being subservient to any form of conflict of interest, he or she can be relied upon as independent. The Code of Corporate Governance 2012 shed light on the expression "independent director" as a director who is not connected or does not have any other relationship, whether pecuniary or otherwise, with the listed company, its associated companies, subsidiaries, holding company or directors. However, the practical implication of this definition is vague. Therefore, CCG 2012, considers directors as independent in the absence following circumstances:

a) He/she has been an employee of the company, any of its subsidiaries or holding company within the last three years;

b) He/she is or has been the CEO of subsidiaries, associated company, associated undertaking or holding company in the last three years;

c) He/she has, or has had within the last three years, a material business relationship with the company either directly, or indirectly as a partner, major shareholder (10% or more shares having voting rights in the paid-up capital of the company) who holds or director of a body that has such a relationship with the company:

d) He/she has received remuneration in the three years preceding his/her appointment as a director or receives additional remuneration, excluding retirement benefits from the company apart from a director’s fee or has participated in the company’s share option or a performance-related pay scheme;

e) He/she is a close relative of the company’s promoters, directors or major shareholders. Law defines close relative means spouse(s), lineal ascendants and descendants and siblings A lineal descendant is a blood relative in the direct line of descent – the children, grandchildren, great-grandchildren, etc. of a person. Lineal ascendants are the people from whom a person is descended, or from whom he derives his birth, for example parents.

f) He/she holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;

g) He/she has served on the board for more than three consecutive terms from the date of his first appointment provided that such person shall be deemed “independent director” after a lapse of one term.

h) Any person nominated as a director under Sections 182 and 183 of the Ordinance, shall not be taken to be an "independent director" for the above mentioned purposes.

CCG 2012 also restricts the companies not to have more than 33% of elected directors as executive directors and this ratio is inclusive of Chief Executive Officer. This clause is supposed to make board free of managerial responsibilities and more towards supervisory role. Similarly the code binds the institutional investors, if required, to nominate their representative, through a resolution of its board of directors. Also to maintain transparency, CCG 2015 requires the policy regulating nominating of any person for the board should be annexed to the Directors’ Report of the investor company. In the case of vacant seat, due to any reason, on the board of directors should be filled up, at the earliest but not later than 90 days.
The idea of professional indemnity insurance cover have been presented and encouraged for independent directors in the code. Professional indemnity insurance provides cover for the legal costs and expenses in defending the claim, if one is alleged to have provided inadequate advice, services or designs to a client. Such insurance cover often provides compensation payable to the client for rectification of the decision.

CCG 2012 decreases the number of directorships any person can hold in listed companies from ten to seven. However, while maintaining the prudence, the limit of seven directorships does not include the directorships in the listed subsidiaries of a listed holding company.

6.3 Responsibilities, powers and functions of board of directors:
The code expects and requires the board of directors of a listed company to exercise their powers in the best interest of the company. To attain this objective, the board should perform its fiduciary responsibilities with independence and objective judgment. The board of directors, therefore, should ensure that “professional standards and corporate values are put in place that promote integrity for the board, senior management and other employees in the form of a Code of Conduct, defining therein acceptable and unacceptable behaviors”. Appropriate steps need to be taken by the board to educate all concerned, including stakeholders outside the company, about Code of Conduct along with supporting policies and procedures. It is also responsibility of board is to ensure that “adequate system for identification and redress of grievances arising from unethical practices is in place”.

Code requires that in order for efficient and effective management along with governance vision and/or mission statement coupled with strategic corporate policy should be prepared by the board. Such corporate policy will be enhanced with the help written significant policies which may include governance, risk management and compliance issues; human resource management, human resource succession plan; procurement rules; investors’ relations, marketing; terms of credit and discount to customers; receivables write-off policy, advances and receivables; capital expenditure, planning and control; investments, disinvestment and borrowing of funds; delegation of administrative and financial powers; handling with associated companies and related parties transactions; the corporate social responsibility (CSR) initiatives and last but not the least is the whistleblower policy.

The board is also responsible to maintain a complete record such significant policies along with the approval and enforcing dates. Code also requires board to put in place a mechanism for evaluating its own performance within two years.

Code put some stringent conditions to ensure good governance and discount any malpractice in shareholder funds. It requires form the board to ensure sound internal control system, effectively implemented and maintained, at all levels within the company. It also requires that the board should define the materiality level, keeping in view the ground realities in the company. One such materiality level is already set by code which states that when investment and disinvestment of funds is taking place for six month or more, then such transaction need to be documented by a resolution passed at the board meeting. However, such resolution will not be needed in the case of banking companies, non-banking finance companies and insurance companies. Similar resolution will be required in determination of the nature of loans and advances made by the listed company and fixing a monetary limit thereof.

The effective role of board can only be achieved if all significant issue shall be before it, either for decision making or for information and consideration. The board will have discretion to consider at board level or to formalize corporate decision-making process, send these to its committees for further deliberation.

CCG 2012 states that “the significant issues for this purpose may include (i) the CEO shall immediately bring before the board, as soon as it is foreseen that the company will not be in a
position of meeting its obligations on any loans (including penalties on late payments and other
dues, to a creditor, bank or financial institution or default in payment of public deposit), TFCs,
Sukus or any other debt instrument. Full details of the company’s failure to meet obligations shall
be provided in the company’s quarterly and annual financial statements. (ii) annual business plan,
cash flow projections, forecasts and strategic plan; (iii) budgets including capital, manpower and
overhead budgets, along with variance analyses; (iv) matters recommended and/or reported by the
committees of the board; (v) quarterly operating results of the listed company as a whole and in
terms of its operating divisions or business segments; (vi) internal audit reports, including cases of
fraud, bribery, corruption, or irregularities of a material nature; (vii) management letter issued by
the external auditors; (viii) details of joint venture or collaboration agreements or agreements with
distributors, agents, etc. (ix) promulgation or amendment to a law, rule or regulation, enforcement
of an accounting standard and such other matters as may affect the listed company; (x) status and
implications of any law suit or proceedings of material nature, filed by or against the listed company;
(xi) any show cause, demand or prosecution notice received from revenue or regulatory authorities;
(xii) failure to recover material amounts of loans, advances, and deposits made by the listed
company, including trade debts and inter-corporate finances; (xiii) any significant accidents,
dangerous occurrences and instances of pollution and environmental problems involving the listed
company; (xiv) significant public or product liability claims made or likely to be made against the
listed company, including any adverse judgment or order made on the conduct of the listed
company or of another company that may bear negatively on the listed company; (xv) report on
governance, risk management and compliance issues. Risks considered shall include reputational
risk and shall address risk analysis, risk management and risk communication; (xvi) disputes with
labor and their proposed solutions, any agreement with the labor union or collective bargaining
agent and any charter of demands on the listed company; (xv) whistleblower protection mechanism;
(xvi) report on CSR activities; and (xvii) payment for goodwill, brand equity or intellectual property."

6.4 Directors’ Training Program

Being corporate sector of a developing country, sometimes elected directors of listed companies
are not finance and law literate. To overcome this problem, code 2012 encourages the companies
to nominate directors for trainings programs. Code states that trainings programs related to
corporate law, code of corporate governance and other related knowledge should be managed by
the listed companies for their directors. These trainings programs are supposed to enable directors
to discharge their fiduciary responsibilities, on behalf of shareholders, in effective manner. Currently
such training programs, as approved from SECP, are being offered by ICMAP, ICAP and Lahore
University of Management Sciences.

Such directors training program has been declared mandatory for all the directors of the listed
companies. However, exemption from training program is available for the individuals with a
minimum of 14 years of education and 15 years of experience on the board of a listed company.

6.5 Separation of CEO and Chairperson

To ensure the absence of unfettered power and a sense of accountability, code states that the
Chairperson and the Chief Executive Officer (CEO), by whatever name called, shall not be the
same person. To ensure reasonable independence, code further restrict that election of the
Chairperson should be among the non-executive directors of the listed company. It is the
responsibility of the board to demarcate the roles and responsibilities of the Chairperson and Chief
Executive Officer. The code explicitly provides the basic principle that the leadership of the board
and its effective role is responsibility of the chairperson.

6.6 Meetings of the board of directors:

To ensure reasonable attendance and effective decision-making, code requires that notices for
holding board meetings along with its agenda should be circulated at least seven days before. In
rare case of emergency, this requirement of this notice period may be reduced or waived off. The
Company Secretary will hold the seat of secretary to the board. However, it will be the sole
responsibility of Chairperson that the minutes of meetings are appropriately recorded.
Keeping in view the importance of board meetings towards effective governance, code requires that "in the event that a director of a listed company is of the view that his dissenting note has not been satisfactorily recorded in the minutes of a meeting of the Board of Directors, he may refer the matter to the Company Secretary. The director may require the note to be appended to the minutes, failing which he may file an objection with the Securities and Exchange Commission of Pakistan (SECP) in the form of a statement to that effect. The objection may be filed with the SECP within 30 days of the date of confirmation of the minutes of the meeting."

For effective decision making process, the code makes it mandatory for the CFO and Company Secretary of a listed company to attend all meetings of the board, unless such meeting, partly or fully, involves of an agenda item relating to the CFO and Company Secretary respectively. In the absence of the CFO and Company Secretary, their nominee, appointed by the board, shall attend all meetings of the Board of Directors.

6.7  Related party transactions:
Transparency is an effective way towards governance and it can only be achieved through financial disclosure. Proper disclosure regarding related party transactions is extremely important for transparent decision making. Related parties. Parties are considered to be related if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.

The disclosure requirements of related party is enforced through International Accounting Standard (IAS) 24. The standard defines related party in detail. As per IAS24, a party is related to an entity if it controls or it is controlled, directly or indirectly through one or more intermediaries, or is under common control with the entity. This includes holding company, subsidiaries, and fellow subsidiaries companies. An associate company and a joint venture in which the entity is a venturer includes in the definition of related party. If a party is a member of the key management personnel of the entity or its parent and a close member of the family include in the definition of related party. Key management personnel is defined as someone who have the authority and responsibility for planning, directing, and controlling the activities of the entity, directly or indirectly, including all types of directors.

The definition of related party represents the potential conflict of interest which can be harmful towards shareholder's interest. Related party transaction represents transfer of resources, services, or obligations between related parties, regardless of whether a price is charged or not. Keeping in view such reasons, the code 2012 restricts listed companies to provide the following disclosure in annual report of listed companies about related party transactions:

a) Transaction record with related parties should be placed before the board of directors for review and approval, after recommendations of the same from Audit Committee.

b) The pricing methods for related party transactions, on arm's length transaction prices, shall be approved by board of directors. However, all such transactions, not executed at arm's length price, should be placed before board meetings, separately, along with necessary justification on recommendation of the Audit Committee of the listed company.

c) Party wise record of related party transactions, along with all relevant documents and explanations will be maintain by listed companies. Such record will have the related particulars such as related party name; nature of relationship with related party; nature and amount of transaction along with the terms and conditions of transaction, including the amount of consideration received or given.

6.8  Chief Financial Officer (CFO), Company Secretary and Head of Internal Audit
CFO, company secretary and head of internal audit are three most important position after the position of CEO. That is why, corporate law and code of corporate governance explain their process of appointment, removal and qualifications explicitly. According to code, the board of directors are
competent to decide about the terms and condition of appointment and compensation for employment of the Chief Financial Officer (CFO), the Company Secretary and the Head of Internal Audit of listed companies. Similarly, the removal of the CFO and Company Secretary of listed companies shall also be made with the approval of the board of directors, whereas the removal of Head of Internal Audit shall be made with the approval of the board only upon recommendation of the Chairman of the Audit Committee. It is important to explain here that code makes it clearer that non-renewal of contracts for these three posts will be considered as removal.

The qualifications criteria for appointment of CFO at listed company require the candidate to be either a member of a recognized body of professional accountants; or having postgraduate degree in finance from a HEC recognized university or equivalent along with at least three (3) years of experience of being engaged in or employed in a public practice (audit/accounting) firm, or in managing financial or corporate affairs functions of a company. Similarly, to be appointed as the Head of Internal Audit, a person needs to be either a member of a recognized body of professional accountants; or Certified Internal Auditor; or a Certified Fraud Examiner; or a Certified Internal Control Auditor of a listed company along with at least three (3) years of relevant experience in audit or finance or compliance function.

However, the individuals already performing services as CFO or head of internal audit at a listed company for the last five years, at the time of enforcement of this Code, shall be exempted from the qualification requirement.

6.9 Framework for corporate and financial reporting:

Armstrong (2016) explains that the “corporate governance research typically focuses on one of two types of agency problems that give rise to a conflict of interest between managers and shareholders. The first type arises when the interests of the board of directors and shareholders are assumed to be aligned (that is, the board is composed of individuals who make decisions that are in the best interest of shareholders), but the interests of management are not aligned with those of the board and shareholders. Research on this type of conflict includes studies that examine executive compensation plans, incentive structures, and other monitoring mechanisms used to ensure that managers act in the interest of shareholders. The second type of agency problem arises when the interests of the board and management are assumed to be aligned with each other (that is, the board is composed of directors who are beholden to the CEO), but their interests are not completely aligned with the interests of shareholders. Research on this type of conflict includes studies onboard independence, entrenched CEOs, and shareholder actions to influence, challenge, or overturn board decisions (such as shareholder proxy contests, class action lawsuits, and “say-on-pay” proposals”). To mitigate the adverse impact of both type of agency cost/problem, information symmetry is the solution. Standard corporate and financial reporting helps to create this information symmetry.

Holmstrom (2005, 711-2) provides a succinct characterization of the issues related to information flow between management and non-executive directors: “Getting information requires a trusting relationship with management. If the board becomes overly inquisitive and starts questioning everything that the management does, it will quickly be shut out of the most critical information flow—the tacit information that comes forward when management trusts that the board understands how to relate to this information and how to use it. Management will keep information to itself if it fears excessive board intervention. A smart board will let management have its freedom in exchange for the information that such trust engenders. Indeed, as long as management does not have to be concerned with excessive intervention, it wants to keep the board informed in case adverse events are encountered. Having an ill-informed board is also bad for management, since the risk of capricious intervention or dismissal increases”.

Companies Act 2017 and code of corporate governance 2012 provides framework for corporate and financial reporting in detail. This framework includes various reports and necessary information which should be annexed with directors’ reports, frequency of financial reporting, requirement of
corporate compliance, responsibility of financial reporting, and most importantly the mechanism of internal and external audit for listed companies.

6.10 Financial reporting frequency:
Frequency of financial reporting for listed companies has been set on quarterly basis. Every listed company is required to publish quarterly unaudited financial statements to circulate along with directors’ review on the affairs of the listed company. In addition, companies are required to issue second quarterly financial statements after limited audit review by the statutory auditors. The scope of this limited audit review will be ascertained by the Institute of Chartered Accountants of Pakistan (ICAP) and duly approved by the SECP.

In addition to quarterly financial statements, code also restricts every listed company to immediately disseminate every material information that is expected to affect the market price of its shares. Such material information will also be provided to SECP in addition to respective stock exchange. Such material information may include “any material change in the nature of business of the company; information regarding any joint ventures, merger or acquisition or any material contract entered into or lost; purchase or sale of significant assets; franchise, brand name, goodwill, royalty, financial plan, etc.; any unforeseen or undisclosed impairment of assets due to technological obsolescence, etc.; delay or loss of production due to strike, fire, natural calamities, major breakdown, etc.; issue or redemption of any securities; a major change in borrowings including projected gains to accrue to the company; any default in repayment or rescheduling of loans; and change in directors, Chairman or CEO of the listed company.”

6.11 Financial reporting responsibility:
To ensure the issuance of authentic financial reporting, code has made executive management accountable. Therefore, financial statements of listed company must be endorsed through the signatures of the CEO and the CFO, for consideration and approval of the Board of Directors, before issuance. Code also made it “mandatory for the CEO and CFO to have the second quarterly and annual accounts (both separate and consolidated where applicable) initialed by the external auditors before presenting it to the audit committee and the Board of Directors for approval.”

6.12 Corporate compliance responsibility:
It is the responsibility of the Company Secretary of a listed company, according to the code, to furnish a Secretarial Compliance Certificate, along with annual return filed with the registrar at SECP. Such compliance certificate will contain material stating that all corporate and secretarial requirements of the companies act 2017 have been properly complied with.

6.13 Statements annexed with Directors Report u/s 236:
The directors of listed companies are required to present an overall picture of affairs of the listed company, understandable to common men. Such Director’s report will be coupled with following statements, prepared under Section 236 of the Ordinance:

a) The complete set of financial statements. As per IAS, financial statements consist of five statements including Statement of financial position, Statement of income, Cash flow statement, Statement of Shareholders equity and notes to financial statements. Preparation of financial statements is the responsibility of management.

b) Financial statements have been prepared as per International Financial Reporting Standards (IFRS) and International Accounting Standard (IAS), as applicable in Pakistan. If any departure from IFRS/IAS has been made, proper disclosure along with explanation has been provided.

c) Proper books of account of the listed company have been maintained;

d) Financial statements have been prepared using consistent accounting policies;

e) Discretionary accruals i.e. accounting estimates used in financial statements are based on reasonable and prudent judgment;

f) Sound internal control is in place and is being periodically monitored and improved;
g) Going concern assumption holds in preparing financial statement and there are such situation exist suggesting shut down of business in foreseeable future.

6.14 Additional voluntary information annexed with Directors Report:

The information requirement mentioned above are as per section of companies Act which are applicable on every type of company. Now as per code of corporate governance, listed companies are required to provide “following additional information, where necessary, annexed to the Directors’ Reports:

a) If the listed company is not considered to be a going concern, the fact along with the reasons shall be disclosed;

b) Significant deviations from last year in operating results of the listed company shall be highlighted and reasons thereof shall be explained;

c) Key operating and financial data of last six years shall be summarized;

d) If the listed company has neither declared dividend nor issued bonus shares for any year, the reasons thereof shall be given;

e) Where any statutory payment on account of taxes, duties, levies and charges is outstanding, the amount together with a brief description and reasons for the same shall be disclosed;

f) Significant plans and decisions, such as corporate restructuring, business expansion and discontinuance of operations, shall be outlined along with future prospects, risks and uncertainties surrounding the listed company;

g) A statement as to the value of investments of provident, gratuity and pension funds, based on their respective audited accounts, shall be included;

h) the number of board and committees’ meetings held during the year and attendance by each director shall be disclosed;

i) the details of training programs attended by directors;

j) the pattern of shareholding shall be reported to disclose the aggregate number of shares (along with name wise details where stated below) held by a) associated companies, b) undertakings and related parties (name wise details); c) mutual funds (name wise details); III. Directors and their spouse(s) and minor children (name wise details); IV. Executives; V. public sector companies and corporations; VI. Banks, development finance institutions, non-banking finance companies, insurance companies, takaful, modarabas and pension funds; and VII. Shareholders holding five percent or more voting rights in the listed company (name wise details). Here expression “executive” means an employee of a listed company other than the CEO and directors.

k) The directors’ report shall cover, loans, TFCs, Sukukas or any other debt instruments in which the company is in default or likely to default. There shall be a clear presentation with details as to the aggregate amount of the debt overdue or likely to become overdue and the reasons for the default/emerging default situation and the measures taken by the company to address and settle such default situation.

l) All trades in the shares of the listed company, carried out by its directors, executives and their spouses and minor children shall also be disclosed. Here, “executive” means the CEO, COO, CFO, Head of Internal Audit and Company Secretary, and other employees of the company for whom the board of directors will set the threshold to be reviewed on an annual basis and disclosed in the annual report."

6.15 Directors’ remuneration

Code believe in the transparency and it is needed most in case of directors. Code requires companies to have a formal and transparent procedure for deciding the compensation packages of directors. The basic principle for deciding such packages is their non-involvement in deciding their own remuneration. Code also does not put any restriction on determination of remuneration for nonexecutive directors. However, code advises that such package should not be perceived to compromise their independence. Another important disclosure, as per code, requires that the Annual Report of the company must disclose details of the aggregate remuneration, both of
executive and non-executive directors, including salary/fee, benefits and performance-linked incentives etc.

6.16 Disclosure of interest by a director holding company’s shares
Insider trading is one of the prevalent financial crime all across corporate world. To ensure the reasonable control on insider trading and to make directors avoid conflict of interest, certain mechanisms have been suggested in the code to disclose the any interest help by directors in other companies. Code states that “where any director, CEO or executive of a listed company or their spouses sell, buy or transact, whether directly or indirectly, in shares of the listed company of which he is a director, CEO or executive, as the case may be, he shall immediately notify in writing to the Company Secretary of such transaction”.

Code further states that the details about transaction including number of shares, prices etc. will be provided to the Company Secretary, within two days, who will shall immediately forward the same to the SECP. If any director/CEO/executive fails to do so, it is the responsibility of Company Secretary to bring the matter before the board of directors. Directors, CEO, and executives are prohibited to deal, directly or indirectly, in shares of the listed company in closed period adjacent to the announcement of interim/ final results and any business decision. The closed period, decided by the board, “shall start from the day when any document/statement, which forms the basis of price sensitive information, is sent to the board of directors and terminate after the information is made public.”

6.17 Committees of the board
The importance of committees in the board has been discussed at length in second chapter. Keeping in view the research related to role of committee in board, code of corporate governance 2012 at least two committee which are very importance for smooth and effective working of listed company in corporate sector.

The first very important committee is audit committee. Code requires that “the board of directors of every listed company shall establish an Audit Committee, at least of three members comprising of non-executive directors and at least one independent director. The chairman of the committee shall preferably be an independent director, who shall not be the chairman of the board. The board shall satisfy itself such that at least one member of the audit committee has relevant financial skills/expertise and experience”.

Another important area of research is executive compensation. To ensure independence and transparency, code states that “there shall also be a Human Resource and Remuneration (HR&R) Committee at least of three members comprising a majority of non-executive directors, including preferably an independent director. The CEO may be included as a member of the committee but not as the chairman of committee. The CEO if member of HR&R Committee shall not participate in the proceedings of the committee on matters that directly relate to his performance and compensation”.

The responsibilities of HR&R committee include “the recommendation about human resource management policies to the board, recommending to the board the selection, evaluation, compensation (including retirement benefits) and succession planning of the CEO, recommending to the board the selection, evaluation, compensation (including retirement benefits) of COO, CFO, Company Secretary and Head of Internal Audit; and consideration and approval on recommendations of CEO on such matters for key management positions who report directly to CEO or COO”. There will be a reasonable disclosure about each type of committee in the annual report of the company.

6.18 Audit Committee meetings frequency:
Every listed company is required to have at least four meetings, i.e. once every quarter of the financial year, of audit committee every year. Companies are encouraged to have more than four
audit committee meetings as this will improve overall accountability and financial transparency in the company. However, the code requires that one meeting should be held prior to the approval/announcement of interim financial results by the board. Similarly, audit committee should meet before and after completion of statutory audit. Meeting of Audit Committee can also be called upon request by the external auditors or the Head of Internal Audit. For effective working of audit committee, the presence of representative from finance and internal audit is imperative. Therefore, in all such meetings where accounts and audit issues are to be discussed, the CFO, the Head of Internal Audit and external auditors represented by engagement partner or in his absence any other partner designated by the audit firm are required to attend.

