FINANCIAL DISCLOSURE AND ITS IMPORTANCE IN CORPORATE GOVERNANCE: SPECIAL REFERNCE TO DIRECTORS REMUNERATION

A DISSERTATION SUBMITTED TO THE DEPARTMENT OF LAW INTERNATIONAL ISLAMIC UNIVERSITY ISLAMABAD IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF LAW (LLM CORPORATE LAW)

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This work is dedicated to

My Nani,

Parents, and

Brothers and sisters.

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GLOSSARY OF ABBREVIATIONS

AOA	ARTICLES OF ASSOCIATION
AICPA	AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
BoD	BOARD OF DIRECTORS
CCI	COUNCIL OF INSTITUTIONAL INVESTORS
CEO	CHIEF EXCUTIVE OFFICER
CG	CORPORATE GOVERNANCE
CCG	CODE OF CORPORATE GOVERNANCE
FSA	FINANCIAL SERVICES AUTHORITY
FRC	FINANCIAL REPORTING COUNCIL
IAS	INTERNATIONAL ACCOUNTING STANDARDS
IASB	INTERNATIONAL ACCOUNTING SETTING BOARD
ICAP	INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN
IFRS	INTERNATIONAL FINANCIAL AND REPORTING STANDARDS
ISAR	INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING
MOA	MEMORANDUM OF ASSOCIATION
OECD	ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT
Ord.	ORDINANCE
PCAOB	PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
PICG	PAKISTAN INSTITUTE OF CORPORATE GOVERNANCE
SE	STOCK EXCHANGE
SEBI	SECURITIES AND EXCHANGE BOARD OF INDIA
SEC	SECURITIES AND EXCHANGE COMMISSION, USA
SECP	SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN
TARP	TROUBLED ASSET RELIEF PROGRAM
UNCTAD	UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UEF	UNITED FOR A FAIR ECONOMY

ABSTRACT

The financial disclosure requirements under the laws of Pakistan, particularly relating to the self-dealing transactions such as directors and executive remuneration and compensation packages are not according to prevailing International Standards. Due to less stringent regulation, the corporate governance model is not producing the required results such as economic accountability, transparency, efficiency, investors' confidence etc.

Corporate Governance is a uniquely complex and multifaceted subject. It has a strong linkage with economics, law, finance, accountancy; therefore it is essential for every enterprise to formulate a comprehensive framework of corporate Governance in the legal, auditing, accounting and regulatory framework.

The financial information of an enterprise plays a vital role in the economy of a country, proper and timely financial disclosure persuade the investor to invest, in result whereof the company make progress, which further enhance and strengthen the economy, that is an important object of Corporate Governance, therefore, accurate, timely and proper financial disclosure helps in achieving the aims of a Good Governance structure. The quality of financial reporting standards significantly depends on the robustness of the financial reporting standards on the basis of which the information is prepared. Independent audit function, in addition to the financial reporting standards, provides an objective assurance that the financial statements present a true and fair view of the financial condition and performance of an audited entity.

The main object of Corporate Governance is nothing but, to avoid conflict of interest among three parties they are share-holders, management, outsiders (e.g. Creditors) therefore; all the stake holders are interested in the financial disclosure of all related party transactions and self dealing transactions, so that no party could obtain undue benefit. In Pakistan the financial disclosure requirements particularly related to related party and self dealing are less stringent in this regard.

The other jurisdictions of the world, understand the importance of financial disclosure of related party transactions and self dealing transactions and their overall impact on the corporate governance structure. Thereafter they made stringent rules to maintain a proper check and balance on all such transaction. Not only this they have also adopted certain procedures to make the process of setting the remuneration, an independent one, some independent committees have been constituted on the board. Mandatory disclosure and the shareholders approval are some of the strategies adopted in the jurisdiction to counter the situation. In Pakistan the Code of corporate Governance 2002 and Companies Ordinance 1984 has a few provisions relating to financial disclosure of self dealing transaction such as remuneration and compensation issues, but the laws are either deficient or much relaxed, therefore, there is a need of improving these.

This research work is divided into four chapters each of which focuses on specific area related to the research. In the first chapter a brief over view of the Corporate Governance, financial disclosure and relationship between the two has been explained.

The second part focuses on the corporate governance and regulatory framework in Pakistan and other jurisdiction round the globe. The third chapter focuses on the accounting and reporting standards in Pakistan and other jurisdictions. The issue of independence of auditors has also been explained in the portion. The fourth chapter focuses on the disclosure requirements of related party and self dealing transactions. It also explains how the jurisdictions have maintained the check and balance of such transactions. The position of Pakistani law has also been explained, and after the complete comparison some suggestions have been made.

The thesis suggests some of the deficiencies in these provisions and also provides solutions for them. I have adopted analytical as well as perspective approach for the research work. First, I will analyze the existing provisions of Pakistani Law relating to financial disclosure requirements, their implementation, then look up the deficiencies in these provisions and provide an appropriate solution for replacing those deficiencies, so as the make our legislations effective and in accord with international standards.

CHAPTER NO 1

INTRODUCTION OF CORPORATE GOVERNANCE

1.1. Introduction of Corporate Governance

Corporate governance is a uniquely complex and multi- faceted subject, devoid of a unified or systematic theory, its paradigm, diagnosis and solutions can be found in multi-disciplinary fields i.e. economic, law, finance, agency, theory accountancy, etc. Therefore, it is essential that a comprehensive framework of corporate governance is codified in the accounting, auditing, legal and regulatory framework of every organization.[1] Every debate of Corporate Governance focused only one thing around i.e. how properly and effectively a corporation is governed. Good governance is essential for modern and well managed corporations. The Corporate Governance is not an ancient concept; it has evolved in recent past, [2]as there has been renewed interest in the corporate governance practices of modern corporations since 2001.[3]

1.1.1. How the concept of Corporate Governance evolves

The need to study and understand the corporate governance arose because of high profile financial collapses of large corporations in United States for instance "Enron Corporation", "WorldCom" and "Adelphia" etc, the effect of these financial collapses is massive, therefore,

[1]Shamshad Akhtar, "Corporate Governance in Pakistan" (address at the Conference on Corporate Governance, for Pakistan Institute of Corporate Governance and International Finance Corporation, Karachi, Pakistan May 29, 2006) available at <http://www.sbp.org.pk/about/speech/Governors/Dr.Shamshad/2006/Governance-29-May-06.pdf> (last accessed July 07, 2009).

[2]Chris Mallin, "The Relationship between Corporate Governance, Transparency and Financial Disclosure," in *Selected Issues in Corporate Governance: Regional and Country Experiences* (New York and Geneva: United Nations Publication 2003), 7. UNCTAD/ITE/TEB/2003/3.

[3] <http://www.citizendia.org/Corporate_governance> (last accessed on October 11, 2010).

as a preventive measure, the jurisdiction round the globe considers it essential to formulate comprehensive legal framework of corporate governance; resultantly different corporate governance codes were emerged.

Corporate governance, despite some feeble attempts from various quarters, remains an ambiguous and often misunderstood phrase, for quite some time it was confined only to corporate management.[4] However, in reality, the scope of corporate governance is broad, "Corporate Governance includes a fair, efficient and transparent administration;" moreover, it aims to achieve some core objectives like "the quantity, quality and frequency of financial and managerial disclosure; the degree and extent to which the board of Director (BOD) exercise their trustee responsibilities, and the commitment to run the organization in a transparent manner."

In Pakistan, corporate governance has significantly improved in recent past; however much needs to be done. "Code of Corporate Governance" 2002 issued by the "Securities and Exchange Commission of Pakistan" (SECP), "Companies Ordinance, 1984" and regulations of three stock exchanges forms the legal basis for corporate governance in the country. The up-coming portion of the chapter will explain the concept of corporate governance, the need for it, the elements and dimensions of corporate governance.

1.1.2. What is Corporate Governance?

Corporate Governance is an idea, or a theory; it has no particular definition; however it has been elaborated by different institutes, experts and organizations encompassing different aspects of the corporate governance in the following manners:

[4]<http://www.absoluteastronomy.com/topics/Corporate_governance> (last accessed June 29, 2009).

"Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled, it also includes the relationships among the many stakeholders involved in the corporation and to achieve the goals for which the corporation is governed."[5]

Gabrielle O'Donovan[6] defines corporate governance as: "an internal system encompassing policies, processes and people, which serve the needs of shareholders and other stakeholders, by directing and controlling management activities objectivity and integrity."[7] In most simplistic manner; "corporate governance is the mechanism that allowed the shareholders of the firm or company to oversee the firm/company management and the management decision."[8] Corporate Governance may also be defined as the whole system of controls, both financial and otherwise, by which, a company is directed and controlled.[9]

Corporate Governance Committee of "Securities and Exchange Board of India" (SEBI) defines it as: "the acceptance by management, the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company."

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[5] <http://www.mcg.cc/software.asp> (last accessed September 25, 2009).

[6] Gabrielle O'Donovan has worked with major companies for many years on change management and is an Associate Professor for the MBA programme at Danube University, Austria and Hong Kong Polytechnic University, China.

[7] Gabrielle O'Donovan, "A Broad Culture of Corporate Governance." *Corporate Governance International Journal* 6, no.3 (2003).

[8] Peter Grosvenor. Munzing, "Enron and the Economics of the Corporate Governance" (Diss., Stanford University, Stanford 2003), 12.

[9] Adrian Cadbury, "Report of the Committee on Financial aspect of Corporate Governance" (UK: Burgess Science Press 1992) available at <http://www.ecgi.org/codes/documents/cadbury.pdf> (last accessed January 15, 2009). (Hereafter referred as Cadbury Report).

Organization for Economic Cooperation and Development (OECD) defines it as: "a set of relationships between a company's management, its board, share-holders and other stakeholders." The stakeholders are those who have any interest in the functioning of the business, for the purposes of corporate management, the term stakeholders includes but not confined to the shareholders, directors, and management of a company, as defined by the corporate charter, bylaws, formal policy and rule of law. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance and determined. Good Corporate Governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the Company and shareholders and should facilitate effective monitoring; thereby encouraging firms to use resources more efficiently.[10]

The "Council of Institutional Investors" (CII) defines it as: "Corporate governance structures and practices should protect and enhance accountability to, and ensure equal financial treatment of, shareholders."

Corporate Governance is a set of relationship between the board, shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.[11] From the perspective of supplier of finances, CG can be explained as the ways in which supplier of finance of corporations assure himself of getting a return on his investment.[12]

[10]<http://www.sbp.org.pk/about/corp_gov/Chapter%201%20-%20Introduction.pdf> (last accessed August 06, 2009).

[11]Organisation for Economic Co-Operation and Development, *Principles of Corporate Governance* (Paris: OECD Publication Services, 2004).

[12]Mallin, "The Relationship between Corporate Governance, Transparency and Financial Disclosure," 54.

We have discussed the way in which different authors/organizations explains Corporate Governance, the explanations have been provided from different perspectives; however after perusing the above mentioned elaborations it can safely be concluded that there are certain elements which are addressed by each definition: and the same can be summarized as follows;

(a) System of control within the company;

(b) The relationship between the board of the company and all other stakeholders;

(c) Greater transparency, disclosure and accountability;

(d) Company is a responsible and accountable institution;

(e) A system through which a particular company is directed and controlled;

(f) Recognition and protection of stakeholder's rights;

(g) Reduce and Eliminate Agency Problem;

(h) Provides structure for setting and attaining company objectives in accordance with the law.

1.1.3 Issues/elements in Corporate Governance

As discussed in the aforementioned pages, one thing becomes clear that the disclosure and transparency has strong nexus with good corporate governance, needless to mention here that without an effective system of disclosure, there can be no efficient Corporate Governance policy. Nevertheless, the CG is a vast field; there are different elements/factors which are associated in the scheme of Corporate Governance. It is difficult to mention all the disclosure items involved in the Corporate Governance scheme. However, United Nations Conference on Trade and Development (UNCTAD), after a long discussion has formulated a benchmark of fifty three items, which must be disclosed in any good corporate governance scheme (these items are hereinafter referred as ISAR benchmark). UNCTAD was established in 1964 as a permanent intergovernmental body, aiming to maximize the trade, investment and development opportunities of developing countries and assist them in their efforts to integrate into the world economy on an equitable basis.[13] The ISAR working group, created in 1982 by the United Nations Economic and Social Council (ECOSOC) with the mission to facilitate investment, development and economic stability by promoting good practices in corporate transparency and accounting.[14] ISAR working group is hosted by UNCTAD. The ISAR benchmark has grouped the disclosure items into five broad categories or subject areas of CG disclosure. These items are based on the "Intergovernmental Working Group of experts" on "International Standards of Accounting and Reporting" (ISAR) document of 2006."[15] Following are the categories/subject areas:

a) Financial transparency and information disclosure;
b) Board and management structure and process;
c) Ownership structure and exercise of control rights;
d) Corporate responsibility and compliance; and
e) Auditing.[16]

The above mentioned categories/subject areas are further divided into different items. However, in order to narrow down the research topic, main focus would be on first category

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[13]It is the principal organ of the United Nations General Assembly dealing with trade, investment, and development issues.

