

Manual of Corporate Governance



Securities and Exchange
Commission of Pakistan

This manual is for reference only and does not constitute any legal requirement on companies, their officers, directors or auditors. This manual may be used for guidance and compliance must be ensured with the provisions of applicable laws and regulations.

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CORPORATE GOVERNANCE IN PAKISTAN

I. INTRODUCTION

1.1 In March 2002, the Securities and Exchange Commission of Pakistan (the SEC) issued the Code of Corporate Governance (the Code) to establish a framework for good governance of companies listed on Pakistan's stock exchanges. In exercise of its powers under Section 34(4) of the Securities and Exchange Ordinance, 1969, the SEC issued directions to the Karachi, Lahore and Islamabad stock exchanges to incorporate the provisions of the Code in their respective listing regulations. As a result, the listing regulations were suitably modified by the stock exchanges.

1.2 The Code is a compilation of "best practices", designed to provide a framework by which companies listed on Pakistan's stock exchanges are to be directed and controlled with the objective of safeguarding the interests of stakeholders and promoting market confidence; in other words to enhance the *performance* and ensure *conformance* of companies. In doing this, the Code draws upon the experience of other countries in structuring corporate governance models, in particular the experience of those countries with a common law tradition similar to Pakistan's. The Code of Best Practice of the Cadbury Committee on the Financial Aspects of Corporate Governance published in December 1992 (U.K.), the Report of the Hampel Committee on Corporate Governance published in January 1998 (U.K.), the Recommendations of the King's Report (South Africa), and the Principles of Corporate Governance published by the Organization for Economic Cooperation and Development in 1999 have been important documents in this regard.

1.3 The Code is a first step in the systematic implementation of principles of

good corporate governance in Pakistan. Further measures will be required, and are contemplated by the SEC, to refine and consolidate the principles and to educate stakeholders of the advantages of strict compliance. Ultimately, a change in the way in which directors, managers, auditors, shareholders, and other stakeholders in Pakistan perceive corporate entities and their respective roles in their conduct and control would be desirable this will necessitate a change of corporate culture, which must not only be incremental but necessarily relevant. This study is a contribution towards this effort.

II. WHAT IS CORPORATE GOVERNANCE?

(i) The Background

2.1 Corporate governance is a relatively new term used to describe a process, which has been practiced for as long as there have been corporate entities. This process seeks to ensure that the business and management of corporate entities is carried on in accordance with the highest prevailing standards of ethics and efficacy upon assumption that it is the best way to safeguard and promote the interests of all corporate stakeholders.

2.2 The process of corporate governance does not exist in isolation but draws upon basic principles and values which are expected to permeate all human dealings, including business dealings principles such as utmost good faith, trust, competency, professionalism, transparency and accountability, and the list can go on. Corporate governance builds upon these basic assumptions and demands from human dealings and adopts and refines them to the complex web of relationships and interests which make up a corporation. The body of laws, rules and practices which emerges from this synthesis is never static but constantly evolving to meet changing circumstances and requirements in which corporations operate. From time to time, crisis of confidence in effective compliance with, or implementation of, prevailing corporate governance principles acts as a catalyst for further refinement and enhancement of the laws, rules and practices which make up the corporate governance framework. The result is an evolving body of laws, rules and practices, which seeks to ensure that high standards of corporate governance continue to apply.

2.3 At their earliest development, the business and management of corporate

entities were governed in accordance only with the basic principles of agency and trust, which included the requirement for utmost good faith, transparency and accountability. However, with the growth in size of corporate entities, increasing complexities of business environment and the absence of a formal regulatory framework, basic agency and trust principles were found to be inadequate to fully safeguard and promote the interests of stakeholders. These early experiences led to the introduction of special laws to regulate registration of companies and the requirement for such companies to conform to prescribed laws, rules and practices in the conduct of their business and management. Also introduced at this time was the concept of limited liability the ultimate instrument of shareholder protection which effectively limited maximum liability of the shareholder but did nothing to safeguard and promote the investment which the shareholder had already made.

2.4 Through this evolutionary process has emerged a complex system of laws, rules, and practices dealing with every aspect of corporate governance. The process of evolution continues.

2.5 Some examples of corporate governance issues arising are the circumstances surrounding the collapse of the South Sea Company (frequently referred to as the “South Sea Bubble”) in England in 1720. More recent examples are the Taj Company Scandal in Pakistan and the Enron Scandal in the United States. Many other Pakistani and international examples exist.

(ii) Definition of Corporate Governance

2.6 The term “corporate governance” came into popular use in the 1980's to broadly describe the general principles by which the business and management of companies were directed and controlled. Although its use is now common, and the objectives to be achieved thereby generally understood, there is no universally

accepted definition of “corporate governance”. Although the utility of definitions is invariably exaggerated, definitions do have the advantage of providing a general framework for discussion and debate. For this purpose, and in view of the comparative infancy of the subject in Pakistan, a limited discussion of the definition of corporate governance is provided below.

2.7 Governance is the manner by which a function is conducted, and hence corporate governance is the manner by which corporations are and should be conducted. The term contains many attributes of which trust, transparency and accountability are fundamental aspects. It includes all aspects that are significant to decision making in a company.

2.8 A basic definition of corporate governance, which has been widely recognized, was given in a report by the committee under the chairmanship of Sir Adrian Cadbury titled *The Financial Aspects of Corporate Governance* (the Cadbury Report):

“Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the directors include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The Board's actions are subject to laws, regulations and the shareholders in general meeting.”

This definition of corporate governance has been endorsed in various other discourses on the subject, including the 1998 final report of the Committee on

Corporate Governance (the Hampel Report) by Sir Ronald Hampel.

2.9 Other definitions include that by the International Chamber of Commerce in its web based guide to corporate governance for business managers:

“Corporate governance is the relationship between corporate managers, directors and providers of equity, and institutions who save and invest their capital to earn a return. It ensures that the Board of directors is accountable for the pursuit of corporate objectives and that the corporation itself conforms to the law and regulations.”

2.10 The Organization for Economic Cooperation and Development provides another perspective in its Principles of Corporate Governance by addressing five areas: (i) the rights and responsibilities of shareholders; (ii) the role of the stakeholders; (iii) the equitable treatment of shareholders; (iv) disclosure and transparency; and (v) the duties and responsibilities of the Board. It defines corporate governance as:

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

2.11 Kenneth Scott of Stanford Law School, (March 1999) states:

“In its most comprehensive sense, “corporate governance” includes every force that bears on the decision-making of the firm. That would encompass

not only the control rights of stockholders, but also the contractual covenants and insolvency powers of debt holders, the commitments entered into with employees and customers and suppliers, the regulations issued by governmental agencies, and the statutes enacted by parliamentary bodies. In addition, the firm's decisions are powerfully affected by competitive conditions in the various markets in which it operates. One could go still further, to bring in the social and cultural norms of the society. All are relevant, but the analysis would become so diffuse that it risks becoming unhelpful as well as unbounded."

2.12 Taken together, all definitions of corporate governance lead to the basic idea, which refers to the system by which companies are directed and controlled, focusing on the responsibilities of directors and managers for setting strategic aims, establishing financial and other policies and overseeing their implementation, and accounting to shareholders for the performance and activities of the company with the objective of enhancing its business performance and conformance with the laws, rules and practices of corporate governance.

2.13 Corporate governance is also the mechanism by which the agency problems of corporation stakeholders, including the shareholders, creditors, management, employees, consumers and the public at large are framed and sought to be resolved.

(iii) The Benefits of Corporate Governance

2.14 Good and proper corporate governance is considered imperative for the establishment of a Competitive market. There is empirical evidence to suggest that countries that have implemented good corporate governance measures have generally experienced robust growth of corporate sectors and higher ability to

attract capital than those which have not. The International Chamber of Commerce in its guide to corporate governance states:

“[s]ound corporate governance practices have become critical to worldwide efforts to stabilise and strengthen good capital markets and protect investors. They help companies to improve their performance and attract investment. Corporate governance enables corporations to realize their corporate objectives, protect shareholders rights, meet requirements and to demonstrate to the wider public how they are conducting their business ... [r]esearch shows that investors from all over the world indicate that they will pay large premiums for companies with effective corporate governance. One such study conducted by The McKinsey Quarterly found that institutional investors in emerging market companies would be willing to pay as much as 30 percent more for shares in companies with good governance. Furthermore, it showed that companies with better corporate governance had higher per book ratios, demonstrating that investors do indeed reward good governance ... importance of corporate governance has been recognized by the financial sector most recently, corporate governance practices are also being looked at by rating agencies, and they have an impact on the cost of capital. ”

2.15 Radical changes have taken place in world economies over the past two decades. This change has also affected Asia. The most palpable developments can be observed in capital markets, which today demand companies that offer more transparency, stricter auditing, and more rights for minority shareholders, all of which are aspects of better corporate governance.

(iv) The Pakistani Corporation

2.16 The evolution of the Pakistani corporate entities has, historically, closely followed the path taken by English corporate entities. The English Companies Act, 1844 provided the initial impetus to the development of corporations in undivided India. In 1855, the Joint Stock Companies Act was enacted in undivided India, which, for the first time, provided for registration of companies. This was followed by the Indian Companies Act, 1882 and later by the Indian Companies Consolidation Act, 1913. Upon independence, Pakistan inherited the Indian Companies Consolidation Act, 1913. In 1949, this Act was amended in certain respects, including its name, whereafter it was referred to as the Companies Act, 1913. Until 1984, when the Companies Ordinance, 1984 (the Companies Ordinance) was promulgated, following lengthy debate, Pakistani companies were established and governed in accordance with the provisions of the Companies Act, 1913.

2.17 Even today, under the Companies Ordinance, many provisions remain unaltered from those contained in the Companies Act, 1913 and its precursors. As a result, development of corporate law in Pakistan continues to be influenced by English company law. This has been made possible because of one of the rules of statutory interpretations, according to which if statutory provisions are consolidated or are similar or identical to previous provisions it is legitimate to refer to case law interpreting such provisions. This rule has been recognized by Pakistani courts.

2.18 Notwithstanding the long experience of corporations borrowed from English law and as developed in undivided India, the circumstances that have influenced and contributed to the evolution of the Pakistani corporation and corporate culture have been fundamentally different from those prevailing at any time in England or in undivided India and for that matter most other developing and developed countries. The period immediately following independence of Pakistan had thrown up quite unique challenges and opportunities for the manner in which corporations and corporate culture was to develop in Pakistan. The family

company became and remains central to that development. In addition, the oldest stock exchange in Pakistan was incorporated in 1949 - two years after independence. Stock exchanges in Lahore and Islamabad have developed even later.

2.19 Corporate entities in Pakistan are primarily regulated by the SEC under the Companies Ordinance, the Securities and Exchange Ordinance, 1969, the Securities and Exchange Commission of Pakistan Act, 1997, and the various rules and regulations made thereunder. In addition, special companies may also be regulated under special laws and by other regulators, in addition to the SEC. In this way, listed companies are also regulated by the stock exchange at which they are listed; banking companies are also regulated by the State Bank of Pakistan; companies engaged in the generation, transmission or distribution of electric power are also regulated by the National Electric Power Regulatory Authority; companies engaged in providing telecommunication services are also regulated by the Pakistan Telecommunication Authority; and oil and gas companies are also regulated by the Oil and Gas Regulatory Authority. This list is not exhaustive.

(v) The Origins of Corporate Governance in Pakistan

2.20 The SEC, since it took over the responsibilities and powers of the erstwhile Corporate Law Authority in 1999, has been acutely alive to the changes taking place in the international business environment, which directly and indirectly impact local businesses. As part of its multi-dimensional strategy to enable Pakistan's corporate sector meet the challenges raised by the changing global business scenario and to build capacity, the SEC has focused, in part, on encouraging businesses to adopt good corporate governance practices. This is expected to provide transparency and accountability in the corporate sector and to safeguard the interests of stakeholders, including protection of minority shareholders' rights and strict audit compliance.