In order to ensure uninterrupted representation by the concerned departments, the code explicitly requires that, at least once a year, the Audit Committee shall meet the external auditors without the CFO and the Head of Internal Audit being present. Similarly, the Audit Committee shall meet the head of internal audit and other members of the internal audit function without the CFO and the external auditors being present, once in a year.

Being answerable to shareholder, engagement partner of statutory auditor or representative along with the chairman of the Audit Committee shall be available during the shareholder’s Annual general meeting for any questions or feedback.

The responsibility of secretary of the Audit Committee can be undertaken by either be the Company Secretary or Head of Internal Audit. However, the code restrict CFO not to undertake the responsibility of secretary to the Audit Committee. It is responsibility of secretary to circulate minutes of the Audit Committee meeting to all its members. The copy of minutes should also to be send to all directors, Chief Financial Officer and to the Head of internal Audit prior to the next meeting of the board. If sending of minutes of the meeting is not possible due to any reason including time limitation, then it will be the responsibility of the Chairman of the Audit Committee to disseminate the synopsis of proceedings of meeting to the board. However, the minutes shall still be circulated immediately after the meeting of the board.

6.19 Terms of reference of Audit Committee

It is important to prepare terms of reference of the audit committee for its effective working. The responsibility of preparation of terms of reference lies on the Board of Directors of every listed company. Provision of adequate resources along with authority to enable the Audit Committee to carry out their responsibilities effectively also lies upon board of director.

One important assignment of the Audit Committee is recommending the appointment of external auditors, their removal, and audit fees to the board of directors. Audit committee will also recommend the provision of any other services in addition to audit by the external auditors. To ensure the proper weight of audit committee consideration, code restricts the Board of Directors to record the reasons if they acts otherwise.

The code also suggest that following can be included in “the terms of reference of the Audit Committee:

a) Determination of appropriate measures to safeguard the listed company’s assets;

b) review of quarterly, half-yearly and annual financial statements of the listed company;

c) Review of major areas of judgment in financial statements including significant adjustments resulting from the audit, the going concern assumption, amendments in accounting policies, compliance with applicable accounting standards and with applicable regulatory requirements, and compliance with the best practices of corporate governance and identification of significant violations, if any, etc.

d) review of preliminary announcements of results prior to publication;

e) facilitation of external auditors through discussion about major audit observations during conduction of interim and final audits;
f) review of management letter issued by external auditors and management’s response thereto;
g) to ensure reasonable close liaison between the internal and external auditors;
h) review of the scope and extent of internal audit and ensuring that the internal audit function has adequate resources and is appropriately placed within the listed company;
i) consideration of major findings of internal investigations of activities characterized by fraud, corruption and abuse of power and management's response thereto;
j) ascertaining that the internal control systems including financial and operational controls, accounting systems for timely and appropriate recording of purchases and sales, receipts and payments, assets and liabilities and the reporting structure are adequate and effective;
k) review of the listed company’s statement on internal control systems prior to endorsement by the Board of Directors and internal audit reports;
l) instituting special projects, value for money studies or other investigations on any matter specified by the Board of Directors, in consultation with the CEO and to consider remittance of any matter to the external auditors or to any other external body;
m) Any other issue decided by the Board of Directors."

6.20 Internal audit:
Internal audit is one of the very important function at listed company which ensure transparency and accountability. The code makes it compulsory for every listed company to have an internal audit function, whose head will, functionally, report to the Audit Committee. This function can be carried out by internal employee or can be outsourced to any professional audit and accounts firm or by the internal audit staff of parent/holding Company. It is important to mention here that external auditor cannot be appointed as internal auditors, if this function is outsourced. To ensure the integrity and independence of this function, a director of listed company will have no role in whatsoever capacity in internal audit function.

Code explicitly emphasized that, due to its important nature, suitably competent, qualified and experienced persons, conversant with the company’s policies and procedures, should be engaged in the internal audit. If this function is outsourced, a fulltime employee (other than CFO), must be designated as Head of Internal Audit, to provide a liaison between the board of directors and outsourced firm. Code further requires that internal audit reports must be made available for the review of external auditors. The auditors shall discuss any major findings in relation to the reports with the Audit Committee, which shall report matters of significance to the Board of Directors.

6.21 External auditors
To improve the quality of statutory audit, the code puts some further conditions on appointment of auditors. These are the additional conditions imposed by the code:

a) External auditors of listed company must have satisfactory rating by the Institute of Chartered Accountants of Pakistan under the Quality Control Review program of the Institute.
b) Firm of external auditors or its partner should not be non-compliant with the International Federation of Accountants’ (IFAC) Guidelines on Code of Ethics.
c) External auditors should not be assigned additional services in addition to external audit to eliminate potential conflict of interest.
d) External auditors are required to observe applicable IFAC guidelines and shall ensure not to perform any management functions or decisions of the listed company.

The code also states that “the Board of Directors of a listed company shall recommend appointment of external auditors for a year, as suggested by the Audit Committee. The recommendations of the Audit Committee for appointment of an auditor or otherwise shall be included in the Directors’ Report. In case of a recommendation for appointment of an auditor other than the retiring auditor the reasons for the same shall be included in the Directors’ Report”. External auditors must submit Management Letter, within 45 days of the date of audit report, to its board of directors. It is also
important to note that “any matter deemed significant by the external auditor shall be communicated in writing to the board prior to the approval of the audited accounts by the board”.

Code 2012 requires that external auditors need to be changes every five years in all listed companies in the financial sector. All banks, non-banking financial companies (NBFC’s), modarabas and insurance/takaful companies comes into the definition of financial sector. All listed companies other than those in the financial sector shall, at a minimum, rotate the engagement partner after every five years. To ensure independence of external auditor, code restrict listed companies to appoint “a person as an external auditor or a person involved in the audit of a listed company who is a close relative, i.e., spouse, parents, dependents and non-dependent children, of the CEO, the CFO, an internal auditor or a director of the listed company”.

6.22 Conclusion
After going through code of corporate governance 2012, it is almost evident the efforts of policy makers towards efficient working of corporate sector while establishing certain parameters for accountability as well. Pakistan, being a developing nation, consist of corporate sector which is crowded with the companies having controlling interest, both fully and partially. To emphasis governance principles in such public sector companies, SECP promulgated Public Sector Companies governance rules in 2013. Next chapter is devoted towards those governance rules.
Corporate Governance in Public Sector Organization

There are various services which cannot be delivered by the private sector in most economies therefore state assume the responsibility for provision of such services. Also sometimes, it is in the strategic national interest of countries not to leave its citizen in the vicious hands of cut throat competition. Also, some countries keep certain key organizations under state ownership for purely investment purposes, so that their profits contribute in a meaningful way to the country's treasuries. Pakistan, also has vast numbers of public sector organizations aimed to provide services to its citizens. Some of the important public sector organizations in Pakistan provide services in the field of telecommunication, travel, oil and gas exploration and steel sector etc. Currently, there are currently more than 200 public sector organizations in Pakistan, either fully or partially controlled or owned by state. Some critics stress the "need to rationalize this list in the interest of segregating them as strategically important or of investor interest".

After code of corporate governance 2012, policy maker realized the importance of enforcing best practice of governance in public sector organization. The seeds of this realization relates to the fact that public sector organization, in Pakistan, have history of bad governance and high losses. Some experts argue that the public sector organization losses almost 1.5% of GDP every year. Keeping in view this position, SECP promulgated the Public Sector Companies (Corporate Governance) Rules on March 8, 2013.

7.1 Defining Public Sector Organization

The definition of public sector companies should not be confused with public companies. Public companies, also known as public limited companies, are the companies which have power to offer their share capital to general public, whereas public sector companies generally means the organization having public funds invested in it. Public Sector Companies (Corporate Governance) Rules, hereafter called PSCCG rules, define Public Sector Company as “a company, whether public or private, which is directly or indirectly controlled, beneficially owned or not less than fifty one percent of the voting securities or voting power of which are held by the Government or any instrumentality or agency of the Government or a statutory body, or in respect of which the Government or any instrumentality or agency of the Government or a statutory body, has otherwise power to elect, nominate or appoint majority of its directors, and includes a public sector association not for profit, licensed under section 42 of the Ordinance”.

7.2 Salient features of Governance rules for Public Sector Companies:

PSCCG rules 2013 have defined the term executive and independent director. As per PSCCG rules, “Executive means an employee of a Public Sector Company, who is entrusted with responsibilities of an administrative or managerial nature, including the Chief Executive and Executive Director”. Whereas “Independent Director means a Non-Executive Director who is not in the service of Pakistan or of any statutory body or anybody or institution owned or controlled by the Government and who is not connected or does not have any other relationship, whether pecuniary or otherwise, with the Public Sector Company, its associated companies, subsidiaries, holding company or directors”. It is important to mention here that the term independence is almost impossible to define as no law can make it sure that certain restriction will make anyone independent in his or her thoughts and actions. The rules, while realizing this limitation, states that “the test of independence principally emanates from the fact whether such person can be reasonably perceived as being able to exercise independent judgment without being subservient to any form of conflict of interest”. However, to make it easy for implementation, the rules provides some guidelines as who cannot be considered as independent as per the PSCCG rules 2013. For example, a person shall not be considered as independent director if he or she has been an
employee of the Public Sector Company, any of its subsidiaries, or holding company during the last two years. Rules further states that even, in last two, if some remuneration has been paid to individual in the capacity of a director or has been beneficiary of Public Sector Company's share option or a performance-related pay scheme. A person having close relationship (for example spouse, brothers, sisters, and lineal ascendants and descendants) with promoters, directors or major shareholders of the public sector company. Similarly, a person having a material financial ties with the Public Sector Company, directly or indirectly, or holds cross-directorships or has significant links with other directors through involvement in other companies or bodies.

One very important condition relates to continuous term as independent director. The rules prohibits an individual to assume the position of independent director if he has served on the Board for more than two consecutive terms from the date of his first appointment. Code however allow such person to be deemed as independent director, at least, after a lapse of one term.

7.3 Management Qualification:
PSCCG rules 2013 requires that the integrity, due care and objectivity along with professional skills should be upheld while managing the Public Sector Company (PSC). PSCs should be managed by a sufficient number of persons who fulfill the “fit and proper criteria (FAPC)”, as specified by these rules, to hold the positions. It is mandatory that each director and chief executive officer, of the Public Sector Company complies with FAPC.

PSCCG rules 2013 define fit and proper person criteria. To be considered as fit and proper person, the appointing authorities should see the following minimum requirements:

a) He or she be at least graduate, possess good reputation, character and a recognized professional or businessman with experience in similar industry;
b) He or she must has financial integrity, traits of efficiency and honesty, with no convictions or civil liabilities;
c) He or she does not suffer from any disqualification to act as a director stipulated in the Ordinance;
d) He or she has not been subject to an order passed by the Commission cancelling the certificate of registration granted to the person individually or collectively with others on the ground of its indulging in insider trading, fraudulent and unfair trade practices or market manipulation, illegal banking, forex or deposit taking business;
e) He or she is not a stock broker or agent of a broker; and does not suffer from a conflict of interest including political office holders of any type;
f) He or she has not been subject to an order passed by the Commission or any other regulatory authority, withdrawing or refusing to grant any license or approval to him which has a bearing on the capital market.

The rules further clarifies that an existing director shall cease to be considered as a “fit and proper person” in the following cases:

a) If he or she is convicted by a court for any offence involving moral turpitude, economic offence, disregard of securities and company laws or fraud;
b) if an order for winding up has been passed against a company of which he/she was the officer as defined under section 305 of the Ordinance;
c) if he/she (including close relatives) have been engaged in a business which is of the same nature as and directly competes with the business carried on by the Public Sector Company of which he/she is the director;
d) he or she does not conduct his duties with due diligence and skill;
e) his/her association with the Public Sector Company is likely, for whatever reason, to be detrimental to the interest of the Public Sector Company, or be otherwise undesirable.
The rules also directs the PSCs to maintain its accounting and related records at adequate level. The said adequate level will be considered if the whole set of financial and other record, as a whole, comply with the obligations imposed under corporate rules and laws and also with all professional standards and pronouncements of relevant professional bodies as applicable in Pakistan. Another criteria is that if Public Sector Company fails to conduct its business as per development targets of the Government and with the legitimate policy objectives, it shall not be regarded as conducting its business in a sound and prudent manner.

7.4 Composition of the Board

The rules require a diverse board of director for public sector Company having “the requisite range of skills, competence, knowledge, experience and approach so that the Board as a group includes core competencies”. To ensure diversity in board, the rules require PSCs to have at least one-third of its total members as independent directors. Moreover, rules require PSC to take necessary steps for election of director(s) representing minority shareholders.

The rules requires that the particulars of non-executive, executive and independent directors, of public sector companies, need to be disclosed in annual report. It also states that Independent directors shall not be allowed to participate in any such schemes resulting in entitlement of any interest in the Public Sector Company. Directors of the Public Sector Companies are not allowed to be on the board of more than five companies simultaneously, except their subsidiaries. The rules further require that the competent authorities while appointing/nominating directors, shall keep in mind the fit and proper criteria (FAPC).

7.5 Director's Term and removal:

The appointment of a director, removal, filling of casual vacancy, and disqualifications are managed through related sections and clauses of Companies Act 2017. The term of director after appointment or election shall be three years, unless resignation or removal occur. In the case of any casual vacancy, seat shall be filled as per related sections of Companies Act 2017.

The removal of an elected director shall only take place as per Companies Act 2017. However, the rules states the criteria about removal of nominated directors in detail. Notice of removal to a nominated director, as per rules, must also give reasons. The conditions for removal of nominated directors are the following:

a) if the performance of director are not up to mark as per performance evaluation criteria;
b) if the director fails to fulfil his duties and responsibilities under these rules;
c) if the director is found to be in non-compliance with the provisions of the Ordinance or these rules;
d) if the director fails to comply with or deliberately ignores policy directives of the Government;
e) if the appointing authority decides to withdraw the nomination;
f) if he is found of having misconduct, which includes the following:
   i. indulging in a competing professional or personal conflict of interests’ situation;
   ii. using the funds, assets and resources of the Public Sector Company without due diligence and care;
   iii. failing to treat the colleagues and the staff of the Public Sector Company with respect, or using harassment in any form of physical or verbal abuse;
   iv. making public statements without authorization by the Board;
   v. receiving gifts or other benefits from any sources external to the Public Sector Company offered to him in connection with his duties on the Board;
   vi. abusing or misusing his official position to gain undue advantage or assuming financial or other obligations in private institutions or for persons which may cause embarrassment in the performance of official duties or functions:
7.6 Separating the role of the chairperson and chief executive:
These rules require to keep two important positions in the company, i.e. chairperson and CEO, to be separate. Rules further require that, if not appointed by the government, then chairman of the Board shall be elected by the Board of Directors of the Public Sector Company.

While explaining the role of the chairman of the Board, the rules state that proper working of the board, conduction of board meetings and ensuring governance matters of Public Sector Company is the responsibility of chairman. He shall ensure that “all the directors are enabled and encouraged to fully participate in the deliberations and decisions of the Board”. The chairman should not be engaged in operational activities of the company but his role is to ensure its effective functioning and continuous development by assuming a key role to lead the business. On the other side, the responsibility of managing the Public Sector Company rests with chief executive officer. He is responsible for “making appropriate arrangements to ensure that funds and resources are properly safeguarded and are used economically, efficiently and effectively and in accordance with all statutory obligations”.

7.7 Responsibilities, powers and functions of the Board
PSCCG rules 2013 emphasize a lot on board, its composition, power and responsibilities. The fiduciary duties of directors in the board have been explained in length in these rules. The directors, including ex officio directors, in public sector companies are the person who, with a sense of objective judgment, will assist the company to achieve its objectives.

If the chief executive officer of Public Sector Company is not nominated by the government then it shall be the responsibility of the Board to evaluate the candidates for the post of CEO and recommend at least three candidates to the Government for its concurrence for appointment of one of them as chief executive of the Public Sector Company. The development and succession planning of the chief executive shall also be the responsibility of the board. Summarily, the board shall be responsible for the following:

a) To inform all shareholders about all material events in a timely manner:
b) To ensure the placement of professional standards and corporate values
c) To disseminate the “code of conduct” which articulate acceptable and unacceptable behaviors.
d) To ensure that adequate systems and controls are in place for the identification and redressal of grievances arising from unethical practices.
e) To establish a system of sound internal control, which shall be effectively implemented at all levels within the Public Sector Company, to ensure compliance with the fundamental principles of probity and propriety; objectivity, integrity and honesty and relationship with the stakeholders;
f) To develop and adopt a vision or mission statement and corporate strategy
g) To formulate significant policies of the Public Sector Company
h) To ensure compliance with policy directions received from Government from time to time.
i) To ensure compliance with the reporting requirements from all concerned. The board shall nominate the company secretary or any other official at appropriate level as focal person for maintaining liaison with the Government regarding the aforesaid matters.

It is the responsibility of the board to formulate significant policies. A complete record of particulars of the said policies shall be maintained along with approval or amendment dates. Such significant policies include, but not limited to, the following:-

“(a) the formal approval and adoption of the annual report of the Public Sector Company, including the financial statements; (b) the implementation of an effective communication policy with all the stakeholders of the Public Sector Company; (c) the identification and monitoring of the principal risks and opportunities of the Public Sector Company and ensuring that appropriate systems are in place to manage these risks and opportunities, including, safeguarding the public reputation of
the Public Sector Company; (d) procurement of goods and services so as to enhance transparency in procurement transactions; (e) marketing of goods to be sold or services to be rendered by the Public Sector Company; (f) determination of terms of credit and discount to customers; (g) write-off of bad or doubtful debts, advances and receivables; (h) acquisition or disposal of fixed assets and investments; (i) borrowing of moneys up to a specified limit, exceeding which the amounts shall be sanctioned or ratified by a general meeting of shareholders; (j) Corporate social responsibility initiatives including, donations, charities, contributions and other payments of a similar nature; (k) determination and delegation of financial powers to Executives and employees; (l) transactions or contracts with associated companies and related parties; (m) health, safety and environment; (n) development of whistle-blowing policy and protection mechanism; (o) capital expenditure planning and control; (p) protection of public interests; and (q) human resource policy including succession planning.”

After formulating key policies, the board should establish such appropriate mechanism to have access of all information and resources for effective decision making. For this, significant issues shall be placed before the board for approval or consideration. Such significant issues shall include the following:

a) annual business plans, cash flow projections, forecasts and long term plans; budgets including capital, manpower and expenditure budgets, along with variance analyses;
b) internal audit reports, including cases of fraud or major irregularities;
c) management letters issued by the external auditors;
d) details of joint ventures or collaboration agreements or agreements with distributors, agents, etc.;
e) promulgation or amendment of a law, rule or regulation or, enforcement of an accounting standard or such other matters as may affect the Public Sector Company;
f) status and implications of any lawsuit or judicial proceedings of material nature, filed by or against the Public Sector Company;
g) any show cause, demand or prosecution notice received from any revenue or regulatory authority, which may be material;
h) material payments of government dues, including income tax, excise and customs duties, and other statutory dues including penal charges thereon;
i) inter-corporate investments in and loans to or from associated concerns in which the business group, of which the Public Sector Company is a part, has significant interest;
j) policies related to the award of contracts and purchase and sale of raw materials, finished goods, machinery etc.;
k) default in payment of principal or interest, including penalties on late payments and other dues, to a creditor, bank or financial institution or default in payment of public deposit;
l) failure to recover material amounts of loans, advances, and deposits made by the Public Sector Company, including trade debts and inter-corporate finances;
m) any significant accidents, dangerous occurrences and instances of pollution and environmental problems involving the Public Sector Company;
n) significant public or product liability claims made or likely to be made against the Public Sector Company, including any adverse judgment or order made on the conduct of the Public Sector Company or of any other company that may bear negatively on the Public Sector Company;
o) disputes with labor and their proposed solutions, any agreement with the labor union or collective bargaining agent and any charter of demands on the Public Sector Company;
p) annual, quarterly, monthly or other periodical accounts as are required to be approved by the Board for circulation amongst its members;
q) reports on governance, risk and compliance issues;
r) whistle-blower protection mechanism;
s) report on Corporate Social Responsibility (CSR) activities; and
t) Related party transactions.
The rules further state that appointing authority (i.e. the government) will evaluate the performance of the board, the chairman and the chief executive. Whereas the performance of executives/senior management will be monitored and evaluated by the board, at least annually, against some key performance indicators (KPIs).

7.8 Board Meetings in Public Sector Companies
The Board is required to hold at least four meetings in a year, i.e. once in every three months. These minimum number of meetings will help board in discharging board’s duties and obligations efficiently and effectively. The rules require that “written notices of meetings, including the agenda, duly approved by the Chairman, 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 by the Board”. It shall be the responsibility of the chairman of the Board, to ensure the proper record maintenance of proceedings of meetings of the Board, by approving them under his signature. After approval of chairperson of the board, these minutes of meetings shall be circulated, to directors and officers entitled to attend Board meetings, not later than fourteen days. It is important to note that Board meeting through video-conferencing is a valid meeting in eyes of law provided its proceedings are properly recorded.

In case of non-compliance about one meeting every quarter, the matter shall be reported to the SECP with justification and explaining the reasons of non-compliance, within fourteen days of the end of the quarter in which the meeting should have been held.

The rules 2013 makes it mandatory for chief financial officer and the company secretary of a Public Sector Company to attend all meetings of the Board. However, in this capacity, they are not entitled to cast a vote at meetings of the Board.

7.9 Related party transactions
One important way toward effective governance is through proper financial disclosure. Proper disclosure regarding related party transactions is extremely important for transparent decision making. Related parties. Parties are considered to be related if one party has the ability to control the other party or to exercise significant influence or joint control over the other party in making financial and operating decisions.

The definition of related party represents the potential conflict of interest which can be harmful towards shareholder’s interest. Related party transaction represents transfer of resources, services, or obligations between related parties, regardless of whether a price is charged or not. The rules 2013, in general, requires the public sector companies to maintain party wise detailed record of related party transactions. Such detail will include the related party name; nature of relationship; amount of transaction along with the terms and conditions of transaction, including the amount of consideration received or given.

Another additional clause in these rules with respect to Public Sector Company is that PSC may seek a “general mandate from its members for recurrent related party transactions of revenue or trading nature or those necessary for its day-to-day operations such as the purchase and sale of supplies and materials, but not in respect of the purchase or sale of assets, undertakings or businesses. A general mandate is subject to annual renewal”.