[14]<http://www.un.org/en/ecosoc/index.shtm> (last accessed April 15, 2011).

[15]Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) (Geneva: n.p. 2007) available at <http://www.thefullwiki.org/United_Nations_Conference_on_Trade_and_Development> (last accessed September 14, 2010). (Hereafter referred as ISAR Standards).

[16]Intergovernmental Working Group of Experts on International Accounting and Reporting Standards, *Review of* 2008*International Standards* (New York and Geneva: United Nation Publication 2010) available at <http://www.unctad.org/en/docs/diaeed20096_en.pdf> (last accessed June 13, 2010).

i.e. "*financial transparency and information disclosure.*"[17] Financial transparency and information disclosure; the first item/subject area is further divided into nine sub categories i.e.

a) Financial and operating results;
b) Nature, type and elements of related-party transactions and elf dealing transactions;
c) Company objectives;
d) Critical accounting estimates;
e) Board responsibilities regarding financial communications;
f) Impact of alternative accounting decisions;
g) Rules and procedure governing extraordinary transactions;
h) The decision making process for approving transactions with related parties and self dealing transactions, and
i) Disclosure practices on related party transactions where control exists.

However for the purposes of instant research the main focus shall only be on the nature, type and elements of related party transactions, disclosure practices and decision making process for related party transactions.[18]

1.1.4. Importance of corporate governance

The economy of a country depends on the efficiency of the business activities, which are largely run and managed by the companies. In order to effectively run the affairs of the

[17]United Nation Commission on Trade and Development, *Review of* 2007 *International Standards* (New York and Geneva: United Nation Publication 2010), 16.
[18] Ibid. 18.

business and to run the new projects, the corporations require the finances. The general public is invited to participate in the business, such participation could be required by adopting two modes firstly, by joining the persons in the ownership of the company, this can be done by the issuance of shares. The second mode of financing is the issuance of debentures, thereby the company requires loan from the debenture holder; in return the holder is entitled for interest at a fixed rate. Shareholders as well as the creditor/debenture-holder, provides their finances to the companies. The determining factor which instigates them to put their funds in the hands of the company is their assurance for the receipt of fair share of the organizational returns. Conversely, if a party receives more than fair the other participants may choose to quit from the game, the result would be the organizational collapse. Corporate Governance is there only for single point agenda i.e. to minimize the chances of organizational collapses and to maintain a balance between the distributions of returns of organization. The effective corporate governance scheme is transparent, it protects the rights of shareholders, and it provides such a scheme where the directors perform their duties honestly. Therefore the primary need for a good corporate governance scheme of company forms of business is to minimize the organizational collapses, and to maintain a balance between different stakeholders, which ultimately is the strength of economical condition of a country, "hence good corporate governance is a tool for socio-economic development of a country."

1.1.5. Effects of corporate governance

Corporate governance ensures "fairness, transparency, accountability, sustainable financial performance, increased shareholder confidence, access to external finance and foreign investment, fair treatment of the stakeholders in a company, maximization of shareholders' value and the enhanced reputation of a company, nation and economy."[19]

Efficient corporate governance practices ensures high return on capital employed, attraction of long-term capital, mitigation of systematic risk, higher return for shareholders, improvement in the confidence of domestic and foreign investors, reduction in the cost of capital, stable flow of finance, availability of international capital, and greater productivity.

The "corporate governance structure does not exist in isolation but draws upon basic principles and values which are expected to infuse all human dealings, including business dealings, such as utmost good faith, trust, competency, professionalism, transparency and accountability."[20] The positive effect of good corporate governance on different stakeholders ultimately is a "strengthened economy and hence good corporate governance is a tool for socio-economic development. After East Asian economies collapsed in the late 20th century, the World Bank's president warned those countries, that for sustainable development, corporate governance has to be good. Economic health of a nation depends substantially on how sound and ethical businesses are."[21]

1.1.6. Effect of corporate governance on economy

Due to good corporate governance the economy of a nation effects in following ways:

i. If companies work on good corporate governance, then there is more transparency in business activities.

[19] Andrei Shleifer and Robert W Vishny, "A Survey of Corporate Governance," *The Journal of Finance* 42, no. 2 (1997) available at <http://www.jstor.org/pss/2329497> (last accessed on May 25, 2010).

[20] <http://www.scribd.com/doc/38685250/Role-of-Audit-in-Corporate-Governance> (last accessed March 31, 2011).

[21] <http://www.scribd.com/doc/38685250/Role-of-Audit-in-Corporate-Governance> (last accessed August 08, 2010).

ii. Due to good working of the companies, the investors are safe to invest.

iii. This also attract foreign investors, due to foreign investments, there is more chance to enhance foreign reserves

iv. Good and healthy business activity gives a good effect on stock exchange

v. Enhancing business on stock exchange ultimately because a booming effect on the economy.

1.1.7. Institution for corporate governance

The "Council Institutional Investor's" (CII) is a premier advocacy group, aiming to educate its members, policymakers and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on its members' behalf. According to CII "Corporate governance involves the structure of relationships between shareowners, directors and managers of a company, good corporate governance is a system of checks and balances that fosters transparency, responsibility, accountability and market integrity."[22] CII believes that good corporate governance is a universal goal that all public companies should embrace[23] as a corporate governance system is to strongly emphasis on shareholders' welfare.

The Council of Institutional Investors has long held that "good corporate governance defined to include general issues affecting market transparency, integrity and accountability and specific relationships between boards, management and shareowners—is in the best long-term interests of shareowners". The "Council believes that shareowners, other investors and other stakeholders benefit when rules and regulations provide adequate protections to owners and ensure that important information is promptly and transparently provided to the

[22] <http://www.cii.org/about> (last accessed August 05, 2010).

[23] <http://www.cii.org/internationalCorporateGovernance> (last accessed August 05, 2010).

marketplace."[24] "In its 'Global Investor Opinion Survey' of over 200 institutional investors first undertaken in 2000 and updated in 2002, it was found that 80% of the respondents would pay a premium for well-governed companies."[25]

1.1.8. Components of Corporate Governance

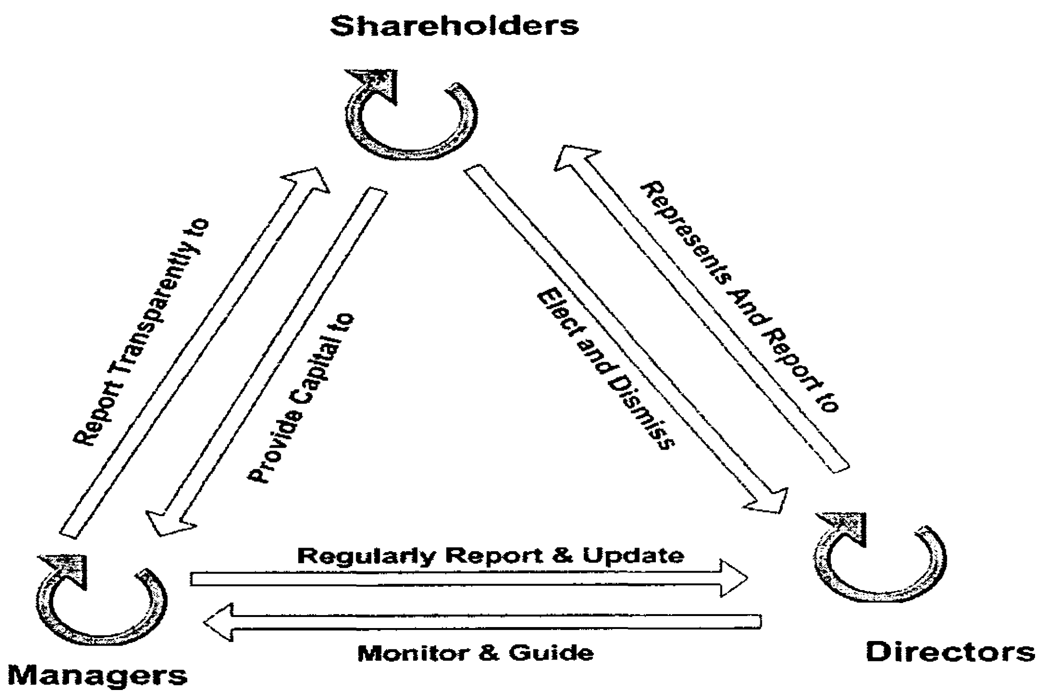

Figure 1 explaining the concept of Corporate Governance

As discussed in the earlier part of the chapter, the basic aim of every CG scheme is to minimize, if not eliminate the conflict of interest among different stake holders of the company. Therefore, it is essentially requires to have an idea about the stake holders and their interests. The stakeholders are those who have interest in the affairs of business, or the

[24] <http://www.cii.org/UserFiles/file/Statement%20on%20the%20Value%20of%20 Corporate%20Governance.pdf> (last accessed January 19, 2010).
[25] <http://mobile.answers.com/topic/corporate-governance?curtab=2750_1> (last accessed February 25, 2010).

persons who are directly affected from a corporate decision, the affect could be positive or vice versa. The term includes but not confined to the shareholders, creditors, directors, and management of a company, and the government represented by the corporate regulator. In the broader spectrum the term "stakeholders also includes the persons who take part in the business of the company i.e. the suppliers, employees, customers and the community at large."

The main participants in the control and management of a company are the shareholders directors, creditors and the regulator. Beside these, there is chief executive and the company secretary, who are the employees and agents of the company. Creditors are also an interested group who may be permitted to nominate directors and influence the winding up.

In corporate structure, agency problem is found in most of the situations. The shareholders have no responsibility for the daily administration of the company, though they are ultimately responsible for choosing the BOD. The company officers and other employees owe no direct liability to shareholders. The interest of shareholder is to get maximum dividend. They delegate their right of decision making to the manager/directors in response whereof the directors/managers are required to act in the best interest of shareholders. However this power structure makes it ineffective for the shareholders to control management decisions; hence there is strong apprehension that this separation creates a conflicting situation. Therefore, a system of good corporate governance provides a procedure to minimize this conflict.

The government regulator is there, to protect the rights of general masses. It is also the function of the regulator, to implement the state laws, and to maintain check and balance on the companies. All the above mentioned actors have interest in effective corporate governance structure; their interest may be direct or indirect. "Directors, workers and management receive salaries, benefits and reputation, the shareholders receive capital return/dividend, the customers receive goods and services; suppliers receive compensation for their goods or services, resultantly these individuals provide value in the form of natural, human, social and other forms of capital."[26]

The concept of CG at length, has been explained in the afore-mentioned pages, now comes the core issue i.e. the Financial Disclosure, and the role played by the financial disclosure in the corporate governance scheme.

1.2. Definition and concept of Financial Disclosure

1.2.1. What is Financial Disclosure

Literally disclosure means, the act or process of revealing or uncovering something, or in other words disclosing information or giving evidence about another. Financial position of a corporation is considers to be the back-bone for the progress and growth of a company.

Financial disclosure means any information, relating to, or involving finance, finances, or financier, such information involving financial matters, fiscal responsibility etc. In business, this is the ethic to reveal the full truth about any matter that the other party should know in order to make a valid decision.[27]It also depicts the financial health and stability of the organization.

Any information which quantitatively describes the financial health of a company is called financial disclosure, this includes an income statement, a balance sheet, and often also

[26]<http://www.citizendia.org/Corporate_governance> (last accessed October 11, 2010).
[27]<http://www.attorneykennugent.com/library/f.html> (last accessed August 06, 2009).

includes a cash flow statement.[28] A "financial statement is the summary of all transactions that have occurred over a particular period, the accounting reports and financial statements are as revealing of the health of a business as pulse rate and blood pressure reports are in revealing the health of a person."[29]The "Qualitative characteristics of financial information disclosure" include: "understandability; reliability; comparability; relevance; and true and fair view/fair presentation."[30]

A company releases the information pertaining to the company's business activity. On the basis of this information, the investors make their investment decision. The financial information influences the investor's decision. Generally, security exchanges and the regulators of the companies require the companies to disclose to the investment community those facts that will affect the firms' stock prices. Financial Disclosure is also required when the companies raised the funds by way of public offerings either by issuance of shares or debentures.[31]

1.2.2. Purpose for financial disclosures

The stakeholders of the corporate sector raise their voices for financial disclosure. They have showed their concern about the disclosure of financial information of the company. Their concern increased with every financial scandal, and they requires from the legislature for accounting and financial reforms to force the companies for mandatory disclosure.

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[28]<http://www.investorwords.com/1957/financial_statement.html (last accessed August 07, 2009).

[29]<http://faculty.valenciacc.edu/srusso/ch18bus.htm (last accessed August 12, 2009).

[30]<http://webcache.googleusercontent.com/search?q=cache:sNnB99V0c7IJ> (last accessed April 08, 2011).

[31]<http://financial-dictionary.thefreedictionary.com/Disclosure+(information)> (last accessed August 31, 2009).

