Pakistan Institute of Development Economics

Knowledge Brief

July 2022

No. 2022:75

CORPORATE GOVERNANCE: COMPLIANCE WITH THE SELECTION CRITERIA OF BOARD OF DIRECTORS IN PUBLIC SECTOR COMPANIES

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1. INTRODUCTION

Safeguarding the interests of shareholders and stakeholders from managerial misconduct and fraud is one of the core domains of corporate governance. Corporate governance activities can be classified into five broad areas: Board Effectiveness, Audit and Risk/External Accountability, Remuneration and Reward, Shareholder Relations and Stakeholder Relations. Adhering to the Code of Corporate Governance (CCG) can facilitate a company's success by achieving effective and prudent management.

The first corporate law passed in Pakistan was the Companies Ordinance 1984. The Security and Exchange Commission of Pakistan (SECP) has revised this ordinance to issue Regulations CCG, 2017 for listed companies, which has further been revised as CCG, 2019. The critical change is a shift from a 'compliance based' to a 'comply or explain' approach as per regulations, whereby companies must comply with compulsory provisions or provide appropriate explanations of their non-compliance.

Extant research has investigated corporate governance in Pakistan in terms of profitability and companies' growth (Yasser et al., 2011), non-compliance to CCG (Shamsi et al., 2014), undue government interference (Arthur M. Mitchell & Clare Wee, 2004), ownership concentration (Javid & Iqbal, 2010), non-compliance to international standards like accountability and transparency (Aziz et al., 2019) etc. Likewise, the control exercised by the interplay of ownership structure and the composition of boards in companies has also been studied (Haque & Hussain, 2021).

In line with extant literature, this article investigates if the current practices in board composition comply with the regulations of CCG.

What is Corporate Governance

Corporate governance is the system of rules, practices, and resolutions to direct and manage a company. The term encompasses the internal and external factors that affect the interests of a company's all stakeholders, including shareholders, customers, suppliers, government regulators and management. This postulates a structure to set the company's objectives and provides means to attain these objectives.

Source: From web

Board of Directors: An instrument to ensure better Corporate Governance

Shareholders own the business, and the management runs the company. Shareholders interfere in a company's affairs through their representative Board of Directors (BODs), making a Principal-Agent dyad. The company's board is the primary regulatory body to foster good corporate governance to monitor the company's operations and ultimate profitability. A BODs is principally a panel of individuals elected by the shareholders to represent shareholders. Thus BODs act as fiduciary for shareholders. The integral roles played by effective BOD to secure an excellent organisational reputation, attract capital investment and engage a skilled workforce have been acknowledged globally.

The roles played by BODs can broadly be classified as oversight, advisory and conducting directional functions. The BODs draw their power from company constitutions like Articles and Memorandum of Association, Companies Act Law and resolutions approved by shareholders, and industry practices.

Selection Criteria of Board of Directors as per Code of Corporate Governance, 2019

The members of the Board are elected at either an Annual General Meeting (AGM) or an extraordinary shareholders' meeting convened for that purpose. Shareholders or groups of shareholders holding more than 10 per cent of ordinary shares can nominate candidates for the BODs. The appointing authorities (shareholders or the Government) should nominate the candidates for election as Board members as per fit and proper criteria given in CCG, 2019. Generally, a deadline for submitting nominations is set. The shareholders can vote in person or even designate someone else to vote. The more shares a shareholder has, the more votes he/she can cast. After selection, the directors are appointed for some specific term. On the expiry of the tenure, the directors can be re-elected and re-selected on the Boar.

The CCG 2019 has specific regulations that public sector limited companies must comply with to select Board members. The criteria are outlined briefly in Table 1.

Number Directorships:	**A person can hold office as a director of a maximum seven listed companies simultaneously (Section 155 of the Act), excluding their subsidiaries.**
Diversity in the Board:	**BODs must have an appropriate mix of members to ensure diversity (skills mix) in core competencies, skills, experiences, technical expertise, and knowledge.**
Balance of Composition of Board:	**The Board must have a suitable composition of directors and gender to ensure a balance of representation and power exercised by directors, including executive, non-executive, female & independent directors.**
Executive Directors (EDs):	**The number of EDs, including the CEO, must not be more than one-third of the Board.**
Independent Directors:	**There must be at least two or one-third of members on the Board, whichever is higher, as INEDs.**
Female Director:	**Board must have at least one female director for gender representation & balance.**
Chairperson and CEO:	**The offices of the Chairperson and the CEO cannot be held by one person. The Chairperson shall be elected by the BODs or the Government (Section 192 of the Act).**
Directors' Training Program (DTP):	**It is compulsory for the listed companies to provide DTP to their directors to familiarise them with the regulations of CCG, 2019 for effective compliance and to upgrade their skills when needed. CCG 2019 encourages DTP to the extent that by June 30, 2020, at least half of the directors on the Board, by June 30, 2021, at least 75 per cent of the directors by June 30, 2022, all the directors on their Board must have acquired the prescribed certification under any director training program offered by institutions, local or foreign. However, the directors having a minimum of 14 years of education and 15 years of experience on the Board are exempted. At least one female executive and at least one head of the department every year shall also be appointed for DTP.**