Every Public Sector Company is required to prepare quarterly financial statements, within one month of the close of quarter, for the Board’s approval. These quarterly statements need not be audited however in case of listed company, half-yearly financial statements should have gone through limited scope review by the external auditors. Annual report of Public Sector Company should be available on the Company’s website. The financial statement of Public Sector Company shall be according to International Financial Reporting Standards, as per section 234 of the Ordinance.
The financial statement of Public Sector Company shall be submitted to the board, after signature by the chief executive and the chief financial officer, for consideration and approval of the audit committee and the Board. After the approval of the Board, financial statement will be authorized for issuance and circulation.

The rules 2013 also emphasized on the Orientation courses for directors to make them well conversant with the corporate laws and practices. In Public sector companies, the resources in the hands of directors relates to public funds. Therefore, in order to acquaint the Board members with the wider scope of responsibilities concerning the use of public resources, PSCs are required to arrange at least one orientation course annually for the directors. The scope of such training should be to provide knowledge about the aim and objectives of the company, its key policies and procedures, risk management and internal control framework, delegation of financial and administrative powers, and background of key personnel. The information about their job descriptions, board and staff structure; and budgeting, planning and performance evaluation systems will provide more insight to the directors.

7.10 Board committees in Public Sector Companies
Rules suggest various committees for PSC for efficient working of the companies. These committee are the following:

a) Audit committee, for an efficient and effective internal and external financial reporting mechanism;
b) risk management committee, in case of Public Sector Companies either in the financial sector or those having assets of five billion rupees or more, to effectively review the risk function;
c) human resources committee, to deal with all employee related matters including recruitment, training, remuneration, performance evaluation, succession planning, and measures for effective utilization of the employees of the Public Sector Company;
d) procurement committee, to ensure transparency in procurement transactions and in dealing with the suppliers; and
e) nomination committee, to identify, evaluate and recommend candidates for vacant positions, including casual vacancies, on the Board, including the candidates recommended by the Government for consideration of shareholders or in case of casual vacancy to the board of directors after examining their skills and characteristics that are needed in such candidates. The nomination committee shall submit its proposal within thirty days of a vacancy arising or on a recommendation made by the Government as the case may be.

All the committees shall be chaired by non-executive directors with the presence of independent directors, not be less than their proportionate strength. Such committees must have written terms of reference that define their duties, authority and composition, and shall report to the full Board.

7.11 Chief Financial Officer, Company Secretary and Chief Internal Auditor
The board of Public Sector Company is the appointing authority for the post of Chief Financial Officer, Company Secretary and Chief Internal Auditor. Their appointment, remuneration and terms and conditions of employment shall also be determined by the board. Therefore, the removal for three posts cannot be made except with the approval of the Board.

To be appointed as the chief financial officer of a Public Sector Company, the candidate should be member of a recognized body of professional accountants with at least five years relevant experience, in case of Public Sector Companies having total assets of five billion rupees or more; or holding a master degree in finance from a university recognized by the Higher Education Commission with at least ten years relevant experience, in case of other Public Sector Companies.

The job description of company secretary shall be to ensure the compliance with board procedures, corporate laws, rules and regulations including other relevant statements of best practice. If the
PSC does not have full time company secretary, the role of company secretary may be combined with chief financial officer or any other member of senior management.

To be appointed as the company secretary of a Public Sector Company, the candidate must be member of a recognized body of professional accountants; or member of a recognized body of corporate or chartered secretaries; or person holding a master degree in business administration or commerce or being a law graduate from a university recognized by the Higher Education Commission with at least five years relevant experience.

7.12 Directors’ report to the Shareholders
It is one of the responsibility of directors to inform shareholder about their sum of money in laymen terminology. The Board shall make the following statements to inform the shareholders, as required under relevant section of Companies Act 2017, that the Board has complied with the relevant principles of corporate governance along with identifying the rules not complied with. The complete set of financial statements along with statement that proper books of account of the Public Sector Company have been maintained and accounting policies have consistently been used and discretionally accruals (i.e. accounting estimates) are based on reasonable and prudent judgment. Director’s report also states that a sound system of internal control has been implemented and regularly reviewed and monitored. Another important statement is that the appointment along with compensation of chairman and other members of Board are in the best interests of the Public Sector Company as well as in line with the best practices.

7.13 Disclosure of Interests by Directors and Officers
The governance rules 2013 for Public Sector Company require form its directors and other senior management to disclose their interest at the meeting of the board. If he/she or his/her relative, is in any way, directly or indirectly, concerned or interested in any contract or arrangement entered into, or to be entered into, by or on behalf of the Public Sector Company shall disclose the nature of his concern or interest at a meeting of the directors. Such directors and officer and the company shall ensure that such information is properly presented at such reasonable forum where the matter relating to such proposed contract or arrangement is to be discussed and approved. The similar condition will be applicable if directors/officers have such interest before joining the Board.

7.14 Directors’ Remuneration
The rules suggest for a formal and transparent procedure for fixing the remuneration packages of individual directors with the underline principle that no director shall be involved in deciding his own remuneration. Rules further require public sector Company to disclose the details of the remuneration of each director, including salary, fringe benefits and performance-linked-incentives, if any.

7.15 Audit Committee
Audit committee is one of the most important tool for ensuring effective governance. In public sector Company, the members of audit committee shall be financially literate and majority of them, including its chairman, shall be Independent Non-Executive Directors. The names of members of the audit committee shall be disclosed in each annual report of the Public Sector Company. To ensure independence, the chairperson of the Board and the chief executive shall not be a member of the audit committee. To assist the audit committee, the CFO, the chief internal auditor, and a representative of the external auditors shall attend all meetings of the audit committee. However, at least once a year, in the absence of chief internal auditor, the audit committee shall meet the external auditors to ensure independent communication between the external auditors and the audit committee. Similarly, at least once a year, the audit committee shall meet chief internal auditor and other members of the internal audit function in the absence of the chief financial officer.

There should be a secretary of the Committee, appointed by the board, to disseminate the information and minutes of its meetings to the all concerned, within fourteen days of the meeting.
7.16 Audit Function in Public Sector Company

Every Public Sector Company shall have an internal audit function which will be headed by the chief internal auditor, who shall be accountable to the audit committee and have unrestricted access to the audit committee. To be appointed as chief internal auditor, one should be approved as “fit and proper” by the Audit Committee. He or she must have at least five years of relevant audit experience and is a member of a recognized body of professional accountants; or certified internal auditor; or certified fraud examiner; or certified internal control auditor; or person holding a master degree in finance from a university recognized by the Higher Education Commission. The internal audit function should have an audit charter in accordance with the standards for the professional practice of internal auditors issued by the Institute of Internal Auditors Inc.

Similarly, every Public Sector Company must have an external audit function, also known as statutory audit. The external auditors, working on behalf of shareholders, shall independently report to them in accordance with statutory and professional requirements. External audit report shall be submitted to the Board and audit committee as well.

To avoid any possible conflict of interest, the external auditors shall avoid non-audit services in addition of external audit assignment. Auditors should not perform management functions or make management decisions.

External auditors of every Public Sector Company, in the financial sector, must be changed every five years. However, company other than those in the financial sector shall, at a minimum, rotate the engagement partner after every five years. To ensure independence and integrity of external audit function, the rule require that “no Public Sector Company shall appoint a person as its chief executive, chief financial officer, chief internal auditor or director who was a partner of the firm of its external auditors (or an employee involved in the audit of the Public Sector Company) at any time during the two years preceding such appointment”.

Every Public Sector Company is required to publish a statement certifying its compliance with PSCCG rules 2013. The company shall also ensure the certification of said compliance statement by the external auditors, where such compliance can be objectively verified. Only SECP ha right to relax any of these PSCCG rules if the commission is satisfied that it is not practicable to comply. “Whoever fails or refuses to comply with, or contravenes any provision of these rules, or knowingly and willfully authorizes or permits such failure, refusal or contravention shall, in addition to any other liability under the Ordinance, be punishable with fine and, in the case of continuing failure, to a further fine, as provided in sub-section (2) of section 506 of the Ordinance”.

Conclusion

Public Sector Companies (Corporate Governance) rules 2013 is right step in right direction. Improvement in governance and accountability mechanism in public sector companies will have multiplier impact on GDP and overall economic growth.
Govemance, Strategy and Risk Management in Corporations

This chapter provides coverage to risk management, corporate strategy and corporate governance. Corporate governance has become an argumentative and hot-button topic in both the modish and financial media. A link between various risk management strategies has been described in this chapter and how it relates to corporate governance mechanism that how it strengthens the risk management and besides this what is the background that lie aside of both the subject matter. In this new era whether there exist any scope of risk management with corporate governance. The world has witnessed the financial distress which resulted in demise of several big organization including American International Group, Adelphia, Bear Stearns, Enron, Global Crossing, Lehman Brothers, Tyco, and WorldCom. This chapter concludes whether corporate governance and risk management strategies are practiced in listed and state companies or simply theoretical still.

8.1 Defining the nexus

Risk management deals with chances of loss that arises as a result of exposure. It includes actions and policies that management apply for adverse outcomes and increase the chances of positive outcomes, and is a tool for managing several risk strategies. On the other side, corporate strategy is the injunction and a mission with specific objectives any organization undertakes with the aim of accomplishing business success in long run. Latest approaches have central eye on the need of companies to accommodate and accept changes in business atmosphere. Whereas corporate governance is a mechanism which administer with problems that arises because of fractionalization and control. Therefore, governance framework requires an effective risk management strategy which should be in congruence with overall corporate strategy. One important objective of effective corporate governance is, therefore, to ensure the deliberation on corporate strategy and risk management.

8.2 Objectives of risk management, corporate strategy and corporate governance

Risk in a corporation is categorized into two type, i.e. operational risk and nonoperational risk. Operational risk includes quality of a products, sustainability, health and its environment, whereas non-operational risk includes market its strategy, governance judicial and finance in formation. The main objective of risk management is to create a framework that sort out the companies' risk. This risk is linked with the companies on side by side and should be planned by highest level for the management process and strategies process. Organization are faced with various types of risk within the broader classification of operational vs. non-operational risk. These are the following:

- Pure risk which is exogenous in the presence of any error
- Risk associated with market and the change in price commodities known as market risk.
- The default risk mainly known for recovery rate
- Risk attached with fraud and breakdown etc.
- Liquidity risk mainly arises due to dis-honoring short term obligations.

A system of rules and regulations as well as policies the responsibilities and measurement assign by shareholder to erase the conflict which takes place in the firm. For the functioning of market corporate governance is an essential tool, and this instrument is used for market which have an impact on risk and value associated with the firm. Some of the important objectives of corporate governance includes to minimize the cost of conflict between managers and shareholders and to ensure that stewardship of assets of company.
The objectives of corporate strategies insured that its aim is to keep prosperous the current and upcoming health of business. Objectives are given priority on the basis’s of SWOT (Strengthen, weaken, opportunities and treats). Corporate strategy aims to set the financial resources and physical resources and keep in touch with development of innovation ad actions.

Risk is known as a phenomenological fluid. Risk management has become a latest corporate function. Risk management takes place after World War 2. This subject matter is linked with market insurance to guide individuals and companies from huge losses. New configuration of pure risk management come up during the mid of 1950s. As a choice to market insurance when it became expensive and incomplete and some business risk were costly or impossible to insure. The use market derivatives as a solution to manage risk in 1970s and spread fast till 1980s. Financial risk management has become supplemental to pure risk management for many companies. Financial risk developed models formulas and calculation to keep them self from anticipated risk and to reduce capital. Therefore, risk management have an eye on the stop and alleviate of losses. Corporate strategy is linked with the activities of the company to the environment in which it grows. As a result of inducing wealth a change in industrial sector shifts the power balance between a country and other factors. The history of corporate governance first come into being into the 1970 in US. Newspapers produce detailed data of corporate deception, accounting dishonor, insider trading, extravagant compensation, and other organizational failures—many of results in lawsuits, surrender, and bankruptcy.

Corporate governance provides a code for companies due to which every financial institution gets equal rights. In the sudden crash of The Wall street Crash 1929 judicial scholars such as Adolf Augusts, Edwin Dodd and Gardiner C. Means deliberate on the changing role of the modern corporation in society. From the Chicago School of Economics, Ronald Coase introduce the notion of transaction costs into the understanding that why firms are made and why their behavior changes massively. In the early 2000 the huge fall of ENRON led interest in the corporate governance. This was clearly mentioned in Sarbanes Oxley act 2002. In East Asia the financial distress clearly effects the economies of Thailand, Indonesia, South Korea, Malaysia and Philippines. The lack of corporate governance mechanism in these countries clearly shows the weakness of the institution in their economies and business cycles, And after this, Iran and Gulf countries also introduce their code of corporate governance.

8.3 Risk management, strategies and governance in corporate crises

Corporate mis-governance was of the reason behind the global financial crisis. A large number of financial and non-financial institutions collapse during the crises and some were bailed out by government. Policy makers and academicians are convinced that the risk management had a wide impact on firms that were defaulted during the crises period because risk management is the responsibility of the board. A crisis can be defined as a time, a period of assorting, a climax and time of economic crisis all over the environment. The theme of the crises is very often compare to the concept of a crisis situation; where these concepts are not same and somehow difference lies in between them – A crisis is a component of every company and of a crisis period, – Every risk is a crises situation sometimes, but not every crisis situation has an element of a crisis. Its occurrence does not change the firm as whole but gives some objectives for being out of crises situation. Once a risk is identified it means all types of risk are known including all types of hazards as well as causes and remedies attached with that crises. And for the identification procedure all type of material information should be availed. The way for defining risk can possess the following such as brain-storming; questions answers; business wheel, which by discuss and describe the internal and external factors of the activity.

Risk estimations a key used in risk to conclude and determines risk route. Risk can be measured both by qualitative and quantitative method and is based on the probabilism as well statistical procedure.
Evaluation of risk mean the estimated values of risk compared, with the conclusion from its estimation, with the yardstick taken up by the organization. The major objectives are satisfied for knowing the level of risk. Risk planning involves the purposefulness of the specific level of risks and its acceptable standard and the way how to manage and plane according to different types of risk. Control means the organized tool for the threshold of the risk-management plan due risk verification. It also keeps an eye on whether the risk level had increased or decreased and make changes related to risk.

Risk assessment is the way to check where any hazard arises because of risk management or not. As large number of institutions were collapsed in crises of 2007-2008. Many consider it as a fault of corporate governance. There was a huge increase in CEO turnover for financial institution during the period of crisis. Some of the scholars suggests that the major focus of the independent directors and the organized institution invest on short term profit that had led to poor performance of CEOs and directors and firms are encouraged for crises. CEOs turnover is more sensitive for the well-being of stakeholder and shareholder and losses for firms and greater board independence with massive institutional ownership, but less in range for shareholder and firms with huge insider ownership. And independent board investors should keep in mind the shareholder profit to challenge the CEOs, if the company is in losses and should have the right to remove the CEOs if they are uncomfortable with him. Investors can exercise on corporate governance discussion through legal and without indirect activities. Many variables are used to capture corporate governance during the period of crises: insider ownership, board independence, ownership of institution and CEOs compensation. If corporate strategy is applied for success plans than it can well be applied for controlling risk strategies of a company. If corporate strategy is applied so it enhances the boom to business. Corporate strategy is at a locus point for capitalizing and responds to the surrounding environment at the time of development through the accession of competitive position. OECD conditions and rules states that the board of the company should monitor the risk while in some companies it is left solely on management of the company. Also research finds that risk management policies are either not prepared or not implemented properly. The system of remuneration need to be linked to strategy and risk in long run.

8.4 Strategic Risk Management and governance
The present economic situation and the negativity that prevails because of financial crisis of 2008-09 have significantly affected many institutions. It gives great importance to strategic risk management. After that event directors of many organizations have started focusing on the risk management and related issues of their organizations and they regularly asked questions from their management how they identify, monitor their risk. They actively get participation in risk management and in risk assessing initiatives, especially chief financial officers and other management teams. Many directors think that to focus on risk and risk management is new and somehow frightened. However, the most important question is where to initiate, risk management and managed their valuable time to make high profit for the organizations.

After interaction with senior executives and many directors, we come to know that the right place is to initiate from identification and strategic risk management. It is not important to focus on every single risk that organization is going to face but most importantly to identify only those risk that have ability to achieve its business objectives and strategies. Accordingly, these risks deserve directors, senior management time, and their attention.

Following are the four ways, by which an organizations manage their risk:

- Corporate
- Department
- Borough and,
- Project
Corporate
Risk that is generated at the corporate level have a severe and most possibly shocking effect on how we work. It is noticeable by the people and it can generate huge media coverage because of risk occurring event. Furthermore, it includes strategy level risk in decision-making. Corporate risk can normally be control by splitting it to a number of business areas. To manage risk and to offered suitable leadership, risk ownership is essential at high level.

Department
Risk that happens at the departmental level does not have any severe impact for the organization as a whole but it is only concerned for the related department. They are still noticeable by many other departments and might affect areas of work particularly their impact can be feel in relevant department. Risk ownership will be assign to the head and other specific risk will be assign to senior officer in their relevant areas.

Borough
Risk that happens at the borough level are the one that have severe impact on the provision of service in that region, however the influence of such risk does not impact organization as a whole unless other regions also were suffering from similar risk event. It can be control either by sitting with regional commander and station manager or through management funds and policies.

Project
Risk management in project follows the similar principles and similar risk assessment to value project risk. In many cases, it keep on with the project and assigned to an elected project team member. It can also intensified to corporate level via project supporter who is accountable for the project risk.

8.5 Strategic Risk Management
SRM is an essential but sometimes it is unnoticed characteristic of Enterprise Risk Management (ERM), strategic risk management is more significant as compare to operational risk and ERM, because later more focused on financial. Recent studies of large companies has designated that strategic risk explain for more than sixty percent of main reduction in market capitalization while impact of operational risk on market capital reduction is about thirty percent and ten percent is effected by financial risk.

Strategic risk is always confused with operational risk. It is arises when company do not anticipate well on time what market need in order to meet them.

Why many people who are risk averse expose themselves deliberately to risk in order to increase their disclosure over time? They may believe that, by exploitation of risk they can gain & generate value. There are many example of successful companies who prefer taking risk rather than avoid it. But there are many, who attribute the achievement of these companies to luck. Many companies must have a pattern that help them deal with risk that provides gain over competition.

Generally, Effective risk management can be define as to evade strategic failures. We may classify five cohesive elements that support a firm’s aptitude in risk management each element is relates to one another.
8.6 Elements of corporate governance to manage strategic risk

Culture
Culture plays an important role in maintenance of an attitude with arrogant. It also encourage secrecy but often reluctance to accept failure that have produced dreadful consequences. According to Schein (1996), culture plays an important and influential role in decision-making and an organization strategy. It can be helpful in strategic risk management but it also involve some sort of negative behaviors. In 1996, Professor Schein’s reveals that the personality of the founders can make and shape the culture of an organization. He further perceives that culture is also influenced by past events and it can be reshaped by system. Expressively, he believes that the managers of an organization should know that culture of an organization has power to effect values.

In order to ensure a healthy culture in an organization, academics have identified many ways. Professor Schein endorses that we need to develop learning capacity in an organization and also spread awareness regarding culture that how it help in shaping organization effectiveness, he further says that, to achieve this goal we need coaching skills and consultation. Many professors recommend cultural audit to evaluate an organization and define its improvement. They suggest that board’s director should involve firm from outside for cultural audits & it should conduct after every 3 years. In cultures, Prof. Morrison and Milliken propose that there is need to change in top management and for that, time and struggle are required to overwhelmed employee hesitation. Author propose to the board many ways to address the cultural weakness that includes implementing strong and new control over management team, they need to educate their employees, they should increase communication system and provide each and every one coaching.

Leadership
In an organization the empowerment of any worker is mainly depends on organizational capability to reveal a leadership style. It help in building a safe atmosphere where teams feel relaxed and support participation. In an environment where employee feels safe and have a voice companies through involvement of supporting leadership can more promptly classify and address possible threats and can drop volatility & risk. Professor Conger reveals dark side that the skills and leaders personality that is help in rising to the best, sometimes also leads toward their downfall. The study proves that allure, does not produce positive effects on its own. Boards should also protect against bad leadership by implementing on seven mechanism. These mechanisms are

a) Expending values-based management
b) Set an example
c) Creating clear prospects of ethical behavior
d) Providing feedback, and support concerning ethical behavior
e) Identifying and rewarding performances that sustenance administrative values
f) Being responsive of individual variances among assistants and
g) Creating leadership teaching and mentoring.
Board member and the leaders who engage themselves can expand the standard of risk management and governance. Appropriate leader are important for rising values, culture, ethical character & in development of an organization.

**Alignment**
The US SOX and other supervisory changes want firms to expand alignment between financial reporting, governance and risk management. The board should evaluate the efficiency of the audit committee. The audit committee plays an important role in management of risk. There are many significant features of alignment between strategic risk management, risk management and governance. Misalignment can rise from quick organizational change, failure of governance, & absence of implementation of a strategic perception on risk & decision-making. There is need to identify these misalignment and deal with them. Corporate strategies should be well align. Leadership plays an important role in efficiency of an organizational alignment. It should be align with structure & culture system.

**Systems**
In order to improve risk management a firms need to consider the capability of system to analyze manage identify and forecast a large range of strategic risk. However, there is important interaction among the fundamentals of CLASS. It is suggested that, global firms must take national cultural changes in manipulating control systems.

**Structure**
SOX-404 needs managers to pay more attention at the structure of an organization. It is necessary that they should be aware of association between structures of internal control. Farrell also proposes the characteristics of internal auditor that may become more projecting as the requirement for communication and internal knowledge sharing is effective for risk management practice. Within an institution an auditor, become promoter and an educator for best practices. Structure may emphasize an individual for their organizational role, and it can affects culture.

8.7 **Risk Management Strategies**
Risk management strategy is not only about reduction of risk taking, which is truly an essential driving force in a business. One lesson that we have learnt from financial crisis is that we need to emphasis more on risk management practice in both financial & non-financial companies. It is to recognized, that, in latest years listed companies has been focusing more significantly on risk management. They received short-term information as said by directors. Financial & non-financial risk is face by most of companies that is why they focused more on market, credit and liquidity risk & emphasized more on operational risk. Same risk is face by non-financial organizations but their extent is not always same as that of financial organizations. Risk governance procedures are suitable for financial organizations thus; it is not directly relates to non-financial organizations. Most of lesson that we learn in financial sector is due to risk management failure. In the non-financial organization, little work have done from the lesson learnt from the risk management failure.