The objective of reveling the financial statements or financial disclosure is to provide information about the actual financial position, performance and changes in the financial position of an entity that is useful to users in making investment decisions and to provide the current financial status of the entity to its shareholders and public in general.[32] The issue of financial disclosure is also necessary for the share-holders, to assure themselves that their funds are not being misappropriated by the management. Further to enhance their confidence that their agents are performing their duties, honestly and with loyalty. Financial information disclosure is useful, because it shows the financial condition of a company at a given period.[33]

1.2.3. Importance of Financial Regulations

Regulations plays vital role in the efficiency of any organization. "Financial regulations are a form of regulation or supervision, which subjects financial institutions to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system, the regulations may be handled either by a government or non-government organization."[34]The purpose of financial regulation is "the protection of public at large and its central tasks are to explain who will receive the benefits or burdens of regulation and to ensure that regulation results in efficiency of resource allocation, there must be the right

[32] <http://www.ifrs.com/international_Financial_Reporting_Standards> (last accessed August 31, 2009).

[33] <http://hubpages.com/hub/The-Importance-of-financial-statements> (last accessed August 31, 2009).

[34] <http://www.about-internet.com/money/finance/topic_50.asp> (last accessed May 03, 2010).

blend of regulations, disclosure and enforcement, which should be made after consultation between the public, industry and regulators."[35]

1.3. Relationship between Financial Disclosure and Corporate Governance

Good corporate governance is an essential prerequisite for the integrity and credibility of financial institutions, stock exchanges, incorporated companies and the whole economy; it builds greater confidence and trust by ensuring transparency, fairness and accountability with respect to shareholders and other stakeholders.[36]

In the above paragraphs it is explained that CG is nothing but a device to protect and maximize the interest of shareholders/Investors, and to avoid any "conflict of interest" between the stake-holders of a company. This is also an undeniable fact that the decision of investment is dependent upon the reliability, soundness and accuracy of financial situation of the company.

The importance of relationship between good corporate governance, transparency and financial disclosure, can best be experienced by Arthur Levitt, former Chairman SEC, USA in 2000 while addressing at a conference, at Manhattan, USA 2000, he explained the relationship in the following manner:

> "If a country doesn't have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax

[35]<http://www.financialexpress.com/news/role-of-regulation-in-market-development/196575/3> (last accessed April 10, 2009).

[36]<http://www.picg.org.pk/Profile.html> (last accessed August 12, 2010).

accounting and reporting standards, capital will flow elsewhere. All enterprises in that country -- regardless of how steadfast a particular company's practices may be — suffer the consequences. Markets must now honor what they perhaps, too often have failed to recognize. Markets exist by the grace of investors. And it is today's more empowered investors who will determine which companies and which market will stand the test of time and endure the weight of greater competition. It serves us well to remember that no market has a divine right to investor's capital."[37]

[37]Arthur Levitt, "The Relationship between Good Corporate Governance, Transparency and Financial Disclosure" (address at a conference organized by Federal Reserves, Manhattan, USA 2000) available at <http://www.secp.gov.pk/corporatelaws/pdf/CodeofCorporateGovernance> (last accessed August 30, 2009).

CHAPTER NO 2

CORPORATE GOVERNANCE AND REGULATORY FRAMEWORK IN DIFFERENT JURISDICTION

2.1. Concept of Governance and Regulatory framework in Pakistani Corporate sector and Different Jurisdictions

The Company law is that branch of law which governs the corporate sector more particularly the companies. Due to its impact, on the corporate sector, company law is increasingly being perceived throughout the world as an important building block in the functioning and development of economic system of a country. The instantaneous function of corporate law is defining the form of enterprise and containing the conflicts among the participants of the enterprise. The overall object of corporate law is to serve the interests of the shareholders and at the broader spectrum the interest of the society by enabling such an environment that the economic growth and social policies of the nation are strengthened. The company law, through its rules, advances the welfare of shareholders by maintaining their effective participation and control, employees without undue sacrifice and without any discrimination. It provides a regulatory system which minimizes risks for the businessman. It also provides adequate disclosure of information and proper auditing of the corporation.[38] To provide a regulatory framework for the companies and to establish an efficient "Corporate Governance" model is also the basic object of the company law.

2.1.1. Concept of governance

The term Governance refers to the act or process of governing; it has existed since the dawn of civilization. Different dictionaries take the term differently, for instance shorter Oxford Dictionary defines governance simply as: the office, function or power of governing.[39] Webster's dictionary regards it as the: exercise of authority; control; management; power of government.[40]

In the concept of corporate law, fair governance implies that mechanisms, function in a way that allows the executives/ the agents to respect the rights and interests of the stakeholders/the principals, in a democratic spirit. The "organizations often use the word *governance* to describe both: the laws and customs (rules) applying to that direction and the manner in which boards or their like direct a corporation."[41]

2.1.2. Regulatory framework and its importance

There is no denial for the importance of a regulatory framework; the obvious reason is that it provides protection of shareholders. The basic aim of regulator is to explain who will receive the benefits or who will bear the burden of regulation. Moreover the regulations ensure the

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[38] Imran Ahsan Khan Nyazee, *Company Law* (Islamabad: Advance Legal Studies Institute ALSI, 2008), 10-11.

[39] *Oxford English Dictionary*, s.v. "governance." available at <http://oxforddictionaries.com/definition/governance> (last accessed on January 26, 2009).

[40] *Webster Dictionary*, s.v. "governance." available at <http://www.websters-online-dictionary.org/definitions/governance> (last accessed on January 26, 2009).

[41] <http://www.andal.com.pl/en/wiki/Governance.html> (last accessed May 14, 2009).

efficiency of resource allocation. The regulator tries to find out a proper balance between the conflicting interests among the stake-holders. The regulatory framework is essential because if the markets are left alone; no one can guarantee the protection for the rights of all stake-holders. Alternate to regulator we require fairness, loyalty, trust from all the players of market, which, however is not possible at a larger scale. The regulatory framework "provides the right framework within which an economy can thrive through competition, innovation, fairness, efficiency and confidence."[42]

In a regulatory framework the regulator plays a significant role in monitoring and overseeing the regulated area. The regulatory duties are to be performed by a regulator, who is "an official authority; responsible for control and supervision of a particular activity or area of public interest."[43] The authority to regulate is "the power that the legislature gives an agency to enforce statutes, to develop regulations that have the force of law, and to assist the public in complying with laws and regulations."[44] A regulatory authority is "a public authority responsible for exercising autonomous authority over some area of human activity in a regulatory or supervisory capacity."[45]

As discussed in the previous chapter, the object of "Corporate Governance" scheme is to minimize the conflict of interest between different stake-holders. There are different CG schemes prevailing in the world to address the issue. Therefore, in order to have better understanding of those schemes, and subsequent recommendation for Pakistan; it is necessary to have a look at the governance structure models and regulatory framework in different countries. In the following passages brief over-view of CG models and regulatory

[42]<http://www.financialexpress.com/news/role-of-regulation-in-market-development/196575/3> (last accessed April 10, 2009).

[43]<http://www.thefreedictionary.com/regulator> (last accessed April 10, 2010).

[44]<http://www.answers.com/topic/regulatory-authority-1> (last accessed September 22, 2010).

[45]<http://www.amazines.com/Regulatory_Authority_related.html> (last accessed June 30, 2011).

frameworks have been explained. The Chapter consists of two portions; the former will give brief overview of the Corporate Governance and regulatory framework in different countries whereas in the later part the corporate governance and regulatory framework in Pakistan context will be elaborated.

2.2. Corporate governance models and regulatory framework in different jurisdictions

There are different CG models working in the world; "a considerable variation can be observed in these models on the basis of their respective economic system, however all models try to respond same corporate governance challenges."[46]

2.2.1. Corporate Governance and Regulatory framework in United Kingdom

The Corporate Governance developed in UK in last three decades because of "the collapse of the BCCI bank and the Robert Maxwell pension funds scandal both occurred in 1991, thereafter the UK business community recognised the need to put its house in order. Which led to the setting up in 1991 of the Committee on the Financial Aspects of Corporate Governance,"[47] commonly known as "Cadbury Committee" the committee issued a report comprising series of recommendations called as the "Cadbury Report" in 1992. "The report

[46]Enriques L. Volpin P, "Corporate governance reforms in Continental Europ," *Journal of Economic Perspectives* 21, no. 1 (2007): 117–140 available at <http://www.tkyd.org/files/downloads/Corporate_Governance_Reforms_in_Continental_Europe.pdf> (last accessed August 13, 2009).

[47]<http://www.clevelandpa.org.uk/admin/uploads/attachment/14_June_2007Best%20Value%20 Appx%20B.pdf> (last accessed June 27, 2010).

addressed issues such as the relationship between the chairman and chief executive, the role of non-executive directors and reporting on internal control and on the company's position."[48] In compliance of the recommendations, "a requirement was added to the Listing Rules of the London Stock Exchange that companies should report whether they had followed the recommendations or, if not, explain why they had not done so."[49] After the report another committee was constituted which published its report in 1995 called the "Greenbury report"[50] that set out "recommendations on the remuneration of directors" a step forward for the implementation of good corporate governance model. "In 1998 the "Cadbury and Greenbury reports" were combined and incorporated in the "Combined Code", which was updated in 2003 after the incorporation of recommendations put forward by the "Higgs Report"[51] and "the Smith Report."[52] The combined code is the basis of corporate governance in UK. The UK Government assigned "Financial Reporting Council" (FRC) to publish and maintain the Code, which made certain changes of limited nature to the Code in 2006. However the comply or explain approach first set out in the Cadbury Report remains intact."[53]

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48 Cadbury Report sets out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures. The recommendations of Cadbury Report have been adopted in varying degree by the European Union, the United States, the World Bank, and others.

49 <http://www.apb.org.uk/documents/pagemanager/frc/FRC%20The%20UK%20Approach%20to%20Corporate%20Governance%20final.pdf%20> (last accessed January 12, 2010).

50 United Kingdom Confederation of Business and Industry on Corporate Governance, *The Greenbury Report* (UK: n.p. 1995) available at <http://www.ecgi.org/codes/documents/greenbury_less_recommendations.pdf> (accessed January 14, 2010). The Greenbury Report followed in the tradition of the Cadbury Report and addressed a growing concern about the level of director remuneration. The modern result of the report is found in the Combined Code. (hereafter referred as Greenbury Report).

51 Derek Higgs, *Review of the role and effectiveness of non-executive directors* (UK: n.p. January 20, 2003) available at <http://www.freshfields.com/publications/pdfs/practices/5004.pdf> (accessed on January 15, 2010). The report reviewed the role and effectiveness of non-executive directors and of the audit committee. According to Higgs Review, Non-executive directors' main roles are those of strategic support and monitoring of management, executive directors, in a unitary board. Their independence from important potential conflicts of interest which can affect executive directors is fundamental.

52 Robert Smith, *Audit Committees: Combine Code Guidance* (UK: n.p. 2003) <http://www.kpmg.co.uk/aci/docs/FRCSmithReport.pdf> (accessed January 16, 2010).

53 <http://www.apb.org.uk/documents/pagemanager/frc/FRC%20The%20UK%20Approach%20to%20Corporate%20Governance%20final.pdf%20> (last accessed January 07, 2009).

Looking at the regulatory framework, we found "Financial Services Authority" (FSA) as the regulator of the financial services industry in the UK. FSA is an independent non-governmental body, established by the "Financial Services and Markets Act 2000" with statutory objectives of market confidence, financial stability, public awareness, consumer protection, and reduction of financial crime,[54] the treasury appoints the FSA Board, which sets overall policy, and the ordinary management affairs rest with the Executive Committee, the authority is accountable to Parliament through treasury ministers. FSA is operationally independent of government; it receives funds from the firms and companies under its regulation.[55]

2.2.2. Corporate Governance and Regulatory framework in United States

Corporate governance has been the subject of significant debate in the United States since the late 1970's. The subject has changed since 1980, when the business scholars have started pointing out the undesirability of the corporate governance structures prior to 1980s as it was more beneficial for the managers rather the shareholder.[56] Thereafter bold, broad efforts to reform corporate governance have been driven, in part, by the needs and desires of shareowners to exercise their rights of corporate ownership and to increase the value of their shares and, therefore, wealth.[57] In early 1990s, "the issue received more press attention due to

[54]<http://www.fsa.gov.uk/Pages/About/Who/index.shtml> (last accessed August 28, 2010).

[55]<http://www.compliance-officer.org/FSACompliance.htm> (last accessed May 13, 2011).

[56]Gordon Donaldson and Jay Lorsch, *Decision Making at the Top* (New York: Basic Books 1983) and Michael Jensen, "The Modern Industrial Revolution." *Journal of Finance* (1993): 831-880 available at <http://www.compliance-officer.org/FSACompliance.htm> (last accessed on January 19, 2009).

[57]<http://www.citizendia.org/Corporate_governance> (last accessed October 11, 2010).

the wave of CEO dismissals (e.g.: IBM, Kodak, Honeywell) by their boards." The California Public Employees' Retirement System (CalPERS)[58] led a wave of institutional shareholder activism (something only very rarely seen before). In early 2000s, the massive bankruptcies of "Enron"[59], "Worldcom", "Adelphia Communications", "Arthur Andersen", and "Tyco", increased [60]"shareholder and governmental concern in corporate governance. Resultantly the Sarbanes-Oxley Act of 2002" was promulgated.[61]

As far as the regulator is concerned, the "Securities and Exchange Commission" (SEC), USA has been assigned with the function to regulate the corporate entities functioning in USA. SEC was established by the SEC Act 1934, with the mission to protect investors, maintain fair, orderly, and efficient markets, and to facilitate capital formation.[62] The US Companies are primarily regulated by respective state of incorporation however the Public companies are also regulated by the federal government.