2.21 In December 1998, the Institute of Chartered Accountants of Pakistan (the ICAP) took the initiative to develop a framework of good governance in Pakistan. A committee representing the SEC, ICAP, the Institute of Cost and Management Accountants of Pakistan and the stock exchanges was established. A sub-committee was formed to undertake the task of formulating recommendations for drawing up a draft code of corporate governance. On March 28, 2002, after a process of consultation with stakeholders, the draft code was finalized and issued by the SEC. The SEC, in exercise of its powers under Section 34(4) of the Ordinance, issued directions to the Karachi, Lahore and Islamabad stock exchanges to insert the provisions of the Code appropriately in their respective listing regulations. Through this measure, the Code was incorporated into the respective listing regulations of the stock exchanges and is now applicable to all listed companies.

2.22 The Code is a compilation of principles of good governance and a combined code of good practices. The Code provides a framework tailored to address the complexities of the corporate sector in Pakistan and also draws together recognized best practices as embodied in various prominent international models of corporate governance.

2.23 Compliance with the provisions of the Code is mandatory except for two that are voluntary in nature. The mandatory provisions deal with such matters as directors' qualifications and eligibility to act as such, their tenure of office, responsibilities, powers and functions, disclosure of interest, training, meetings of the Board of directors and the business to be conducted by it, the qualifications, appointment and responsibilities of Chief Financial Officer (CFO) and company secretary, the appointment and responsibilities of the Audit Committee, the appointment and responsibilities of internal and external auditors, and compliance by listed companies with the Code. The two voluntary provisions pertain to the appointment of independent non-executive directors and those representing minority interests on the Board of directors and the restriction for brokers to be

appointed as directors of listed companies.

III. THE NEED FOR CORPORATE GOVERNANCE

3.1 The popularity and development of corporate governance frameworks in both the developed and developing worlds is primarily a response and an institutional means to meet the increasing demand of investment capital. It is also the realization and acknowledgement that weak corporate governance systems ultimately hinder investment and economic development. In a McKinsey¹ survey issued in June 2000, investors from all over the world indicated that they would pay large premiums for companies with effective corporate governance. A number of surveys of investors in Europe and the US support the same findings and show that investors eventually reduce their investments in a company that practices poor governance.

3.2 Corporate governance serves two indispensable purposes. It enhances the performance of corporations by establishing and maintaining a corporate culture that motivates directors, managers and entrepreneurs to maximize the company's operational efficiency thereby ensuring returns on investment and long term productivity growth. Moreover, it ensures the conformance of corporations to laws, rules and practices, which provide mechanisms to monitor directors' and managers' behaviour through corporate accountability that in turn safeguards the investor interest. It is fundamental that managers exercise their discretion with due diligence and in the best interest of the company and the shareholders. This can be better achieved through independent monitoring of management, transparency as to corporate performance, ownership and control, and participation in certain fundamental decisions by shareholders.

3.3 Dramatic changes have occurred in the capital markets throughout the past decade. There has been a move away from traditional forms of financing and a collapse of many of the barriers to globalization. Companies all over the world are

¹McKinsey & Company is a management consulting firm advising companies and institutions on issues of strategy, organization, technology, and operations.

now competing against each other for new capital. Added to this is the changing role of institutional investors. In many countries corporate ownership is becoming increasingly concentrated in institutions, which are able to exercise greater influence as the predominant source of future capital. Corporate governance has become the means by which companies seek to improve competitiveness and access to capital and borrowing in a local and global market.

3.4 Effective corporate governance allows for the mobilization of capital annexed with the promotion of efficient use of resources both within the company and the larger economy. It assists in attracting lower cost investment capital by improving domestic as well as international investor confidence that the capital will be invested in the most efficient manner for the production of goods and services most in demand and with the highest rate of return. Good corporate governance ensures the accountability of the management and the Board in use of such capital. The Board of directors will also ensure legal compliance and their decisions will not be based on political or public relations considerations. It is understood that efficient corporate governance will make it difficult for corrupt practices to develop and take root, though it may not eradicate them immediately. In addition, it will also assist companies in responding to changes in the business environment, crisis and the inevitable periods of decline.

3.5 Corporate governance is the market mechanism designed to protect investors' rights and enhance confidence. Throughout the world, institutions are awakening to the opportunities presented by governance activism. As a result, Boards and management are voluntarily and proactively taking steps to improve their own accountability. Simply put, the corporations, including Pakistani corporations, have begun to recognize the need for change for positive gain. Along with traditional financial criteria, the governance profile of a corporation is now an essential factor that investors and lenders take into consideration when deciding how to allocate their capital. The more obscure the information, the less likely that investors and lenders would be attracted and persuaded to invest or lend. The lack

of transparency, unreliable disclosure, unaccountable management and the lack of supervision of financial institutions (all of which are the consequences of inadequate corporate governance) combine to infringe investors' rights. Poor corporate governance has a tendency to inflate uncertainty and hamper the application of appropriate remedies.

3.6 *“Transparency”* can be achieved through three key market elements: openness, accounting standards, and compliance reporting. Efficient markets depend upon investor confidence in the accuracy and openness of information provided to the public. Also, compliance with internationally recognized accounting standards is necessary to ensure that investors can effectively analyze and compare company data. With incorporation of the Code in the listing regulations of the Pakistan's stock exchanges, listed companies are now under an obligation to act transparently.

3.7 *“Accountability”* describes the Board of director's duty to shareholders. In particular, the Board of directors has a special duty and responsibility to develop the company's strategic vision, ensuring the enhancement of long-term share values. In doing so, the Board and management should be open and accessible to inquiry by shareholders and other stakeholders about the condition and performance of the company and should disclose how key decisions were made, including those that affect executive compensation, strategic planning, nomination and appointment of directors and appointment and succession of managers and financial controls.

3.8 Initially, principles of corporate governance were more specifically framed to facilitate the so called *“agency problems”* that were a consequence of the separation of ownership and management in publicly owned corporations. As the ownership of corporations is widely dispersed, management of the corporation is

vested in directors who act as agents for the owners, (the shareholders). From this stems the theory that the interest of the shareholder is not determined or protected by any formal instrument, unlike the interest of most stakeholders and investors which can generally and adequately be protected through contractual rights and obligations with the company. It is, for this reason, that corporate governance is primarily directed at the effective protection of shareholder interests.

3.9 The corporate governance system specifies the rights of the shareholder and the steps available if management breaches its responsibilities established on equitable principles from this springs the “*equity contract*”. In addition to the applicable general law, the equity contract is created under Section 31 of the Companies Ordinance. Similar provision exists under the English Companies Act, namely Section 14.

3.10 The inability or unwillingness to make credible disclosure constitutes a bad equity contract which potentially makes it difficult for the market to distinguish good risk from bad resulting in an inability to attract investors. The long term consequences of such inabilities prove to have a crippling effect, not only on corporations, but also on the stock market as it blocks crucial liquidity of the stock market, with the resultant weakening of the entire financial system. Consequently, the increased cost of capital reallocates financing and the capital market towards debt. A distinctive characteristic of the Pakistani corporate culture, however, is the pyramidal ownership structure and corporations with concentrated ownership enabling large shareholders to directly control managers and corporate assets. Thus the need for corporate governance should not, perhaps, arise under the prevailing structure as the conflict of interest that emerges gives rise to the “*expropriation problem*” as opposed to the “*agency problem*”. It is imperative, however, at this stage, to acknowledge the rapid developments that are taking place within the Pakistan corporate culture and the fading out of the traditional and

more conventional corporate formation. Furthermore, a good governance system is required for such institutions as the success of any institution is a combined effort comprising of contributions from a range of resource providers including employees and creditors. It is for this reason that the role of the various stakeholders cannot go ignored and their rights and the corporations' obligations must be determined. Financing of any kind, whether for publicly traded companies or privately held and state owned companies, can only be made possible through the exercise of good corporate governance.

IV. THE STAKEHOLDERS

(i) General

4.1 A corporation enjoys the status of a separate legal entity; however, the formation of a public listed company is such that its success is dependant upon the performance of a contribution of factors encompassing a number of stakeholders. A “*stakeholder*” is a person (including an entity or group) that has an interest or concern in a business or enterprise though not necessarily as an owner. The ownership of listed companies is comprised of a large number of shareholders drawn from institutional investors to members of public and thus it is impossible for it to be managed and controlled by such a large number of diversified minds. Hence, management and control is delegated by the shareholders to agents called the Board of directors. In order to achieve maximum success, the Board of directors is further assisted by managers, employees, contractors, creditors, etc. Therefore it is imperative to recognize the importance of stakeholders and their rights. Communication with stakeholders is considered to be an important feature of corporate governance as cooperation between stakeholders and corporations allows for the creation of wealth, jobs and sustain ability of financially sound enterprises. It is the Board's duty to present a balanced assessment of the company's position when reporting to stakeholders. Both positive and negative aspects of the activities of the company should be presented to give an open and transparent account thereof.

4.2 The annual report is a vital link and, in most instances, the only link between the company and its stakeholders. The Companies Ordinance requires directors to attach in the annual report a directors' report on certain specific matters. The Code expands the content of the directors' report and requires greater disclosure on a number of matters that traditionally were not reported on. The aim

is for the directors to discuss and interpret the financial statements to give a meaningful overview of the enterprise's activities to stakeholders and to give users a better foundation on which to base decisions. Specific emphasis has been placed upon the fiduciary obligations of directors and hence the need to understand the implications of such obligations also arises.

4.3 Apart from the above, stakeholder communication should consist of a discussion and interpretation of the business including:

- its main features;
- uncertainties in its environment;
- its financial structure and the factors relevant to an assessment of future prospects; and
- other significant items which may be relevant to a full appreciation of the business.

The discussion should go beyond a mere analysis of the results for the year. It should cover trends and changes, profit forecasts and future projections as well as information and events beyond the balance sheet date that are relevant to a full appreciation of the company's affairs.

4.4 Recognition of stakeholders, globally, has gained eminence over the past few years. A lot of research has been carried out and strategy developed for the purpose of protecting stakeholders' rights with the objective to keep the stakeholders informed about aspects of companies' performance and operations. The focus has been on improved transparency and disclosure so that stakeholder communication per se

- Is clear and concise that can be readily understood by the average

stakeholder;

- is objective, unbiased and balanced and covers positive as well as negative aspects;
- deals with comments made in previous communications and whether or not these have been borne out by events;
- follows a top-down structure by discussing individual aspects of the business in the context of the business as a whole;
- is a narrative rather than a numeric analysis although figures should be used where appropriate;
- interprets ratios or numeric information in relation to the financial statements;
- looks toward the future as well as reviews the past;
- is prompt, relevant, open and transparent. Substance should take precedence over legal form.

(ii) Shareholders

4.5 We have already discussed the growth of the equity market and the importance of the equity investor in developed as well as developing economies. The equity share gives rise to property rights as the share may be bought, sold or transferred, entitling the investor to participate in the profits of the corporation while limiting the liability to the amount of investment. It also gives rise to the right of the shareholder to information pertaining to corporate matters along with the right to influence decision making on such matters. Therefore, it is essential for a corporate governance framework to protect the rights of all shareholders.

4.6 A shareholder is not responsible for managing corporate activities as responsibility for corporate strategy and operations is entrusted with the Board and the management team. Shareholder rights must, therefore, focus on issues such as the election of the Board, amendments to the company's organic documents, approval of extraordinary transactions in addition to basic issues specified in the Companies Ordinance and internal company documents. In order to exercise

these rights shareholder participation is essential in general meetings. Shareholders, including institutional investors, should carefully consider the costs and benefits of exercising their votes. A shareholder must be familiar with the rules that govern shareholder meetings so that he/she may effectively vote. Dates, locations and agendas of general meetings annexed with the issues proposed to be discussed must be provided for purposes of allowing the shareholders a familiarity of the subject so that they may raise questions and may also be able to place items on the agenda.

4.7 The rules and procedures concerning the acquisition of control in capital markets and transactions, such as mergers and sales of substantial portions of shares, should be clearly articulated and disclosed so that investors clearly understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders; anti take-over devices should not be used to shield management from accountability.

4.8 All shareholders should receive equitable treatment, including minority and foreign shareholders and all shareholders should be able to obtain effective redress for violation of their rights.

(iii) Directors

4.9 The primary responsibility for the administration and performance of a company lies with the directors. The directors administer the company on behalf of shareholders and their powers and duties are covered in the statute. The role of directors, in statutory and fiduciary context, is discussed in detail in chapter VI.