**Risk management practices in state-owned enterprises**
Two types of organizations have raised in the last crisis, when evaluating risk-seeking behavior these are as follows

- SOEs which is considered as state owned financial organization
- SOEs which is considered as enterprises owned by sub national level of government,

The most challenging examples of risk management happened in banks and other institutions that are owned by SOEs. These institutions comparatively faced great losses then private entities. It happens may be due to their low quality risk governance. The board of directors in the state own companies are of low quality as compare to the private sector hence they did not perform their function appropriately.
Risk management practices in unlisted companies
The purpose of risk management in unlisted companies is to certify that company is working efficiently and information that it reveals is reliable. It is responsibility of the board of directors and the managers that company should operate according to the law and article that is associated with company. Risk management is to certify that risks that affects company's business should be recognized and monitor properly.

8.8 Challenges and Issues in Implementing ERM
Jerry Micolism highlighted some of main issues with respect to implementation of enterprise risk management in his article “Implementing Enterprise Risk Management: Getting the fundamentals Right”. According to him, most of the companies consider the concept of enterprises risk management, most are unsatisfied by the execution issues that has seemingly not made their enterprises risk management practice more positive, as it possibly is. The COSO (Committee of Sponsoring Organizations’ of the Treadway Commission reports that most difficult management challenge is to determine the risk an organization is willing to take.

8.9 Conclusion
The core principle of risk management is not eradicating risk but it is which risk to take and which one to avoid and pass it to the investors. In this chapter, the process of identification and monitoring of risky has been discussed at length. The important features of risk takers and risk avoiders have also been presented. Finally, the effects of institutional structure and culture on inspiring and fostering risk taking is discussed. The chief financial officer and their management team have an opportunity to support senior management & directors in risk management process. So that they can dedicate their full attention towards risk strategy.

The Strategic Risk management can deliver a foundation and first step for governance and risk management that will explain the path to evolving risk management proficiencies for how risk is evaluated, managed and monitored. It is important to understand that less attention is paid to the significance of institutional risk culture and to the strategic risk management process. Without suitable risk culture all, the institutions are not in a position to identify, mitigate & manage risks. Most comprehensive research is require in order to study strategic risk management within these sectors.
CHAPTER-9

Financial Reporting, Disclosure and Audit

9.1 Introduction
The start of this century has witnessed various huge collapse of big organizations e.g. Adelphia, Enron, WorldCom etc. Further investigation of these collapses reveals that most important reason, among others, was related to low quality of financial reporting, auditing quality, and audit committee. Financial reporting along with accounting disclosures and quality audit not only help in ensuring accountability and transparency but also investor’s confidence can be maintained. This chapter focuses on the role of financial reporting and auditing along with the impact of an audit committee on overall financial transparency and its impact on corporate governance.

The corporate structure influence the quality of financial reporting crucially. The board at the organization with concentrated ownership or block-holding, normally care less about quality of financial reporting as they are of the view that agency problem is less likely to exist there. However, the organization having disperse ownership, the need of quality reporting increases manifold. In these organization, shareholders being the ultimate owner of the company, elect directors to supervise or oversight the management of the corporation. The collective status of directors is known as board of directors. This board consist of combination of executive directors and non-executive directors including some independent and minority interest directors. The executive directors in the organization have a greater influence in the decisions within the organizations. Non-executive directors do not involve in day to day operations of the organization and perform a supervisory role generally. The primary goal of financial reporting quality, auditing quality and disclosures is the protection of the investors and as well as users demand and its main focus is to enhance the user’s confidence towards organization. It is very important that the firms reporting’s disclosures should be presented true and fair view from every aspect.

The audit process although has been in the compromising situation because of auditors independence and conflict of interest as witnessed in ENRON and WorldCom cases. However, the mechanism of Audit committee has improved it. An independent audit committee has a great influence on the financial reporting process. The independence of the audit committee determines the quality of corporate disclosures. This is why, as a principle, audit committee is generally consist of non-executive directors of the corporation. The directors are not supposed to have any influence on an audit committee and term of reference along with powers and responsibilities are mentioned clearly.

9.2 Importance of financial reporting for Corporate Governance
The importance of financial reporting can be categorized in two different approaches. First is known as “investor’s protection approach” and the second is known as “user demand approach”. It is very obvious from the approaches. Investor are not insiders for the organization. They do not know the actual position in the organization. They do get understanding through financial reporting. As a proxy for financial reporting quality there is need for the investment view and primarily uses the true and fair disclosures for shareholders. In an organization the financial reporting has significant importance because there are many stakeholders and shareholders which are directly or indirectly associated with the company and they have also some interest of benefits associations and to protect their such benefit interests there is important that the company should have some financial reporting which represents the company’s performance and also regarded this there are also some voluntary disclosers are there.

Similarly, financial reporting is needed for its user. Sometime users are internal and sometime external. The scope of financial reporting needs to be broader in nature to satisfy a general
audience. The quality of financial statement should be the demand which is needed to its users and it should be according to the usefulness from its user’s viewpoint.

It is in the knowledge of related people that there are various informational advantages managers have over shareholders, directors, and other stakeholders. Financial reporting, if as per standards, tend to reduce this informational disadvantage as well. Although, being inside the organization, managers have access to detailed firm-specific information and there exist information asymmetry with respect to directors and shareholders. It is also quite obvious through observation that managers do not always report information, truthfully, that is detrimental to their personal interests, such as information about poor performance or their consumption of private benefits. This information asymmetry makes the Boards at disadvantage while supervising managers. Jensen describes these informational problems in following words, “Serious information problems limit the effectiveness of board members in the typical large corporation. For example, the CEO almost always determines the agenda and the information given to the board. This limitation on information severely hinders the ability of even highly talented board members to contribute effectively to the monitoring and evaluation of the CEO and the company’s strategy (1993, 864)”. Armstrong et al., (2016) states that “in the absence of information asymmetries, boards would likely be able to mitigate many, if not most, agency conflicts with managers. The reason is that boards retain considerable discretion to discipline managers and could therefore take immediate action upon receiving new information. Thus, one potential role for financial reporting is to provide outside directors and shareholders with relevant and reliable information to facilitate their mutual monitoring of management and, in the case of shareholders, their monitoring of directors. Further, to the extent that financial reporting serves to reduce information asymmetries, one expects to observe corresponding variation in the governance mechanisms that are associated with financial reporting characteristics”.

9.3 Auditing and Corporate Governance

The informational advantages of managers over shareholders, directors, and other stakeholders creates a trust deficit as well. The stakeholders including directors come to know the position and performance of company through the documents known as financial statements. How to authenticate that financial statements present true and fair view of the organization. To authenticate these statements, the process of auditing comes into picture as third party certification.

The discipline of auditing, in United Kingdom, was evolved as a profession in 19th century. The basic objective of auditing process has always been providing an opinion on financial statements, as these provides true and fair view or not?. Throughout time process, being professional auditors got involved in other related activities like accounting consultancy, taxation services etc. Now, the audit function is classified into at least two types; first is external audit and second is internal audit. Corporate governance focuses on both types of audit and these function are governed through audit committees in corporation.

External Audit is the independent inspection of an entity’s financial statements. It is mandatory requirement for every company therefore also known as statutory audit. On the basis of audit evidence drawn from audit procedures, the auditor gives an audit opinion as whether the financial statements present “true and fair view” and is there any material misstatement or not.

Auditor can provide four types of audit opinions on financial statements. First type is the “unqualified opinion”, it is given by the auditor when all the documents and financial records presents the true and fair view then the auditor says its unqualified report; second is the “qualified opinion” when all the statements presenting not true and fair view then the auditor says its qualified report; third is the “disclaimer opinion” when the auditor unable to perform audit due to some circumstances which may be created by the management bound the audit team not properly access to the records by the management then in this case the auditor gives the disclaimer opinion; fourth is the “adverse opinion” it is the severe situation when auditor gives such type of opinion, mostly when management provides misleading financial statements or incomplete financial statements then auditor give adverse opinion.
The auditor generates its remarks that the entity prepared its financial statements according to the applicable reporting framework. The key to differentiate external audit with internal audit is to understand that external audit is undertaken after transactions are executed and financial period is complete.

Internal Audit function is performed by individual to ensure that processes within organization are being performed as per applicable rules and regulations. This function is established by directors to oversight the management operations including financial transactions. Internal audit functions is ultimately answerable to the board of directors with the adequate effectiveness of the internal control and accounting. It is commonly used with issues and related to the risk management of the organization and as well as the other aspects of the governance is concerned.

9.4 How Internal Audit is different than External Audit
The following five factors explain the difference between Internal and external audit:

Independence: The external audit experts are the independent (outsiders) of the entity but in case of internal audit, the experts to the internal audit are the, generally but not compulsory, employees of the organization.

Accountable: External audit is responsible to provide the true and fair view to the members or owner of the company but in case of internal audit they just provide to its head of the internal audit.

Role of Watchdog: The external audit provides results for the society corporate as a whole but in case of internal audit its only provides to the internal corporate.

Work Scope is defined: The external audit is the responsibility to provide the opinion on the basis of true and fair view of the financial statements which are prepared by the directors and management for the shareholders of the company.

Regulation Exist: The external audit firms which are providing the external audits are the regulated by the professional accounting bodies and also government statutes, but the internal audit providers firms are not regulated by such regulatory authorities.

9.5 Financial statement frauds and the role of auditing
The manipulation in financial statements is not something new to the world. According to the report of the Committee of Sponsoring Organizations of the Tread way Commission (COSO-1992) that “there are versatile areas for financial statements frauds in which include recognition of improper revenues, assets overstatements (which are related to the revenue fraud other than account receivable), expenses and liabilities understatements, misrepresentations of the assets, and the financial disclosures misappropriations”. According to some estimates a big loss to the corporate world is the cause of financial statements frauds where assets and liabilities are overstated very significantly.

The treatment of improper accounting, recording of assets at the market value, improper calculation of depreciations, inappropriate calculation of amortization against income, capitalization of expenses, transfer of goods recording improperly which are being sold to related party, omission of contingent liabilities in off-balance sheet not recorded as liability properly and omitting liabilities from financial statements have been the practice in the past.

9.6 Auditing and risk based approach in the inspection of financial reporting
There are four popular approaches are to use these approaches the external auditor carry its work in which consist of substantive procedure approach, the balance sheet approach, the risk based approach and the system based approach. From these four approaches no single approach ensures the perfect audit. The auditor used more than one approach to avoid audit failure. Risk based approach are generally adopted in auditing.
The evaluation of the internal audit control system either its working efficiently based on the system audit approach by the external auditor and on the basis of these evolution then focus on the substantive procedures specially on the weak areas which have been assumed objectives to the achievable.

The risk based approach is the direct approach to the financial statements which might be suspect able to misstatements or fraudulent. To identify the material misstatements in which first to understand the entity environment in this regard the auditor used risk approach. The auditor can also using the risk approach comprehends risks in which compliance risk, operational risk and the financial risk. It is very important to observe the risk in misstatements of the financial reports it is compulsory to get understanding to auditor about the entity control system.

9.7 Corporate Frauds and the role of Auditing

Many corporate frauds make the alarming situation in the world. In US, based on the statistics there are billions of dollars are being frauds per year in the business organizations. To avoid from the bad publicity in the public also to bear the high costs to get the prosecution and it's also not possible to proof easily its time taking too. So that is why many organizations bear such loss.

Auditing has a crucial role to prevent such type of frauds but based on the records which are provided by the management and with the effective control system in the organization.

9.8 Financial Disclosures, investors’ confidence and Corporate Governance

Corporate disclosures have the significant importance for the stock markets for its effective performance. Investors trust is directly connected with the corporate disclosures which is provided by the management and disclosed by the corporations for its users. It has a vital role to capture the investor’s interest on the corporations to buy its shares in the stock market; on the behalf of this statement we mentioned above that it is very important for the effectiveness of the stock market.

The financial disclosures also plays a vital role to minimize the asymmetry information and agency problem between the management and principles (Shareholders), the voluntary disclosures has a significant role in this regard to broadcast the corporate financial information to its stakeholders. The disclosure in formations which are provided by the corporations to the investors and users; it might exceed from the cost of disclosures, such as cost of capital and debt cost. Provided the above mentioned benefits, the Financial Accounting Standard Board (FASB, 2000) identify “voluntary disclosures” as “information primarily outside of financial statements that are not explicitly required by the accounting rules or standards”. It has a critical role in the capital markets functions effectiveness.

Researchers are much interested to assess the determinants of voluntary disclosures which are needed to users need or requirements. Those countries have the highly developed capital markets; most of the studies regarding to the voluntary disclosures practices and determinants. As compared to the highly developed capital markets; the emerging markets there is a little research conducted on the voluntary disclosures. There are other factors may involve in developed countries or may have the same influence on voluntary disclosures; such as the main factor may be the institutional mechanism is much strong as compared to less developed countries because these countries which they are less developed have different economies, politics, society, and as well as cultural differences.

Our studies main focus on the voluntary disclosures practices in the corporate annual reports. The corporate literature shows that there are many differences in voluntary disclosures and the main determinant in the corporate governance mechanism in the quality and level of voluntary disclosures practices.

There are eight important elements which are representing the corporate governance mechanisms have been developed to explore these issues are as follows.
1- The family members' rulings on the corporate governance
Signaling theory consideration is being used to derive these elements. To distinguish board, firm and also to themselves, as the board of directors are qualified to operate the business and this may be get from different approaches such as better firm performance and the disclosures policy of the firm. There is a crucial impact of these family rulings on the strategies of the firm and as well as the policies of the firm, such as the disclosures of the firm are concerned. So, there may be expected a causal relationship between the family rulings presence and disclosures of the organization.

2- Government ownerships
From the perspective of the stakeholder’s theory, the government has a key factor in the disclosure of the corporations and most the emerging markets were considered in the ownership structures. The firms which have high level of government ownerships; in this regard these firms have a better potential to expand its operations because government provides the funds to the owned organization to push its operations. Due to this there is less motivation in the disclosure of the financial statements because the main purpose is to attract the investors towards the organization for the purpose to raise funds for to run the operations of the company. In the case of government owned company which also have needs of funds to operate its operations and when its demand funds from the governments it's provided frequently.

3- Family Members on the Board
The constitution of the executive and non-executive directors from the family members has much influence on the quality of the information which is broadcasted for the corporations users. Also in the other case they may have the greater influence to affect the election process of the board of directors and as well as the chairman of the board. There are also some threats are there in which they may have some control in the appointment process of the Chief Financial Officer (CEO) and the other managers of the organization. In the above heading scenario we are talking about the family of that person who owned the company.

4- Audit Committee
There is a significant supervisory mechanism in the organization which is called an audit committee. Audit committees major responsibility is to assist the board as a whole to perform in proper manners, its internal responsibilities and also to increase its effectiveness. There are also some other important responsibilities such as we have already previously that its major role is to oversight the financial reporting process; it has the significant importance in the organizations. The audit committee has also much importance in the internal control system and due to it if the internal control system is working effectively due the some influences by the audit committee then it may have the significant affects in the financial reporting and disclosures.

5- Non-executive directors on the board
In the board of directors there are different types of directors in which executive directors, non-executive directors, independent directors and also the directors who represent the minority shareholders in the organization. Shareholders prefer to select the non-executive directors to oversight the firm on the behalf of the shareholders. It is also expected that the non-executives directors’ existence in the board has a greater influence in the quality of the voluntary disclosures and also its help to decrease the withholdings information with the board.

6- The Duality Role
The issue of duality has been in discussion since Cadbury committee in 1991. There is a sensitive relationship between the principle and the agent in the corporate governance mechanism and the duality of the CEO has the significant affect in this scenario. The most of the discussion in the corporate governance that the chairman of the board and the CEO should be one individual or there should be two individuals. There are pros and cons to both sides of arguments. If the same person will be the CEO and the chairman at the same time then there may arise the conflict in the disclosure of the financial information. Whereas, if there will be two people, then the interest of CEO might not be as shareholders’ centered as it should be.
7- Cross Directorships
Cross directorship is another burning issue in corporate governance discipline. Although seems very simple to understand, still it is one of the complex issues to handle. Cross directorship compromise the independence of director without knowingly. Cross director is define as “a director who is appointed as a director of the other one or two organizations at the same time he is working in an organization. In the cross directorships, the director is the director of different firms at the same time but in this regard they have access of information and due to it there are positive impacts of the financial disclosers of the organization”. It may create the competitive environment between the directors because of one director of different firm at the same time.

8- Board Size
The boards of directors play the most important role in ensuring corporate governance. The diversity in the board, including reasonable persons in numbers, is very much needed. There are some policies and strategies in the board which are followed by the management and as well as the board members to asymmetric the problems of information. The large number of board may reduce the lack of certainty in the information. The size of the board is expected to have great influence when it comes to monitoring the management. The smaller board, relatively without prejudice, has the less capacity to process the information.
CHAPTER-10

Role of Financial Media in ensuring Governance

10.1 Introduction
Corporate governance is the system of rules, practices and processes by which a company is controlled. Corporate governance very deeply involves mechanism the interests of a company's many stakeholders, like as shareholders, management, customers, suppliers, financiers, government and the community. Since CG also provides the framework for attain a company's objectives, it encompasses practically every area of management, from action plans and internal controls to performance measurement and corporate disclosure. However there many issues have risen in recent year due to unethical behavior of executives.

Evolution corporate of governance occurred with some horrible and greedy accident. Some largest companies were involved in fraudulent activities like the Enron, Bearing Bank, BBCCI, and world come. These companies are caused of formation of corporate governance. Here we give bird eye about the causes of governance formation and how these companies contributed.

10.2 Conceptual background
Board personals and executives have been involved in criminal and civil actions over concealed debt, inflated earnings, insider trading, tax evasion, misuse of funds, and breaches of fiduciary duties. Companies like as Enron, WorldCom, and Tyco have become very popular because failures in governance. In India, Harshad Mehta (Securities Scam) and Ramalinga Raju (Satyam Scandal) has darkened the post-global India-shining discourses. In Pakistan, the financial history has episodes of Cooperative society scandals, Taj Quran Company scandal and Double Shah scandal etc.

Such type of activities has triggered the need for clearness and trust among firms, investors and the public. They have highlighted governance issues related to power, representation on boards of directors, responsibilities of directors, independence of directors, financial auditors, independent executive compensation, and relations between boards and executives.

Governance refers specifically to the set of rules, controls, policies and resolutions put in place order to corporate behavior. Though the governance is indirectly affected by the Proxy advisors and shareholders stakeholders, but these are not examples of governance itself. The board of directors is crucial in governance, and it can have major ramifications for equity valuation. These above given just the importance of governance and remarked some issues before corporate governance. The most important pillar of governance is information symmetry. For the sake of this information, governance mechanism focuses on reporting, disclosure and audit.

The media can play a role in corporate governance by affecting reputation in at least three ways. First, media attention can drive politicians to introduce corporate law reforms or enforce corporate laws in the belief that inaction would hurt their future political careers or shame them in the eyes of public opinion, both at home and abroad. Second, media attention could affect reputations through the standard channel that most economic models emphasize. Managers' wages in the future depend on shareholders' and future employers' beliefs about whether the managers will attend to their interests in those situations where they cannot be monitored. This concern about a monetary penalty can lead managers not to take advantage of opportunities for self-dealing. Third, media attention affects not only managers' and board members' reputations in the eyes of shareholders and future employers, but media attention affects their reputation in the eyes of society at large. Thus the media does play a role in shaping the public image of corporate managers and directors, and they also pressure them to behave according to societal norms.
10.3 Why media should report the issues of corporate Governance

Apart from importance of reporting, disclosure and audit, in today’s world the most important source of information is media, whether print, electronic or even social media. However, electronic media, being most speedy and relatively authentic than social media, is the center of attention now days. The names of CNBC, Bloomberg, or Fox Business Network are household names. Acquiring a central position, financial media is playing a strong role in corporate governance as well. That is why, this chapter is to discuss the media related issues and its importance in corporate governance. However financial press is very significant role in disclosures of financial position of any corporate but in past year press might involve some hypocritical activities. It did not tell the true picture of company according to press has been vying disclosure through its financial analysis and revealing stores of corporate wrongdoing.

In April 1992, the Wall Street Journal published a strange advertisement. It was a full-page picture of a profile of the board of directors of Sears Roebuck with the title “The non-performing assets of Sears” the advertisement was given by shareholder activist Robert Monks, exposed of all the directors, those who were identified by name, as accountable for the poor performance of Sears’ stock. The executives, very much embarrassed by the exploration, chose to adopt many of the proposals advanced by Robert Monks, even though he had received only 12 percent of the votes in the previous election for board members and had failed to get a seat on the board (Monks and Minow 1995, pp. 399-411).

In September 2003 Richard Grasso, the chairman of the New York Stock Exchange, misplaced his position because his lavish compensation was exposed and vilified in the press. These are some issues above given exposed by the financial media now the question is what is the role of media in corporate governance?

The media role is to gather info, select, clarify and repackage. It is reduce the cost economic agents dramatically. When the wall street publish journal report table with quarterly performance of mutual fund, for example investors don’t have enough time to collect all pieces of information themselves. Shareholders cannot collect information individually because some time the cost of information exceeds its benefits. Here comes the role of media, to overcome the rational ignorance and the media enhance the number of people who can learn the behavior of other people that increases the effect of reputations.

According to Justice Brandeis “Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants electric light the most efficient policemen.

The question raises here why mass media report the issues of corporate governance. There are two basic reasons the first one is related to ethical dimension in democracy second one is concerned with the pragmatic aspect of create the value of news brand showing and survival in competitive market.

10.4 Corporate managers and media disclosures

It is important to explain why corporate managers respond to media news. There are various empirical reason but theory is the most important thing. The first one is social responsibility theory of media. The media is a guardian of democratic process vigilant on behalf of the citizen and in the interest of fair representation. It works like a watchdog and brings the true and fair news and provides the safeguard to the society. As we know when a corporation becomes fall then millions of people victimize like the shareholder director or all other stakeholder we can say all nation indirectly or directly affected.

Second issue is media ethics it should make sustainable engagement with the force of democracy. The main source of media revenue is advertisement in case of print media and cable fee etc. as we know the media want to maximum viewer rating through it can get better repute. Media make the news interesting as people want to watch and give the power their news same like in corporate affair shall be driven by the desire for maximum audience attention. However effective media keep the corporate accountable to the stakeholder. Here the picture adverse media involve some ineffectiveness and inefficient.
Here some further argues how the media affected corporate governance. We take some different country example also different companies how media make that companies hero with some suitable detail. The press also intersects with different corporate governance mechanisms. Shareholder activists and media. While activists such as “Robert Monks and Nell Minnow” have found the media helpful in their fights with supervision in the United States, do the media have a like effect in emerging markets?

Recent events in the Republic of Korea indicate that it did. Korea had long spam been known as a place where controlling shareholders in the biggest firms of Korea (chaebol) get benefit of their position at the expense of small investors. National corporate laws suggest a small number of rights to external investors they score only 2 out of 5 in La Porta and others (1998) index that measures the strength of guard for minority shareholders and hope in relation to law enforcement are small. Korea has a level half of the average in the industrial countries similarly an index describes to levy countries’ law and order tradition.

10.5 Empirical Evidences for Link
Historical data has been used to choose some specific variable that could be highlighted the various issue related to media issue in corporate governance.