2.2.3. Corporate Governance and Regulatory framework in India

The Indian corporate scenario was more or less stagnant till the early 1990s. However the position and goals have been changed after the liberalization of policies in 1990s. In 1996,

[58]The California Public Employees' Retirement System (CalPERS) is an agency in the California executive branch that manages pension and health benefits for more than 1.6 million California public employees, retirees, and their families. In fiscal year 2007-2008, $10.88 billion was paid in retirement benefits, and in calendar year 2009 it is estimated that over $5.7 billion will be paid in health benefits. CalPERS is known for its shareholder activism available at <http://www.answers.com/corporate%20governance> (last accessed October 11, 2009).

[59]The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, and the dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. Shareholders lost nearly $11 billion when Enron's stock price, which hit a high of US$90 per share in mid-2000, plummeted to less than $1 by the end of November 2001. In addition to being the largest bankruptcy reorganization in American history at that time, Enron was attributed as the biggest audit failure.

[60]<http://www.cibe.org.cn/CIBE/bencandy.php?id=282> (last accessed March 26, 2010).

[61]<http://www.nhbar.org/publications/archives/display-journal-issue.asp?id=13> (last accessed January 26, 2010).

[62]<http://www.scsnc.org/schools/bfm/pobpfresourceguide81.html> (last accessed October 16, 2010).

"Confederation of Indian Industry" (CII) took a special initiative on Corporate Governance, to develop and promote a code for corporate governance to be adopted and followed by Indian corporate entities, be these in the private/public sector, banks or financial institutions, this initiative by CII flowed from public concerns regarding the protection of investor interest, especially the small investor, the promotion of transparency within business and industry.[63]

Coming towards the regulatory regime we came across, the "Securities and Exchange Board of India" (SEBI) established on April 12, 1988, SEBI was established with a dual objective; to protect the rights of small investors and to regulate and develop the stock markets in India. In 1992, the "Bombay Stock Exchange" (BSE) witnessed the first major scam thereafter the analysts unanimously felt that if more powers had been given to SEBI, the scam would not have happened. As a result the Government of India brought in a separate legislation by the name of 'SEBI Act 1992' and conferred statutory powers to it. Thereafter SEBI became fully autonomous body; recently SEBI announced strict corporate governance norms for publicly listed companies in India.

Recently, in order to enhance CG SEBI requires from Indian firms to implement Clause 49 which strengthens the role of independent directors serving on corporate boards, said Clause has recently been revised by the SEBI, and it is included in the listing agreement between listed companies and the stock exchanges, SEBI is all set to enhance the CG requirements, primarily through increasing the responsibilities of the board, consolidating the role of the Audit Committee and making management more accountable. These changes are aimed at

[63] <http://www.scu.edu/ethics/practicing/focusareas/business/conference/2007/ presentations/ItiBose.pdf> (last accessed May 25, 2010).

moving Indian companies rapidly up the evolutionary path towards business processes and management oversight techniques.[64]

2.3. Corporate Governance structure and Regulatory framework in Pakistan

Sound corporate governance has emerged as an essential success factor in national and international markets, this is empirically tested that jurisdictions that have implemented good governance measures are able to attract more capital.[65] Corporate Governance is somehow a new phenomenon for Pakistan; due to large financial scandal round the globe the stakeholders of corporate sector felt the need to establish an efficient "corporate governance model". Responding to those concerns of the public, In March, 2002 "Securities and Exchange Commission of Pakistan" issued "Code for Corporate Governance" which "became part of the listing regulations of the three stock exchanges and is now applicable to all public listed companies."[66] The Code is the first institutional effort of its kind in Pakistan. The primary aim of the Code is to establish a system whereby a company is directed and controlled by its directors in compliance with the best practices, so as to safeguard the interests of diversified stakeholders, it also proposes the restructuring of the board of directors which include the minority shareholder's representation, the combination of executive and non-executive directors, it also emphasizes openness and transparency in corporate affairs and the decision-making process[67] it also requires from the directors to

[64]Ibid.

[65]<http://www.accountancy.com.pk/forum/topic.asp?TOPIC_ID=1572> (last accessed May 04, 2010).

[66]<http://www.secp.gov.pk/corporatelaws/pdf/CompaniesOrdinance984-17-03-2011.pdf> (last accessed January 15, 2010).

[67]<http://www.academyofcg.org/ejournal.htm> (last accessed May 04, 2010).

discharge their fiduciary responsibilities in the larger interest of all stakeholders in a transparent, informed, diligent and timely manner.[68]

Since its inception, SECP has been particularly keen to encourage good corporate governance to ensure transparency/accountability in the corporate sector and safeguard the interest of all stakeholders especially the minority shareholders.[69] SECP established the "Pakistan Institute of Corporate Governance" in "public- private partnership" under Section 42 of the Companies Ordinance, 1984[70] aiming to promote awareness and encouraging good corporate governance practices in Pakistan, and to engender sound corporate governance practices and to provide an enabling environment for implementation of Code issued by SECP.[71] The Institute has nineteen founder members, representing the regulatory bodies, the professional institutions, stock exchanges, corporate/financial sector and academia, the institute works through creation of awareness about corporate governance through conferences, seminars, lectures etc.[72]

The institute also acts as a forum for participation of all concerned to contribute towards developing a balanced corporate governance framework and also "assigned the task to issue guidelines on matters of corporate governance to the directors/management/auditors, secretaries/general investors. The establishment of the Institute fulfils the need for an institutional arrangement where all major stakeholders jointly study governance practices and identify the problems, remain responsive to the external environment and initiate a

[68] <http://finance.kalpoint.com/economic-updates/exclusive-articles/corporate-governance-practices-in-pakistan.html> (last accessed December 18, 2009).
[69] <http://www.accountancy.com.pk/forum/topic.asp?TOPIC_ID=1572> (last accessed September 22, 2010).
[70] Ibid.
[71] <http://icmap.com.pk/ma022k5.pdf> (last accessed October 05, 2010).
[72] <http://www.accountancy.com.pk/forum/topic.asp?TOPIC_ID=1572> (last accessed May 04, 2010).

combination of legislation, facilitation, cultural change, social values and changes in their respective roles, where necessary.[73]

The main focus in the upcoming paragraphs is upon the regulatory frame work of corporate sector in Pakistan.

2.4. Regulatory Framework in Pakistan

Company was one of the most prominent and reputable institutions in the financial and Corporate sector of Pakistan which was the most regulated sector and the company being one of the largest and most prestigious financial market institutions, was expected to be conversant and fully complied with the regulatory requirements.[74]

Pakistan inherited the "Indian Companies Consolidation Act", 1913; this Act was amended in 1949 and referred as the "Companies Act', 1913 which was later replaced by the "Companies Ordinance", 1984. The "Companies Ordinance" is the basic law which "deals and governs the corporate sector" of Pakistan. It provides rules for the establishment of company, provides rules concerning the issuance of shares, the functioning of the companies, the rights, powers and duties of the Board of Directors. It also provides the venues for adjudicating the corporate disputes. The Companies Ordinance also provides a reference to set up a regulator who will ensure the compliance of the companies' ordinance. At the time of promulgation of the ordinance, the legislature setup an authority namely corporate law authority "CLA", assigned with the function to ensure the compliance of the ordinance. However said authority could not perform as expected therefore it is replace by the SECP.

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[73] <http://www.accountancy.com.pk/forum/topic.asp?TOPIC_ID=1572> (last accessed October 05, 2010).

[74] 2010 Corp. L. Dec. 103.

Commission, as a regulator was obliged to look into the affairs of the entities it regulated, to ensure that those were not being managed in a manner which would deprive its members of a reasonable return on their investments; that the affairs of the company were managed in accordance with sound business principles and prudent commercial practices etc.[78]

2.5. Conclusion

The concept of corporate governance is not an independent concept. It is supported and emerged by concept of corporate law. Corporate law deals with every issues and conflict which originated within the corporation. From the above chapter, I construe that for minimizing the conflicts and for assuring the interest to each member of the corporation, there must be a proper system and mechanism, the regulator should be efficient and meet the need of time. There are no hard and fast rules for the establishment of code of corporate governance. The roots and purposes of the code are same, but still countries adopted it according to the requirements of their own legal setup and their own needs.

[78]2010 Corp. L. Dec. 157.
available at <http://www.secp.gov.pk/orders/pdf/Orders_05/Dec_5_Khairpur_265_final.pdf> (last accessed September 14, 2010).

CHAPTER NO 3

INTERNATIONAL FINANCIAL REPORTING STANDARDS

3.1. International Financial Reporting Standards

International Financial Reporting Standards (IFRS) are a set of accounting standards developed by the International Accounting Standards Board (IASB).[79] IASB is an independent standard-setting body of the "International Accounting Standards Committee Foundation." IASB is established to promote and protect the public interest, the Board is having mandate to develop a single set of high quality, understandable and international financial reporting standards (IFRSs) for general purpose financial statements.[80] IFRS are the global standards for the preparation of public company financial statements. Approximately one hundred twenty nations and reporting jurisdictions require mandatory compliance of IFRS for domestic listed companies although approximately ninety countries have fully conformed to IFRS as promulgated by the IASB and include a statement acknowledging such conformity in their audit reports.[81]

3.1.1. Advantages for the adoption of IFRS

The benefit for adopting IFRS is uniformity on presentation of financial statements on the same pattern as its foreign competitors, it made comparisons easier for the stakeholders,

[79]<http://english.ymm.net/blogs/english/archive/2010/06/08/_3101_nternat_3101_onalf_3101_nac_3101_al-report_3101_ng-standards.aspx> (last accessed June 08, 2011).

[80]<http://www.justanswer.com/questions/22zoi-i-need-150-words-on-each-of-the-following-with-url-references> (last accessed May 10, 2010).

[81]<http://www.ifrs.com/ifrs_faqs.html> (last accessed December 09, 2010).

investors and authorities. Moreover, the companies with subsidiaries in different countries also need to convert to IFRS if they are a subsidiary of a foreign company that uses or requires the implementation IFRS, or if they have a foreign investor that must use IFRS, the adoption of IFRS is also beneficial if a company wants to raise capital from abroad.

3.2. Financial Reporting Standards prevailing in the World

International Financial and Reporting Standards are used in many parts of the world, including the European Union, Hong Kong, Australia, Malaysia, Pakistan, Russia, South Africa, Singapore and Turkey, as of August 27, 2008, more than 113 countries, including all of Europe, is requiring or permit IFRS reporting.[82] Approximately eighty five of those countries require IFRS reporting for all domestic, listed companies, additionally, the US is also gearing towards adoption of IFRS, the SEC is slowly but progressively shifting from requiring only US GAAP to accepting IFRS and will most likely accept IFRS standards in the long term.[83] The stance of Australia in this regard is somehow different from the other jurisdictions, "the Australian Accounting Standards Board (AASB) has issued Australian equivalents to IFRS (A-IFRS), numbering IFRS standards as AASB 1–8 and IAS standards as AASB 101–141."[84] The AASB has made certain amendments to the IASB pronouncements in making A-IFRS; however these generally have the effect of eliminating an option under IFRS, introducing additional disclosures or implementing requirements for not-for-profit entities, rather than departing from IFRS for Australian entities, accordingly, for-profit entities that prepare financial statements in accordance with A-IFRS are able to make an unreserved statement of compliance with IFRS.

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[82]<http://webcache.googleusercontent.com/search?q=cache:sNnB99V0c7IJ> (last accessed April 08, 2011).

[83]<http://www.ifrs.com/International_Financial_Reporting_Standards#Requirements_of_IFRS (last accessed December 05, 2010).

[84]<http://www.answers.com/topic/IAS> (last accessed July 10, 2009).

As far as the Indian jurisdiction is concerned, "the Institute of Chartered Accountants of India (ICAI) has announced that IFRS will be mandatory in India for financial statements for the periods beginning on or after 01.04.2011. This will be done by revising existing accounting standards to make them compatible with IFRS."[85] The government will come up with a separate road map for banking and insurance companies.

3.3. Financial Reporting Standards adopted in Pakistan

"The Institute of Chartered Accountants of Pakistan" (ICAP) is the accounting standards-setting body in Pakistan; it works closely with the apex corporate regulator (SECP), stock exchanges, the State Bank of Pakistan. In recent years, Pakistan has made significant progress in adopting and implementing IFRS for listed companies through joint efforts and close cooperation of the accounting profession and regulatory bodies.[86] The "Securities and Exchange Commission of Pakistan" and "The Institute of Chartered Accountants of Pakistan" agrees in principal that public entities should prepare their financial reports in conformity with the international financial reporting standards, to generate high-quality financial information which should be relevant, comparable, consistent and transparent in order to serve the required needs. Pakistan is on track and not too far away in achieving full IFRS compliance in the next two to three years, in line with the IFRS strategy approved by the Council of ICAP.[87]

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[85] <http://reference.canadaspace.com/search/International%20Financial%20 Reporting%20Standards> (last accessed August 28, 2010).