(iv) Employees

4.10 All employees have some responsibility for implementation of effective internal control procedures as part of their accountability for achieving objectives. They collectively should have the necessary knowledge, skills, information and authority to operate the company. This will require an understanding of the

company, its objectives, the industries and markets in which it operates, and the risks it faces. Their endeavors towards these requirements will contribute positively to the performance of the company and success will ensure job stability and satisfaction. A secure work environment and one that protects and safeguards the rights of employees is a means by which to attain optimum levels of performance. The Code requires that a statement of ethics and business practices must be prepared and circulated annually by the Board of directors of every listed company to establish a standard of conduct for directors and employees.

(v) Creditors

4.11 Contractual stakeholders like customers, contractors and sub-contractors are fundamental for any corporation. A relationship based on trust develops between the corporation and such stakeholders and it is normal, especially where transactions are frequent, for credit to be extended. Past experience with the company establishes the basis for the development of such trust; however a framework that protects the interest of the creditor is essential in instances where the trust has yet to develop or in the event of disputes, which may arise. When extending credit, the creditor must be satisfied and convinced that an efficient and speedy system for recoveries has been outlined in order to provide redress if the need arises.

4.12 In terms of the Companies Ordinance, creditors may nominate directors on the Board of the borrower. Through their nominee, creditors can play a significant role in the corporate governance framework.

V. PROMOTING REFORM AND SHAREHOLDER ACTIVISM

5.1 Shareholder activism is a catalyst by which to monitor, control and influence the Board and the management. It is very rare for individual shareholders to participate in the decision making process and until recently shareholder activism was largely exercised in the United States. While one of the most effective tools to instill good governance practices, much remains to be done to promote shareholder activism in Pakistan. However, it would be useful to share a few examples of shareholder activism in other jurisdictions as a mechanism for change.

5.2 In March 1998, the US activist fund Lens Inc. joined forces with UK fund manager, Hermes, to form Hermes Lens, a UK focus fund with an objective to exploit the rights of shareholders to turn around under-performing companies. In early 1999, Hermes Lens was engaged in an activist campaign targeting the Mirror Group. By the end of 1998, Hermes Lens had acquired a 3% stake in the Mirror Group. Phillips and Drew Fund Management was a major Mirror shareholder, holding 22% of the stock and was also a willing activist.

5.3 Numerous strategic decisions had destroyed shareholder value of Mirror Group under the chief executive officer (CEO) David Montgomery who also had a rather estranged relationship with the owners. In 1998 shareholders prevented Montgomery from taking over the chairmanship from Robert Clark by refusing to endorse Montgomery's succession plan.

5.4 Sir Victor Blank took over as non-executive chairman of Mirror Group also in 1998 and pursued ongoing merger talks with publishing group, Trinity. Montgomery was opposed to the merger plans and, therefore, the plans did not materialize into anything meaningful. The talks had been followed by the Financial Times which stated itself to have been "horrified" by the breakdown of the talks.

Continued talks in 1999 failed due to the same reasons. Shareholders were concerned by opportunistic bid prices and were of the view that Regional Independent Media's offer of 200p a share in January 1999 seriously undervalued the company. Shareholders of up to 50% of the equity were of the view that Montgomery should be removed. Phillips and Drew, Hermes Lens, and Prudential (a 5% holder) told Sir Victor that they would support any Board effort to remove Montgomery.

5.5 The Mirror Board consisted of a majority of executive directors (eight in total). There were only six non-executive directors. The executive directors were confronted with a conflict of interest as the possibility of Montgomery surviving such an effort existed. While four of the non-executive directors supported Montgomery's removal, six executive directors stood behind him. The UK governance system grants direct power to the owners, enabling shareholders representing 10% of stock to call an Extraordinary General Meeting (EGM) to vote on a resolution of their choosing. Here, dissatisfied shareholders represented nearly 30% of the stock and expressed their willingness to call an EGM for Montgomery's removal if the executive directors would support a no confidence motion.

5.6 Montgomery refused to resign on a request made by Sir Victor at a January 1999 Board meeting. Hermes highlighted the many areas of bad performance when he and the other Institutions met three executive directors straight after the meeting. The executive directors decided to abstain on any no confidence vote and Montgomery, acknowledging his weak position, resigned and a new CEO was later recruited.

5.7 Similar groups have been active in South Asia, for example, PEC-PSPD, an independent civil rights advocate NGO that was founded in 1994 and involved in

shareholder activism since January 1997. The NGO is funded by individual donations and consists of lawyers, CPAs and professors who extend voluntary services. Companies targeted by the NGO include Samsung Electronics, SK Telecom, Hyundai Heavy Industry, Hyundai Investment Trust Co., Dacom, and Daewoo Corp. PEC-PSPD activities have focused around monitoring, attending shareholders' meetings, inspecting financial records and constructive talks with management of the aforementioned companies and initiating a number of legal suits:

- Derivative Law Suits:
 - US\$36 million against Chairman and directors of Korea First Bank
 - US\$20 million against Chairman Kim of Daewoo
 - US\$350 million against Chairman Lee of Samsung Group
- Suit to nullify agenda passed at shareholders' meetings.
- Suit to nullify convertible bond and bond with warrant issued to the Chairman's family.
- Injunction to prevent Samsung Electronics Co. from paying Chairman Lee's debt for the Samsung Motor failure.
- Suit against auditing and accounting firm.

5.8 The NGO has also, successfully, campaigned for the election of independent outside directors:

- SK Telecom
 - Management accepted three outside directors
 - Outside directors have veto power on related party transactions which proves to be very effective
- Hyundai Heavy Industry
 - Management accepted one outside director

- Outside director presence and minority shareholders monitoring are effectively utilized by management

In the case of Samsung Electronics Co., PEC-PSPD were unsuccessful in their endeavour for the election of one independent outside director and were only able to gain 16% support and that too mainly from foreign institutional investors. Persistent campaigning has, however, affected reforms that have strengthened minority shareholder's rights and corporate governance regulations have been adopted as a result of constant efforts.

VI. ROLE AND RESPONSIBILITIES OF DIRECTORS AND MANAGERS

(i) Directors and Managers Distinguished

6.1 A company is one type of '*corporate body*', which has a separate legal personality distinct from its members. Being an artificial legal personality, it needs to be managed by people who fall in two broad categories: directors and managers. Both directors and managers within a company have their respective rights and obligations but before making an attempt to outline their individual job responsibilities, it is necessary to define them. In simple words, a director is a "chief administrator" - a person appointed or elected to sit on a Board that manages the affairs of a corporation or company by appointing and exercising control over its officers. A manager, on the other hand, is a person appointed to administer, supervise or manage the affairs of business of a company (BLACK'S Law Dictionary, 7th edition). The aforesaid definitions may be too simplistic; however, there are many essential differences between the job description of directors and managers of a company. Annexure A provides a comprehensive list of differences.

(ii) Appointment and Proceedings of Directors

6.2 Persons who primarily guide the policy and carry on or superintend the business of a company are called directors. Under Section 2(13) of the Companies Ordinance, a director includes any person occupying the position of a director, by whatever name called. Directors are variously described as trustees, agents and managing partners, yet they are not, in a strict legal sense, any of these. The legal position of directors is a complex amalgam of legal duties and powers.

6.3 Section 174 of the Companies Ordinance lays down the minimum number

of directors for various types of companies. Under Section 175, only a natural person can be a director and no director can be the variable representative of a body corporate.

6.4 The first directors are appointed by the subscribers of the memorandum of association. They hold office until the election of directors in the first annual general meeting (AGM). Subsequent directors, elected in accordance with Section 178 of the Companies Ordinance, hold office for a term of three years. The retiring directors shall take immediate steps to hold the election of directors and, in case of any impediment, report the circumstances of the case to the Registrar within 15 days of the expiry of the term. The retiring directors shall continue to perform their functions until the successors are elected.

6.5 A director may, before the expiry of term of office, resign or become disqualified from being a director or otherwise cease to hold office. Any casual vacancy arising will be filled up by the directors within 30 days for remainder term.

6.6 The procedure for election of directors has been laid down in Section 178 of the Companies Ordinance, which states that the number of directors shall be fixed not later than 35 days before the date of AGM. Notice of the meeting at which directors are to be elected shall, among other things, state the number of directors to be elected and the names of retiring directors. The contesting directors are required to file notice of intention with the company not later than 14 days before the date of the meeting. All notices are to be transmitted to members seven days before the general meeting. A cumulative voting system exists and every member of a company (having share capital) has the right to vote equal to the product of number of shares held by him and the number of directors to be elected. A member may give all votes to a single candidate or to different candidates. The candidate getting the highest votes is to be declared as elected and so on until the specific number of directors have been elected.

6.7 Under Section 182 of the Companies Ordinance, creditors may nominate directors on the Board of a company in addition to the elected directors on the basis of contractual agreement.

6.8 Under the Code, listed companies are required to encourage effective representation of non-executive directors, including those representing minority interests, on the Board so that the Board includes core competencies considered relevant in the context of each listed company. It is desirable that:

- election of minority shareholders by proxy solicitation is facilitated. For this purpose, the Code encourages that:
 - there may be annexed to the notice of general meeting a statement of candidates representing minority interests and their profiles;
 - information about shareholding structure and copies of register of members shall be provided to minority shareholder candidates; and
 - an additional copy of proxy form, duly filled in by the minority shareholder candidates, may be annexed to the notice of general meeting at the cost of the company and transmitted to the shareholders.
- the Board includes at least one independent director representing institutional equity interest. Independent director is one who is not connected on the basis of family relationship with the listed company or its promoters or directors or does not have pecuniary relationship with the company or its associated companies, directors, executives or related parties.
- there shall be not more than 75% executive directors on the Board though the SEC can relax this condition (this condition does not apply to banking companies).

6.9 The Code further requires that a declaration shall be filed with the SEC that

the director is aware of his/her duties and powers under the relevant laws, memorandum and articles of association and listing regulations of stock exchanges in Pakistan. The declaration is to be filed along with the consent to act as director. In terms of Section 184, the consent must be filed with the Registrar within fourteen days of appointment or nomination.

6.10 The following persons are ineligible to become directors:

- minor (The age of majority is 18 years under Majority Act 1875);
- a person of unsound mind;
- a person who has applied to be adjudicated as an insolvent;
- undischarged insolvent;
- convict of offence involving moral turpitude;
- a person debarred from holding office (Section 186);
- a person declared as lacking fiduciary behaviour under Section 217 of the Companies Ordinance within the last five years;
- not a member except in the case of:
 - a person representing government or institution which is a member; or
 - an employee director; or
 - CEO; or
 - nominee of creditors.

defaulter in the payment of loan of more than Rs. 1 million to any financial institution; and

member of a stock exchange engaged in the brokerage business or his spouse.

6.11 In addition to the above requirements, under the Code, a listed company cannot have as director a person:

- who is serving as director of 10 other listed companies; or
- whose name is not borne on the register of National Tax Payers (not applicable to non-residents); or
- who is a member in default of a stock exchange.

6.12 A director automatically ceases to hold office in the following circumstances:

- becomes ineligible under Section 187 of the Companies Ordinance;
- absent in three consecutive meetings or all meetings of the Board for a continuous period of three months, whichever is longer, without leave of absence; or
- he, his firm or private company, in which he has interest, accepts an office of profit except as CEO, legal/technical advisor and banker without sanction of the company or accepts a loan or guarantee in contravention of Section 195 of the Companies Ordinance.

6.13 A person not qualified to act as director but who represents himself as such may be punished with a fine of Rs. 200 per day for each day of contravention. Penalty on a person who is not qualified to act as director, being an undischarged insolvent, is more severe and may comprise of two years imprisonment and/or Rs. 10,000 fine.

6.14 Election of directors may be declared invalid by the court under Section 179 of the Companies Ordinance upon an application of holders of 20% voting rights made within 30 days of the elections. Under Section 185 of the Ordinance, the acts of directors are not invalid due to defective appointment, although such a director is not to exercise powers till such defect in appointment has been rectified. Heavy penalties exist for violation of Section 185, comprising a fine of up to Rs.

10,000 and debarment from being appointed as director for up to three years.

6.15 A director's remuneration is to be fixed by the directors or the company in general meeting in accordance with the provisions of the articles of association.