The commencement of efforts to force varies in Korea dates to 1996 and the formation of the People’s unity for Participatory Democracy (PSPD) driven by Jang Ha-Sung of Korea University. As in the United States, this investor activist has focused his attention on changing corporate policies in the largest Korean firms, and has relied both on legal pressures, including proxy battles, criminal suits, derivative suits, and on the use of the media to shame corporate executives into changing their policies.

Maybe to an even greater amount than in the US, the victory stories have resulted more from the creation of public opinion stress than from legal sanctions. The most booming challenge to date has been the battle to stop internal dealings in SK Telecom. SK Telecom was an tremendously profitable company but its financial results did not explain this because the company used shift pricing to benefit two companies almost 100 percent owned by the chairman of SK Telecom and his family. The PSPD drew notice to these policies. After the London-based Financial Times pulled out the story, a press campaign ensued to be a focus for proxy votes. This operation involved publishing advertisements in newspapers and using television and radio. In March 1997 SK Telecom’s directors capitulated and decided to the requests PSPD’s. This success stands in quick distinguish with the failure of legal actions. For example, shareholders ‘proposal are severely restricted and cannot engage the removal of directors or auditors.

Though the only booming legal challenge has been the one to make sure investors’ rights to talk at meeting, though the right to speak can only be used to have an effect on the reputation of the parties involved not to produce any legal remedy. For example, the media gave broad coverage to the information that the Samsung shareholders’ meeting lasted 14 hours. The produce of shareholder and public opinion force was enhancing in the clearness of Samsung’s financial statements.

10.6 How media affect various stakeholders of CG
While institutional investors have many authorized mechanisms to push change in corporate policies, the attendance of an active media increases their authority. It gives a fairly cheap way to put remedies on corporate and to manage the response of other investors in availing themselves of possible legal safety. The California State retirement fund for Public Employees (CalPERS), for example has adopted a policy of identifying performing firms and generating huge media concentration as an worth full tool in its efforts to change companies policies to raise their income. CalPERS recognize a long list of ineffective performing firms according to criteria such as shareholder profits, economic value added and corporate governance. Armed with this list CalPERS legislative body talk to companies to try to get them to change their policies with the warning that if they do not CalPERS may start a proxy competition and will go ahead and disclose the firms in a “focus list.”
This warning of public disclosure is an important part of CalPERS' approach. CalPERS found that when it removed this publicity hazard its policy did not work. In 1993 when numerous CEOs convinced CalPERS that a "kinder gentler" strategy would be less aggressive and more effective, only 2 of the 12 under attack companies negotiated admissable agreements with CalPERS and 4 resisted even meeting with CalPERS personals. As CalPERS chief executive Dale Hanson commented: "'Kindler, gentler' is not functioning. It has exposed us that a numeral of companies won't move unless they have to deal with the problem because it's in the public eye" (Dobrzynski 1992, p. 44). In 1993 CalPERS returned to the policy of publicizing its target lists.

Another case of investors in Russian firms. William Browder, CEO of Hermitage Capital administration, the biggest public equity fund in Russia reported to us that "the single most important corrective mechanism we have against miss governance is the press" (email, May 21, 2002). For instance Browder brought misdeeds at Gazprom in October 2001 to the press concentration and was thereby able to generate publicity about management failures with stories in the international business media with big business Week, the New York Times, the Financial Times, the Wall Street Journal, and the Washington Post.

10.7 How media affect returns

Such media difficulty seemingly had the helpful effect of facilitating synchronization by institutional investors and shaming them to take action to vote for a special audit of the firm amazing that necessary the sanction of 12% of the shareholders and of contributing to other changes in corporate policies. Media reporting on miss governance can also shame politicians and managers who care about their international reputations to act to improve policies in firms. Interestingly, media concentration is viewed as equally significant to legal challenges. As William Browder, Chief Executive Officer and co-founder of the investment fund Hermitage Capital Management ("Hermitage"), reported to say that “The media is one of the reasons why we pursue lawsuits. We have pursued 24 lawsuits so far and lost 23. That is the way it is in Russia. But the advantage is the publicity”.

10.8 Media pressure works?

Media pressures workers by various means and the famous way is by reporting their unethical practices. Unethical practices imply the behaviors conducted and the decisions made by organizational leaders which are illegal and violating the moral standards and those that impose processes and structure that promote unethical conduct by the followers.

The most common unethical practice by the management is the fraud. Some managers engage in fraud by submitting falsified reports that show they have completed work they haven’t done, turning in false expense reimbursement requests, awarding contracts to vendors and suppliers that provide a kickback, selling information to competitors, stealing or using company supplies or property for personal use, funneling company money into their own pockets on an ongoing basis or embezzling significant money before leaving the company. Work with your accounting department to set up internal controls that limit how employees can award contracts, request payments and receive funds. And just to mention but an example of the famous organization which engaged itself into such an activity is the Enron.

So, media as platform will expose all the unethical practices of the management. This will have a great significant to the company as well as the shareholders. Besides spoiling the reputation, his or her career will be gone as well. In fear of the consequence, no brave man will wait for a disaster of such kinds to befall him. Secondly, no one is willing for his or her name to be associated wills bad practices in the media inform of their families. Besides tarnishing their names, legal implication as well will be subjected to the culprit and severe penalties be impose thereafter. On this regards and with the financial media and other forms of media platform all over the place, managements will be performing their duties in line with the company’s framework policies and code of corporate governance.
On the other hand, the shareholders and stakeholders as well will be the major beneficiaries out of the media exposure. They will be rest assured that their investment will be well gathered for under good management thereafter. This is because the management will stick to the corporate governance guidelines and policies which will require proper disclosures of the business records and profitability status to the shareholders annually.

10.9 Media impact on corporate governance
Organizations have mostly been structured based on their customers' needs, the legal and political constraints of their country, and the economic and technological changes impacting their environment. During the introduction of the financial media, organization had a different perspective against its indented purpose. They were thinking that this would be a means for them to bring closer to their customers, to connect with them, market their product which will ultimately leads to some greater sales. They didn’t factor in the greater impact that would have on their internal structure.

Studies shows that many companies are in constant move looking at social media technologies as a way to market their product and learn about their competitors. It wasn’t until 2006 that companies started considering using social media technologies to engage their customers.

Financial media has constantly reduced the product creation cost because most of the product coverage on its usefulness is being done on media especially financial media. So, the company reduces the design cost of the product by greater means. Its distribution cost as well has drastically reduced because instead of the corporation itself to moving door to door advertising their product, the customers themselves are the one to follow-up on the product after learning from the financial media and other mode of media as well.

Besides financial media, in 2008, blogs and twitter just to name few social media have become the most powerful tools for the corporations to market their products and services. Companies have realized that social media is a powerful medium which is changing the way the world communicates.

However, many organizations are often shocked by the impact of online communities on their internal organization structure. Companies have become a major target by the media bodies for their hidden sensitive agendas within the organization. Because they are operating within a legal and competitive environment, they are in a position to highlight some of the management dealings which are behind the screen. This will create Major Avenue for the flow of the companies' institution across the globe. Thus, shaping the management self-interest dealings within the company, so, they in turn pursue the correct measures within the organization rather than engaging themselves in such malpractices.

So, with rampant increase in modes of media apart from the financial media alone, information concerning the organization is no longer restricted towards the marketing department alone rather, all employees of the organizations are part of the chain management of the organization. Employees are online talking to the customers, colleagues, suppliers who are connected through various social modes and especially social networking. They are in constant touch with one another by sharing experience of their organization background, impressions and expectations regarding their jobs, organization and the entire management. Thus the speed at which the information travels is beyond the control of the organization. Every employee, customer and supplier has become a reflection on how the organization functions and operates. The power has shifted from what the company wants to relay to the public, to what employees, customers and suppliers say about the company—for better or worse.

With varied modes of media all over the place, organization is no longer in a position to filter the information on what to release to the media and what to retain. In most of the cases, this information has already channel its way out through the employers, customers or even the suppliers. The main merits of the information finding its way out are the reasons why most of the management are opting to stand by the guiding policies of the organization. Success and failures are reported within a span of seconds. Reputation of the management can easily be tarnished within some seconds as well. The good part is that the organization is willing to admit to their failures and seek to redress
the loophole with a plan to make correction otherwise they will risk losing their customers and leave alone spoiling their reputation.

Management are conscious of the financial media and social media having a large impact within the organization. Employers also are not left behind on the same. They all know the impact media is having concerning their dream jobs. In case of any inappropriate comment getting leaked to the media, they are much aware of the rough consequences befalling their way. They know that they are the part and parcel of the organization and whatever they are doing and saying within the workplace will still get its way out to the media. This is a clear evidence that organization structure and social media has become one community. Media to be precise has become a watchdog of the organization such that in case of any leaked information, it won’t last a day long before getting released to the public. Through this, financial media as an example, will not be left behind rather, in one way or the other, they are building their reputation.

The current technology and business environment are forcing the organizations to restructure their process and the way they conduct themselves within the organization. All these should start from the board of managements. Organization management should reflect the desires of the shareholders which are to maximize their profit. So, management should not be focusing on their own personal interest which will end up conflicting with the interest of the shareholders.

Ultimately, the new social media platform at the moment to engage in doing business is the social commerce. Unless the management and leadership of each and every corporation embrace the new change failure will be inevitable. Collaboration between departments is a must to harness the power of social media and to take advantage of the customer engagement. The best investment an organization could do is training the managers and the employees to respond in a timely manner to customer’s questions and inquiries. It is the only way to harness the power of social commerce and uncover opportunities to help the organization prosper in the digital era.

10.10 Conclusion
This study has thoroughly gone through literature on the role of the media in corporate governance. Literature is of the view that media generally does not necessarily impact on the available stakeholders but also drive the potential one into action. Based on the main studies it is debated that media response to the corporate governance dealings and its impact on the shareholders and the public in general is considered by the factors related to the media.

To wind up, financial media promote its reputation by channeling corporate information and specially to do with the managements alongside company’s shareholders. Also, this is a platform for the media to share out useful information pertaining the company to the general public as well. With this appropriate mechanism, the general public will be enlightened on the company’s performance, transparency which will in turn promote the performance and firm value. In contrary opinion, financial media can act as well as a platform for tarnishing reputation of the main management of the company. In case of any frauds and unfair means associated to the company, this platform will end up ruining the well-built reputation of the management over the years. This platform also can act a demolishing ground for the business. As in the case of Bank of credit commercial international which leads to its subsidiaries being close after a leak by the Sunday Times in England?
Convergence in Corporate Governance

11.1 What is Convergence?
Globalization literally means that the exchange or movement of capital, material things, goods and services all over the world. As it is said to be a global village when it comes through the internet, communications among the developed and developing nations. Globalization may not only cover the single perspective but it blends with culture, governance, world economics and technology. It covers every dimension such as religious, social and environmental.

However, world is changing rapidly, one cannot tell what kind of necessities are attaching towards prevailing objectives in future. Increasing the globalization will tends to hybridization not convergence.

When it comes to governance that how the corporations are controlled, that mechanism is referred to as corporate governance. The governance structures illustrate the rights and responsibilities among various participants of the company or corporations such participants are managers, shareholders, auditors, creditors, regulators, stakeholders and board of directors.

In accordance to the business activities or any matters regarding to the corporations, it comprises of rules and regulations for making decision. “Corporate governance includes the processes through which corporations’ objectives are set and pursued in the context of the social, regulatory and market environment. Governance mechanisms include monitoring the actions, policies, practices, and decisions of corporations, their agents, and affected stakeholders. Corporate governance practices are affected by attempts to align the interests of stakeholders.”

The convergence in corporate governance is refers to as “an increasing isomorphism in the governance practices of public corporation from different countries”. The isomorphism means similarity and by similarities means here is that the same governance practices should be prevailing among countries in different corporations. Whereby, the exact isomorphism implementation could not be possible even when you are dealing with the different firms in a single country. The metrics of the convergence in corporate governance is a challenging subject.

The convergence explicitly explained by two distinction proposed by the researcher named as Gilson (2004), convergence in “form” and convergence in “function”. The convergence in “form” means that the legal framework is similar and other one is convergence in “function” which entails that there is different rules and different countries but still performing the same such as fair disclosure and manager’s responsibilities.

Another way of explaining the two distinctions related to the convergence, first one de jure and second one is de facto convergence. By de jure means that the same code or rule of corporate governance is followed by two different countries, for example, in case of corruption and bribery that there is rule for this which have been followed by all countries. And where by de facto convergence, when code or rule of corporate governance is implemented. The decoupling convergence is the one when just the adoption of laws of corporate governance is confirmed but not implemented over the country or any corporation.

Due to some limitations, the convergence is not possible in the law or code of corporate governance but still there has been some adoption, such barriers can be due to political reasons or some other which restrict them to implement. Then alternative form would be by contracts. Contractual convergence which is by the way proposed by the Gilson (2006). The convergence dimension in corporate governance is given in table 1.
The analytical framework is presented above in figure 1. There are some forces that compel the country or firm to the convergence in governance. And these forces are known as "drivers of convergence" and the other one is "impediments to convergence". At what speed it is converging and at what scale and how it is converging. These both forces such that drivers and impediments can have impact at the firm or institutional level. However, when the convergence is achieved at the country level or institutional, ultimately the firm will also practice the governance.
11.2 Global Convergence

In 2015, during G20 Finance Ministers and Central Bank Governors meeting, Organization for economic cooperation and development (OECD) has come up with corporate governance principles which form the basis of converged governance code across different countries. Some of the important OECD principles are as follow:

**Legal framework for an Effective Governance Framework:** OECD recognizes that promotion of transparent and fair markets are essential for effective corporate governance framework. Such framework will lead to efficient allocation of resources and accountability of stewardship of these resource. It also requires a sound legal, regulatory and institutional framework that market participants can rely on while entering into contractual relations. Such legal framework can usefully be complemented by soft law elements based on the “comply or explain” principle such as corporate governance codes in order to allow for flexibility and address specificities of individual companies.

**Shareholders’ Rights and Key Ownership Functions:** Protection of shareholders’ rights is of prime importance. Conveying relevant information timely, safeguarding the existence of the ownership and lastly, election of the board of directors as proxy solicitants implies the effective participation in the election of the board of directors effectively.

**The Equitable Treatment of Shareholders:** The shareholders should be treated similarly. Specially, focusing on the rights of minority shareholders is of prime importance. If there is any change in the board of the director, this should be with the approval of the shareholder’s class.

**Recognition of Stakeholders in Corporate Governance:** The rights and opinion of the stakeholders should be given due weightage in company affairs. The employees of the corporations and the stakeholders should be free to discuss the unethical practices with the board of directors effectively.

**Financial Disclosure and Transparency:** Each country corporate law requires the firms to disclose their financial analysis and other reports at the end of the accounting period to make sure that whether these codes are follow by these firms or not. Discloser must contain the vision and mission of the firms, the directors’ report, the audit committee report, the shareholding structure of the shareholder, a profile of the chairman of the board of director and those risk factor which is associated with the companies.

**The Responsibilities of the Board:** The responsibility of the board of the directors should be mentioned explicitly and the board of the directors should not be involving in the management. Board of Directors are responsible for monitoring the effectiveness of the company’s governance practices and making changes as needed. They are also responsible for selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning. Other significant responsibilities of Board of Directors includes aligning key executive and board remuneration with the longer-term interests of the company and its shareholders and ensuring a formal and transparent board nomination and election process.

The presentation of OECD principles in meeting of G20 Finance ministers and central bankers paved a way towards possible convergence to the single code of corporate Governance. There are mainly two types of Corporate Governance followed by the countries across globe.

i) Countries which consider the Corporate Governance code as mandatory and they are require compiling these codes and have a brief exposure of all the material and these countries are mention in the above countries tables.

ii) Countries which doesn't consider the Corporate Governance code as mandatory and they aren't require compiling these codes and doesn't have a brief exposure of all the material and these countries are mention in the above countries tables as well.
11.3 Empirical Studies on Convergence

As the convergence has become the vast part of the investigation to researchers during the last two decades. There are many empirical and theoretical studies at firm level and country level have carried out to examine the convergence that is there any opportunity to occur convergence? We will take some prominent studies to better understand about convergence whether it is going to be occur or not and what does these studies has concluded. These empirical and theoretical studies assist us to come to a conclusive result by overviewing these studies that whether they in favor of the convergence or not. As we have already mentioned that mostly literature is divided into two broader area. Firstly, studies at firm level. Secondly, the studies at country level, some author has examined a single country and some other author has examined at multi country level. Following is the summarized position of existing literature:

Goergen, Martynova and Renneboog (2005) studies whether convergence is achieved by the implementation of corporate governance through “changes in take over regulation” over 30 European countries from year 1990 to 2004. It has come up with the results that the convergence found in regulation. Toms and Wright (2005) investigated that past changes in corporate governance system in US and UK from year 1950 to 2000 have been seen by increasing shareholders in US and UK. Khanna et al. (2006) studied about the convergence and similarity of corporate governance over 49 countries which are economically interdependence in year 1998. The results tell us about the strong evidence relationship between de jure and economic integration but no evidence regarding de facto similarity governance.

Zattoni and Cuomo (2008) examines the study between the civil laws and the common laws over the 49 countries, taken from year 1992 to 2005 in the adoption of corporate code of governance. It has been concluded that by comparing the civil law and common law countries whereby civil laws are more like ambiguous as compared to the common laws countries. Khanna and Palepu (2004) investigated about the practices corporate governance that have been applied to attract people for their talent, not because of that pressure from the global capital markets. The implementation of US corporate governance has been executed for year 1981 to 2001 which is by the way Infosys (Indian software industry) performs corporate governance. Khanna et.al (2004) studies that whether foreign firms by interacting more with US markets lead them to the greater disclosure, that is how similarities prevail in 742 firms in 2002 year over 24 countries.

Chizema (2008) examined that the ownership pattern affected by the individual’s disclosure. The results show that institutional, state and dispersed ownership are positively related with the disclosure in 126 German firms and the data taken from 2002 to 2005 in this study. Afsharipour (2009) examines about the convergence of corporate governance in India whereas India is unable to implement it, convergence is hard to achieve. The speed of convergence is slow. The requirement of political, institutional and social changes will make it possible little easy to dealing with it.

Siems, Mathias M. (2010) investigated that presence of any convergence in corporate governance prevails. It is almost about a decade that this issue has been in to controversial, but recently there has been debate on it. In this study the methodology applied is known as Lexi metric. Which will measure the convergence through such indicators likewise; shareholder’s codes for measuring development, worker’s protection and creditors. The data has been taken for France, India Germany, US and UK for year 1970 to 2005. The results show that there has been convergence in shareholder’s protection, divergence in protection for workers but trends have been followed through convergence and divergence for the protection of creditor. However, the relevance of civil and common law among countries have been not considered.

Krafft et al (2013) examines the convergence in corporate governance, firm performance and value. Various model has been considered while examining the theoretical questions such models are “new property rights theory”, “transaction cost economics” and “agency theory”. The large international database has been used in empirical literature that how the adoption of US market to best keep fit (best practices) on the non-US firms is affecting the firm performance. Rahim and
Alam (2014) investigates that how “corporate accountability mechanism” has been changed through convergence in (CG) Corporate Governance and (CSR) Corporate Social responsibility. The convergence has been seen in the weak economies companies where by in strong economies companies, convergence is less. The convergence in CG (corporate governance) and CSR (corporate social responsibility) has been seen in case Bangladesh but in accordance to self-regulation of corporation is in less protective environment.

Salvioni et al (2016) examines about the sustainability approach against convergence in corporate governance that sustainability approach can be achieved if the board of directors contemplates all aspects like environment expectations social and economics collectively. No matter, what type of rules related to corporate governance that company is following? De facto convergence can be achieved through sustainability in insider and outsider of corporate governance. This study suggests that it encourages the policy maker to act against sustainability towards best response to the business practice into law, how to put into recommendations and strengthen it.

The further summarized understanding from above studies and conclusions are as follow:

1. Most of the studies argue that the integration of the product market and labor market can be a source of the convergence.
2. There is a significant lack of the studies to analyze the effect of integration of financial markets.
3. The governance convergence can be facilitating by accounting some factors into analysis such as economic interdependence

11.4 Drivers of Convergence in Corporate Governance
Convergence is a controversial issue in the existence literature and a great debate is continued. Most of the researchers are interested and enthusiastic in this area. Some of the researchers are of the view that convergence could occur and the world is on the same path of convergence due to the existence of the several factors such as integrated product markets. However, some are on the opinion that convergence is really complicated and hard in the corporate governance, which implies that it is difficult to overcome the convergence and that all countries are adjust to a single corporate law. The following few factors should be discussed which contribute highly to the convergence of the corporate governance.

11.5 Integration of Financial Markets
The first vital factor that contribute to the convergence is the integration of financial markets. Nestor and Thompson (2000) consider this driving factor as fundamental factor which play a crucial role in convergence. The integration of financial markets involves distinct elements such as declaring the firms share in other countries stock exchange, Portfolio investment comprises another element which increment require, free capital flow and boarder mergers are all the factors that force the countries to converge to single code of corporate governance. In addition, the equity market has recently played a vital role that a finite number of firms listed their share in other several number of countries and it is well experience by the United Kingdom and United states. There are foreign investors who have listed their shares and these are require following the instruction of that country.

Broadly speaking, most of the firms tried to list their share on the stock exchange of those developing and developed countries which require less regulation and rules. Although, these firms are subject to tight rules and regulation requirement. Another aspect of the convergence is the cross-border merger and acquisition that can be easily understand through an example: When a Japanese firm is handling the American firms than they must follow the corporate governance law of both countries, so it is well evident that convergence is about to occur.

11.6 Integration of the Product Market
It is a gain a controversial debate. Those who which favor the convergence are on the opinion that this can also lead us to convergence. Khanna and Palepu (2004) express that global competition and the product market integration can lead one to the convergence. Similarly, Walker et al (2002)
illustrate their opinion that technological and market force put pressure on the firms to follow the similar strategies of the world. Each country wants to attract the firms to operate in their own country by providing some easy regulation through which they can attract the corporation of other companies. These all arguments can lead one to an appropriate convergence. In addition, most of the other consider the competition across the world as factor of convergence.

11.7 Diffusion of Codes of Good Governance and Harmonization of Accounting Rules
The third factor or driver which contribute toward convergence is mentioned above. Aguilera et al., (2004) assess this problem that those economies with the less protection of the shareholders and presence of the robust foreign investors. In such cases the shareholders of the home country require the tight law of the corporate governance to enhance the protection of the shareholders. In addition, they depict that institutional and market pressure both can play a vital role in designing the better code of corporate governance, and thus convergence does occur.

Moreover, the Cadbury Code of Corporate Governance consider the best phase of developing the ideas of corporate governance. As it is considering the best code, most of the countries has followed it. Aguilera et al., (2004) argue that once the code of corporate governance is remaining similar across the world. It is the evident of the convergence that is about to occur.