[86] <http://icap.org.pk/userfiles/file/Case%20Study%20Pakistan%20Final%.pdf> (last accessed October 21, 2010).

[87] Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting, *Trade and Development Board, Commission on Investment, Technology and Related Financial Issues* (Geneva: n.p. October 30–November 1, 2007) available at <http://www.unctad.org/en/docs/iteteb20075_en.pdf> (last accessed June 01, 2009).

The "Companies Ordinance", 1984 prescribes the basic requirements, which all the companies in Pakistan have to adopt while preparing their financial reports. The Ordinance requires the preparation, presentation and publication of financial statements, including disclosures and auditing of all companies incorporated in Pakistan. Additionally there exists various provisions regarding financial reporting, for instance the Fourth Schedule of the Ordinance lays down the form, content and certain disclosure requirements for preparing financial statements for listed companies, whereas the Fifth Schedule outlines the same for non-listed companies. The provisions of "Companies Ordinance" including the Fourth Schedule have already been revised in compliance with the requirements of IFRS. It is mandatory for holding companies incorporated in Pakistan that have subsidiaries to prepare consolidated financial statements in accordance with requirements of the IFRS notified by SECP.[88]

3.3.1. Process followed for the adoption of any reporting standard in Pakistan

The process followed for the adoption of any IAS/IFRS in Pakistan is that the "Institute of Chartered Accountants of Pakistan" (ICAP) considers and recommends each IAS/IFRS and recommends to the SECP for adoption. The IAS/IFRS are applicable to all companies in Pakistan.

The financial statements are prepared in accordance with the approved accounting standards as applicable in Pakistan. Additionally the requirements of Sec 234 Companies Ordinance,

[88]See, Section 234 of The Companies Ordinance, 1984 Law No. XLVII of 19849 *The Gazette of Pakistan, Extraordinary*, Islamabad, July 05, 1984. (Hereafter referred Companies Ordinance).

1984 should also be adhered to, while any such preparation. The approved accounting standards comprise of such IASs as are notified under the provisions of the Companies Ordinance, 1984. Each IAS / IFRS is reviewed by two regional Accounting Standards Committees and a due process of exposure to the members and other stakeholders is carried out prior to recommending adoption.[89]

The World Bank has made an assessment in 2005, focusing on accounting and auditing practices in Pakistan, after the assessment the World Bank commended Pakistan for making progress in bringing national accounting requirements in line with IFRSs, nonetheless, the World Bank, as well as the 2007 UNCTAD report, identifies certain hindrances to the full adoption of international standards in Pakistan. For instance, IAS 39 and IAS 40 have been held in abeyance by the "State Bank of Pakistan" due to resistance to adoption, World Bank also observed some other shortcoming including inadequacies in the technical capabilities of regulators, lack of implementation guidance for accounting and auditing practices, and weak professional training and education.[90]

3.4. The audit reporting requirements of Pakistan

All the listed public companies in Pakistan are bound to pass to shareholders quarterly and annual financial statements in addition to the stock exchanges and "Securities and Exchange Commission of Pakistan". It is also the requirements of the Ordinance that Directors' report to the shareholders on the company's state of affairs, recommendations for dividend, and other matters should be attached to the financial statements, but these need not be audited. A report

[89] Asad Ali Shah, "Status and Roadmap compliance with IFRS in Pakistan" (presentation delivered at Institute of Chartered Accountants of Pakistan, Islamabad, Pakistan n.d.) available at <http://www.iasplus.com/resource/0509wsspakistan.pdf> (last accessed April 25, 2011)

[90] <http://www.estandardsforum.org/pakistan/standards/international-financial-reporting-standards> (last accessed December 09, 2010).

on status of compliance with the "code of corporate governance" must accompany annual financial statements and such status should be reviewed by the auditors. The companies with subsidiaries are also required to publish consolidated financial statements. Waiver of reporting requirements are available, upon application to the SECP, when a company can prove that reporting certain information is either impractical or not in its interest.[91]

3.5. Concept of Independence of auditors

Independence is fundamental to the reliability of auditors' reports, any such report would not be credible; investors and creditors would have little confidence in them, if auditors were not independent.[92] The question how the report is independent or credible, for that purpose the auditor's opinion must be based on an objective and disinterested assessment of whether the financial statements are presented fairly, in conformity with generally accepted accounting principles.[93]

The Council of the "American Institute of Certified Public Accountants" (AICPA) in a statement adopted in 1947 expressed the independence in following manner:[94]

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[91] <http://www.kpmg.com.pk/services/service_audit_financial1.htm> (last accessed February 14, 2011).

[92] <http://www.weil.com/files/Publication/ba847eca-c129-47ba-be7d-9e25e1f397f5/Presentation/PublicationAttachment/1e91cefb-667a-4733-9321-9f727b784c78/WGM_Comparison_of_Corporate_Governance_Guidelines_and_Codes_of_Best_.pdf > (last accessed September 18, 2008).

[93] <http://www.scribd.com/doc/38685250/Role-of-Audit-in-Corporate-Governance> (last accessed 09.02.2011).

[94] Ibid.

Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature.[95]

The independence of the auditors can best be explained as: Auditor independence refers to the independence of the internal auditor or of the external auditor, the former means independence from parties whose interests might not be totally aligned with an effective risk management, whereas later Independence means independence from parties, having an interest in the financial statements of the entity. It is essentially an attitude of mind characterized by integrity and an objective approach to the audit process. The concept requires the auditor to carry out his work freely and in an objective manner. The code of ethics of the Public Accountant profession helps give guidance on independence from suppliers, clients, third parties.

3.5.1. How to maintain the Independence?

Independence can be seen from two perspectives; "independence in fact" (real independence) and "independence in appearance" (perceived independence), both these two perspectives are different from each other. The former "independence" refers to the "actual independence of the auditor, also known as independence of mind is the essential feature for forming the opinion, it relates to the state of mind of an auditor as to how he acts in a particular situation. An auditor who is independent 'in fact' has the ability to make independent decisions even if there is a perceived lack of independence present."[96]

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[95]John L. Carey, *The Rise of the Accounting Profession: The Responsibility and Authority, 1937-1969* (New York: Oxford University Press 1970), 182.

[96]Deborah L. Lindberg and Frank D. Beck, "Before and After Enron: CPAs Views on Auditor Independence." *The CPA Journal* available at

Conversely, the "perceived independent" is also of immense importance. "It is essential that the auditor not only acts independently, but appears independent too". If an auditor is in fact independent, but one or more factors suggest otherwise, this could potentially lead to the public concluding that the audit report does not represent a true and fair view. Independence in appearances also reduces the opportunity for an auditor to act otherwise than independently, which subsequently adds credibility to the audit report.

3.5.2. How auditor's independence is maintained round the globe?

To maintain auditor's independence, United Kingdom has placed various regulations. The auditor's independence is mainly maintained through various provisions of the "Companies Act" 1985 and the "Companies Act" 1989, additionally the matter is also covered by the professional accounting bodies, the rules of professional conduct and the auditing practices board. It is also of note that regulations (i.e. International Accounting Standards or International Financial Reporting Standards) relating to the preparation of financial statements are also applicable in UK". The "Companies Act" 1985 dictates that it is the responsibility of shareholders (rather than directors) to appoint the auditor at the annual general meeting (AGM).

In United States the rules regarding independence of auditors became more stringent after the collapse of Enron. The Sarbons Oxley act provided the establishment of a board called Public Company Accounting Oversight Board (PCAOB). The board consisted of five members out of which two is CPA (Certified Public Accountant) and remaining three belongs to general public, all the members are not working for profit and their term is five years. Every firm engaged in the function of "public company accounting" shall be registered with "PCAOB".

<http://www.nysscpa.org/cpajournal/2004/1104/essentials/p36.htm> (last accessed December 06, 2010).

For the purposes of registration a public accounting firm requires to submit a list containing the information of the issuers whose audit conducted by the audit firm in last one year and also contain information containing future clients; also to disclose the fee collected by the audit firm in last one year, list of partners/auditors working with the firm; and whether any civil/criminal proceedings initiated against the firm by the issuers, disagreement in disclosure between the issuers and firm in last one year, quality control policy of the firm. United States maintained the independence of auditors in the following manner;

1. It is unlawful for a director/manager of an issuer to force or try to mislead a Public Accounting firm to procure a favorable statement;
2. Registered Public firm which is providing accountant/audit services to an issuer shall not provide with the non-audited services such as;
    a. book keeping;
    b. broker services;
    c. legal services;
    d. management functions/human resource;
    e. Actuarial services.
3. Auditor's rotation the auditor shall not provide audit services to an issuer where such public accounting firms leading partner is providing for past five years such issuer with audit services. Any accounting firm providing audit services to an issuer shall report to the audit committee of the issuer such reporting shall relate to any or all accounting principles and practices being used by the public accounting firm.
4. An audit firm shall not perform the accounting services to the issuer if the CEO, CFO or person in similar capacity was employed by issuer and participated in the audit of the issuer one year from date of proposed initiation of audit.

3.5.3. How independence is maintained in Pakistan?

In company form of business, the capital required for the business was contributed by the shareholders and usually the shareholders are not managing the affairs of the company. Shareholders; the ultimate beneficiaries did not have any direct control over the company except that they elected Directors for a period of three years and entrusted the officers of the company to them in the hope that they would manage the company to their benefits. Practically however, shareholders had no control over the way their company was managed by the Directors appointed by them, it was, in circumstances necessary that there must be some arrangement in place whereby the share holders must get some independent view as to how the Directors have managed the affairs of the company.[97]

Companies Ordinance, in circumstances, had provided that shareholders should appoint an auditor, who would be responsible to audit the books of accounts and make out a report to them at the end of each year, this is the only safeguard provided by the law to the shareholders to ensure that the business was carried on by the Directors in accordance with sound business principles and prudent commercial practices and no money of the company was wasted or misappropriate.[98]

Law, in circumstances, had made auditors responsible in case to make out report in accordance with the legal requirement and it was, extremely important for the auditors to be vigilant and perform their duties and obligations with due care while auditing the accounts

[97]<http://www.secp.gov.pk/orders/pdf/Orders_05/july_25_Sarwars.pdf> (last accessed May 10, 2010).

[98]Ibid (last accessed September 08, 2009).

and books of account.[99] In order to promote the independence of audit functions, the legislature have incorporated provisions in "companies Ordinance". Auditors Independence is an essential requirement under the "Companies Ordinance" 1984. Law has provided two types of audit functions one is internal while the other is external audit functions. The earlier audit function is to be carried out by an audit committee which is the concept introduced by the "Code of Corporate Governance", which made it compulsory for Board of directors to establish an audit committee, the board is also responsible to made terms of reference for the audit committees. It is also mandatory requirement that the CFO, the head of internal audit and representative of external auditors shall attend the meeting. The other form of audit is prescribed in shape of external auditor; every listed company shall have an external auditor, appointed on the recommendation of the audit committee.

Regarding the maintenance of independence, the Ordinance provides that "an auditor cannot be a director or officer of the company, moreover he cannot be a partner or employee of a director or officer, or be indebted to the company."[100] A person cannot be acted as auditor of a company if he is a present of past director, officer or employee of the company during the preceding three years. The firm of external auditors, engaged in the auditing of a listed company or any partner of the audit firm and their spouse and minor children are prohibited to hold, purchase, sell or take any position in shares of the listed company or any of its associated companies or undertakings.[101]

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[99] 2008 Corp. L. Dec. 861 available at <http://www.secp.gov.pk/orders/pdf/Order030624B.pdf> (last accessed August 19, 2010).

[100] <http://www.kpmg.com.pk/services/service_audit_financial1.htm> (last accessed September 05, 2010).

[101] Ibid. (last accessed February14, 2011).

The concepts of audit committees have been introduced by the code of corporate governance issued by the "Securities and Exchange Commission of Pakistan" on March 28, 2002, prior to which there was no concept of audit committees in Pakistan. However, the compliance of the CCG is obligatory only for listed companies."[102] The CCG is also a part of Listing Regulations of all the three "Stock Exchanges of Pakistan." Unlike USA and India there is no statutory provision dealing with the audit committee in the Companies Ordinance of Pakistan. Similarly, unlike UK there is no role of SECP in Pakistan that mandate the presence of the Audit Committee in registered companies. In Pakistan the only document dealing with the Audit Committee is the CCG which is incorporated as it is in the Listing Regulations of the stock exchanges. The independence of the members of the Audit Committee increases its competence and efficiency.[103]

Companies Ordinance provides the powers and duties of the auditors, failure of auditors to perform their professional duties with reasonable degree of care and skill, international accounting and auditing standards, resulted in imposition of penalty. Section 255 of the Ordinance provides the powers and duties of an auditor whereas section 260 of the Ordinance provides the penalty for non-compliance with the provisions by the auditors. If the auditors had failed to design audit procedure in a manner so as to have enabled the discovery of violation and had failed to appropriately modify all the relevant reports. auditors in the present case had committed a breach of fiduciary duty cast upon them by the shareholders and had signed the audit reports otherwise than in conformity with the requirement of S.255

[102]Zahid Zaheer, "Enhancing Corporate Governance Standards in Commonwealth member countries in Asia: Country Paper Pakistan" (paper presented at Commonwealth Secretariat & Global Corporate Governance Forum, Maldives, June 17-18 2006).