6.16 No director can assign his office without first obtaining a special resolution of the company in accordance with the articles of association. A substitute or alternate director can however be appointed by a director, with the approval of directors, to act for him in his absence from Pakistan of at least three months. Alternate director shall vacate office upon the director's return to Pakistan.

6.17 The legal provisions pertaining to meetings of directors require that:

- the quorum for Board meetings of a listed company should be not less than one-third of their number or four, whichever is greater;
- the Board shall meet at least once in every quarter of a year in case of a public company;
- Chairman of a listed company shall preside over the Board meetings;
- written notice (including agenda) shall be circulated at least seven days before meeting (does not apply to emergency meetings);
- minutes of the Board meetings are to be recorded and circulated among directors within 14 days of the date of meeting;
- a director may refer to the company secretary where in his view his dissenting note has not been satisfactorily recorded in the minutes. The director may require the dissenting note to be appended to the minutes, failing which he may file an objection with the SEC; and
- directors and the Chairman shall be liable if meeting is held in absence of quorum. Penalty for default, in the case of listed companies, is Rs. 10,000 and then Rs. 100 per day for continuing default.

6.18 Under Section 194 of the Companies Ordinance, any provisions in the articles or otherwise exempting directors, CEO, other officers or auditors from

liability in respect of negligence, default, breach of duty or breach of trust in relation to the company shall be void.

(iii) Fiduciary Duties

6.19 In an attempt to embark upon a discussion on fiduciary duties in relation to company law, it is necessary to bear in mind that a company is one type of 'corporate body' or 'corporation' which has the essential characteristic, in contrast to partnerships and other unincorporated associations such as clubs and societies, of being a legal person or entity distinct from its members. Since a company is an artificial legal person, it needs individuals, i.e. directors who can act for it, represent it and make decisions concerning how it is to be run. Directors are, in short, responsible for the proper running and management of the company. This responsibility is fiduciary in nature.

6.20 The Code states that, “[t]he directors of listed companies shall exercise their powers and carry out their fiduciary duties with a sense of objective judgment and independence in the best interests of the listed company”. In Black's law dictionary, a fiduciary relationship is defined as:

“a relationship in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship; Fiduciary relationships such as trustee-beneficiary, guardian-ward, agent-principle, and attorney-client require the highest duty of care. Fiduciary relationships usually arise in one of four situations: (1) when one person places trust in the faithful integrity of another, who as a result gains superiority or influence over the first, (2) when one person assumes control and responsibility over another, (3) when one person has a duty to act for or give advice to another on matters falling within the scope of the

relationship, or (4) when there is a specific relationship that has traditionally been recognized as involving fiduciary duties, as with a lawyer and a client and a client or a stockbroker and a customer.”

6.21 A fiduciary is defined in the same as

“1. One who owes to another the duties of good faith, trust, confidence, and candor <the corporate officer is a fiduciary to the shareholder> . 2. One who must exercise a high standard of care in managing another's money or property <the beneficiary sued the fiduciary for investing in speculative securities...”

6.22 D.W.M. Waters, in *The constructive Trust 4* (1964) stated

“Fiduciary is a vague term, and it has been pressed into service for a number of ends...My view is that the term fiduciary is so vague that plaintiffs have been able to claim that fiduciary obligations have been breached when in fact the particular defendant was not a fiduciary stricto sensu but simply had withheld property from the plaintiff in an unconscionable manner.”

6.23 Some of the commonly discussed fiduciary duties include The Good Faith Test, The Proper Test, and The Duty to Protect the Company's Property etc. According to the Good Faith Test the directors, according to Lord Greene, must act '...bona fide in what they consider is in the interest of the company, and not for any collateral purpose.' In view of the second test a director must not use his powers for a purpose other than the purpose for which they were conferred. A very important aspect of a director's fiduciary duty is that he must not let the interest of the company come into conflict with his personal interest. He must never make a profit

from his office other than by receiving duly authorized remuneration.

6.24 There are volumes of decided cases in which the courts have upheld the importance of fiduciary duties.

The Fiduciary Duties and Common Law System

6.25 The high standards of business and professional conduct required of company directors, agents, trustees, lawyers have traditionally been imposed in English Law by a set of legal principles - known as "Equity" - laid down by the courts of law. It is pertinent to note that these principles in particular recognize the fiduciary obligations of directors. In a general sense, equity means fairness. In English law, equity means that body of rules originally enforced only by the Court of Chancery. It has been described as "a gloss (i.e. a supplement) on the common law", filling in the gaps and making the English legal system more complete. It emanated from persons unable to obtain justice in the common law courts sending petitions to the King as "fountain of justice". These petitions were examined by the King and his Council and relief was granted or refused. Due to pressure of business in the Council, these petitions were later sent to the Lord Chancellor who, as Chief Secretary of State and "Keeper of the King's Conscience", dealt with them. By the end of the fifteenth century the Chancellor had established his own court and considered petitions on the basis of conscience and right.

6.26 As with other general doctrines and remedies of Equity, the term fiduciary has often created much doubt and confusion and, though accepted to be ill-defined, it retains a significance, common usage and reference. L.S. Sealy, in his short analysis of fiduciary obligations, indicates that the term only sustained currency in law reports towards the middle of the nineteenth century to describe those relationships which were previously designated as relationships of "trust" but

could not be so described as the relationship itself did not fall within the technical meaning of the word “trust”. The term “fiduciary” is not definitive of a single class of relationships. It can, however, be stated to be descriptive; providing the description of a certain relationship by which individual rules and principles have been developed. Arguably, to describe a person as a fiduciary would be meaningless unless the rules and principles explaining the term for the class being described as such are illustrated and explained.

6.27 The history of the English legal system exemplifies that Equity established a new and logical head of law evolving a series of self contained obligations, which individually define their own “fiduciary” for their own respective purposes, thereby creating categories of fiduciaries stemming from the purpose of a particular obligation. The Courts have divided the term into two connotations. It has been used to describe powers which are given to one person to be exercised for the benefit of another as, for example, the Board of directors' power to issue shares has been described as a “fiduciary power”. Secondly, the term describes in a very general way persons who are acting for, or on behalf of, or in the interests of, or with the confidence of another; implying that certain standards of loyalty and fidelity will be expected of that person. The two usages of the term separate the fiduciary aspects of the exercise of limited powers from Equity's duties of loyalty and fidelity.

6.28 The fiduciary duties of directors can be summarized as follows:

The duty of honesty; this includes a duty of loyalty requiring directors to avoid any conflict between their personal interest and their duty as fiduciaries.

The duty of care, skill and diligence in the discharge of their duties. It is not enough for directors to act honestly; they also have a duty of care which is

required. Further qualifications can be added to this duty.

A director need not exhibit a greater degree of skill than would reasonably be expected from a person of his knowledge and experience;

A director need not give continuous attention to the affairs of the company (duties require intermittent not continuous attention); and

Provided there are no grounds for suspicion that anything is untoward, directors may rely on the company's management in respect of the day-to-day running of the company.

The Concept of Fiduciary Duties under Corporate Laws

6.29 Directors stand in a fiduciary relationship towards the company. Their duties under the corporate laws can be summarized as follows:

Loyalty and good faith;

Care and diligence;

Duty to act bona fide in the interest of the company;

Duty to use powers for proper purpose;

Duty to retain discretions;

Duty to avoid actual and potential conflicts of interest;

Duty to act honestly in the exercise of powers;

Duty not to misuse information or position;

Requirement to disclose certain interests pertaining to related party transactions;

Duty to prevent insolvent trading.

6.30 Directors have the powers and the duties to carry on the whole of company's business subject to the restrictions imposed by the memorandum and articles and statutory provisions.

The Concept of Fiduciary Duties under Islamic Law

6.31 The entire notion of fiduciary duties and obligations revolves around the concept of ethics. Business ethics generally encompass the efforts by a corporation or business entity and the person concerned to be good; adhering to generally accepted values and trying to do the right thing for the interest of all the various parties, namely the stakeholders. One may put it as “choosing the good over the bad, the fair over the unfair.”

6.32 Any debate on the existence of fiduciary obligations shall remain incomplete without a discussion on Islam's stance on equity. Historically, Islam has supported a rich culture of ethics. Under Islamic field of business, each individual professional is under a “self monitoring duty” that is an obligation to supervise adherence to his terms of reference and accountability to God and himself. Islamic legal system provides for the regulation of such ethics by bodies like Sharia'h Supervisory Board, which derives its guidance from the fundamental rules encoded in the Quran, the Hadith, Sunnah etc.

6.33 Islam imposes a duty of good faith in contracts and dealings. This is not merely the absence of bad faith but requires the contracting party to take positive steps to do the right thing, make full and honest disclosures and perform his obligations correctly. In view of the Islamic fiduciary obligations, a director, official, agent or representative of an entity shall not make false or misleading statements with fraudulent intent. They must not omit, with fraudulent intent, the recording of a transaction in the accounts of the enterprise nor should they obstruct the performance of the auditors' duties under the provisions of law. On the other hand, the directors, officers and agents of a company must take all possible steps to ensure that business is conducted in a responsible, honest and transparent manner. They remain under a positive duty to promote and encourage proper standards of

conduct and prudent practices. Suppression of illegal, dishonourable or improper practices is also a mandatory requirement.

6.34 In view of the above observations, it is evident that Islam provides for a comprehensive code of corporate governance. It makes provisions for constitution of a Shari'ah Supervisory Board with specialized jurists in commercial jurisprudence or experts of Islamic financial institutions. This is to ensure observance of high ethical practices in economic transactions. In conclusion, it can be said that the Islamic business system enforces important tools that guard the commercial industry. These tools have emerged fast and wide and have been adopted by several jurisdictions promoting ethics in management. The roots of various legal systems including Pakistan, which promote fiduciary obligations, can be traced back to Islamic commercial provisions. Under the Islamic management structure, senior management must attach strong importance to ethical behaviour as example is set by those at the top. Enlightened and ethical leadership is sought and there must always be a gradual and continuing process within the entity based on high ethical principles.

(iv) Powers and Responsibilities of Directors

6.35 Directors of a company shall exercise all powers except those that are to be exercised by shareholders in general meetings. In particular, directors shall exercise the following powers through resolution in their meetings:

- To make calls on shareholders in respect of moneys unpaid on their shares;
- To issue shares, debentures, participation term certificates or any instrument in the nature of redeemable security;
- To borrow money otherwise than by debenture;
- To invest the funds of the company;

To make loans;

To authorize a director to enter into a contract with the company for making sale, purchase, supply of goods or rendering service;

To approve accounts and bonus to employees;

To incur capital expenditure on any single item or dispose of a fixed asset exceeding the prescribed values;

To undertake obligations under leasing contracts exceeding Rs. 1 million;

To declare interim dividend; and

Having regard to such amount as may be determined to be material, to write off bad debts, advances and receivables; write off inventories and other assets of the company; and determine the terms of and the circumstances in which a law suit may be compromised.

6.36 In addition to the above, directors of a public company or its subsidiary may with the consent of shareholders in general meeting:

Sell, lease or otherwise dispose of the undertaking or a sizeable part thereof unless the main business of the company comprises of such selling or leasing;

Remit, give any relief or give extension of time for the repayment of any debt outstanding against any person specified in Section 195(1) of the Companies Ordinance.

6.37 The directors of a listed company shall, in terms of the Code:

Exercise powers and carry out fiduciary duties with a sense of objective judgment and independence in the best interests of the company;

Prepare and circulate annually a 'Statement of Ethics and Business Practices' to establish a standard of conduct for directors and employees.

Adopt a vision/mission statement and overall corporate strategy as well as formulate significant policies, which may include:

- Risk management;
- Human resource management and preparation of succession plan;
- Procurement of goods and services;
- Marketing;
- Determination of terms of credit and discount to customers;
- Write-off of bad debts, advances and receivables;
- Investments and acquisition/disposal of fixed assets;
- Borrowing of money and the amount in excess of which borrowings shall be sanctioned/ratified by the shareholders in general meeting;
- Donations, charities, contributions and other payments of similar nature (No contribution can be made to a political party or to any individual/body for a political purpose under Section 197 of the Companies Ordinance);
- Determination and delegation of financial powers;
- Transactions or contracts with associated companies and related parties; and
- Health, safety and environment.

Ensure that a record is maintained of all policies, including any approvals or amendments thereto.