In addition, the major problem that the corporations are facing is that whenever they want to list in a foreign stock exchange market they are required to revise their financial statements. By following the accounting standards of that country. Similarly, those countries willing to construct the investment portfolio in foreign countries are require following the standards of accounting of that country. These type of standards is currently well establishing by International Accounting Standard Committee. Coffe (1999) argue that harmonization of the accounting is well evident of the convergence of corporate governance across the world. Several other authors are also on the same opinion.

11.8 Public Demand
Public demand is another factor which lead us to the convergence and this implies that after the collapse of ENRON, the USA has implemented the Sarbanes Oxley act as recommendation to the corporation rather than mandatory that either the companies willing to follow or not and those corporation who didn’t follow were asked for the reason that why they haven’t follow this code of conduct. As this code was look very nice so people has made a request that further coming firms, this code should be made compulsory to them and the firms has started convergence after this recommendation by the public sectors.

If we focus on the most recent cases which is occurred in United states and united Kingdom such as the collapse of the ENRON which causes to implementation of Sarsen Oxley act in 2002 and similarly, the case of Bank of Business and Commerce International (BCCI) which was collapse due to unethical practice by a Pakistani named as Agha Hassan Abedi in the United Kingdom and the result of this was the London stock exchange has recommended the Cadbury committee to establish the tight law and finally they have recommend the Cadbury Code of Corporate Governance which had Nineteen Recommendation for executive directors, Non-executive Directors, independent directors and for control and report.

These codes of Sarbanes-Oxley act and the Cadbury code of corporate governance is mostly followed by those countries which remain the colonies of the United State and United Kingdom such as Pakistan which follow the best practices of Cadbury committee and derive the code of corporate governance

11.9 The Barriers to Corporate Convergence
Most of the researcher believe that with the economic and financial integration, corporate governance has contributed much for the efficiency of the businesses where they all compete to follow the best practices of corporate governance available. Why then not work on both the capital
and product markets to impose a common and similar governance structures? Why not have a common code that could be applied in all over the world? It is not as easy as it seems answers to these questions can be given and grouped in the following headings.

**Rent-Seeking and the Persistence of Inefficient Rules**

Although a general rule or code of corporate governance would make companies more productive, all parties involved would not be in favor of modifying existing law to allow such changes. Political entities in countries might have interests to maintain their existing law or form a new code which serves their interest even thought they would be much more inefficient, where history provides obvious examples from US and UK where the reports of Cadbury committee was not applied in US which led to dramatic collapse of world leading companies. More recently an example of japan where they failed to adopt rules developed by Russia, although they know that inefficient rules in place even at the cost of society or country as a whole, where they know that it would adversely affect them.

There are many other reasons for the persistence of the existing rules including the political ability to modify or update inefficient legal rules in any country, more over economic self-interest, national cultural traditions and nationalism may also play a role here, to conclude the political, social and economic barriers are in place that forces the countries to stick to their existing rules although they are inefficient.

Governance structures can persist even it is confirmed that they are not good because of parties who resist change it, because it would reduce their private benefits. Rent-seeking means seeking benefits for different parties involved which could come from a different player including labor unions, banks and lawyers. Many European countries have laws in place precisely designed to protect family controls and convergence towards the US models in these countries.

**Control Premiums and the Risk of Expropriation**

Rules and regulations of corporate governance are not all or even most of them are not mandatory, if this is the case, simply revising inefficient corporate legal rules that may have an uncertain future impact, where the expropriation means the transfer of present wealth to those in the benefit of the society that is transfer of wealth from controlling shareholder to public shareholders. Where the minority shareholder does not have that expectations that corporate wealth will be delivered to them rather than those in control so as majority of shareholders are minority they are not in favor of changing the rules but with the condition that would ensure their rights.

**Complementarities**

Complementary means interdependence or correlative where in the context of barriers of corporate governance means that there are rules that are complementary to each other one exists because of the other so we don’t know that whether a code or practice might be efficient in US but might not be in UK due to their political economical or cultural. Any specific corporate governance practice must be able to adapt to local conditions if they are to survive. In turn, this requires that even a potentially efficient reform must be one size that fits all because if not so they would not be applicable and would not survive.

**Path Dependency**

Most of the corporate governance practices, reforms or codes are affected by path dependence upon the economic systems of the countries in case. Although path dependency is a complex thought with different angles and backgrounds, but the core idea is that initial starting point does matter a lot. Initial conditions and starting of economies follow a path of progress and development from which deviation is not easy.

The important implication of path dependency is that, once events occur that have significant impacts and strengths for changing structure and design of economic institutions, there is no unique
and short answer to the question that what changes are most efficient. For example, in case of USA the collapse of world com and ENRON their rules and regulations cannot be applied in an emerging economy where they do not have even Securities and Exchange Commission or any other regulatory body to regulate these corporations.

**Multiple Optima**

As expressed by Khanna et al. (2006) multiple optima means that government can chose different bundles of the corporate governance but for the same objective irrespective of their path dependence they would end up with the same results. That is, equivalent long-run corporate governance. There are many studies that promote the idea that there is no single optimal model of convergence by number or studies including (Demsetz and Lehn, 1985; Thomsen and Pedersen, 1996; Coles, McWilliams and Sen, 2001)

**Differences in Property Rights Regimes**

Although different countries follow different mix of economic regimes but the respect of property rights is there in each and every economy with considerable variation in how property rights are practiced and enforced and what they are. As Milhaupt’s (2004: 211) core argument is that “property rights institutions are the principal source of diversity among national governance systems.” Therefor convergence in practices of corporate governance is in hurdle due to practices of property rights.

**Differences in Social Norms**

Another obstacle in the path of convergence is the presence of social and commercial norms. There also could be some religious factors involved where in Islam Reba is prohibited so corporations working under the flag of other non-Muslims countries will mostly not welcomed and hence why would they accept rules and regulation made by them Such norms are usually very important to communities specially Muslims.

**Lack of Consensus on an Ideal**

There are many models of corporate governance across the world the question arises that which one to follow so there is strong possibility that there is no consensus on what constitutes the best corporate governance system. This is because each code and model has strengths and weaknesses that may arise with different environment and economies that is why law makers and corporate layers genuinely disagree today, have genuinely disagreed in the past, and most possibly will continue to disagree as to which corporate rules and structures are best.

**11.10 Conclusion**

This study examines the convergence of the corporate governance and conclude with the following few points. First, most of the empirical and theoretical studies indicate that there are somehow similarities in the code of corporate governance across the countries however, there is no that level indication of similarity threshold which lead us or constitute the convergence. Secondly, most of the studies of convergence mainly focus on distinct level data such as firm level or might be single country level and system such as rules, regulations and structure. However, the cross-sectional level or multi country level studies are less in number and multi-level studies can lead one to more comprehensive insights toward convergence because the cross-sectional analysis provides a large number of countries analysis.

Third, the researchers have to analyses the longitudinal studies because convergence is something which take a number of years to occur. On the other hand, the cross-sectional data can’t provide insights as longitudinal data because it actually depicts the similarities between the two countries and that is it. Empirical and theoretical studies have also overviewed in our term paper which embody three distinct result. First, those studies which is in favor of convergence. Second, those studies which argue that corporate governance can resultant into convergence. Lastly, those studies which is failed to report any evident. Moreover, those drivers mentioned in our term paper shall be improve in order to convergence take place. Further, those barriers that deter the convergence should be removed. There may be some chances of convergence to occur.
Corporate Governance in International Perspective

12.1 Introduction
Corporate governance is a huge discipline that is got influence from different sciences including finance, economics, management etc. And when it is considered in an international perspective in addition to the fact that it is a wide discipline, a lot of complexities arises. That is why in this right up we attempt to simplify this complexity by following a framework that combines different theoretical backgrounds which is presented below. Additionally it is a very dynamic field in that its empirical reality is constantly changing. Just has the Anglo-American model takes from the German/Japanese model, the flow of influence also goes the other way.

There are many aspects to the existence of firms, organizations and corporations. The one important aspect that has taken center stage is Corporate Governance. This is not least due to the many scandals that as seen the biggest of firms declaring bankruptcy due to fraud, corruption, embezzlement and mismanagement. When Enron collapsed it was a global giant with close to 30,000 employees all over the globe. Its collapse reverberated all over the globe. Its failure is an example of the consequences of corporate governance failure and hence its extreme importance. The governance of corporations has extensive micro and macro consequences along with approach. The micro level consequence is that it aims to ensure that the corporation, as a productive organization, functions in pursuit of its goals and objectives while on the macro level it aims to efficiently and effectively promote the allocation of the nation’s savings and investment to its most productive use. That is why governments, academics, Non-Governmental organizations and international bodies like United Nations; OECD etc. have placed a lot of emphasis on Corporate Governance.

There was a time when firms were small, controlled and managed by owners. In such a situation governance is not much of an issue. But when the ownership became separated from control and management, the extent to which control and management is acting in consonance with the objective of the corporation becomes an issue. This gave rise to many theories. The most significant is agency theory which posits that the separation of ownership and control leads to agency cost (see Jensen and Mackling (1976). Corporate governance embodies the mechanisms that mitigate this agency cost.

Generally corporate governance embodies the mechanisms through which corporations are controlled and managed. This necessitates an internal and external perspective to understanding corporate governance mechanisms. This sets the bases for the divergent views on the meaning of corporate governance: the shareholder view and the stakeholder view. Additionally, taking an international perspective on corporate governance means a comparative analysis of the different features of observed difference between countries and continents. The basis of which are the differences in economic environment; financial system; legal and regulatory constraints; institutional environment and cultural situations of the countries.

In analyzing the international perspective on corporate governance, corporate governance would be defined in the next section followed by the theoretical framework used for the analysis would be discussed. Thereafter there would be an analysis of what the empirical literature says about which system is most effective.

12.2 Framework for Analysis: International Corporate Governance
Three are various ways in which corporate governance are considered. Some researchers define international corporate governance it as “the study of relationships between parties with a stake in
the firm and how their influence on strategic corporate decision making is shaped by institutions in different countries”. This is why considering an international perspective on corporate governance requires dealing with the overtime diversity (differences and similarities) across countries shaped by the different institutions— including the micro and macro- economic environment, legal systems, culture, political system etc. The analysis is considered at a macro and micro level approach (Keasey et al, 2005; Aguilera and Jackson 2010).

12.3 Micro Level Analysis
The micro approach to analyzing corporate governance with an international perspective is concerned with whether or not the similarities and differences in corporate governance mechanisms across countries and continents results in any specific firm-level outcomes, such as firm performance, stock market returns, economic growth, inequality, innovation patterns, and so on. So in a micro approach for example it is investigated whether Japanese corporations deliver better firm performance and better shareholder values than U.K corporations. Considering the huge body of theories and empirical research in this approach on an international level, this paper only focuses on presenting the empirical researches of the effects some specific corporate governance mechanisms on corporate performance across countries.

Framework of Analysis of Corporate Governance from international perspective

The macro approach describes the differences and similarities in corporate governance mechanisms at the country level. The focus is on the aggregate differences in the systems of corporate governance which discusses the differences and similarities of ownership patterns, board structure, shareholder protection, employee involvement etc. This approach analyses reality such as: why have continental European countries like Germany developed concentrated share ownership, while the U.K. and U.S. shareholding is dispersed?
It is worth noting that the approach followed in the macro analysis goes beyond the agency theory framework. This is because of the extreme deficiency of the agency theory in addressing and accounting for key differences across countries. These deficiencies include not considering the diverse identities of stakeholders within the principal-agent relationship. Also its focus on the bilateral contract between principal and agents belittles the important interdependencies among other stakeholders in firms. Lastly it has a narrow view of the institutional determinant of corporate governance. The approach followed here is “embeddedness” which stresses that economic action is also social action oriented toward others and may be constrained by noneconomic objectives or supported by noneconomic socialites. In other words “embeddedness” approach extends the agency theory to include institutional factors.

12.4 Macro Level Analysis
Corporate governance mechanisms are economic and legal institutions that can be altered through political process (Claessens and Yurtoglu, 2013). This includes (Prowse, 1994); Denis and McConnell, 2003):

A. Internal Governance Mechanisms while there are several of these the focus in this paper is on the following:
   1. Ownership Structure (Ownership Concentration)
   2. Boards of Directors (Board Composition and Size)
B. External Governance Mechanisms: the focus of this write up is
   1. Institutional environments
   2. The Takeover Market
   3. Institutional Investors and Group Affiliation

The next sections consider in details of the internal governance mechanisms and external governance mechanisms with the focus on the broad differences and similarities among countries.

12.5 Institutional environments: legal and regulatory constraints
One of the most significant determinants of the observed diversity in corporate governance mechanisms on an international level among countries is the institutional factors as enshrined in the legal and regulatory frameworks of individual countries. This is manifested in legal components such as 1) countries’ legal origins, 2) strength of countries’ formal legal right 3) rights of creditors and shareholders (creditor rights, legal protection of minority shareholders), 4) degree of enforcement of formal rights (efficiency of debt enforcement, anti-corruption) and 5) the degree to which corporations listed on local stock exchanges have to disclose relevant financial and other information disclosure requirements.

Below is the table provides marked differences among countries on all of these variables. The table classified countries into three categories: Developed (mainly US, Canada, Australia and Western European countries); Transition countries (Russia and the former communist bloc countries) and emerging countries (Asian, Africa and Latin American countries). In as much as these differences persist there would be differences in corporate governance on an international level. On average, developed countries are in a stronger position in all of these variables irrespective of their legal origins than transition and emerging markets which explains why their corporate governance codes are better enforced. It is worth noting that there are wider dispersion in all this variables among emerging countries with some of them like Singapore, Korea and Taiwan doing much better than a lot of developed countries. Interestingly for countries with the same legal origins, their levels of corporate governance development are not same due to the differences in the strength of enforcement of legal rights and anticorruption levels.
<table>
<thead>
<tr>
<th>Country</th>
<th>Per Capita GDP 2005 USD</th>
<th>GDP Growth Annual %</th>
<th>% of GDP</th>
<th>Trade % of GDP</th>
<th>Foreign Direct Investment % of GDP</th>
<th>Private Credit % of GDP</th>
<th>Market Capitalization % of GDP</th>
<th>Stocks Traded % of MC</th>
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<th>Country</th>
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</table>
The table also corroborates some of the findings of earlier studies (reviewed in Davis and Schlitzer 2008), such as that common law country like the US, UK, Canada, New Zealand and South Africa have better investor protections and more developed capital markets than civil law countries especially of French origin. Therefore the US Sarbanes-Oxley Act (2002), the UK Corporate Governance Code (updated 2016; formerly known as the Combined Code) the Australian Corporate Governance Council Principles and Recommendations (reviewed in 2012) south African king Robert 11 (2002) Malaysian code on Corporate Governance (Finance Committee on Corporate Governance 2000) are thought of having better investor protection than civil law based codes of Corporate Governance like the French Loi de Securite Financiere (2003). Though it’s worth noting that other do find a weak correlation between the effectiveness on corporate governance and the legal origin of a country.

Shleife and Vishny (1997) in their research survey on corporate governance argue that a negative correlation exist between the strength of investor protection and the probability of management’s expatriation of shareholder funds suggesting that legal origin and its strength in a particular country does not necessarily translate into better corporate governance. The reason given for this negative correlation is that a weak legal shareholder protection can be surmounted through concentrated shareholding. This is one of the reasons advance for the general relative concentration of shareholding in French civil law and German law origins as opposed to the widespread shareholding found in common law countries of the US and UK. This does not mean that all common law countries especially in Asia and Africa do not have concentrated shareholding. The same reason is given for the concentrated ownership structure in common law based Asian and African countries that is due to the weakness in their application of this laws the concentrated ownership seeks to mitigate this weakness in application of the law.
Table: Adapted from Claessens and Yurtoglu (2013)

There are other reasons in the literature as well. One of the disputed issues is the extent to which national legal systems generate the establishment of efficient corporate governance standards with a high level of shareholder protection laws which leads to the most efficient allocation of financial resources due to a more dispersed shareholding and a broader and deeper capital markets. While La Porta et al. 2002 and Beck and Levine 2001 support this proposition Cornelius 2005 and Cornelius and Kogut, 2004 dispute it, concluding from their own studies that other factors besides a nation's legal framework are just as equally or more important in framing the corporate governance codes and mechanisms. It was therefore not a surprise when Dallas 2004 emphasized from his study that determinants such as cultural factors, the type of financial framework and
economic development influence the variety of corporate governance models in the world. It’s worth noting that while these could be independent factors, the extent of their independence is not clear. Specifically the direction of causality for example between the legal framework and the type of financial framework is questionable.

Some authors like Prowse (1994) discussed extensively how the legal and regulatory restrictions on financial institutions and non-financial institutions in the US and the UK are important factors that led to the widespread dispersion of shareholding in their corporate governance mechanism. For example he pointed out that the largest US pension funds as of 1994, CALPERS has stocks in over 2000 companies with the largest individual stake being only 0.7% of outstanding equity due to legal constraints on concentrated ownership, fiduciary requirements that encourage diversification and a strong desire for liquidity. Also anti-trust laws were used to make Du Pont who had a 25% stake in General Motors to divest it. In contrast the non-enforcement of the relatively few regulatory constraints in the Japanese corporate environment and German’s universal banking principal which is free from any form of regulatory constraints facilitated concentrated shareholding.

12.6 The Takeover Market
Takeover is traditionally an Anglo-American corporate mechanism to deal with the agency problem. It is thought to discipline managers at inefficient corporations. The first theoretical justification for takeovers was presented by Manne (1965) who argued that the takeover market is an external control mechanism over incumbent manager. It is defined as the market where “alternative management teams compete for the rights to manage corporate resources”. The conception is that resources of an economy which are organized through corporations are to be managed by the most efficient managements. Therefore the inefficient managements are replaced by efficient once through the takeover market. The takeover market –hostile takeover – was very active in the 1980s and 1990s in the U.S before companies and government came up with antitakeover measures. This was due to the observed high failure rates of takeovers as would be discussed below blamed partly on the fact that managers were simply wasting corporate resources to maximize the size of their business by overpaying for acquisitions rather than returning cash to the shareholder. Other problems include corporate cultural issues internal to the parent or bought firm.

Takeover as a corporate governance mechanism was something peculiar to the Anglo-American model which has been adopted by the rest of the world. Review of the literature on hostile takeover activity across countries suggest that between 1988 and 2003 478 hostile takeover attempts were announced in the United States and 273 in Britain. While there only 19 were announced in France, 18 in Norway, seven in Germany, three each in Japan and Malaysia, two in Thailand, and just one in Chile therefore even though takeover as a corporate governance mechanism has extended beyond the Anglo-American model it’s still not widely practiced in other countries. This is generally due to the concentrated nature of ownership structures that dominates in most of the other systems of corporate governance in operation in the world.

12.7 Institutional Investors and Group Affiliation
Institutional investors and group affiliation is one of the determinants of the difference in corporate governance mechanisms among countries. It has being observed that many countries have big industrial conglomerates/groupings that are made up of several interrelated businesses. In Japan they are known as keiretsu, in Korea chaebols, and in Russia financial-industrial groups. Groups are also common in Turkey, India, Italy, Brazil and South Africa. For example 20% of all Korean listed companies are members of the 30 biggest chaebols in operation. In Israel 20 business groups are said to control 40% of the market segment (OECD 2017a).

The cost or benefits of being members of conglomerates have been examined in the literature. Its main benefit comes from having an internal factor market that smooth out the constraints of incomplete external financial markets especially when there is a bank within the conglomerate. On the other hand, it could lead to expropriation of minority rights and unclear management structures which would impact negatively on corporate governance.
Institutional investors are more prevalent in developed countries. In the Australia, the UK, and the USA they have a dominance of share ownership. For example as of the end of 2004, institutional investors owned nearly 50 per cent of all UK shares. They traditionally do not play an active role in corporate governance because of their widely diversified portfolio but have now been encouraged to become more actively involved by the corporate governance reforms of the 2000s. This is because it is observed that the effectiveness and credibility of the whole corporate governance framework and corporation oversight depend to a large extent on institutional investors that can make informed use of their shareholding rights and effectively exercise their ownership functions in their investee companies (OECD 2017a). Ownership by institutional investors is considered small and insignificant in emerging markets and they have little control and influence over the corporate governance mechanisms of corporations.

12.8 Corporate Ownership Structures
We now move to the internal governance mechanisms of the macro level analysis. The structure of corporate ownership is an important determinant in international differences of corporate governance mechanisms and models. Discussion on the structure of corporate ownership generally focuses on the degree of ownership concentration and the identity of majority shareholders/block holders. The importance of ownership structure can be found in its potential influence on corporate decision making and firm valuation and performance. Theory suggest that in a widely diffused ownership structure, the monitoring of management’s decision making by individual shareholders would be suboptimal because they do not have enough shares in the corporation to justify devoting resources for the collection of necessary information to influence management decision making process. On the other hand a more concentrated corporate ownership structure would have the necessary incentive and resources to influence the decision make process of management.

The identity of the majority shareholder also has implications for governance. When the majority shareholders are insiders the theoretical issues goes beyond the agency problems of principal and agents. Some academics have described such a situation has principal-principal problems. The “Principal–principal problem occurs between controlling shareholders and minority shareholders due to concentrated ownership, extensive family ownership and control, business group structures, and weak legal protection of minority shareholders”. This is considered more prevalent in countries with concentrated ownership by insiders (shareholders with significant amount/block of shares – block holders) such as found in emerging countries and continental Europe. Controlling owners such as Government, financial institutions, non-financial institutions, individuals and families have different preferences/goals and competent skills and different levels of motivation to influence the governance process. This may not be in tune with the aspiration of minority shareholders which leads to a conflict that potentially lowers firm value (Young et al 2008).

Generally, empirical research points to the fact that concentrated ownership dominates the corporate governance mechanisms internationally. The major exception is the Anglo-American corporate governance model which relatively is dominated by widely dispersed share ownership resulting in weak shareholder influence on management. Share ownership structure is very much peculiar to the US and the UK which is labelled “market-centered economies”. Because they have large numbers of traded corporations with mostly wide dispersed share ownership. The implication of this includes the one-tier board of directors that characterizes their governance system as well as the splitting of the role of chairman and chief executive during the reforms of early 2000s in their corporate governance codes.