[103]Mak Yuen Teen, *Improving the Implementation of Corporate Governance Practices in Singapore* (Singapore: n.p. 2007) available at <http://www.mas.gov.sg/resource/news_room/press_releases/2007/CG_Study%20_Executive_Summary_260607.pdf> (assessed July 20, 2008).

of the Companies Ordinance, 1984 and had committed a default in terms of S.260 of the said Ordinance---auditors having offered to co-operate with the Security and Exchange Commission in the legal course against delinquent management, they were only reprimanded.[104]

3.6. Conclusion

The need for presentation of financial reporting on uniform pattern has always been demanded by the decision makers and stake holders. The importance of presentation of financial reporting on the uniform pattern as of foreign competitors been, accepted & implemented by the majority of the countries, either they have adopted fully fledged IFRS standards or have amended / updated their internal existing standards. This uniform financial reporting helps the decision makers to analyze, understand and make quick & correct decisions.

Pakistan have the efficient financial sectors comparing the neighbor countries, implemented strict controls over implementation of financial (IAS) and reporting standards (IFRS) on uniformity as defined by relevant bodies. SECP and other accounting bodies are striving hard to implement full fledged standards and had issued guidelines in this regard. The strategy is to implement the standards in steps to full economy, at initial phase listed companies (inclusive of banking companies) are instructed to comply with these standards and report their financial data of the next coming financial period on the defined pattern. In next phase, SME sector reporting will be updated in accordingly. Accounting bodies are in process to

[104] 2008 Corp. L. Dec. 861.

prepare separate reporting standards for SME sector, keeping scenario of the current status of reporting for SME sector in Pakistan. ICAP's is ensuring the quality of reporting through its QCR program designed especially for continuous and sustained improvement and to maintain, enhance the reputation, and image of this prestigious profession. The authorities are closely monitoring the performance, implementation and arranging educative workshops, seminars, discussions to get realized the importance of unanimous reporting by the general public.

CHAPTER NO 4

RELATED PARTY AND SELF-DEALING TRANSACTIONS IN DIFFERENT JURISDICTIONS

4.1. Introduction

Over the last 20 years, both academic and practical approaches to corporate governance have increasingly focused on the problem of shareholders expropriation, sometimes also referred to as self-dealing or tunneling. The actors who control a corporation, whether they are Directors, managers, controlling shareholders, can use their power to divert corporate wealth to themselves rather than sharing it with the others. Various forms of such self-dealing include executive perquisites, excessive compensation, transfer pricing, appropriation of corporate opportunities, and self-serving financial transactions such as directed equity issuance or personal loans to insiders, and outright theft of corporate assets.[105]

4.2. Concept of related party

A party whether individual or a group, who is related in some way to other party, is called as a related party, for instance a family member or relative, stockholder, or a related corporation are common forms of related party. There are number of parties involves in corporate functioning which includes directors, shareholders, managers and creditors. The interests of all these persons are in conflict with each other. This includes conflict between shareholders

[105] <http://www.elsevier.com/wps/find/journaldescription.cws_home/505576/description#description> (last accessed December 10, 2010).

and directors and executives, and outsider's i.e. creditors.[106] As discuss in the first chapter, the prime function of corporate governance model is to control and minimize the situation of conflicted interest. For the sake of this research, the focus will only be on those financial transactions and their disclosure requirements that are executed between the management of a company and such transactions are in conflict with the interest of shareholders.

4.3. Related-Party transaction

"A business deal or arrangement carried on between two parties who are joined by a special relationship prior to the deal is called related-party transaction".[107] For instance, a business transaction between a major shareholder and the corporation, such as a contract executed between the shareholder and the company whereby the shareholder was assigned to perform renovations to the corporation's offices, would be deemed a related-party transaction. The parties in such sort of close and privileged relationships are called related parties it includes; the directors of the company; their immediate families and the companies they control.[108]

4.3.1. Self-dealing transaction

"Self-dealing transaction" is similar to "related party transaction" in a sense that in both the transactions there are chances of shareholder's miss-appropriation. A self-dealing transaction occurs when a director is on both sides of the same transaction, in such sort of dealing the director represents both the parties, on the one hand he represents the corporation and on the other hand he is representing another person, entity who is involved in the transaction or his own interest. Self-dealing may endanger a corporation because the corporation may be

[106]Paul Davis and others, *The Anatomy of Corporate Law*; *A Comparative and Functional Approach* (Oxford: Oxford University Press 2009), 21.

[107]Jing Chi, "Performance and characteristics of acquiring firms in the Chinese stock markets," *Emerging Markets Review* 12, no. 2 (2009): 152-170.

[108]<http://fido.asic.gov.au/fido/fido.nsf> (last accessed August 28, 2010).

treated unfairly viz-a-viz the other party, and the other party is benefited more as compared to the corporation.[109]

The self-dealing is the conduct of a trustee; an attorney; a corporate officer; other fiduciary character that consists of taking advantage of his position in a transaction; or anyone acting for his own interests rather than for the interests of the beneficiaries of the trust, corporate shareholders, or clients.

Self-dealing may involve misappropriation or usurpation of corporate assets or opportunities. In corporations self-dealing is treated as a form of conflict of interest between the shareholders and the Directors.[110] "Self-dealing transactions raise questions about directors' duty of loyalty, which is breached when the director puts their interest in front of that of the corporation."[111] Nevertheless, for very practical reasons, it is necessary to allow the directors to enter into self-dealing transactions, therefore; it is acceptable if a director makes a decision for the corporation that profits both him and the corporation. Following are the instances of self-dealing transactions:

a) Executive and directors Compensation;
b) Usurping Corporate Opportunity;
c) Disclosure to Shareholders;
d) Trading on Inside Information;
e) Selling out;
f) Entrenchment;

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[109] <http://answers.encyclopedia.com/question/selfdealing-transactions-358238.html> (last accessed August 28, 2010).

[110] <http://www.answers.com/topic/self-dealing-1> (last accessed October 02, 2009).

[111] <http://nonprofitboardcrisis.typepad.com/mbblog/2009/09/page/2> (last accessed April 14, 2010).

g) The key player's personal financial interests are at least potentially in conflict with the financial interests of the corporation.[112]

For the purposes of instant research I have chosen the first instance of "self-dealing transaction" i.e. the "Executive and Directors compensation". In the up-coming portion of the chapter the historical perspective has been explained, thereafter the strategies adopted in different jurisdictions to maintain check on any such self dealing transaction will be discussed, thereafter the situation of Pakistani law on the subject will be elaborated, a comparative analysis shall be made and in the end some suggestions shall be put forwarded.

4.3.2. Historical perspective of self-dealing and related party transactions

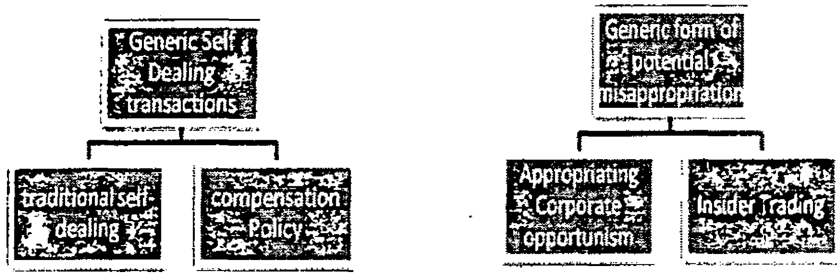

Fig No.2 Graphical representations of Self-Dealing transactions

The traditional approach[113] was that the directors and senior Management were forbidden to deal with their companies,[114] as they are like common law trustees and were enjoining too much discretion.[115] Thereafter the law generally allows it for practical reasons, the most

[112] <http://medlibrary.org/medwiki/Duty_of_loyalty> (last accessed May 03, 2009).

[113] Davis, *Anatomy of Corporate Law*, 101.

[114] Norwood P. Beveridge, "The Corporate Directors Fiduciary Duty of Loyalty: Understanding the Self Interested Directors Transaction," *DePaul Law Review* 45 (1996): 729.

[115] Lucian A.Bebchuk and Christine Jolls, "Managerial Value Diversion and Shareholder Wealth," *Journal of Law, Economics and Organization* 487 (1999): 15.

important of them is that, while dealing with outsiders, the companies would be forced to reveal their trade secrets.[116] When we said that law allows it, than it doesn't mean that there is no legal framework which is checking their transactions however these transactions are subject to legal rules. A company law typically regulates these types of managerial transactions.

In all such cases, the conflict of interest between companies and self- dealing directors and officers are presumed to be acute. Traditional "self dealing" transaction refers to purchase or sale of assets as when a director purchased land from his company, or a company guarantees a CEO's debt to a third party. It also refers "to transactions between the company and related parties of the directors or officers, such as their close relatives or family companies."[117]

Earlier, the UK law does not permit the directors to enter into any transaction when they may have a conflicting personal interest or a conflict with the interests of those they are bound to protect due to the fact that the directors are holding fiduciary character. However, the modern regulations permitted such transactions. Nevertheless, the permission is not absolute but conditional, conflicted contracts are permitted subject to advance disclosure to the shareholders, who then approve the transaction.[118]

4.4. Role of Law regarding self dealing transactions

What should be the role of the law in addressing corporate self-dealing transaction.? There are different views on the issue; some are of the view that the "law should do nothing, this

[116]Davis, *Anatomy,* 101.
[117]Ibid, 102.
[118]<http://www.economics.harvard.edu/faculty/shleifer/files/self_dealing.pdf> (last accessed May 17, 2009).

issue should be left on the market forces to counter whereas some others are of the firm view that the law should provide a mechanism to check such sort of transactions. As far as the first view is concerned; practically speaking no society uses this approach: the temptation to 'take the money and run in an unregulated environment is just too great. Conversely; while adopting the second view a society can prohibit conflicted transactions altogether: all dealings between a corporation and its controllers—or any other entity these controllers also control—could be banned by law. Yet no society finds it practical to use this approach either, because many instances of self dealing and related-party transactions actually make economic sense. So what do societies do.?[119] The societies formulated following guidelines to decide the related party and self dealing transactions;

(1) Who approves the transaction and in what manner?
(2) Whether the transaction needs to be disclosed, if so, then to whom such disclosure is to be made and in what manner?
(3) How the transaction's validity could be challenged?
(4) Access to information and discovery rights; and
(5) Fines and criminal sanctions.[120]

4.5. Decision Making Process while dealing with related Party and self-dealing Transactions in different Jurisdictions

There are different procedures/strategies adopted by the different jurisdictions to decide the transaction involving related parties to protect the interest of the shareholders; some of such strategies will briefly be explained here;

[119]Ibid.
[120]<http://www.elsevier.com/wps/find/journaldescription.cws_home/505576/description#description> (last accessed December 10, 2010).

1. Disinterested Board approval: The trusteeship strategy
2. Shareholders' approval: the right strategy.
3. Mandatory disclosure: the affiliation strategy.

4.5.1. Disinterested Board approval: The trusteeship strategy

The disinterested approval is a universally required for self dealing transaction.[121] A manager who wished to transaction with the company must receive consent form his disinterested superior.[122] Most jurisdictions made board review of conflicted transaction either mandatory or strongly advisable.[123]

Japan and most of continental Europe mandated approval by disinterested approval.[124] French law, which is stringent requires disinterested Board approval if the transaction is not ordinary and at market condition. There is certain limitation on board approval; certain companies are exempted from these rule e.g. smaller companies. The French law requires shareholders approval in such like situation. The United Kingdom makes shareholder approval of conflicted transaction as is default rule.[125]The US encourages interested managers to seek board approval thereafter; there is strong protection from Shareholder challenges.[126] The United States law declares it a business judgment therefore; it makes the transaction very strong protection.[127] In addition both UK and USA requires directors to disclose their

[121]Davis, *Anatomy*, 105.
[122]Ibid.
[123]Klaus J. Hopt, *Self Dealing and use of Corporate Opportunity and information: Regulating Director's Conflicts of interest* (Berlin: de Gruyter 1985), 285-289.
[124]An exception is Switzerland, which doesn't require so.
[125]Davis, *Anatomy*, 106.
[126]Ibid., 109.
[127]Ibid.

personal interests in company related transactions to the board. France mandates extensive discloser prior to seeking shareholders approval, which must frequently be done for interested transaction.

4.5.1.1. Remedies for Inadequate Approval

In all major jurisdiction the consequences of the inadequate board approval are two either to void the transaction or to compensate the company or any harm.UK is of the view that such transaction be treated as void while damages remedy appears to be favorable for USA. Japan and France takes a middle way and nullify the transaction if it backs board authorization and prefer a damage if defective authorization.