Ensure that a system of sound internal control is being effectively implemented.

Take decisions on material transactions by resolution at Board meetings.

Approve appointment and fix remuneration and terms and conditions of CEO and other executive directors.

In the case of a Modaraba or a Non-Banking Financial Institution whose main business is investment in listed securities, approve and adopt an investment policy which must be stated in each annual report of the Modaraba/Non-Banking Financial Institution.

6.38 In terms of Section 195 of the Companies Ordinance, directors of a public company or its subsidiary, other than a banking company, are restricted from obtaining from such company a loan or guarantee/security in connection with a loan. The restriction applies equally to the director's relatives (i.e. spouse and minor children), partner, his firm or the firm of his relative, and company or body corporate in which he has interest. With the approval of the SEC, the company may make a loan or provide guarantee/security to an employee director for specified purposes. Section 195 further stipulates that every director, within 14 days of his appointment, shall file with the Registrar the particulars of any loan or guarantee obtained from the company prior to such appointment.

6.39 It is the responsibility of every director, if interested or concerned in any contract with the company, to disclose the nature of his interest at a meeting of the directors. The director so interested shall also abstain from discussion and voting on the contract and his presence shall not count towards forming a quorum for such discussion or voting. Even if he does vote, his vote shall be void. Failure to comply with these requirements may cause the Court to declare such a director as lacking fiduciary behaviour in terms of Section 217 of the Companies Ordinance.

6.40 Where a director, CEO, or an executive of a listed company or their spouses sell, buy or take any position in shares of a listed company of which he is a director or CEO or executive, directly or indirectly, he shall immediately notify in writing the company secretary of his intentions and deliver a written record of the price, number of shares, form of share certificates and nature of transaction within four days. Such notice shall be presented by the company secretary to the Board at its immediately following meeting. In case of failure to give such notice, the secretary shall place the matter before the Board in its immediate next meeting. Each listed company shall determine a closed period prior to the announcement of the interim/final result and any business decision which may materially affect the market price of its shares. No such officer or director shall deal in the shares of the

listed company in any manner during the closed period to reduce the risk of insider trading.

(v) Liability of Directors

6.41 Directors have three fold liabilities:

Civil liability

- for breach of trust (fiduciary relation) i.e. for misapplication of company's Funds;
- for misfeasance/breach of duty;
- for negligence; and
- in contract.

Criminal liability under the Companies Ordinance for certain defaults e.g.:

- falsification of books;
 - intentionally giving false evidence;
 - for offences committed in connection with the company while winding up;
 - false statements in any report, statement, balance sheet or other document; and
 - for wrongfully obtaining the possession of any property or withholding it or for willfully applying it to unauthorized purposes.
- Criminal liability under Pakistan Penal Code if he has been guilty of any offence in relation to the company for which he is criminally liable (in winding up, prosecution of delinquent directors).

(vi) Executive and Non-Executive Directors

6.42 "The country's economy depends on the drive and efficiency of its

companies. Thus the effectiveness with which their Boards discharge their responsibilities determines Britain's competitive position. They must be free to drive their companies forward, but exercise that freedom within a framework of effective accountability. This is the essence of any system of good corporate governance." (The Cadbury Report, Para 1.1).

6.43 The Cadbury Report initiated the debate about the main functions of the non-executive director. Today, the contribution and the importance of the non-executive director towards the running of a company and towards the economy at large is widely recognized and appreciated. As stated in the Cadbury Report, they "should bring an independent judgment to bear on issues of strategy, performance, resources including key appointments and standards of conduct". In the UK, the recently issued Higgs Report particularly focuses on the role and effectiveness of non-executive directors to improve the performance of the Board.

6.44 Fundamentally, the Board of directors is obligated to ensure the prosperity of the company by collectively directing the company's affairs while meeting the appropriate interests of its shareholders and relevant stakeholders and taking into account the law, relevant regulations and commercial considerations. The directors are responsible for directing and managing the company. This responsibility includes ensuring that adequate accounting records and an effective system of internal control are in place. This statement should not be confused in any way with the work of the external auditors or with their report as the external auditor's function is to report independently on the fair presentation or otherwise of the annual financial statements. The techniques he uses to arrive at this opinion may include testing of and reliance on the adequate functioning of the internal controls, but insofar as this is relevant to his opinion on fair presentation.

6.45 Both the Cadbury and the Hampel Reports stress that the Boards should include independent non-executive directors of sufficient caliber and number for

their views to carry significant weight in the Boards' deliberations. Independent directors are defined in the Cadbury Report as persons who “apart from directors' fees and shareholdings [are] independent of the management and free from any business or other relationships which could materially interfere with the exercise of the independent judgment.”

6.46 The Code defines an independent director to mean “a director who is not connected with the listed company or its promoters or directors on the basis of family relationship and who does not have any other relationship, whether pecuniary or otherwise, with the listed company, its associated companies, directors, executives or related parties. The test of independence emanates from the fact whether such person can be reasonably perceived as being able to exercise independent business judgment without being subservient to any apparent form of interference.”

6.47 There is no legal distinction between executive and non-executive directors and likewise the Code does not distinguish between their responsibilities. The Code does not clearly define the role of the non-executive director and such definition requires construction from various frameworks of corporate governance; however, one finds that the role has been universally defined and there is an inescapable global sense in which the non-executive director's role is seen as balancing that of the executive director so as to ensure that the Board as a whole functions effectively. Effectively, the non-executive director provides an independent view of the company that is removed from its day to day running. Non-executive directors are fundamentally appointed for purposes of bringing independence, impartiality, wide experience, special knowledge and personal qualities to the Board. Although all directors should be capable of seeing company and business issues in a broad perspective, non-executive directors are usually chosen for their experience, caliber and personal qualities and may have some expertise that would provide the Board with valuable insight. This, annexed with their independence, brings a degree of objectivity to the Board's deliberations and

also allows for the monitoring of executive management. The introduction of independent judgment to the Board's activities provides interested parties with greater assurance that the correct strategies are likely to be adopted.

(vii) The CEO

6.48 The CEO in relation to a company means any individual who is entrusted, subject to the control and directions of directors, with the whole or substantially the whole of the powers of management of the affairs of the company. It can be a director or any other person occupying the position of a CEO by whatever name called and whether under a contract of service or otherwise.

6.49 Every company except that managed by a managing agent shall have a CEO. The Board shall determine and approve the appointment, remuneration and terms and conditions of service of the CEO of a listed company.

6.50 The first CEO must be appointed within 15 days of incorporation or on commencement of business of the company, whichever is earlier. He ceases to hold office on the first AGM of the company. Subsequently, the CEO is to be appointed within 14 days of election of directors (or the office of the CEO falling vacant) and shall hold office for a period of not more than three years. Upon expiry of the term of his office, the retiring CEO is eligible for re-appointment. In any case, he shall perform duties until appointment of the successor.

6.51 No person who is ineligible to become a director of a company shall be appointed or work as the CEO of any company.

6.52 A widely debated corporate governance issue is whether the two most important positions in a company - the Chairman of the Board and the CEO - should

be held by two different individuals (a dual leadership structure) or one person may be assigned both portfolios (a unitary leadership structure).

6.53 The dual leadership structure has emerged to be a good corporate governance mechanism to dilute the unfettered power that comes from combining the two offices of the Chairman and the CEO. Unitary leadership structure may result in a number of agency problems. It may hamper effective monitoring and disciplining of the management. Thus, there is a possibility for senior managers to engage in opportunistic behavior, which means that the interests of shareholders will not be properly safeguarded. Executive compensation is another area where the CEO may be able to yield undue influence. It is argued that keeping the two positions distinct will better safeguard shareholders' interests since the Chairman will keep an independent "check" on the CEO and maintain an oversight function.

6.54 Most of the opposition to this structural change is coming from CEOs who favour unitary leadership structure on the premise that it promotes communication and information flow between management and the Board and, thus, results in better decision-making. It is also argued that the CEO has valuable information about the business and affairs of the company that can be better utilized in his capacity as the Chairman. Separating the two positions may result in conflicts and finger pointing. Moreover, choosing the 'right' person with in-depth knowledge of the company's business and industry can be a difficult and costly task.

6.55 When independent from management, the Chairman can play a pivotal role in giving directors (particularly non-executive directors) a strong voice in setting agendas of Board meetings, deciding on executive compensation and encouraging meaningful discussions in Board meetings. The Chairman is also likely to take measures to require circulation of relevant information precisely, accurately and timely to non-executive directors for participating in Board

meetings. Thus, the Board is likely to discharge its statutory and fiduciary responsibilities in a diligent and transformed manner while maintaining effective management oversight.

6.56 It is generally accepted that in order for a Board to effectively perform its functions, separating the positions of CEO and Chairman appears to be imperative. In line with this principle, the Code requires that the Chairmen of listed companies shall preferably be elected from among the non-executive directors. Further, the Board should clearly define the respective roles and responsibilities of the Chairman and the CEO, whether or not these offices are held by separate individuals.

(viii) The Company Secretary

6.57 “Secretary” is a Latin word meaning “confidential writer or notary”. In commercial terms, the secretary is an employee entrusted with confidential correspondence and record. Within the meaning of the Companies Ordinance, the company secretary is “any individual appointed to perform the secretarial, administrative or other duties ordinarily performed by the secretary of a company”. Every listed company must have a whole time secretary.

6.58 Company secretary can be appointed and removed from office by the CEO with the approval of the Board. The minimum qualifications of the secretary of a listed company, as laid down in the Code, are as follows:

- a member of a recognized body of professional accountants, or;
- a member of a recognized body of corporate/chartered secretaries, or;
- a lawyer, or;
- a graduate from a recognized university having five years of relevant

experience in a listed company.

6.59 The company secretary shall attend Board meetings provided he cannot cast vote on any matter. The company secretary cannot, in particular, do any of the following:

- has no independent authority to bind the company by contract;
- cannot borrow money on behalf of the company;
- cannot issue a writ in company's name;
- cannot register a transfer until authorized to do so by the directors;
- cannot strike a name off from the register of members without authority;
- cannot call a general meeting on his own authority;
- cannot attend Board meetings involving consideration of an agenda relating to CFO, secretary, CEO or a director.

6.60 The particulars of the company secretary are to be recorded in the register of directors and officers, maintained under Section 205 of the Companies Ordinance. The secretary shall furnish his particulars to the company within ten days of appointment or any change therein, whereupon the company shall file a return containing the particulars with the Registrar within the time prescribed.

6.61 The Code requires the company secretary of a listed company to file with the SEC a Secretarial Compliance Certificate to certify that the secretarial and corporate requirements of the Companies Ordinance have been duly complied with. The Certificate must be filed within 45 days from the date of AGM or, when no such meeting has been held, from the last day of the year.

(ix) The CFO

6.62 The CFO or “chief accountant” includes any person, by whatever name called, who is charged with the responsibility of maintenance of books of account of a company. His appointment, remuneration, terms and conditions of employment as well as removal shall be determined by the CEO with the approval of the Board of directors in case of a listed company.

6.63 No person shall be appointed as the CFO of a listed company unless:

- he is a member of a recognized body of professional accountants; or
- he is a graduate, having at least five years experience in handling financial or corporate affairs of a listed public company or a bank or a financial institution.

6.64 Every company must ensure that proper books of account have been kept that give a true and fair view of the state of affairs of the company. The books of account must be preserved for a period of at least ten years.

6.65 In terms of the Code, the CFO and the CEO are responsible for presenting the financial statements of a listed company, duly endorsed under their respective signatures, for consideration and approval of the Board of directors.

(x) Internal Control System

6.66 The internal control system is the system of controls, financial or otherwise, established by management in order to carry on the business of the company in an orderly and efficient manner. Directors must ensure that an effective system of internal control has been maintained although the responsibility

for detailed design, implementation and operation is usually delegated to management.

6.67 Internal controls are divided into three main categories:

Operational Controls: These are procedures that are implemented to address the company's basic objectives, including overall performance and profitability. These procedures embrace the administration, efficiency and effective functioning of the business in its broadest sense.

Financial Controls: These are controls established to provide reasonable assurance that assets will be safeguarded against unauthorized use or disposal, proper accounting records are maintained and information used within the business, or made public, is reliable.