Source: SECP Law 2019
https://www.psx.com.pk/psx/themes/psx/uploads/SRO_1163(I)2019-ListedCompanies(CodeofCorporateGovernance) Regulations_2019.pdf

Current Situation of Companies' Compliance with the CCG, 2019

Corporations/companies serve as the foundations for the sustainable economic growth of a country. The regulations CCG, 2019 are to accentuate the significance of balanced, independent and diverse BODs for companies' profitability and growth. These regulations entrust the BODs with the responsibility to protect the interests of all stakeholders and shareholders.

A vigilant and robust corporate governance system prevailing in a company reflects a higher degree of transparency, thus attracting more investment (Cueto, 2007).

To understand how companies in Pakistan comply with the regulations of CCG, the Pakistan Institute of Corporate Governance (PICG) has conducted two surveys, one in 2016 and the other in 2019. The results of the surveys can

Comparison between PICG Report 2016 and PICG Report 2019

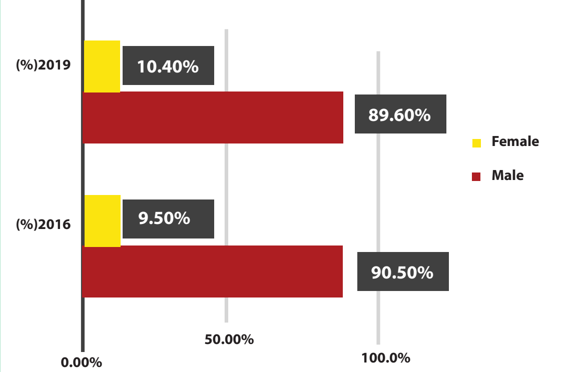
A comparison of the PICG reports (2016 and 2019) and IERU reports for FY-2019 reflects the extent to which the current board composition complies with regulations. Though an upward trend in some areas has been observed, complete compliance is still missing in some spheres.

The findings from the PICG survey (2019) provide a snapshot of the corporate governance practices in terms of board composition, practices and remuneration of BODs in over 130 respondent companies in Pakistan.

Though the data sample comprises two-thirds of the listed and one-third of unlisted companies, the plus point is that 22 per cent of the respondents are from Public Sector Companies (PSCs). This percentage is double the respondents' percentage (10) in PSCs in the PICG survey 2016.

The respondents have designations such as secretaries, Board members, senior executives, Chairpersons and CEOs from various industries and sectors. Only Hospitality Industry has not participated in both surveys.

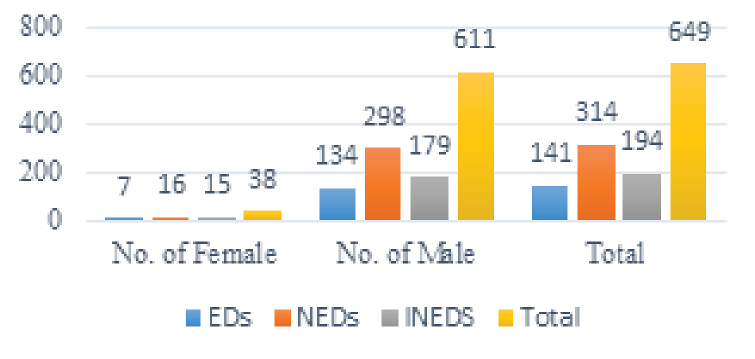
Figure 1: Gender Diversity (%) on Board



Brief Introduction of PICG

PICG is an institute established in 2004 under Section 42 of the Ordinance 1984 to promote good corporate governance practices in Pakistan. PICG has since been involved in corporate governance training and education, policy advocacy, advisory services, research and evaluations, conducting surveys, publishing guidelines and other research material. The founding members of PICG include the SECP, State Bank of Pakistan, Pakistan Stock Exchange, Non-Bank Financial Institutions, Institute of Chartered Accountants Pakistan and Institute of Cost and Management Accountants of Pakistan. PICG has conducted two surveys to generate reports on the corporate governance practices of listed and unlisted companies in Pakistan. One is the Report on the Survey on Board Practices of Public Sector Companies in Pakistan, 2016. The other is Corporate Governance Practices in Pakistan, 2019.Source: PICG website