In contrast, the share ownership structure in Germany and Japan are much more concentrated with banks playing an important role in their governance mechanisms. That is why they are labelled “bank-centered economies”. Research indicate that banks have much more influence in Japan than in Germany while non-financial firms followed by families are more important in Germany. Though in Germany, banks have more voting power than their share ownership because they usually have the proxy votes of other individual shareholders.
As indicated above, most corporate governance ownership structure around the world is concentrated. Claessens and Yurtoglu (2013), in their survey, review these studies in great details. They noted that in south East Asian countries like Indonesia and Malaysia and East Asian like Hong Kong, the largest shareholders – owing about 50% - are usually families who are also directly involved in management. This concentrated ownership rises above 50% in India, Pakistan and Singapore and below in Thailand (about 40%), South Korea (about 20%) and Taiwan (about 30%). It’s also not uncommon for banks, foreigners and governments to have significant stakes in these countries. In China, ownership structure is also largely concentrated. In fact only a tiny portion of shares of corporations are held by individual or foreign investors, with average ownership reported to be 2.38% and 2.66%, respectively. Government and institutional investors own the majority of shares, with 31.27% and 19.86%, respectively.

In Latin America, the research indicates that the majority owners have more than 50% of share concentration – in Colombia, Chile, Peru and Mexico – and in Brazil and Argentina, its more than 60%. Most of the majority owners are wealthy families. Researches from the Middle East and North Africa also indicate concentrated ownership with government playing a relatively significant role through state ownership of shares in a lot of corporations.

Studies also show that the national structure of ownership of corporations is fairly stable over time. This is with regards to ownership structure after the initial IPO or the generally empirically proven structure of national ownership. As per reports by OECD at various intervals, a close observation of the ownership structures makes it obvious that there have been little changes over almost two decades that the study of corporate governance has been extended to developing countries.

12.9 Composition and structure of board of directors
The structure of Board of Directors varies both within and among countries. In several countries such as Germany, Brazil, South Africa, China, Indonesia and Russia etc., a two-tier board of directorship is in operation. This two-tier board separates the supervisory function and the management function into two different bodies. Such systems typically have a “supervisory board” composed of non-executive board members and a “management board” composed entirely of executives. The details of the structure of this two-tier board differ greatly from country to country. For example in Germany Supervisory body “The Supervisory Board” (Aufsichtsrat) is made up of only non-executive board members while the Management Board (Vorstand) consists of only executive board members. There are two categories of supervisory board composition: 1) those subject to co-determination that is listed companies with 501 – 2000 employees must have a supervisory board whose member must include one third of employee representatives. Companies with more than 2000 employees must have a supervisory board that is equally composed of shareholder representatives and employee representatives. And 2) Companies not subject to co-determination that is the Supervisory Board would usually consist of 3 members only with the number allowed to increase according to the companies’ articles of association proportionally with the registered capital of the company concerned and may not exceed a maximum of 9, 15, or 21 members.

On the other hand in Brazil, the two-tier board composition is optional form non state-owned corporations and compulsory for state-owned corporations. The supervisory board, known as the Fiscal Council reports to the shareholders, is independent of management and is elected in the general meeting of shareholders with the purpose of supervising the management’s activities. The Brazilian Corporate Law prevents managers and employees (and their close relatives) of the company, or of a related, to be appointed to the Fiscal Council. Members of the Fiscal Council have the power to act individually, despite the collective nature of the body. According to a KPMG Survey based on data from Brazil's 2016 Reference Forms, 60% of listed companies have a Fiscal Council and 41% of members are appointed by minority shareholders. The management board is responsible for the operations of the company according to the Brazilian Corporate Law. They are made up of executive and non-executive managers (the latter up to the limit of one third of the members). According to a KPMG Survey based on data from Brazil's 2016 Reference Forms, 10% of directors on the boards are executive managers, 60% are outside directors and 30% are
independent directors (OECD 2017a). These two separate examples of two-tier board composition systems show its diversity among nations.

Other countries have “unitary” boards, which includes executive and non-executive board members. This is more prevalent in Anglo-american based governance models such as in the UK, US, Canada, Singapore, Korea, Saudi Arabia and Turkey. In most cases of the unitary board models the Board of Directors is responsible for setting the general strategies for the business and the subsidiaries that it controls and most of the chairpersons do not hold the CEO position at the same time.

Further still some countries are categorized by the OECD fact book as having the option to choose between the one-tier and the two-tier systems such as France, Denmark, Netherlands etc. and some others are considered having a board composition of multiple options with hybrid systems that is they have an additional statutory body for audit purposes systems such as Japan, Italy and Portugal.

Micro level analyses

After examining similarities and analyzing the differences in international corporate governance, we know proceed to the micro level analysis to look at what empirical work says about the firm level outcomes such as firm value, performance etc. of adopting different corporate governance mechanism. Due to the limited nature of this write up, we only cover significant studies that show the effect of a specific governance mechanism on firm performance.

12.10 Corporate Governance Mechanism and Firm Performance

We start by examining what researches say about the effectiveness of Board Composition and size on firm performance. Hermalin and Weisbach (2003) investigate the relative proportion of outside directors and the size of the board using U.S. data. They find that firstly a higher proportions of outside directors are not associated with superior firm performance, but are associated with better decisions concerning such issues as acquisitions, executive compensation, and CEO turnover; secondly board size is negatively related to both general firm performance and the quality of decision making; and lastly changes in the board membership results in poor firm performance, CEO turnover, and changes in ownership structure. Kaplan and Minton (1994) studied the effectiveness of the Japanese system boards of directors’ focusing on the appointment of previous employees of banks or other nonfinancial corporations as outside directors. They noted that such appointments takes place following earnings losses and poor stock performance and are most likely in firms who are members of a corporate group with concentrated shareholders and with significant bank borrowings. They found that such outside directors are effective corporate governance mechanisms, because on average, they stabilize and modestly improve corporate performance, measured using operating performance, sales growth stock and returns.

Studies consistent with the U.S. findings of a negative relationship between board size and firm performance mentioned has also being validated from other countries. For example, data from Singapore and Malaysia suggest negative relationship between board size and firm performance as measured by Tobin's Q. A comprehensive data set of United Kingdom consisting of 2746 UK listed firms for the period of 1981–2002, suggest that board size has a strong negative impact on firm share returns, profitability and Tobin's Q and that the negative relation is strongest for large firms, which usually have larger boards. The main reason for this result is that problems of poor communication and decision-making undermine the effectiveness of large boards. Several other studies for several European countries like Germany, Denmark, Finland, France; Canada, China, Pakistan and Nigeria have also supported this proposition. Therefore the negative relationship between board size and firm value surpasses different corporate governance systems.

With regards to the effect of ownership structure on firm performance, studies have generally found that ownership structure has a greater impact on firm performance in non-U.S. countries than it does in the U.S. and that shareholding concentration has a positive effect on firm value. It’s worth noting that even though the U.S corporation ownership structure is considered widely dispersed,
concentrated ownership (block-holding) is not unheard of. In a random sample of 153 U.S. manufacturing firms; it is found that 56% of the firms in the sample had outside block holders. A much more comprehensive survey by Holderness (2003) of share ownership by insiders – officers and directors of a firm – and block holders - any entity that owns at least 5% of the firm's equity—finds that the average inside ownership in publicly traded U.S. corporations is approximately 20%, varying from almost none in some firms to majority ownership by insiders in others.

Holderness (2003) also surveys the U.S. literature that examines the effects of insider and block holder share ownership on corporate decisions and on firm performance. The theory is that equity ownership by insiders can align insiders’ interests with those of the other shareholders, thereby leading to better decisions or higher firm value or it may result in a greater degree of managerial control, potentially entrenching managers and reducing value. Likewise, the greater control that block holders have by virtue of their large share ownership may lead them to take actions that increase the market value of the firm's shares, benefiting all shareholders or provide them with private benefits that not available to other shareholders therefore potentially reducing firm value.

The U.S. findings on the effects of corporate ownership structure on corporate decisions and on firm performance is ambiguous. A big portion of research concludes that the alignment effects of inside ownership dominate the entrenchment effects and therefore there is a positive effect on firm value but as inside ownership increases beyond some level, the entrenchment effects dominates and higher inside ownership is associated with lower firm value. In contrast, some researcher while using panel data to find that a large fraction of the cross-sectional variation in managerial ownership is endogenous. This suggest that managerial ownership and firm performance are determined by a common set of characteristics and, therefore the causal link between ownership and performance implied by the abovementioned studies is questionable. Some early studies finds no significant relations between firm performance and the holdings of a variety of different types of block holders, including individuals, institutions, and corporations. But it is also observed that the formation of a new block or the trade of an existing block leads to increased firm value. It is also concluded by some that the body of evidence on the relation between block holders and firm value in the U.S. suggests that the relation is at times positive and at times negative and never very pronounced.

Though the U.S findings of the effect of concentrated (block-holdership) on firm value is weak, there are proofs showing that block holders to receive significant private benefits of control. Some researchers have shown that block trades (share trading by block holders) are typically priced at a premium to the market price which is consistent with the expectation that block holders have benefits that are not available to other shareholder (see Barclay and Holderness, 1989; Mikkelson and Regassa, 1991; and Chang Mayers, 1995). But the extent to which such private block holder benefits result in reduction to firm value is still a research question.

Other studies have also investigated the effect of ownership concentration on firm performance in other than the U.S. Research from various parts of the world e.g. Japan, Czech Republic, Germany, and Hungry etc., generally suggest a positive relationship between ownership concentration and firm performance. For example, one research finds that Japanese firms with block holders restructure more quickly following performance declines than do Japanese firms without block holders. It states, however, that the response comes less quickly in Japan than in the U.S. Concentrated ownership comes in different forms and sizes which mean that their effects are not necessarily all positive as mentioned above. There are several types of majority share ownerships like other corporations, institutions, families, and government-and the evidence implies that the relation between large shareholders and value often depends on who the large shareholders are. For example, studies in East Asian countries find that the impact of ownership varies according to the identity of the block holder. Ownership by corporations is negatively related to performance, while ownership by the government is positively associated with performance. It finds no relation between institutional ownership and firm performance. Similar results are also reported for the Gulf Cooperative Council (GCC) where it is noted that ownership by government is positively associated with firm performance on average.
The literature has also compared firm performance in “market-centered” economies and those of bank-centered economies mentioned previously. Several studies investigate the impact of bank involvement on firm value. Research shows that, in Japan, the relation between bank ownership and firm performance depends on the degree of ownership; in particular, the relation is more positive when ownership is high. In German market, concentrated ownership in banking industry strongly increases firm value and performance. Research from Chinese and Indian markets indicate an overall positive relation between ownership concentration and profitability in and they find that this relation is stronger when the majority owners are financial institutions than when the state is the primary major owner.

Overall these findings suggest that the relation between ownership structure and firm performance differs—both by country and by majority shareholder identity. The evidence suggests that there is a more significant relation between ownership structure and firm performance in non-U.S. firms than there is in U.S. firms. Concentrated ownership most often has a positive effect on firm value. The important role that banks play in governance in non-U.S. countries is particularly interesting given that U.S. banks are prohibited from taking a large role in governing U.S. firms.

The effect of the takeover market as a corporate governance mechanism and its effect on firm performance have also been investigated by Holmstrom and Kaplan (2001). The research suggests the following: 1) Average announcement abnormal returns to target firm shareholders are positive, while average abnormal returns to acquiring firm shareholders are at best insignificantly different from zero and are, in most studies, significantly negative; 2) The combined abnormal returns to a target and acquiring firm pair are relatively small, but significantly positive; 3) Poorly performing firms are more likely to be targets of takeover attempts and the managers of poorly performing firms are more likely to be fired. It is important to mention here that in United Kingdom, the firms do not appear to be performing poorly before the acquisition bids was made.

With regards to non-Anglo-American models, hostile takeover attempts are rare such as in Germany, Continental Europe and Asia due mainly to the significant ownership concentration that characterizes their corporations. And the form of takeover is different in form from that of the U.S. and U.K. In these countries, the outsiders attempt a takeover by seeking to acquire one or more blocks from existing block holders. It is also important to note that such changes in block-holder identity and the turnover in board members that usually accompany them, are more likely to follow poor financial and operating performance. The evidences of hostile takeovers are very rare in other markets like Netherlands, Israel, and China. Overall, takeover as a corporate mechanisms is not important outside the fold of Anglo-American model and that is due mostly to the relatively high ownership concentration in the other models.

12.11 Conclusion

The international perspective on corporate governance is a very wide subject. Due to which hard choices had to be made has to what would be discussed. This chapter has followed a framework, present in research, and the analysis is divided into Macro level and Micro level. The macro level analysis describes the differences and similarities in corporate governance mechanisms at the country level by focusing on the aggregate differences in the systems of corporate governance such as ownership patterns, board structure, etc. While the micro level analysis is concerned with whether or not the differences in corporate governance mechanisms across countries results in any specific firm-level outcomes, such as firm performance, stock market returns.

The Macro level analysis sub divides into internal governance mechanisms and external governance mechanisms. The internal governance mechanisms discussed includes ownership Structure (Ownership Concentration) and Boards of Directors (Board Composition and Size) while the external Governance Mechanisms discussed includes Institutional environments, the Takeover Market and Institutional Investors and Group Affiliation. The micro level discussed further what the empirical literature finds on the effect of several governance mechanisms on firm performance in several countries.
There are other approaches that could have been followed to discuss the international perspective on corporate governance but due to the constrained nature of this write up and the complexity and wide breadth of the subject the approach was chosen. It is hoped that a sizeable aspect of the international perspective on corporate governance has been covered and that the diversity, complexity and richness of corporate governance around the world would be appreciated.
Corporate Shari‘ah Governance in Islamic Financial Institutions

13.1 Introduction

Islamic Banking and Finance is a new phenomenon which is growing at a rapid rate in all over the world which was initiated in 1980s. Islamic finance is a Shari’ah compliant alternative to the conventional interest based system. Interest (Usury) is strictly prohibited in Islamic Law, according to the Quran:

\[ \text{يا أيها الذين آمنوا لا تأكلوا الربا أضعافا مضاعفة واتقوا الله لعلكم تفلحون} \]

O you who believe! Devour not usury, doubled and multiplied; but fear Allah that you may prosper.\(^6\)

\[ \text{الَّذِينَ يَأْكُلُونَ الرَّبَا لاَ يَقُومُونَ إِلاَّ كَمَا يَقُومُ الَّذِي يَتَخَبَّطُهُ الشَّيْطَانُ مِنَ الْمَسَّ} \]

Those who devour Rib (Interest) will not stand except as stands one the Satan has driven to madness by his touch. That is because they have said: "Trade is but like Rib (Interest)." but Allah has permitted trade and forbidden Rib (Interest). So, whatsoever after receiving admonition from his Lord desists, he shall be pardoned for the past, and his case is for Allah (to judge); but one who reverts (to the offence), those are the companions of the fire.

\[ \text{They will abide therein (for ever). Allah destroys Rib (Interest) and gives increase for deeds of charity, for Allah loves not any ungrateful/non-believing sinner.} \]

Due to the prohibition of interest, the Islamic finance industry came into being. The interest free financial system was initially started in Egypt a pioneering experiment of putting the principles of Islamic Shari‘ah into practice was conducted in Mit-Ghamr Bank, from 1963 to 1967. The experiment combined the idea of German saving banks with the principles of rural banking within the general framework of Islamic values. Mit-Ghamr was essentially a rural area and the people in general, like elsewhere in the Islamic region, were quite religious. They did not put their savings into any bank because interest is forbidden in Islam. Moreover, hardly any financial institution was available to them. Under these circumstances, the task was not only to respect the Islamic values regarding interest but also to educate the people about the use of banking.

Similar political antagonism to Islamic financial institutions, occurred elsewhere in the Muslim world; Iraq, Oman, Syria and even Saudi Arabia. Two institutions that however survived this early period were the Nasser Social Bank established in 1971 in Egypt and Tabung Hajj, established in 1963 in Malaysia. Nasser Social Bank operated as a public authority with autonomous status but without specific reference to Islam in its Charter while Tabung Hajj was set up in 1963 initially as The Muslim Pilgrims Savings Corporation to help would-be pilgrims save towards Hajj - it gradually evolved into a non-bank financial institution, the success of which provided the needed impetus for establishing a full-fledged Islamic bank in Malaysia: - Bank Islam Berhad (BIMB) was thus established in 1983.

\(^6\) The Quran, Surah Ali ’Imran, Verse, 130

\(^7\) The Quran, Surah Al Baqarah, Verse 276
From the mid-70s a new era was witnessed in the history of Islamic Banking by establishment of the Islamic Development Bank (IDB) in 1975. IDB was established by Saudi Arabia and other Organization of Islamic Conference (OIC) member countries, with the objective of fostering the economic development and social progress of the member countries and Muslim communities individually as well as jointly in accordance with the principle of *Sharī'ah*. Soon afterwards by both private and government Islamic institutions; for instance, Dubai Islamic Bank established in 1975; Faisal Islamic Bank, Egypt established in 1977 and Bahrain Islamic Bank established in 1979.

In Islamic Republic of Pakistan, the process of Islamization was started in 70's, during this period the council of Islamic Ideology was given task to suggest an alternative system to the conventional banking system. The Council submitted two reports the first report was submitted in November 1979 which was accepted after some necessary changes in February 1980. This report proposed initially elimination of interest from the operations of specialized financial institutions including HBFC, ICP and NIT in July 1979 and that of the commercial banks during January 1981 to June 1985.

The procedure adopted by banks in Pakistan since July 1, 1985 was, however, declared un-Islamic by the Federal Shariat Court (FSC) in November 1991. The system was based largely on 'mark-up' technique with or without 'buy-back arrangement'. The FSC declared that various provisions of the laws held repugnant to the injunctions of Islam in its Judgment dated November 14, 1991 would cease to have effect as from July 1, 1992. However, the Government and some banks/DFIs preferred appeals to the Shariat Appellate Bench (SAB) of the Supreme Court of Pakistan. The SAB delivered its judgment on December 23, 1999 rejecting the appeals and directing that laws involving interest would cease to have effect finally by June 30, 2001. In the judgment, the Court concluded that the present financial system had to be subjected to radical changes to bring it into conformity with the *Sharī'ah*. It also directed the Government to set up, within specified time frame, a Commission for Transformation of the financial system and two Task Forces to plan and implement the process of the transformation. The Court indicated some measures, which needed to be taken, and infrastructure and legal framework to be provided in order to have an economy conforming to the injunctions of Islam. This judgement includes following order;

Sharia’s (*Sharī'ah*) Board for scrutiny and evaluation of Board’s procedures and products and for providing guidance for successfully managing the Islamic economics⁸.

The objective of constituting *Sharī'ah* Board at Sate Bank’s level was to scrutinize and evaluating the products and services of the Islamic Financial Institutions. However the contemporary Islamic Banking and Financial system was started in 2002. The State Bank of Pakistan issues regulatory framework for Islamic Banks on regular basis. Due to the importance of *Sharī'ah* Governance framework the SBP issued a comprehensive *Sharī'ah* Governance framework in 2015.

### 13.2 Definition of *Sharī'ah* Governance

There is no any comprehensive definition of *Sharī'ah* Governance however the Islamic Financial services board has defined *Sharī'ah* Governance framework in following words;

“The *Sharī'ah* governance system is a set of institutional and organizational arrangement through which an Islamic financial institution ensures that there is effective independent oversight of *Sharī'ah* compliance over each of the following structures and process:

1. Issuance of relevant *Sharī'ah* pronouncement or resolution. This refers to a juristic opinion on any matter pertaining to *Sharī'ah* issues

⁸PLD 2000 SC 225
in Islamic finance given by the appropriately mandated Shari'ah board.

2. Dissemination of information on such Shari'ah pronouncement or resolutions to the operative personnel of the IFIs who monitor the day-to-day compliance with the Shari'ah resolutions vis-à-vis every level of operations and each transaction. However, this task would normally be done by the internal Shari'ah compliance department.

3. An internal Shari'ah compliance review or audit reports that if there is any incident of non-compliance, it should be recorded and addressed and rectified. With regard to this, IFSB-3 sets out that Shari'ah resolution issued by the Shari'ah boards should be strictly adhered to.

4. An annual Shari'ah compliance review or audit for verifying that internal Shari'ah compliance review or audit has been appropriately carried out and its findings have been duly noted by the Shari'ah boards.

13.3 Importance of Shari'ah Governance

Islamic financial institutions after four decades of contribution in financial industry have emerged as a strong competitor of conventional financial system. Unique and ethical banking made this industry to grow fast and ensure a broader customer base. Every organization is supposed to be supervised and regulated according to some standards, the so-called Governance standards. Similarly, Islamic financial institutions also need to be regulated and monitored in order to augment and strengthen its workings (Shaharuddin, 2011). Prevailing corporate governance does not fulfill this requirement in the context of Islamic financial institutions, due to their distinctive form of activities so Shari'ah governance framework comes in play. Shari'ah governance is responsible to ensure the compliance of Shari'ah principles in the products, instruments, operations, practices and management of Islamic financial institutions. Shari'ah governance is entrusted to increase transparency and disclosure, intensify professionalism, and improve oversight of the Islamic financial institutions. It is believed that such governance mechanism would escalate the credibility of Islamic financial institutes.

The objective of audit is to provide an objective independent opinion on the financial statements of an organization. Audited financial statements guarantee absence of material misstatement, its true and fair view, and presence of going concern assumption of the entity (Kasim and Sanusi, 2013). The Shari'ah audit discloses similar functions to the company audit but is more focused on the compliance of Islamic financial institutions to Shari'ah percepts and requirements. The Shari'ah audit is supposed to certify that the Islamic financial institutions have rigorous and effective internal control systems to conform to the Shari'ah.

The State Bank of Pakistan has recently issued a Shari'ah Governance framework for Islamic Financial Institutions. Considering the importance of Shari'ah governance framework in uplifting the Islamic finance industry to next phase, there is need to look into Shari'ah audit mechanism and, the effects and challenges faced by Islamic banking institutions after implementation of Shari'ah governance framework.

9IFSB. (2009). Guiding principles on Shari'ah governance systems for institutions offering islamic financial services. Islamic financial services board.

13.4 Difference Features of Shari’ah Governance & Corporate Governance

To understand how the Shari’ah Governance System complements the existing governance, control and compliance functions within an Institution offering Islamic Financial Services (IIFS), comparative to the scenario in a conventional financial institution, is provided below:

<table>
<thead>
<tr>
<th>Functions</th>
<th>Typical Financial Institutions</th>
<th>Additions in IIFS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>Board of Directors</td>
<td>Shari’ah Board</td>
</tr>
<tr>
<td>Control</td>
<td>Internal Auditors</td>
<td>ISRU (Internal Shari’ah Review Unit)</td>
</tr>
<tr>
<td></td>
<td>External Auditors</td>
<td>External Shari’ah Review</td>
</tr>
<tr>
<td>Compliance</td>
<td>Regulatory and Financial compliance officers, unit or department</td>
<td>Internal Shari’ah compliance Unit (ISCU)</td>
</tr>
</tbody>
</table>

13.5 Components of Shari’ah Governance

The Shari’ah governance framework includes guidelines for the stakeholder of Shari’ah supervisory board, Shari’ah auditors, and internal Shari’ah audit unit. Appointment of an effective and independent Shari’ah advisory board as per fit and proper criteria, accountability of executive management in implementation of governance frameworks, Shari’ah compliance review mechanism, Shari’ah compliance unit serving as conduit between Shari’ah board and management of the Islamic bank, establishment of independent Shari’ah audit unit and undertaking external Shari’ah audit are the fundamental requirements mentioned in Shari’ah governance framework to be fulfilled by Islamic financial institutions. Every segment lays a block in building a stronger and more credible Islamic banking industry under the guidelines of Shari’ah governance.11

13.6 Introduction of AAOIFI Shari’ah Governance Standard

The Accounting and Auditing Organization for Islamic Financial Institutions has issued 7 standards on Shari’ah governance for Islamic Financial Institution.