Compliance Controls: These are procedures that attempt to ensure that the company complies with the laws and regulations to which it is subject.

6.68 Because internal control is an ongoing and daily process effected by people, it is subject to inherent limitations of human error, abuse or circumvention. Cost/benefit constraints also limit the effectiveness of a system of internal control.

(xi) Reporting Requirements

6.69 Under the Companies Ordinance, the directors' report to shareholders must be attached to the financial statements containing:

information regarding the state of company's affairs;
the amount of dividend to be paid; and
the amount to carry to the reserve account.

6.70 In case of a public company, in addition to the matters stated above, the

directors' report shall:

disclose material changes and commitments affecting the financial position of the company between the balance sheet date and the date of the directors' report;

deal with any changes in the nature of business of the company or its subsidiary except when the SEC allows exemption from this requirement for being prejudicial to the business of a company;

provide information and explanation in regard to any reservations, observations, qualifications or adverse remarks in the auditor's report;

circulate the information about the pattern of holding of shares in the form prescribed;

state the name and country of holding company if established outside Pakistan;

state the earnings per share;

give reasons for incurring loss and a reasonable indication of future prospects of profits; and

contain information about default in payment of debts and reasons thereof.

6.71 The report shall be signed by the Chairman or the CEO on behalf of directors if authorized in that behalf; when not so authorized, it shall be signed by the CEO and the directors who are required to sign balance sheet and profit and loss account under Section 241 of the Companies Ordinance.

6.72 The Code requires, in addition to the above, the following matters to be reported in the directors' report of a listed company:

the financial statements, as prepared by management, present fairly the state of affairs of the company, the result of its operations, cash flows and

- changes in equity;
- proper books of account have been maintained;
- appropriate accounting policies have been consistently applied and accounting estimates are based on reasonable and prudent judgment;
- the international accounting standards (IAS) have been applied and any departure therefrom has been disclosed;
- the internal control system is sound and is monitored and implemented effectively;
- there is no significant doubt upon the ability of the company to continue as a going concern (if the company is not considered to be a going concern, the fact along with reasons must be disclosed);
- no material departure from the best practices in the Code has been made;
- significant deviations from last year in operating results along with reasons;
- key operating and financial data of last six years;
- reasons for not declaring dividend or issuing bonus shares in any year;
- the amount and reasons of any statutory payment on account of taxes, duties, levies and charges that has been outstanding;
- significant plans and decisions like corporate restructuring, business expansion and discontinuance of operations along with future prospects, risks and uncertainties;
- statements as to the value of investments of provident, gratuity and pension funds based on their respective audited accounts;
- number of Board meetings during the year and attendance by each director;
- the pattern of shareholding to disclose the aggregate number of shares held by:
 - associated companies, undertakings and related parties (name wise detail);
 - NIT and ICP (name wise detail);

- directors, CEO, and their spouse and minor children (name wise detail);
- executives, i.e. employees other than CEO or director with annual basic salary exceeding Rs.500,000;
- public sector companies and corporations;
- banks, development finance institutions, non-banking finance institutions, insurance companies, modarabas and mutual funds;
- shareholders holding 10% or more voting interest in the listed company (name wise details); and
- trade carried out in the shares of the company by directors, CEO, CFO, secretary and their spouses and minor children.

.VII. SCRUTINIZING FINANCIAL STATEMENTS - WHAT EVERY DIRECTOR SHOULD KNOW

(i) General

7.1 Directors have a statutory responsibility to review and approve the financial statements before circulation to members. Pursuant to Section 196 (2)(h) of the Companies Ordinance, directors can exercise this power on behalf of the company only by means of a resolution passed at their meeting.

7.2 The Code requires the CEO and the CFO of listed companies to present the financial statements, duly endorsed under their respective signatures, for consideration and approval of the Board of directors. The Board, after proper consideration and approval, should authorize the signing of such financial statements for issuance and circulation. As per Section 241 of the Companies Ordinance, the financial statements of a company should be approved by the directors and signed by its CEO and at least one director. Where the CEO is not present in Pakistan, the financial statements should be signed by at least two directors of the company for the time being in Pakistan. A duly signed statement should also be sub-joined to the financial statements to explain the reason for the departure.

(ii) Liability of Directors

7.3 The Companies Ordinance holds directors responsible for compliance with the statutory requirements regarding preparation and maintenance of proper books of account and circulation of financial statements that give a true and fair view. If a listed company fails to comply with the statutory requirements in this regard, every director including the CEO and CFO of the company, who has knowingly been the cause of the default, is liable to be punishable with:

imprisonment for a term which may extend to one year; and
 fine which shall not be less than Rs. 20,000 nor more than Rs. 50,000; and
 a further fine which may extend to Rs. 5,000 for every day after the first
 during which the default continues.

7.4 Given the civil as well as criminal punishment that can be imposed upon directors in case of irregularities in preparation or circulation of financial statements, it is crucial that they are aware of the regulatory requirements. Outlined below is a synopsis of the information that a director should possess in order to diligently perform his duties while reviewing and approving the financial statements of a listed company.

(iii) Preparation of Financial Statements

7.5 Financial statements are a structured financial representation of the financial position of and the transactions undertaken by a company. The objective of financial statements is to provide information about the financial position, performance and cash flows of a company that is useful to a wide range of users in making economic decisions. Financial statements also show the results of management's stewardship of the resources entrusted to it.

Frequency of Financial Reporting

7.6 All companies must circulate their financial statements on an annual basis among their shareholders and submit the same to the regulatory authorities. In addition, listed companies should also circulate quarterly accounts.

Quarterly Reporting: Under Section 245 of the Companies Ordinance, listed companies are required to prepare and circulate quarterly

accounts for the first, second and third quarters within the financial year among the members, to the stock exchanges, Registrar and the SEC. The quarterly accounts should be circulated within one month from the close of first and third quarters. In case of second quarter's accounts, listed companies may circulate them along with statutory auditors' review report thereon within two months from the close of the second quarter.

Annual Reporting: Section 233 of the Companies Ordinance requires that the annual accounts of the company should be circulated among its members and to the stock exchanges, Registrar and the SEC at least 21 days before the AGM. The accounts are also laid before the shareholders in the AGM for approval. The AGM should be held not later than 18 months after incorporation of the company and, subsequently, once at least in every calendar year within four months from the close of the year. Effectively, the time period for circulation of annual accounts comes to a little more than three months.

Components of Financial Statements

7.7 The financial statements should include:

- balance sheet;
- income statement;
- statement showing changes in equity;
- cash flow statement; and
- accounting policies and explanatory notes.

It is essential to ensure that no component of financial statements is missing. In addition, the statements described below should be attached with the financial statements circulated by a listed company.

Statements Accompanying Financial Statements

7.8 The following statements are prescribed to be circulated along with financial statements of a company.

- The annual accounts should be circulated along with the auditors' report thereon while the second quarter's accounts of a listed company should be circulated along with a review report by the statutory auditors.
- The cumulative figures for the half-year, presented in the second quarter's accounts, should be subject to a limited scope review by the statutory auditors of the company in terms of clause (xxi) of the Code. A review is not an audit; it is limited primarily to inquiries of company personnel and analytical procedures applied to financial data. The manner and scope of the review engagement has already been notified by the Institute of Chartered Accountants of Pakistan (ICAP) to its members, with the approval of the SEC.
- The directors' report, prepared in accordance with the Companies Ordinance and the Code, should be circulated along with the annual accounts. A directors' review on the affairs of the company should be attached to the quarterly accounts. This review need not contain the additional information required to be included in the directors' report in terms of the Code.
- A statement of compliance with the best practices of corporate governance set out in the Code along with a review report thereon should be published and circulated along with the annual reports of listed companies. The statement of compliance should be reviewed and certified by statutory auditors in the manner prescribed by ICAP, where such compliance can be objectively verified.
- In case of a holding company, the consolidated financial statements of the group should be attached.

- The annual accounts of a modaraba should be attached with the financial statements of the modaraba company, which has floated the modaraba.

Requirements Governing the Preparation of Financial Statements

7.9 The financial statements of a listed company and its subsidiary should be prepared in accordance with the requirements of the Fourth Schedule to the Companies Ordinance and such IAS as have been notified by the SEC for the purpose.

7.10 The financial statements should give a true and fair view of the financial position, financial performance and cash flows of a company. It is important to understand what the term 'true and fair view' entails. A true and fair view requires:

selecting accounting policies that comply fully with IAS or, in the absence of an IAS, result in relevant and reliable information;

presenting the information to maximize relevance, reliability, comparability, and understandability;

complying with the relevant legal requirements in preparation and presentation of financial information; and

providing additional disclosures that aid in understanding financial position and performance.

7.11 If financial statements comply with the IAS, this fact is required to be stated. Such a statement, however, should not be made unless there is full compliance with all applicable Standards and Interpretations.

7.12 In the rare circumstances where non-compliance with IAS is necessary in order to achieve a fair presentation, it is required that comprehensive disclosures

should be made in the financial statements in order to justify the non-compliance and to highlight its financial impact.

7.13 In the period in which IAS are applied in full for the first time, the financial statements should be presented as if the company had always applied IAS. Standards and Interpretations should generally be applied retrospectively - and the resulting adjustment treated as an adjustment to the opening balance of retained earnings.

7.14 As a minimum, notes to the financial statements should present:

the basis of preparation of financial statements and the accounting policies followed;
narrative descriptions or detailed analyses of items shown on the face of the financial statements;
information required or encouraged by IAS and Fourth Schedule; and
other disclosures necessary for an understanding and fair presentation of the financial statements.

7.15 Notes should be presented in a systematic manner. Each item on the face of the financial statements should be cross-referenced to the relevant note.

7.16 It is pertinent to consider that disclosure of accounting policies used or other explanations in the notes does not rectify any inappropriate accounting treatment in the financial statements.

7.17 While preparing and reviewing the financial statements, consideration should be given to the following:

the assumption that the enterprise is a going concern is valid;

the presentation and classification of items in the financial statements are consistent with prior periods;
the accrual basis of accounting has been used;
each material item has been presented separately;
there has been no offsetting of assets and liabilities, and income and expenses, except as permitted; and
comparative information has been disclosed.

(iv) **Tools for Directors' Review**

7.18 The directors can adopt certain analytical tools for review of financial statements. In this regard, ratio analysis can be particularly useful. The commonly used ratios are:

Profitability: gross profit margin, net profit margin, earnings per share;

Liquidity: current ratio, inventory turnover, debtors turnover, credit payment period and debt collection period;

Solvency: debt equity ratio; and

Asset Performance Ratios: return on total assets, return on capital employed.

The above is an indicative list of ratios that can be used by directors in identifying significant variations, which may be investigated. However, relevance of each ratio will vary from industry to industry.

7.19 Ratios can only be effectively used if suitably compared. In this respect, directors can undertake a comparison of:

current period's ratios with those of prior periods;

ratios based on actual results with anticipated results (budgets or forecasts) of the company; and
 the company's financial ratios with industry averages or with other companies of comparable size in the same industry.

7.20 The directors can also perform:

year to year analysis: comparison of company's financial information with comparable information for prior periods;
 comparison of company's financial information with anticipated results (budgets, forecasts) of the company;
 consideration of relationship between financial information and relevant non-financial information of the company, e.g. payroll costs to number of employees.

7.21 Through the use of such analytical review methods, directors can identify major variations that may not be apparent from a cursory review of financial statements. The variations must be justified by the management. Alternatively, directors may be able to identify situations where favorable/unfavorable circumstances, which are in the knowledge of the directors, do not justify a smooth trend. The directors should require the management to offer appropriate explanation for all their observations before the financial statements are approved.

(v) How to Prevent Misleading and Fraudulent Financial Statements

7.22 A proper and exhaustive review of financial statements may reveal errors in recording of transactions to the directors. However, fraudulent transactions, which are carefully recorded with the intent to conceal, are extremely difficult to identify. Very often, frauds are discovered after lapse of a considerable period of time. It is, however, imperative that directors and management take appropriate measures for prevention and timely detection of fraud. This is possible through the

implementation and continued operation of adequate accounting and internal control systems.