Figure 2: Gender Classification on Boards of SOEs



Source: PICG Report 2019

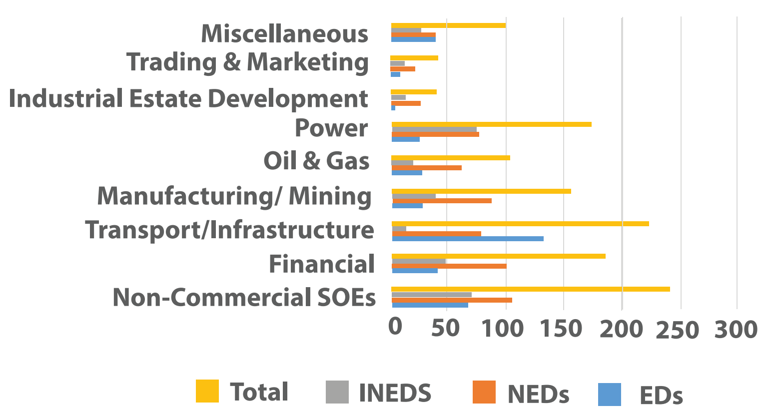
Board Size

The average board size is approximately eight directors in 2019, ranging from 2 to 15, compared to 7 in the 2016 survey. PSCs have the largest average board size. Some 12.39 per cent of companies have added four new directors in the last election. Major factors triggering any change in the board composition of these sample companies are resignation (31 per cent), orderly planned succession (15 per cent), desire for greater diversity (21 per cent), need for specialised knowledge (17 per cent), no change (22 per cent) and others (20 per cent), including retirement, and female directors etc.

Gender Classification on BODs

The number of boards with female directors has increased from one-third in 2016 to two-thirds in 2019, but female directors constitute only 10.4 per cent of the total directors (Figure 1). This is despite the fact that the number of companies with female representation on their boards has increased from 34 per cent of the companies in 2016 to 64 per cent in 2019. One-fourth of the listed companies have no female directors on their boards regardless of the requirement of the regulations CCG, 2019. The low percentage in female selection has been depicted in the findings that at the last election, almost 74.76 per cent of companies report no change in the number of female directors. In comparison, 22.33 per cent of companies have increased this number. The Ministry of Finance, Islamabad, has published two reports.

Figure 3: Board Composition of non-commercial SOEs and various sectors of SOEs.

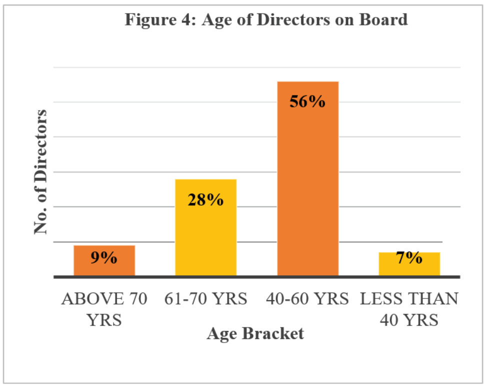


Source: SOEs Annual Report 2019

The State-Owned Enterprises (SOEs) findings on seven sectors highlight the gender diversity on a board (Figure 2). The numbers of female directors in the capacity of Executive Directors (EDs), Non-Executive Directors (NEDS) and Independent Non-Executive Directors (INEDs) are 7, 16 and 15, respectively. The number of male INEDs and NEDs is adequate, which is in line with CCG, 2019. An overall comparison of the board composition of SOEs and non-commercial SOEs is represented in Figure 3.