4.5.2. Shareholders approval; the right strategy

Shareholders, after all are the parties, who loose from the managerial opportunism. Outside directors are disinterested, while shareholders are the interested parties in preserving the corporate value. A principal alternative to disinterested board approval of conflicted transaction is shareholder approval.[128]

France appears to be the most optimistic jurisdiction about the value of shareholder approval of conflicted transactions. The law requires shareholder as well as disinterested board approval for all self dealing transactions that are not taken in the ordinary course of business and reflect market conditions. In addition, SA (public company) shareholders are entitled to a special report by the company's external auditor prior to their vote. However this is important to mention here that the law allows the shareholder consent ex post and require the board

[128]Ibid., 110.

approval ante post. Unlike timing the French law forbids conflicted managers to vote for approving their own transaction.

United Kingdom has traditionally submitted conflicted transactions with directors to shareholder consent, but now the rule is only for the "significant transactions" and for listed companies, director remuneration.[129] The UK law also allows the ratification of the transaction but only to protect directors from the liability claims.[130] In Germany, Japan and the US, traditional self dealing transactions are not subject to any shareholders approval, only some form of managerial compensation is require getting approval.[131] The Japan on other extreme from the French law permits the conflicted managers to vote for approving their own transactions.[132]

4.5.3. Mandatory Disclosure; the affiliation strategy

"Mandatory disclosure" is a form through which the shareholders got knowledge about the fairness of remunerations or otherwise. In the UK, the "Directors' Remuneration Report Regulations 2002 introduced a requirement into the old Companies Act 1985, the requirement to release all details of pay in the annual accounts. This is now codified in the Companies Act 2006."[133] Mandatory disclosure has certain advantages and disadvantages as well. The strategy of forcing the disclosure of related party has obvious advantage, at least if managers and executors of transactions are truthful.[134]The disclosure lowers the risk that

[129]Section 320-22 Companies Act, UK 2006 available at <http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf> (last accessed January 19, 2010).
[130]Davis, *Anatomy*, 111.
[131]For Germany see, sec 113 Aktiengezesetz; for Japan Art 269.
[132]Art 247(1) (iii) Commercial Code France.
[133]<http://en.wikipedia.org/wiki/Director_remuneration> (last accessed May 13, 2010).
[134]Davis, *Anatomy*, 105.

threats the share prices. Additionally, the disclosure or the culpable failure to disclose enforces the substantive restrictions on suspect transactions. Best of all mandatory disclosure impose virtually no constrains on legitimate self dealing, compensation contracts.[135]

On the other hand disclosure of related party transaction is costly if a general system of centralized reporting is not already in place. So far smaller companies; it is not clear that the benefits of disclosure outweigh the costs. An example is that smaller German and French compensations fail to make their accounts publicly available as required by EU law.

4.6. Compensation Policy of directors and Executives

There is a strong international trend to require disclosure regarding the remuneration of directors and executives of both publicly traded. Compensation policy of executives and directors is a classic example of "self-dealing" where the conflict of interest is most likely to occur. Excessive compensation was a key causal factor. The "scholar of Corporate Governance, professional auditors and the personals from regulator and legal profession expresses their concern about directors and executives remuneration packages". However "there are two philosophies addressing the issue, the corporate liberator: The "Irrational Quest for Charismatic CEOs", "Harvard Business School" professor "Rakesh Khurana" documents the problem of excessive CEO compensation; showing that the return on investment from these pays packages is very poor compared to other outlays of corporate resources. Conversely there exists another group that defends the high executive pay on the ground that the global war for talent and the rise of private equity firms can explain much of the increase in executive pay.

[135]Ibid., 105.

"Excessive executive pay, the Wall Street meltdown has demonstrated ever so vividly, endangers our public well-being as surely as any other pollutants."[136] Compensation agreements, technically a form of self-dealing, are unavoidable for companies and therefore less suspect. Nevertheless there is an obvious collusion among senior managers and the board in setting compensation levels. For example directors might oppose excessive compensation because they are richly compensated themselves, or because of their fear of losing their seats on refusal.[137]

Executive compensation is the most critical and visible aspect of a company's governance.[138] Executive compensation is the total pay or financial compensation a director of executive receives from a corporation. A normal executive would receive a basic salary, any and all bonuses, shares, options, and any other company benefit. Over the past three decades, executive pay has risen dramatically beyond the rising levels of an average worker's wage. Director Remuneration is an important part of corporate governance, and is often determined by a company's board of directors. The law adopts a wide range of legal theories / strategies in order to control "related party transactions" and "self dealing" by corporate managers as well as rules and standards to constrain managerial conduct.

Usually "the compensation committee governs the Executive compensation packages, which includes base salary, bonuses and stock awards, the compensation committee initially approves the compensation and also has the discretion to change the same."[139]

[136]<http://www.ips-dc.org/articles/unfinished_business_of_executive_pay_reform> (last accessed August 28, 2010).

[137]Ibid., 102.

[138]<http://trilliuminvest.com/resolutions/say-on-pay-filing-at-unitedhealth-group-inc> (last accessed August 29, 2010).

[139]<http://www.cii.org/resourcesKeyGovernanceIssuesExecutiveCompensation> (last accessed August 29, 2010).

4.7. Compensation Policy in different Jurisdictions

In the following pages I shall discuss as to how different countries round the globe looks at the compensation Policy, thereafter the position regarding Pakistan shall be discussed in detail.

4.7.1. U.S.A

The United States disclosure regime is one of the most comprehensive disclosure regimes in the world and has served as a model for numerous other countries in developing their own disclosure regimes. The shareholders in USA showed their great concern regarding the increased executive compensation. The "US "House of Representatives" passed "The Shareholder Vote on Executive Compensation Act" (HR 1257) by a vote of 269-134. Democratic Representative "Barney Frank" of Massachusetts, Chairman of the "Financial Services Committee" sponsored the bill". The "bill requires that companies give shareholders a yearly non-binding advisory vote on their executive compensation packages. It also requires companies to offer an additional non-binding vote if the company offers a new gold parachute package as they simultaneously negotiate the purchase or sale of the company. The bill had little Republican support and survived a number of Republican attempts to amend, including an amendment that would have taken away the shareholder's advisory vote if the company was within 10% of the average of like companies. In 2006, the SEC changed its disclosure laws on executive pay, requiring companies to disclose to shareholders their executive compensation practices."[140]

The "Emergency Economic Stabilization Act of 2008 requires the shareholder approval of executive compensation during the period in which any obligation arising from financial assistance provided under Troubled Asset Relief Program remains outstanding."[141] The

[140]<http://www.socialfunds.com/news/article.cgi/2284.html> (last accessed August 29, 2010).

[141]It is a program of the United States government to purchase assets and equity from financial institutions to strengthen its financial sector that was signed into law by U.S. President George W. Bush on October 3, 2008. It was a component of the government's measures in 2008 to address the subprime mortgage crisis.

separate shareholder vote would only be required on executive compensation and to briefly explain the general effect of the vote, such as whether the vote is non-binding. However the new rules do not require smaller reporting companies to include a compensation discussion and analysis section in their statements.

The SEC has promulgated new disclosure rules for, publicly traded companies listed on a national stock exchange, according to the said rules, all the companies need to disclose detailed information regarding the remuneration of all directors as well as the Chief Executive Officer, Chief Financial Officer and the three other most highly paid officers. The rules generally require three types of disclosure of executive remuneration paid or earned during the prior year:

(1) Tabular disclosures regarding executive remuneration and director remuneration;

(2) Narrative description of other types of remuneration and any information material to an understanding of the tabular information; and

(3) A Compensation Discussion and Analysis ("CD&A").

The information required to be included in the tabular disclosures for executives includes information for the three preceding fiscal years regarding yearly salary, bonus remuneration, remuneration in the form of equity awards, and remuneration that is deferred. These tabular disclosures must be accompanied by narratives that are to "provide a narrative description of any material factors necessary to an understanding of the information disclosed in the tables.

The largest recent change in disclosure requirements for public companies in the United States was the addition of a requirement that a company's annual proxy statement must include, generally as of December 15, 2006, a CD&A which is to discuss "all material elements of the [company's remuneration] of the named executive officers." The SEC has indicated that a company must address six items in its CD&A: (i) the objectives of the company's remuneration programs; (ii) what the remuneration programs of the company are designed to reward; (iii) what is each element of remuneration; (iv) why the company chooses to pay each element of remuneration; (v) how the company determines the amount for each element of remuneration; and (vi) how each element of remuneration and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements of remuneration.

Beside the "non-binding advisory vote on compensation issue", "mandatory disclosure" is the most significant control in the content of public companies in USA which has most strength disclosure requirements. US securities law requires all companies, USA[142] or Foreign,[143] that trade in the USA, to disclose annually all compensation paid to their top five managers. The US SEC adopted a new compensation disclosure rules to take effect on December 15, 2006.[144] "These rules build up on the existing approach to compensation disclosure, by broadening the amount of information required."[145]The U.S. "Securities and Exchange Commission" (SEC) requires the publicly traded companies to disclose more information explaining how their executives' compensation amounts are determined. The SEC has also posted compensation amounts on its website to make it easier for investors to compare compensation amounts paid by different companies.

The Security Exchange Commission proposed a set of rule revisions intended to improve the disclosure provided to shareholders of public companies regarding compensation and corporate governance matters when voting decisions are made. These new disclosures are designed to enhance the information included in proxy and information statements, and would include information about:

a) The relationship of a company's overall compensation policies to risk,

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[142]See, SEC Regulations, Item no 402 (Executive Compensation).

[143]Louis Los and Joel Seligman, *Fundamental of Securities Regulation* (USA: ASPEN 2001), 181-90.

[144]See, Scurrilities and Exchange Commission, "Final Rule on Executive Compensation and Related Party Disclosure" available at <http://www.sec.gov/rules/final/2006/33-8732a.pdf> (last accessed January 26, 2010).

[145] Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting, *Trade and Development Board, Commission on Investment, Technology and Related Financial Issues* (Geneva: n.p. October 30-November 1, 2007) available at <http://www.unctad.org/en/docs/iteteb20075_en.pdf> (last accessed June 01, 2009).

b) The qualifications of directors, executive officers and nominees,

c) Company leadership structure.[146]

4.7.2. EU Jurisdiction

The USA is demanding stringent public disclosure, conversely EU requirements as distinct from the law of EU Members status, are less so. Listed companies in the EU need only disclose annually the aggregate compensation of directors and senior executive's. EU acting law generally allows companies to remain shy about transaction with its offices and directors. However there are changes coming in the way according to those the EU companies that are regulated by EU markets will have to disclose to Internationals accounting Standards from 2005.[147] The EU commission is also likely to recommend that listed EU companies disclose the details of remuneration of individual directors. In addition, various members' status goes beyond the EU member's disclosure requirements. The "French Clement-Breton law enacted in July 2005 and enforced in 2006, create a binding simply majority role at AGMs for management directors retirement scheme."[148]

The commission understand that director remuneration is one of the key area where executive director may have a conflict of interest and where due account should be taken of the interest of the shareholder. Although the European Commission on December 14, 2004 made certain recommendation to the member states for appropriate legislation, but the response of the members is very low in this aspect. The Commission provides a wide range of strategy to address the issue. The Commission recommended that the form, structure and level of directors' remuneration are matters falling within the competence of companies and their

[146]<http://www.sec.gov/news/press/2009/2009-147.htm> (last accessed July 05, 2009).
[147]EU Regulation on the application of International Accounting Standards [2002] OJL 243/1.
[148]<http://www.proxin.fr> (last accessed February 26, 2010).

shareholders. The commission principally agrees that appropriate process of setting executive director remuneration requires that executive directors have no involvement whatsoever in setting executive remuneration. Instead it should be left on the shareholders or the non-executive directors. Further the shareholders should be able to vote on the remuneration policy and any material change on it, whether in an advisory or binding capacity.

4.7.3. JAPAN

Japanese disclosure requirements are less stringent than those in US; however are more demanding then EU minimum requirements.[149] Japan only requires the disclosure of the value of aggregate director's compensation (distinguish between inside and outside directors, not the ten of individual compensation package.[150]

4.7.4. United Kingdom

The United Kingdom has the most extensive set of disclosure requirements with respect to management compensation in Europe. Under the Companies Act 2006 and the UK Listing Rules, the UK requires publicly traded companies listed on a national stock exchange to disclose executive compensation in their annual reports. The disclosure regime requires the disclosure of salary, fees, bonus benefits, pension and long term incentives in a tabular format. Most notably, the United Kingdom requires a vote of the shareholders to approve the remuneration report. This is a level of disclosure that is not prevalent in the rest of the world but has been cited as "best practices" for listed companies in Europe.

UK and Austria now require corporations to put remuneration committee report to an annual non binding vote. The position of UK addressing this issue is a bit different from the EU's requirements. According to Cadbury report 1992, which address the issue of executive

[149]Davis, *Anatomy,* 104.
[150]See, Art. 103 (1)(x) and 107 (1)(xi) MOJ Ministry of Justice Commercial Code Regulation.

remuneration as: Executive remuneration should be subject to the recommendations of a remuneration committee made up entirely or manly of non-executive Directors.[151]

Similar recommendations were made by the Green bury report,[152] the important part is that the report is solely addressing this issue of directors remuneration, according to them report there should be established a remuneration committee; entirely consistent of non-executive directors" and this is the duty of the committee "to determine the remuneration of directors and CEO". While considering the recommendations of the two reports mentioned supra combine code was incorporated in 1998, thereafter a review was made in 2003 by Higgs Report[153] and number of changes was recommended following which Revised Combined Code was incorporated in 2006. Through a recent amendment all companies of UK, are required to submit the report of the company's remuneration committee and the report must identify each director and specify his complete compensation package.