7.23 The term "internal control system" means all the policies and procedures (internal controls) adopted by the management of a company to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business. This involves adherence to management policies, safeguarding of assets, prevention and detection of fraud and error, accuracy and completeness of accounting records, and timely preparation of reliable financial information. The internal control system extends beyond those matters that relate directly to the functions of the accounting system and comprises the 'control environment' and 'control procedures'.

7.24 Control environment refers to the overall attitude, awareness and actions of directors and management regarding the internal control system and its importance in the company. A strong control environment, for example, one with tight budgetary controls and an effective internal audit function, can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the internal control system. Factors reflected in the control environment include:

- The function of the Board of directors and its committees;
- Management's philosophy and operating style;
- The company's organizational structure and methods of assigning authority and responsibility;
- Management's control system including the internal audit function, personnel policies and procedures and segregation of duties.

7.25 The management should establish control procedures to achieve the entity's specific objectives. Specific control procedures include:

Reporting, reviewing and approving reconciliations.

Checking the arithmetical accuracy of the records.

Controlling applications and environment of computer information systems, for example, by establishing controls over changes to computer programmes and access to data files.

Maintaining and reviewing control accounts and trial balances.

Approving and controlling of documents.

Comparing internal data with external sources of information.

Comparing the results of cash, security and stock counts with accounting records.

Limiting direct physical access to assets and records.

Comparing and analyzing the financial results with budgeted amounts.

7.26 Typically, the following types of internal controls should exist in a company:

Organization: There should be a properly defined organizational structure, which should allocate responsibilities and identify lines of reporting for all aspects of the company's operations. The delegation of authority and responsibility should be clearly specified.

Segregation of Duties: It involves separation of those responsibilities or duties, which, if combined and entrusted to one individual, would enable that individual to record and process a complete transaction. Segregation of duties reduces the risk of intentional manipulation or errors and increases the element of checking. Functions that should be separate include those of authorization, execution, custody, recording and, in the case of a computer-based accounting system, systems development and daily operations.

Custody: Appropriate procedures and security measures should be designed to ensure that access to assets is limited to authorized personnel only. This includes both direct access and indirect access via

documentation.

Personnel: The personnel within the company should have capabilities commensurate with their responsibilities. The qualification, selection and training as well as inherent personal characteristics of the personnel involved are important features to be considered in setting up any control system.

Authorization and Approval: All transactions should require authorization or approval by an appropriate, responsible person within the organizational structure. The authorization limits should be specified.

Arithmetical and Accounting: There should be controls within the recording function to check that the transactions to be recorded and processed have been authorized, that they are complete and that they have been correctly recorded and accurately processed. Such controls include checking the arithmetical accuracy of records and maintenance of reconciliation, control accounts and trial balances.

Supervision: Any system of internal control should include supervision by responsible officials of the day-to-day transactions and the recording thereof.

Management: The management should exercise controls outside the day-to-day system. Such controls include the review of management accounts and comparison thereof with budgets, the setting up of an effective internal audit system and other special review procedures.

7.27 It is pertinent to consider that the Code now requires the Board of directors of every listed company to establish a system of sound internal control, which is effectively implemented at all levels within the company. In addition, the directors are required to state in the directors' report that the system of internal control is sound in design and has been effectively implemented and monitored.

7.28 In discharging their responsibility under the Code, the directors should be wary of the inherent limitations of any internal control system. Such limitations include:

- management's usual requirement that the cost of an internal control does not exceed the expected benefits to be derived;
- most internal controls tend to be directed at routine transactions rather than non-routine transactions;
- the potential for human error due to carelessness, distraction, mistakes of judgment and the misunderstanding of instruction;
- the possibility of circumvention of internal controls through the collusion of a member of management or an employee with parties outside or inside the entity;
- the possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control; and
- the possibility that procedures may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

Appropriate attention should be directed to these limitations that may undermine the effectiveness of an internal control system.

(vi) External Auditors

7.29 The auditors' report on the financial statements of a company often constitutes the most crucial factor in the directors' approval of those statements. If the auditors have expressed an unqualified opinion, there is a tendency to approve the financial statements without further examination. No doubt, the professional opinion of an independent auditor should be a deciding factor but it is important

that the directors first consider the risk that the auditor's independence may have been compromised. There may be circumstances where auditors become beholden to management. However, the recent regulatory requirements, coupled with the requirements of the Companies Ordinance, provide adequate safeguard against such possibilities and it is, therefore, essential for the directors to ensure full compliance with the regulatory and statutory requirements.

Qualification Criteria

7.30 No person can be appointed as auditor of a public company or of a private company being subsidiary of a public company, unless he is a chartered accountant. In terms of Section 254 of the Companies Ordinance, a person is not qualified for appointment as auditor of a company if he:

is, or at any time during the preceding three years was, a director, other officer or employee of the company;

is a partner of or in the employment of, a director, officer or employee of the company;

is the spouse of a director of the company;

is indebted to the company;

is a body corporate;

or his spouse or minor children, or in case of a firm, all partners of such firm, hold shares of an audit client or any of its associated companies. Where such a person holds shares prior to his appointment as auditor, the fact shall be disclosed on appointment as auditor and shares will be disinvested within ninety days;

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.

7.31 The listing regulations put additional restrictions on listed companies in appointing their statutory auditors. The salient requirements of the listing regulations are:

The auditor of a listed company should possess a satisfactory rating under the Quality Control Review (QCR) programme of the ICAP. The list of sole proprietors/firms, which have been awarded satisfactory rating is available on ICAP's website www.icap.org.pk. This list is continually reviewed and updated by ICAP.

It must be noted that listed companies are also required under the listing regulations to facilitate the QCR programme by giving their consent to statutory auditors to produce all relevant information, including the audit working papers, before the ICAP reviewers. The QCR programme is being carried out by ICAP to ensure that audits are conducted by its members in accordance with the applicable auditing standards and relevant laws and regulations. This programme is expected to raise the quality of statutory audits.

The external auditors must be rotated after every five years.

The auditors should not perform management functions or make management decisions, responsibility for which remains with the Board of directors and management of the listed company. Moreover, the auditors should not be engaged to provide non-audit services, including services related to the designing of accounting systems or compilation of accounts. However, certain non-audit services that are synergistic to the audit and are not likely to infringe on the independence of auditors have been exempted from this restriction. The exempted services are as follows:

- Attestation, certifications, special purpose audits/reviews and agreed upon Procedures as defined in the International Standards on Auditing
- Taxation services
- Opinion on accounting standards

- Information Risk Management (IRM) Assurance and Risk Management Reviews
- Corporate laws compliance services including representation before authorities
- Financial due diligence exercise in relation to acquisitions and mergers

While providing such exempted non-audit services, the auditors should observe applicable International Federation of Accountants' (IFAC) guidelines in this regard.

A listed company should not appoint or continue to retain any person as an auditor if a person associated with the auditor is, or has been, at any time during the preceding three months, engaged to provide non-audit services.

A person is considered to be associated with the auditor if the person:

- is a partner in a firm or is a director in a company or holds or controls shares carrying more than 20 percent of the voting power in a company, and the auditor is also partner of that firm or is director in that company or so holds or controls shares in such Company; or
- is a company or body corporate in which the auditor is a director or holds or controls shares carrying more than 20 percent of the voting power in that Company or has interest to that extent.

The services listed above are also exempted from this restriction.

The external auditors of a listed company (or a partner of a firm of auditors) should not be non-compliant with the IFAC Guidelines on Code of Ethics, as adopted by ICAP.

The CEO, CFO, internal auditor or a director of a listed company should not have been a partner of the firm of its external auditors (or an employee involved in the audit of the listed company) at any time during the two years preceding such appointment within the company. This restriction is applicable to a close relative, i.e. spouse, parents, dependents and non-dependent children, of such partner (or employee).

Appointment and Removal of First Auditor

7.32 The first auditor of a company shall be appointed by the directors of the company within 60 days of the date of incorporation of the company. The first auditor appointed in the above manner shall hold office until the conclusion of the first AGM unless removed by the company. The company in general meeting may remove the first auditor and appoint another auditor who has been nominated for appointment by a member of the company and of whose nomination notice has been given to the members not less than 14 days before the date of the meeting.

7.33 If the directors fail to appoint the first auditor within the prescribed time, the company in general meeting may appoint the first auditor provided that the auditor appointed in an AGM shall not be removed during their tenure except through a special resolution. In case of failure of the company to appoint the first auditor in general meeting within 120 days of the date of incorporation, the SEC may appoint the auditor to fill the vacancy. The company shall, within one week of the SEC's powers under Section 252 (6) becoming exercisable, give notice of that fact to the SEC.

7.34 Where a notice is given of the removal of first auditor and the auditor makes a representation in writing, not exceeding a reasonable length, and requests its communication to the members, the company shall, unless the representation is received by it too late for it to do so:

in any notice of resolution given to members, state the fact of the representation having been made; and

send a copy of the representation to every member to whom notice of meeting is sent whether before or after receipt of the representation by the company.

If a copy of the representation is not sent, auditors may require the representation to be read out at the meeting.

7.35 If on the application of the company or of any other person who claims to be aggrieved, the Registrar is satisfied that the rights conferred as above are being abused to secure needless publicity for defamatory matter, it shall not be necessary to send out or to read out the representation at the meeting.

Appointment and Removal of Subsequent Auditors

7.36 Every company shall, at each AGM, appoint an auditor/auditors who hold office from the conclusion of that meeting until the conclusion of next AGM.

7.37 The Board of directors of a listed company shall recommend appointment of external auditors by shareholders in AGM. Unless there are strong grounds to proceed otherwise, the Board shall act in accordance with the suggestions of the Audit Committee. When recommending such appointment, it should be ensured that the relevant legal requirements have been complied with and there is no potential risk to the independence and credibility of auditors.

7.38 The recommendations of the Audit Committee for appointment of retiring auditors or otherwise shall be included in the Directors' Report. In case of a recommendation for change of external auditors before the elapse of three consecutive financial years, the reasons for the same shall be included in the Directors' Report.

7.39 Any casual vacancy in the office of auditor may be filled by the directors but while the vacancy continues, the surviving or continuing auditor or auditors, if any, may act. Any auditor appointed to fill in the casual vacancy shall hold office

until the end of the next AGM.

7.40 An auditor/auditors appointed in a general meeting may be removed before conclusion of the next AGM through a special resolution.

7.41 Where at an AGM no auditors are appointed or where auditors appointed are unwilling to act as auditors or where a casual vacancy in the office of an auditor is not filled within 30 days or auditors are removed by the company, the SEC may appoint a person to fill the vacancy.

7.42 A retiring auditor shall normally be appointed at the next AGM unless:

he has become disqualified for appointment, or

a resolution has been passed appointing another auditor in his place or providing expressly that he should not be reappointed, or

he has given the company written notice of his unwillingness to be reappointed, or

he has been engaged for five consecutive years as the auditor of a listed company.

7.43 Special notice must be given in the AGM of a resolution appointing a person other than the retiring auditors, as auditor of the company. The member shall give such a notice to the company not less than 14 days before the AGM, which shall be forwarded by the company to the retiring auditor and to the members of the company. In case of a listed company, the notice shall also be published in two newspapers of English and Urdu languages.

7.44 Where the retiring auditor, on receipt of notice of such resolution, makes a representation in writing not exceeding a reasonable length and requires, its

communication to the members, the company shall, unless the representation is received too late for it to do so:

in any notice of resolution given to members, state the fact of the representation having been made, and
send a copy of the representation to every member to whom notice of the meeting is sent whether before or after receipt of the representation.

If a copy of the representation is not sent, auditors may require the representation to be read out at the meeting.

7.45 If, on the application either of the company or of any other person who claims to be aggrieved, the Registrar is satisfied that the rights conferred by Section 253 of the Companies Ordinance are being abused to secure needless publicity for defamatory matter, it shall not be necessary to send out or read out the representation at the meeting.

Rights and Powers of Auditors

7.46 The auditors:

have a right of access, at all times, to the books, papers, accounts and vouchers of the company;

are entitled to require from the company, and directors and other officers of the company such information and explanations as they think necessary for the performance of their duties.

have a right of access to such copies and extracts from the books and papers of a branch outside Pakistan as have been transmitted to the principal office in Pakistan; and

have the right to attend any general meeting of the company, and to receive the same notices of general meetings as the members, and to be heard at any general meeting on any part of the business which concerns them as auditors. In terms of the Code, partner of the firm of external auditors shall attend the AGM of a listed company at which audited accounts are placed for consideration and approval of shareholders.