1. Shari’ah Supervisory Board: Appointment, Composition and Report,
2. Shari’ah Review,
3. Internal Shari’ah Review,
4. Audit & Governance Committee for Islamic Financial Institutions,
5. Independence of Shari’ah Supervisory Boards,
6. Statement on Governance Principles for Islamic Financial Institutions,

11 ibid

According to the AAOIFI standards Shari'ah supervisory board defined as;

"An independent body of specialized jurist in fiqh al mua'malat (Islamic commercial jurisprudence). However, the Shari'ah supervisory board may include a member other than those specialized in fiqh mua'malat, but should be an expert in the field of Islamic financial institutions (IFIs) with the knowledge of fiqh al mua'malat." 12

Their responsibility of the Shari'ah supervisory board is to ensure Shari'ah compliance in Islamic financial institution by providing guideline, direction, reviewing the activities of the Islamic financial institution. The Shari'ah supervisory members, should be appointed in the annual general meeting upon the recommendation of the BOD. 13 Shareholders may also authorize the board of directors to fix the remuneration of Shari'ah supervisory board. The appointment letter should have an evidence of the agreement of engagement of Shari'ah supervisory board by IFIs. It is suggested that at there should be at least three members in the board. The board is allowed to seek the service of consultants who have the expertise in business, economics, law, accounting and etc. To maintain the independency of the board, the members should not be the directors and hold any significant shares. For the dismissal of the member, it shall require a recommendation from the board of directors and subjected to the approval of the shareholders in a general meeting. 14

13.7 Introduction of IFSB Shari'ah Governance Guidelines

The Islamic Financial Services Board (IFSB) is an international standard setting institutions which issues standards and guiding principles for Islamic Financial Institutions to strengthen governance structures and processes in the Islamic financial services industry in line with its mandate to promote soundness and stability of the Islamic financial system. The IFSB Council, during its ninth meeting in Jeddah, approved the preparation of a set of comprehensive Guiding Principles on the Shari'ah governance system, which provides guidelines regarding Shari'ah audit/review process for compliance with Shari'ah rulings; and harmonization of the Shari'ah governance structures and procedures. 15

According to IFSB the Shari'ah governance system is defined as "a set of institutional and organizational arrangement through which an Islamic financial institution ensures that there is effective independent oversight of Shari'ah compliance over each of the following structures and process:

a) Issuance of relevant Shari'ah pronouncement or resolution. This refers to a juristic opinion on any matter pertaining to Shari'ah issues in Islamic finance given by the appropriately mandated Shari'ah board.

b) Dissemination of information on such Shari'ah pronouncement or resolutions to the operative personnel of the IFIs who monitor the day-to-day compliance with the Shari'ah resolutions vis-à-vis every level of operations and each transaction. However, this task would normally be done by the internal Shari'ah compliance department.

c) An internal Shari'ah compliance review or audit reports that if there is any incident of non-compliance, it should be recorded and addressed and rectified. With regard to this, IFSB-

13Ibid;
15IFSB. (2009). Guiding principles on Shari'ah governance systems for institutions offering islamic financial services. Islamic financial services board.
3 sets out that Sharî‘ah resolution issued by the Sharî‘ah boards should be strictly adhered to.

d) An annual Sharî‘ah compliance review or audit for verifying that internal Sharî‘ah compliance review or audit has been appropriately carried out and its findings have been duly noted by the Sharî‘ah boards.\(^{16}\)

Furthermore the IFSB explains about the complements of the Sharî‘ah governance system in existing governance, compliance and control functions in IFIS. Regarding Sharî‘ah governance aspect, IFIs should have Sharî‘ah Supervisory board in addition to the BOD. The Islamic Financial Institution should have both internal and external Sharî‘ah review unit in addition to the conventional internal and external auditors for control mechanism. In terms of compliance, IFIs should comply with Sharî‘ah in addition to compliance with the conventional regulatory and financial requirements.

13.8 Introduction of Sharî‘ah Governance Framework Issued by Bank Negara Malaysia

The foundation of the Islamic Finance are Sharî‘ah principles, through the observance of the tenets, principles and conditions espoused by the Islamic Sharî‘ah. The Bank Negara Malaysia always places great importance to the Sharî‘ah compliance in overall Islamic financial system. This objective is being achieved through the two-tier Sharî‘ah governance structure comprising two components 1\(^{st}\) centralized Sharî‘ah advisory body at the Central Bank\(^{17}\) 2\(^{nd}\) internal Sharî‘ah Committee in each IFI. The mandates of the Sharî‘ah Advisory Council, is to ascertain the Sharî‘ah rules relating to financial matter and issue fatwas on it. The SAC also advise the Bank and the Islamic Financial Institutions concerned on any Sharî‘ah issues relating to Islamic finance and business activities or transactions. The duties of the internal Sharî‘ah Committee at the industry level in advising respective Islamic financial Institutions are further deliberated in the Guidelines on the Governance of Sharî‘ah Committee for the Islamic Financial Institutions issued in 2004. The Bank Negara Malaysia has developed the Sharî‘ah governance framework for Islamic Financial Institutions, where the main objective is to enhancing the role of the Sharî‘ah board, the Sharî‘ah Committee and the management in relation to Sharî‘ah matters.\(^{18}\) The main objective of the Sharî‘ah Governance Framework for the IFIs is to;

i. Sets out the expectations of the Bank on an IFI’s Sharî‘ah governance structures, processes and arrangements to ensure that all its operations and business activities are in accordance with Sharî‘ah;

ii. Provides a comprehensive guidance to the board, Sharî‘ah Committee and management of the IFI in discharging its duties in matters relating to Sharî‘ah; and

iii. Outlines the functions relating to Sharî‘ah review, Sharî‘ah audit, Sharî‘ah risk management and Sharî‘ah research.

The Framework shall be applicable to all IFIs regulated and supervised by the Bank. Any reference to ‘IFI’ for the purpose of the Framework means:

i. An Islamic bank licensed under Islamic Banking Act 1983 (IBA);

ii. A takaful and re-takaful operator registered under the Takaful Act 1984 (TA);

iii. A financial institution licensed under the Banking and Financial Institutions Act 1989 (BAFIA) that participates in the Islamic Banking Scheme; and

\(^{16}\) Ibid, p5

\(^{17}\) The Sharî‘ah Advisory Council of Bank Negara Malaysia (SAC) is a body established under section 51 of the Central Bank of Malaysia Act 2009 that has positioned the SAC as the apex authority for the determination of Islamic law for the purposes of Islamic financial business.

I. A development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) that participates in the Islamic Banking Scheme.¹⁹

13.9 Sharī’ah Governance Framework issued by State Bank of Pakistan

The Compliance with the principles of Sharī’ah According to the Holy Quran and the Sunnah is the essence of Islamic banking industry. A sound and effective Sharī’ah compliance framework is thus critically important to give confidence to the general public about Sharī’ah conformity of Islamic Banking Institutions (IBIs)’ products and services. To ensure the operation of the Islamic Financial Institutions compliance with the rules and principles of Sharī’ah the State Bank of Pakistan (SBP) issues regulations time to time since the re-launch of Islamic Banking in Pakistan.

In 2008 SBP issued Sharī’ah Compliance guidelines for IBIs²⁰. However keeping in view the recent developments in the Islamic banking industry, a comprehensive Sharī’ah Governance Framework has been issued. The framework is be applicable to all IBIs. The main objective of this Sharī’ah Governance framework is to strengthen Sharī’ah compliance in the IBIs and to define the roles and responsibilities of the followings;

1. Board of directors,
2. Executive Management,
3. Sharī’ah Supervisory Board,
4. Sharī’ah Compliance Department (SCD)
5. Internal and External Auditors towards Sharī’ah Compliance.

1. ROLE OF BOARD OF DIRECTORS (BOD)

According to the Sharī’ah governance framework the Board of Directors are ultimately responsible and accountable for ensuring full conformity of the Islamic Bank’s operations with Sharī’ah principles. They should introduce an effective mechanism including diligent oversight on functioning of the Framework and compliance with the fatwas issued by the Sharī’ah Board, instructions, and guidelines of the Sharī’ah Board²¹. Furthermore they are liable to take following actions;

- They should be fully aware of its fiduciary responsibility, particularly, towards Investment Account Holders (IAHs). The IBIs to not only exercise prudence in deployment of their funds in different avenues but to also ensure Sharī’ah conformity of returns to be earned and distributed to them. The BOD is thus expected to introduce the necessary mechanisms and risk management systems to safeguard the interests of IAHs/PLS depositors.²²

- The BOD shall appoint a SB to perform such functions as stipulated under Para 3(B) of this Framework and shall cause to take appropriate measures for introducing and implementing an effective Sharī’ah compliance framework. It shall also approve the Terms of Reference (TOR) of the SB and fix remuneration of the SB members. In case of foreign banks having Islamic Banking Branches, the appointing authority shall be the Country Manager/CEO in Pakistan.

- The BOD shall meet the SB at least on a half yearly basis to have a detailed briefing regarding Sharī’ah compliance environment, the issues/weaknesses (if any). However, one of the meetings between the SB and BOD, during a calendar year, may be held through video conferencing.

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¹⁹ Ibid
²⁰ IBD Circular No. 2 of 2008
²² Ibid
2. **ROLE OF EXECUTIVE MANAGEMENT (EM)**

The Executive Management of an IBI shall be responsible for implementation of the Framework. Every concerned executive and staff shall ensure that all procedure manuals, product programs and structures, process flows, related agreements and contracts, etc. as approved by the SB are made available to and understood by everyone working in his/her group or functional area. Moreover, every executive shall be responsible for arranging adequate training to his/her group employees in coordination with Training Department and SCD of the IBI. Every group head and executive shall also be accountable and responsible for implementation of decisions, rulings, fatwa and guidelines given by SB relating to his/her group or functional area. The EM needs to show zero tolerance on Shari’ah non-compliance and take appropriate action against employees who have failed to ensure compliance with the Shari’ah rules and principles in their respective areas of responsibility. Instances of Shari’ah non-compliance shall also have a strong bearing on their performance appraisals, promotions, increments, and bonuses etc. Besides these the EM will take following necessary actions:

- IBIs should arrange trainings and/or orientation programs on Islamic banking and finance for the members of the BOD and appropriate training programs for senior executives to improve their understanding and general acumen in Islamic finance.
- The management is also expected to arrange programs on a regular basis for orienting and sensitizing the BOD and key executives about the business utility and importance of an enabling Shari’ah compliance environment and the key distinguishing features of Islamic finance products vis-à-vis conventional banking products.

3. **ROLE OF SHARI’AH BOARD (SB)**

According to the SGF Every Islamic Banking Institution shall have a Shari’ah Board comprising at least three Shari’ah scholars appointed by the BOD as per the Fit and Proper Criteria\(^{24}\) subject to prior written clearance of SBP for a term of three years and shall be eligible for reappointment.\(^{25}\) The responsibilities of the Shari’ah supervisory Board is to supervise the financial transactions of the Islamic Banking institution and issue fatwas related to banking transactions. The IBI can also seek services of or engage lawyers, accountants, economists and such other professionals to assist and advise the SB on banking, legal, financial, economic and other relevant matters.

The SB shall be empowered to consider, decide and supervise all Shari’ah related matters of the IBI. All decisions, rulings, fatawa of the SB shall be binding on the IBI whereas SB shall be responsible and accountable for all its Shari’ah related decisions. The SB shall cause to develop a

\(^{23}\) Ibid, p 3

\(^{24}\) As per (Annexure – A) of the Sharī’ah Governance framework, the Fit and proper criteria for appointing a Shari’ah Board member must have ‘Shahadat ul Aalamiyyah (شہادۃ العالمیہ) Degree (Dars e Nizami) from any recognized Board of Madaris with minimum 70% marks and Bachelor’s Degree with a minimum of 2nd Class OR Post Graduate Degree in Kuliyyatush Shari’ah (كلیۃ الشريعۃ) or Kuliyyah Usooluddin (کلیۃ اصول الدين) or L.M. (Shari’ah) with a minimum GPA of 3.0 or equivalent from any recognized University. He must also have at least four (4) years’ experience of giving Shari’ah rulings including the period of Takhasus fil Itta; or at least five (5) years post qualification experience in teaching or Research and Development in Islamic Banking and Finance. Preference will be given to those who have certificate in Takhsas fil Fiqh/Takhasus fil Itta. Majority of Shari’ah scholar members of Shari’ah Board of an IBI, including RSBM, shall have at least three (3) years’ experience as Shari’ah Advisor or Member of Shari’ah Board (SB) of an Islamic Financial Institution (IFI) or deputy to a Shari’ah Advisor or member of the Shari’ah team of an IFI. For details please see (Annexure – A) of SGF.

\(^{25}\) Ibid
comprehensive Shari’ah compliance framework for all areas of operations of the IBI. All products or services to be offered and/or launched by the IBI shall have prior approval of the SB.

All reports of internal Shari’ah audit and Shari’ah compliance reviews shall be submitted to the SB for consideration and prescribing appropriate enforcement action. The SB shall take up the unresolved issues with management and shall include all significant outstanding issues in its annual report on the Shari’ah compliance environment of the IBI. Moreover, the Head of SCD and RSBM shall discuss both the significant and unresolved issues with SBP inspection team during their on-site inspection.

3.1. Shari’ah Board Meetings, Quorum, Minutes

The meetings of the SB shall be on quarterly basis and each member of the SB shall attend at least two thirds of the meetings held during a calendar year. Further, in addition to the mandatory quarterly meeting, the Chairperson of the SB may convene SB’s meetings as and when he deems it necessary. The quorum of the SB meetings, including that with BOD of the IBI, shall be at least two thirds of Shari’ah scholar members. The SB decisions should preferably be made through consensus of the Shari’ah scholar members; however in case of difference of opinion, the decisions may be made by a majority vote of the Shari’ah scholar members. In the event of equality of votes, the Chairperson shall have a second or casting vote and all meetings shall be chaired by the Chairperson of the SB and in his absence one of the Shari’ah scholar members, other than the RSBM, shall be elected as the acting Chairperson to preside over the meeting. The agenda of the SB meeting along with sufficient details and documents shall be sent to SB members well in advance enabling them to come prepared to the meeting; the specific timelines for submission of the agenda shall be set by the SB itself. Further, the minutes shall be signed by all the SB members who attended the meeting and a copy thereof be provided to each member of the SB.

The minutes of meetings of the SB shall be submitted to IBD-SBP within 45 days of the meeting for information and record. Further, the minutes shall be made available to the BOD, SBP inspection teams, internal auditors and external auditors on request, enabling them to appreciate and understand the rationale and background of the SB rulings, decisions and fatwas.

3.2. Report of Shari’ah Board

The SB shall, based on the findings and reports of internal Shari’ah audit and external Shari’ah audit and Shari’ah compliance review, prepare a report on the IBI’s Shari’ah compliance environment and conditions. The minimum requirements for the report are given in Annexure – B of this Framework. The report shall be signed by all the members of the SB. Further, the report shall also be placed before the BOD meeting for discussion and shall be published in the IBI’s annual report.

4. Resident Shari’ah Board Member (RSBM)

The SB of an IBI shall, in consultation with the management, designate one of the SB members other than the Chairperson as RSBM. The RSBM shall oversee the procedures to be adopted for implementation of the resolutions, pronouncements and fatawa of the SB and provide guidance thereon. In principle, RSBM shall be appointed on a full time basis; however, SB having regard to specific circumstances of the IBI may, at its own discretion, allow RSBM to devote some time to academic activities related to the Shari’ah. Further, RSBM of an IBI shall not serve in any capacity whatsoever in any other IBI in Pakistan. However, he may with prior approval of the SB of IBI serve as a member of Shari’ah Board of a maximum two other IFIs.

5. Shari’ah Compliance Department (SCD)

Every IBI shall have a SCD which may be headed by a RSBM or a suitably qualified, trained and experienced officer recommended by the SB. The SCD shall have dedicated and adequate staff as per the advice of the SB, so as to enable it to discharge its due responsibilities in a proper
and timely manner. Further, the SCD shall work under the overall guidance and supervision of the SB and its Head shall report to the SB and

5.1. Secretariat of Shari’ah Board
It shall serve as the Secretariat to the SB with the responsibility to provide all the necessary secretarial support to the SB including timely provision of meetings’ agenda, proposals, and working papers. It shall also maintain proper record of agenda items, minutes of the SB meetings and fatawa issued by the SB along with their rationale.

5.2. Shari’ah Compliance Review
The SCD shall keep a continuous watch on the IBI’s Shari’ah compliance environment and shall ensure that all organs of Shari’ah Governance including the BOD oversight mechanism, internal Shari’ah audit, and enforcement of the SB’s directives by EM are operative and are effectively discharging their respective functions and responsibilities as defined in the Framework. In order to monitor and ensure compliance of IBI’s operations on an ongoing basis with the rules and principles of Shari’ah, the SCD under the supervision of RSBM shall, on sample basis, conduct an internal Shari’ah control review of the IBI’s business units, branches, and other Head Office departments.

The Shari’ah compliance review shall be conducted to ensure that the IBI’s operations are in conformity with fatawa/guidelines issued by SB of the IBI and directives, regulation, instructions and guidelines issued by SBP in accordance with the rulings of SB’s Shari’ah Board. Based on these reviews and other mechanisms as may be introduced by the SCD for assessing conformity of the IBI’s operations with the principles and rules of the Shari’ah, the RSBM shall periodically submit a report to the SB on the overall Shari’ah compliance environment of the IBI, the ownership and commitment of the BOD and EM in building the necessary infrastructure for Shari’ah compliance together with identifying key areas of improvement. The frequency of this report shall be decided by the SB.

5.3. Enforcement of Shari’ah Audit Reports
All the reports of internal Shari’ah audit, external Shari’ah audit, internal Shari’ah review, and SBP Shari’ah compliance inspection shall be sent to SB for information and for determining appropriate corrective actions. The Board Audit Committee (BAC) shall ensure compliance of the corrective actions determined by SB on the reports of ‘internal Shari’ah audit’ and ‘external Shari’ah audit’. The SCD shall, however, be responsible for enforcement of corrective actions directed by the SB on the reports of ‘internal Shari’ah review’ and ‘SBP Shari’ah compliance inspection’. The BAC and SCD shall also keep record of all unresolved issues requiring compliance and shall apprise the SB of their status at least on a half yearly basis. The SB shall take up the unresolved issues with the management and shall include all significant outstanding issues in its annual Shari’ah Report to be published in the Annual Report of the IBI. Moreover, SB/Head of SCD shall discuss all the significant and unresolved issues with SBP inspection team during their on-site inspection.

5.4. Training on Shari’ah Compliance
The SCD shall facilitate Training Unit of Human Resources Department of IBI to develop training material and to organize Shari’ah training activities as per training plan approved by the management and the SB. Moreover, the SCD shall be responsible for ensuring that necessary training has been imparted to all the Islamic banking staff and that periodic refresher courses are also organized by HRD to keep the staff abreast with the latest developments in the field. The management shall provide all required facilities for this purpose and the SCD shall report its concerns, if any, in this regard to the SB.

6. INTERNAL SHARI’AH AUDIT
Every IBI shall have an Internal Shari’ah Audit Unit (ISAU) which may be a part of the internal audit department or an independent unit, depending on the size of the IBI. Moreover, Head of ISAU shall
report to Head of Internal Audit in case it is part of Internal Audit Department, whereas in cases where ISAU is independent, it shall report directly to Board Audit Committee (BAC).

The IBI shall ensure that staff of ISAU are adequately qualified and trained to perform their duties. Internal Shari’ah audit staff shall be dedicated to Shari’ah audit only; however, Internal Shari’ah audit and regular audit of a branch or a function can be performed simultaneously.

The scope, methodology, Internal Shari’ah audit manual and format of Internal Shari’ah audit report shall be reviewed and approved by the SB. Furthermore, the SB shall review the methodology and Internal Shari’ah audit manual at regular intervals.

The Internal Audit Department or ISAU, as the case may be, shall prepare Internal Shari’ah audit plan which, after review by the SB, shall be approved by the BAC. The final Internal Shari’ah audit report shall be submitted to SB for consideration and for determining appropriate corrective action(s).

The final report along with the enforcement/corrective actions determined by the SB shall be sent to the BAC for information and ensuring compliance with the SB directives on the report. The SCD shall submit a report regarding the status of compliance of audit observations to the SB for information on a periodic basis.

7. **External Shari’ah Audit**

In order to have an independent assessment of the Shari’ah governance and compliance environment of an IBI, the scope of external audit of IBIs shall also include an independent and objective assessment of the conformity of IBI’s operations with Shari’ah rules and principles. The audit firms would need to take appropriate measures to have the capacity in relation to resources and methodology to conduct the Shari’ah audit of an IBI.27

For the purposes of this Framework, the scope of external Shari’ah audit shall be limited to assessing compliance of an IBI’s financial arrangements, contracts, and transactions with Shari’ah rules and principles. The Shari’ah rules and principles for the purpose of the external Shari’ah audit shall mean the following, in the sequence provided below:

- Essentials, Regulations, Instructions and Guidelines issued by the State Bank of Pakistan (SBP) including the Shari’ah Standards issued by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), as adopted by SBP with suitable modifications, if any;

8. **Conflict Resolution**

In case of any difference of opinion between an IBI and the SBP inspection team or any other department of SBP regarding Shari’ah conformity of IBI’s products, services, contracts and transactions, the matter shall be referred to IBD-SBP. If deemed appropriate by IBD-SBP it may escalate the case to SBP’s Shari’ah Board for consideration and decision.

ii. Similarly, in case of a difference of opinion between IBD-SBP and IBI on Shari’ah conformity of IBI’s products, services, contracts and transactions, IBD-SBP shall refer the case to SBP’s Shari’ah Board for consideration and decision on the issue of Shari’ah permissibility of such matters.

iii. The SB of the IBI may also refer Shari’ah issues to SBP for seeking opinion of its Shari’ah Board. The case shall be sent to SBP along with all relevant documents and the related Shari’ah arguments. The SBP’s Shari’ah Board shall consider and give its decision or provide guidance, as the case may be, on such issues at its earliest convenience.

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27 Ibid, p 9
REFERENCES


93. The report of the Committee of Sponsoring Organizations of the Treadway Commission (COSO-1992)