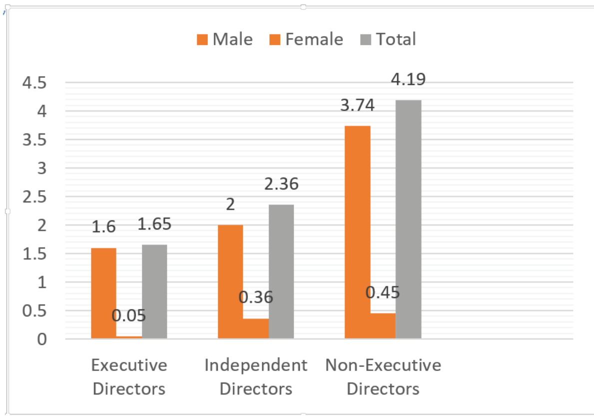
Age of Directors

Of the total directors in the sample, 62 per cent of companies (unlike 66 per cent in 2016) have 56 per cent directors aged 40 to 60 years (Figure 4). It shows that 62 per cent of companies have no director aged below 40 or above 70 years. Only 9 per cent of directors are above 70 years of age, and seven directors of directors are less than 40 years of age.



Source: PICG Report 2019

Figure 5: Categories of BODs



Source: SOEs Annual Report 2019

INEDs on Board

The number of INEDs on board has increased significantly. Almost 22 per cent of the listed companies mandated several INEDs. While some 25 per cent of listed companies do not have the recommended number of INEDs as mandated by the CCG, 2019.

The clause of including Independent Directors on the board is to protect the interests of all shareholders, notably those of minority shareholders. But, there is no parameter to measure an INED's independence (Haque & Hussain, 2021). Companies use various methods to find appropriate INEDs registered on databanks[1] (Section 166) for their boards. The government can nominate INEDs in the case of PSCs. Other methods include special regulations, mutual agreement between majority shareholders and industry leaders, head hunting by a sponsoring group, BODs nomination and utilising contacts etc.

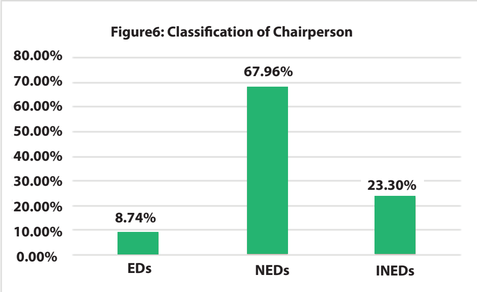
Regarding the category of directors, Figure 5 shows a mix of executive, non-executive and independent directors. This also indicates that very few females are elected. At the same time, while 33 per cent of the listed companies have independent female directors on their boards, 28 per cent of all companies have shown the presence of independent female representation on their boards. A tendency on the part of non-executive directors to serve for three consecutive terms on the same board has also been observed. Some 45.63 per cent of NEDs have served over three terms (PICG Survey, 2019). There are specific parameters to gauge the degree of Board effectiveness.

The presence of an Independent Chairman and separate CEO shows a positive impact. Similarly, a higher percentage of NEDs and female directors, a higher percentage of board meeting attendance, a higher number of board meetings, and a higher age range of BODs indicate compliance with the regulations. The higher percentage of directors on board over nine years and have less than seven directors signify deviation from the CCG, 2019.

Separate Offices to be held by CEO and Chairperson

In compliance with the regulations of CCG, 2019, the position of CEO and Chairperson must be held by different persons. It is noted that over 93per cent of the companies have reported that different individuals are performing the role of the Chairman and the CEOs. In almost 67.96 per cent of companies, the Chairperson is a NED, and in 23.30 per cent of companies, the chairperson is the INED. At the same time, 8.74 per cent of Chairpersons are executive (Figure 6).

1Data Bank: SECP has authorized Independent Directors Databank maintained by the PICG, which has been operational since 2016. SECP has also authorized Overseas Pakistani Foundation (OPF) to create and maintain databank of INEDs and post such data on its website for appointment of directors. SECP has notified Companies Regulations (SRO.1570 (I)/2018 dated December 26, 2018), specifying procedure of selection of INEDs from such databank.



Frequency of Board Meetings

4 to 6 Board meetings are held annually to evaluate companies' performance and discuss strategic matters in PSCs. Board members are supplied with background materials some weeks before the meeting. The information is concise, covering all significant issues and is provided in hard or/and electronic form.

Antecedents of Poor CG Practices

Compliance with regulations is more than a box-ticking exercise. For good corporate governance, specific measures need to be implemented. Ownership should be separated from the executives for effective oversight and good governance (Salman & Siddiqui, 2013). Though the statistics have shown some improvement in corporate governance in Pakistan, there are still areas that need reforms responsible for substandard performance. Admittedly, companies' poor corporate governance practices are attributed to mismanaged board composition, and family-controlled orientation in most Pakistani businesses hampers the development of an equity culture. This orientation shallows the market (Hamid and Kozhich, 2007). Network analysis shows that BODs members for BODs are selected from a small club (Haque and Hussain, 2021), which explains the ineffectiveness of INEDS in Pakistani companies (Ameer, 2013).