Duties of Auditors

7.47 The duties of auditors mainly depend on the terms of appointment, the articles of association and the statutory provisions.

7.48 In terms of Section 255 of the Companies Ordinance, the auditors must make a report to the members on the financial statements of the company. The auditor's report shall state:

Whether or not they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of the audit.

Whether or not in their opinion proper books of accounts as required by the Companies Ordinance have been kept by the company.

Whether or not in their opinion the balance-sheet and profit and loss account or the income and expenditure account have been drawn up in conformity with the Companies Ordinance and are in agreement with the books of accounts.

Whether or not in their opinion and to the best of their information and according to the explanation given to them, the said accounts give the information required by the Companies Ordinance in the manner so required and give a true and fair view of the state of the company's affairs and of changes in financial position or sources and application of funds.

Whether or not in their opinion the expenditure incurred during the year was for the purpose of the company's business, and the business conducted, investments made and expenditure incurred during the year were in accordance with the objects of the company: and

Whether or not in their opinion Zakat deductible at source under the Zakat and Usher Ordinance, 1980 was deducted by the company and deposited in the Central Zakat fund established under Section 7 of that Ordinance.

7.49 Where any of these matters is answered in the negative or with a qualification, the report shall state the reason for such answer along with the factual position to the best of the auditor's information.

7.50 Where the auditor's report contains a reference to any other report, statement or remarks which they have made on the financial statements examined by them, such statement or remarks shall be annexed to the auditor's report and shall be deemed to be a part of the auditor's report.

7.51 Only the person appointed as auditor of the company, or the company, or where a firm is so appointed in pursuance of sub-Section (2) of Section 254, only a partner in the firm practicing in Pakistan shall sign the auditor's report or sign or authenticate any other documents of the company required by law to be signed or authenticated by the auditor. The report of auditors shall be dated and indicate the place at which it is signed.

7.52 The auditor's report shall be read before the company in general meeting and shall be open to inspection by any member of the company.

7.53 In case of listed companies, the Code requires that external auditors furnish a Management Letter to the Board of directors not later than 30 days from the date of audit report.

Penalty for Non-compliance by Auditors

7.54 In case of non-compliance with the requirements of Section 157, Section 255 or Section 257 of the Companies Ordinance or where the audit report is untrue or fails to bring out material facts about the affairs of the company, the auditor concerned and in the case of a firm all partners of the firm shall, if the default is willful, be punishable with fine which may extend to Rs. 100,000. If such auditor's report is made with the intent to profit such auditor or any other person or to put another person to a disadvantage or loss or for a material consideration, the auditor shall, in addition to the aforesaid penalty, be punishable with imprisonment for a term which may extend to one year and with fine which may extend to Rs. 100,000.

7.55 An auditor, who has been found guilty of professional misconduct by the SEC or by a Court of law, may be debarred from appointment as auditor of a listed company for a period of three years unless the SEC has determined a lesser period. In case a partner of a firm has been held guilty of professional misconduct, the firm would be eligible for appointment as an auditor of a listed company if a written confirmation is given by the firm to all the stock exchanges of the country and to the SEC, with a copy to ICAP, that such a partner would not be engaged in the audit of any listed company for the specified period.

(vii) Role of the Audit Committee

7.56 The Code requires every listed company to establish an Audit Committee, comprising at least three members including the chairman, from among its directors. The majority of the members of the Committee should be non-executive directors of the company while the chairman of the Committee should also preferably be a non-executive director.

7.57 According to the Blue Ribbon Committee of US SEC, the role of the audit committee is to function as the “ultimate guardian of investor's interest and corporate accountability”. In setting up the Audit Committee, the Board of directors should ensure that there would be no conflict of interest for the members on the Committee. Accordingly, care should be taken that the CFO, internal auditor and CEO are not represented on the Audit Committee. Given the nature of responsibilities of the Audit Committee, it is, however, desirable that at least one member of the company possesses sufficient financial knowledge. This should not be taken to mean that a director, connected with the finance/ audit function within the company itself, is appointed on the Committee.

7.58 The names of members of the Audit Committee should be disclosed in each annual report of the company.

7.59 The Audit Committee is entrusted with an extremely crucial role. It carries out a detailed review of interim and final accounts, establishes the scope of internal audit, examines internal audit reports, reviews external audit findings, recommends appointment of external auditors and follows-up with management on internal and external audit observations. The Code requires the Board of directors to set the terms of reference of the Audit Committee, which should include the following:

Recommend appointment of external auditors to the Board of directors and consider any questions of resignation or removal of external auditors, audit fees and provision by external auditors of any service to the listed company in addition to audit of its financial statements;

Determine appropriate measures to safeguard the company's assets;

Review preliminary announcements of results prior to publication;

Review quarterly, half-yearly and annual financial statements of the

company prior to their approval by the Board of directors, focusing on:

- major judgmental areas;
- significant adjustments resulting from the audit;
- the going concern assumption;
- any changes in accounting policies and practices;
- compliance with applicable accounting standards; and
- compliance with listing regulations and other statutory and regulatory requirements.

Facilitate external audit and discuss with external auditors major observations arising from interim and final audits and any matter that the auditors may wish to highlight (in the absence of management, where necessary);

Review management letter issued by external auditors and management's response thereto;

Ensure coordination between the internal and external auditors of the listed company;

Review the scope and extent of internal audit and ensure that the internal audit function has adequate resources and is appropriately placed within the listed company;

Consider major findings of internal investigations and management's response thereto;

Ascertain that the internal control system including financial and operational controls, accounting system and reporting structure are adequate and effective;

Review the listed company's statement on internal control systems prior to endorsement by the Board of directors;

Institute special projects, value for money studies or other investigations on any matter specified by the Board of directors, in consultation with the CEO and consider remittance of any matter to the external auditors or to

any other external body;

Determine compliance with relevant statutory requirements;

Monitor compliance with the best practices of corporate governance and identification of significant violations thereof; and

Consider any other issue or matter as may be assigned by the Board of directors.

7.60 The audit committee in every listed company should meet at least once in every quarter of the financial year. The meetings should be scheduled prior to the approval of interim results by the Board as well as before and after completion of external audit. In addition, meetings of the Audit Committee may be held on request of the external auditor or head of internal audit.

7.61 The CFO, head of internal audit and representative of external auditor must attend all meetings of the Audit Committee at which issues relating to accounts and audit are discussed. The Audit Committee should also meet the external auditor once a year without the presence of CFO and head of internal audit and meet the internal audit staff once a year without the presence of CFO and external auditor.

7.62 There should be a secretary of the Audit Committee who should prepare minutes of meetings of the Audit Committee and provide other secretarial assistance. The secretary should circulate minutes to all members, directors and the CFO within a fortnight.

7.63 The secretary of the Audit Committee may be appointed from among the employees of the company. However, adequate assurance should be obtained that there would be no conflicts of interest for the person so appointed. On this basis, the company secretary should preferably be appointed as the secretary of the Audit Committee. In case the positions of company secretary and CFO are held by the

same person within a company, the secretary of the Audit Committee should be appointed from among the employees of the company who are not involved in the preparation and maintenance of accounts of the company and the audit thereof.

7.64 The Board of directors may institute a reporting system for the Audit Committee so that the major findings of the Committee are brought to their notice at regular intervals. This would also enable the directors to review and monitor the performance of the Audit Committee on a continuous basis.

(viii) Role of Internal Audit

7.65 The listed companies are required to set up an internal audit function under the Code. The internal audit function must be independent from the management/directors of the company.

7.66 A company may outsource the internal audit function except that it should not appoint its statutory auditors as internal auditors. While outsourcing the function, it is essential that suitably qualified and experienced persons, who are conversant with the company's policies and procedures, are engaged in internal audit. In addition, these persons must be involved in the internal audit function on a full time basis.

7.67 Internal auditor is an officer within the meaning of Section 2(24) of the Ordinance and his particulars are to be filed with the Registrar on Form 29 under Section 205.

7.68 It is essential to continually assess the effectiveness of the internal audit function. The following factors merit consideration in this regard:

degree of independence of internal audit function;

scope and objective of work;
technical competence of internal auditors; and
resources available to internal audit function.

7.69 The internal audit reports should be sent to the CEO and the Audit Committee. The CEO should ensure that internal audit findings are suitably investigated, where necessary, and suitable action is taken on the basis of recommendations contained in the internal audit reports. As discussed above, the Audit Committee should review the internal audit reports and follow-up with the management on action to be taken. Where the internal audit reports contain significant issues, including cases of fraud or irregularities of a material nature, the reports should also be presented before the Board of directors for their consideration and decision.

7.70 The internal audit reports should also be provided for the review of external auditors. The head of internal audit should have free access to the chair of the Audit Committee.

VIII. CONCLUSION

8.1 As a result of incorporation of the provisions of the Code into the listing regulations, the mandatory provisions of the Code are now enforceable by the respective stock exchanges in Pakistan. Any company failing to comply with any provision of the listing regulations, including those pertaining to corporate governance, may be sanctioned, suspended or de-listed. Moreover, the SEC, being the apex regulator of the corporate and securities laws, also takes cognizance of departures from the Code. Successful implementation of the Code will depend equally upon effective enforcement of the Code by the stock exchanges and the SEC under powers available to them as well as persuading companies and stakeholders of the advantages of compliance with the Code.

8.2 It is hoped that this introduction to the prevailing corporate governance framework in Pakistan will provide the basic context in which further discussions and debate may occur. The objectives to be achieved through good corporate governance principles are clear *enhance business performance of listed companies and to ensure their conformance to the applicable laws, rules and practices*. The Code was a first step in the realization of these objectives. Much work remains to be done in prioritizing principles and identifying methods for their effective implementation.

8.3 In preparation of this manual, we are grateful to Az Zaman Advocates and Legal Consultants, Islamabad for its research and compilation of initial drafts.

Appendix A

DIFFERENCES BETWEEN DIRECTORS AND MANAGERS

	DIRECTORS	MANAGERS
LEADERSHIP	It is the responsibility of the Board of directors to provide central leadership, direction and formulate strategies regarding the company	It is the duty of the managers to implement the strategies and policies on behalf of the Board of directors.
DECISION MAKING	The directors have control of the company's assets and business and must determine the future of the organization. They must also protect its assets and reputation and take into account how their decisions relate to "stakeholders" and the regulatory framework.	Managers have no primary decision making responsibility for the company (unless specifically delegated by the Board), hence are only concerned with implementing the decisions taken by the Board of directors.
DUTIES AND RESPONSIBILITIES	Considering that the directors have the eventual responsibility for the long-term prosperity of the company, they have multiple duties and obligations. Broadly speaking, there are legal, contractual and fiduciary obligations. Directors are under a positive duty to exercise their powers with due skill and diligence when acting on behalf of the company. Any breach of a duty can render a director liable both under civil and criminal law.	The managers have far less legal responsibilities and obligations. Most of their duties arise out of the contract between them and the company. As opposed to directors, the strict interpretation of equitable fiduciary obligations does not apply to managers.
RELATIONSHIP WITH SHAREHOLDERS	Directors are usually appointed by the shareholders. The shareholders may restrict the powers exercised by the directors by altering the articles and may also remove them from	Managers are usually appointed by the directors or management. They are accountable to either the CEO or directors in terms of their contract of appointment.

	office. The directors are accountable to the shareholders for the company's performance.	
COMPANY ADMINISTRATION	The directors are entrusted with the task of company's administration. They are responsible for the company's assets and business and are answerable to the company and the shareholders in the general meeting.	The managers enjoy delegated responsibilities. While they perform duties related to the company's administration, they cannot be held solely liable for mal-administration.
ETHICS AND VALUES	Directors play a key role in prescribing the ethical code, which is to be followed by the company in the conduct of its affairs.	Managers, taking guidance from this code, implement the ethics while performing their duties towards the company.
STATUTORY PROVISIONS	In the event of the company becoming insolvent, directors may be held personally and criminally liable under the Companies Ordinance. In addition, there are many other statutory provisions that can create offences of strict liability under which the directors may face penalties if the company fails to comply.	Majority of such statutory provisions do not apply to the managers, hence reducing their civil and criminal liability.



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