Factors include:

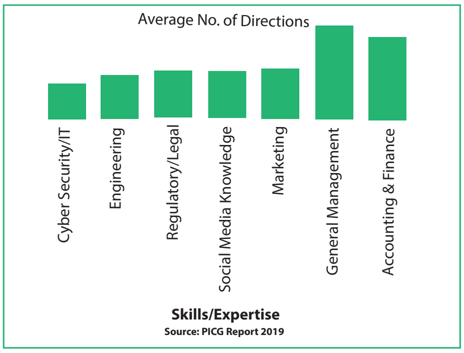
- Retention of the same directors over many terms.
- Inefficient use of databank for directors' selection.
- Retarded growth of corporate governance.
- Compromise on the independence of INEDs and fear of NAB/Agencies.
- Government unmeritorious nomination.
- No regular remuneration but only meeting fee is paid to INEDs
- No or insufficient compensation to Directors.
- Resistance to 'Outsiders'. Companies are not open to new ideas and change.
- Inefficient Board practices.

Skill Sets of BODs and Directors Training Program

The PICG survey 2019 showed that BODs generally possess the required knowledge in finance, marketing and general management with legal know-how (Figure 7). Other skills possessed by directors are audit, risk management, human resource, treasury, credit, investment banking, education and research. Some directors have more than one skill set. A skill gap analysis of directors can help identify the areas that need improvement by Directors Training Program[2] for efficient BODs.

For the professional development of their directors, most companies maintain a budget to conduct director orientation sessions (76.5 per cent) and SECP-approved DTP (82 per cent). Consequently, by 2019 almost 50 per cent of the total directors have been certified under approved DTP.

Figure 7: Skill Sets of BODs



Performance Evaluation

To improve the composition and structure of a Board, there is a need to evaluate board performance. The common prevalent evaluation mechanism is to conduct an in-house evaluation, followed by an external evaluator. Some companies have a mixed mechanism to evaluate board members. The evaluation results are then discussed at the board meetings. Similarly, some companies do not review CEO's performance, while most companies review CEO's succession plan only when required. Some companies review succession plans every 2-3 years as well.

A balanced board composition with an adequate number of INEDs is crucial to enhancing board effectiveness. Companies with engaged board members knowing the critical business drivers and risks show better performance than passive board members, who generally leave matters at the CEO's and management's discretion.

2PICG offers DTPs, consultancy, corporate governance research and needs analysis services to the organizations in Pakistan. To date, there are over 1500 PICG certified directors. PICG has conducted more than 170 boards' evaluation.

To attract competent INEDs, the remuneration policy should be revised to increase the board fee structure. About 78 per cent of companies have a formal remuneration policy. In 50.5 per cent of companies, this policy is reviewed once in three years using in-house market analysis (74 per cent) or external consultants (6 per cent) to make the remuneration market competitive.

Conclusion and Recommendations

In compliance with CCG, 2019, many companies have shown significant improvement in gender diversity, increase in INEDs number, separation of the role of Chairperson and CEO, more directors training etc. However, many public sector companies have not met the minimum compliance requirements, especially concerning board composition, the required number of INEDs and female directors on boards. The other area that needs improvement is the evaluation mechanism of BODs and CEOs. BODs must be informed in advance of the evaluation criteria, and the findings of evaluations should be utilised to improve board effectiveness. BODs should be informed of all necessary matters to deliver their fiduciary responsibilities effectively.

Following are some recommendations to improve the corporate governance mechanism in Pakistan.

- Many companies are missing the recommended number of female directors and INEDs on boards. The Independent Directors Databank can facilitate companies, on-demand, to select suitable INEDs and female directors. It is time to select qualified INEDs through formal authorised channels like ID databanks than from a narrow pool of social contacts.
- Likewise, nomination committees must be in place to formalise the selection process of INEDS and other members of the Board.
- By advertising, the opportunity to appoint board members would improve the objectivity of the process.
- The remuneration policy should be revised to ensure the active engagement of the INEDs.
- The rule of one shareholder (not one share), one vote would dilute the monopoly of dominant shareholders while selecting INEDs.
- The criterion of the range of skills required for Board positions should also be considered to have a perfect skill mix on Board.
- The nomination of a Chairperson through political intervention should be minimised. This authority should be vested in BODs.
- An Evaluation mechanism of the performance of BODs and CEOs should be impersonal and impartial.

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