4.7.5. Australia

Australia has made its own regulations to address the challenges of the "executive compensation." The pressure of the society has mounted to adopt a transparent way to determine the CEO compensation; therefore in the "late 1980s disclosure regulations required executive salaries commencing at $85000 and in each successive $ 10000 band should be disclosed". Through the 1990s "the pressure on disclosure has continued culminating in the 1998 "Company Law Review" Act, which focuses on the composition and relationship of executive pay to organizational performance." "The paradox of this process may be that it

151 Cadbury Report.
152 See, Greenbury Report, UK.
153 See, Higgs Report.

invokes a 'domino effect' where CEO compensation becomes focused on comparative data as a source of benchmarking rather than company performance."[154]

4.7.6. TCL approach about compensation issues

"The Corporate Library TCL, a governance analysis firm that provides information on corporate issues including corporate pay issues, supports a non-binding vote on executive compensation at publicly listed companies. "Paul Hodgson", a Senior Research Associate for TCL, told Socialfunds.com."[155] If the executive compensation bill is signed into law, it will require investors to have a greater understanding of compensation policy in order to be able to make informed, intelligent voting decisions. It will also require institutional investors actually to think about compensation and its implications for value growth and investment and not simply vote with management as happens too often, "Hodgson said": "United for a Fair Economy (UFE) a non-profit, nonpartisan organization that works for greater economic equality and to build awareness that concentrated wealth undermines democracy, has written an annual executive excess report for the past ten years."[156]

It used to be a big deal when one of the major papers or magazines would write about CEO pay, said "Mike Lapham, project director of the Responsible Wealth project at UFE." Now it is part of the mainstream public conversation. People are starting to realize that most of the economic gains of the past two decades have gone to those at the top, and CEO pay is one of the most egregious examples of this. When people see $50 million pay packages for executives while their wages are relatively flat, they get mad.

[154]<http://www.utas.edu.au/mgmt/wps/wps_files/20_05pap.pdf> (last accessed March 22, 2011).

[155]<http://www.sirp.se/web/page.aspx?pageid=48409&newsid=22529&page=63> (last accessed July 20, 2010).

[156]Ibid.

"People concerned about the discrepancy of earnings between CEOs and other workers have long called for companies to be transparent around how they award top wages. Shareholders, pension and mutual funds, including the California State Teachers' retirement System (CalSTRS) and the Interfaith Center on Corporate Responsibility (ICCR), have been working for years to have a say on how executives are compensated."[157]

4.8. Compensation Policy under Pakistani laws

Directors' compensation is now universally recognized as a key component of "Board efficacy". "Pakistan Institute of Corporate Governance" (PICG) recently conducted a survey on the compensation policies of Board of Directors in Pakistan in relation to Corporate Governance practices. The study is based on 2008 compensation data submitted by both listed and unlisted companies from the major business industries in Pakistan. The findings indicate that compensation of Directors in Pakistan is considerably low compared to international standards. A majority of companies do not pay their Chairperson a higher amount for attending board meetings and Director Liability Insurance cover is provided by only a few of responding companies. Furthermore, none of the companies provide stock options to their nonexecutive Directors; these are some of the major findings discussed in the annual study of directors' compensation and board practices released by the Pakistan Institute of Corporate Governance. The report has been developed as a reference tool wherefrom future compensation policies can be developed.[158]

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[157] <http://www.socialfunds.com/news/article.cgi/article2284.html> (last accessed November 19, 2008).

[158] Pakistan Institute of Corporate Governance (PICG) conducted a survey on the compensation policies of Directors of Boards in Pakistan in relation to Corporate Governance practices. The study is based on 2008 compensation data submitted by both listed and unlisted companies from the major business industries in Pakistan.

The Companies Ordinance 1984 hereinafter referred as Ordinance, is the substantive provision that deals with the issue of Directors/Managers remuneration,[159] which is reproduced as follows;

(1) Restrictions on Directors remuneration of the director performing extra services including the holding of the office of the chairman, shall be determined by the directors or the company in general meeting in accordance with the provisions in the company' articles;

(2) The remuneration to be paid to any director attending meetings of the directors or a committee of the directors shall not exceed the scale approved by the company or the directors, as the case may be in accordance with the provisions of the articles.[160]

In addition to section 191 of the Ordinance, there is another section that provides the procedure with regard to the remuneration packages of the directors and Chief executive officers. Section 218 provides that it is mandatory to disclose to the shareholders about the directors interest in the contract appointing chief executive, managing agent or secretary.[161] This disclosure is only necessary when "any director of the company is in any way, whether directly or indirectly, concerned or interested; or varies any such contract already in existence. In such eventuality the company shall make out and attach to the report[162] an abstract of the terms of the appointment or contract or variation, together with a memorandum clearly specifying the nature of the concern or interest of the director in such appointment or contract or variation. The abstract and the memorandum shall be sent to every

[159] See, Section191 of the Companies Ordinance, 1984.

[160] <http://www.secp.gov.pk/corporatelaws/pdf/CompaniesOrdinance984-17-03-2011.pdf> (last accessed May 20, 2011).

[161] Ibid.

[162] <http://www.pcp.org.pk/PDF/Comp_Ord1984.pdf> (last accessed October 26, 2009).

member of the company within twenty-one days from the date on which the director becomes so concerned or interested.[163]

The Ordinance also impose another condition of the appointment which says that all contracts entered into by a company for the appointment of a managing agent, chief executive or secretary shall be kept at the registered office of the company; and shall be open to the inspection of any member of the company at such office; and extracts may be taken therefrom and certified copies thereof may be required by any such member, to the same extent, in the same manner and on payment of the same fee. If any "default is made in adopting the procedure, then the company and every officer of the company who is knowingly and willfully in default shall be liable to a fine which may extend to five thousand rupees."[164]

Looking at the practical side, we came across that Pakistani companies have adopted different procedures to address the issues of remunerations of directors and executives. World Call Telecom Limited established an Executive Committee which was assigned the task of setting the remuneration packages of the directors. The members of the executive committee are other then the members of Board of Directors. The executive committee shall also assign with the task to "determine the structure of remuneration packages of the senior management. The executive committee also makes recommendations to the board regarding the content of Boards annual report to the shareholders on director's remuneration including the company's policy on executive's director's remunerations, details of individual remuneration and other terms and conditions. The chairman of the committee shall attend the Annual General

[163] <http://www.mca.gov.in/MinistryWebsite/dca/actsbills/pdf/Companies_Act_1956_Part_1.pdf> (last accessed March 03, 2009).

[164] Ibid.

meeting to answer shareholders questions on remuneration issues."[165] However it is important to state here that the company is following this procedure referring to "Schedule 7A of the Companies Act" 1985 and the UKLA Listing Rules. The other larger companies mostly followed the BOD approval for setting the remuneration packages "Oil and Gas Development Company Limited" decides the remuneration of the board through a specific remuneration committee and it does not requires the shareholders approval for this. "Pakistan Telecommunication Company Limited" (PTCL) also decided the remuneration through Board of directors and does not require the shareholders approval.

The provisions referred supra gave some idea about the remuneration packages of directors, chief executives etc however the provisions does not provide with any idea as to how the remuneration is determined for the directors, this sections only deals with limited event such as when the director perform extra services. However their normal remuneration package is not the subject matter of the section, but it has to be dealt in accordance with the companies articles, so the articles shall have the reference as to how the same is to be decided, the board of directors or the AGM.[166]

4.8.1 Precedent law on the remuneration issues

Looking at the precedent laws on the subject, the latest judgment in field is Platinum Insurance Company Ltd versus Director (Insurance) SECP.[167]

Precisely stated the facts of the case are that on examination of annual accounts for the year

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[165] <http://www.burberryplc.com/bbry/corpres/corpgov/terms_remuneration_committee.pdf> (last accessed October 13, 2010).

[166] Nazir Ahmed Shaheen, *A Practical Approach to the Companies Ordinance*, 1984 (Rawalpindi: Federal Law House, 2007), 597.

[167] 2010 Corp. L. Dec. 1190.

ended 31-12-2008, it transpired that the is Platinum Insurance Company "Company" has not disclosed the change in the terms and conditions which have affected the remuneration of the "Chief Executive Officer" ("CEO") in the "Directors' Report" annexed to the Accounts. The remuneration increased by 222 per cent i.e. from Rs.157,500 in 2007 to Rs.350,500 in 2008, and the nature and terms and conditions were not reported in the "Directors' Report", as required under section 218(1) of the Ordinance. Thereupon "Show-cause notice" was issued to the "CEO and Directors" of the company. The Company submitted its reply. Thereafter the response passed the Order and imposed penalty of Rs.5000 on the Company.

The company have assailed the order under "section 33 of the Ordinance" and argued that the remuneration of the CEO had not increased for the last eight (8) years and the CEO was drawing Rs. 157,500 since 2002. The increase in remuneration in the year, 2008 was on account of one time allowance and the contract of employment of CEO was not varied, therefore, "section 218 of the Ordinance" is not applicable. It was further argued that the increase in remuneration was backed by the resolution of "Annual General Meeting" ("AGM"); therefore, the spirit of section 218 of the Ordinance has been fulfilled.

The respondent contended that section 218 of the Ordinance applies in the instant case as all payments made to the CEO, whether one time or on regular basis, must be in accordance with the terms of service of the CEO. It was argued that the increase in remuneration was not disclosed in the Directors' Report as required under section 218(1) of the Ordinance. Further, any reference to the fulfilment of the spirit of section 218 is irrelevant as the appellant was required by the "Ordinance" to do a particular thing in a particular manner i.e. in accordance with section 218 of the Ordinance.

After hearing the arguments of both the parties, the bench conclude that the provisions of the Ordinance clearly states that where there is any variation in a contract of appointment of the

CEO, an abstract of the variation shall be attached to the "Directors' Report" together with a memorandum clearly specifying the variation. Further, the company is required to send an abstract of the variation in terms to every member of the company within twenty one (21) days from the variation in the contract. The bench also observes that it is not willing to accept that mere mention of the remuneration in the Directors' Report fulfils the requirement of section 218 of the Ordinance and also not willing to accept the resolution of AGM, which cannot substitute the requirements of the aforesaid section. Resultantly the appeal was dismissed.

Another case law reported on the subject is of Messrs General Tyre And Rubber Company Of Pakistan Limited.[168] The Enforcement Department, while examining financial statements of the Company for relevant year, noticed that remuneration of Chief Executive of the Company had been increased from Rs.4.059 million to Rs.6.330 million without intimation to shareholders as per requirements of subsections (1) and (2) of S.218 of the Ordinance. The Representatives of company, in response to show-cause notice, contended that there was no major variation in the existing terms of appointment of Chief Executive and it was a normal annual increase. The bench observes that more than 50% increase having been made in the remuneration of the Chief Executive, representatives were asked to provide documentary proof i.e. contract evidencing such a huge increase as annual increment, but they failed to do so and finally admitted that company had made default of provisions of S.218 of the Ordinance, 1984. Default was established, however, keeping in view company's past track record, lenient view was taken in the matter, instead of imposing fine of Rs.5, 000 each on company and its Secretary, fine of Rs.5,000 was imposed on the Company only.

[168]2006 Corp L. Dec 1060.

With regard to the strategy adopted by Pakistan in respect of compensation packages of the directors and executives, we came across that the Pakistani law is following the concept of shareholder approval by adopting the concept of mandatory disclosure under section 219 of the Ordinance, but practically speaking this is not adopted properly, all the transactions are considered to be the day to day affairs of the company; therefore; they are subject matter of the approval of the "board of directors". Similarly there is no concept of any committee which decides their remuneration as we found in UK. As stated earlier, when the responsibility is left on the managers then there are chances of collusion. So in my view there is a strong need that the executive and directors remuneration should be made a part of mandatory disclosure and be also subjected to shareholder approval.

4.9. Conclusion

After the complete research of the topic, it is crystal clear that the financial disclosure requirements, relating to self-dealing transaction, focusing on directors and executives remunerations, as provided in Pakistani law, are not according to International standards. Due to less stringent regulation, the corporate governance structure is not producing the required results such as transparency, accountability, and containing conflict of interest between the management and shareholders. There are number of suggestions/strategies that could be employed to organize such sort of transaction. Some of the suggestions are as follows;

a) Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.[169]

b) An independent and transparent manner should be applied for setting up the remuneration and compensation packages for directors and executives. This could be made in two ways; either it should left on shareholders to decide the remuneration package of each director or a remuneration committee was established, consisting upon Independent non-executive directors. Notably, no director should be involved in deciding his or her own remuneration. [170] The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management.[171]

c) From the strategic and control perspective, the compensation plans and salary packages should be placed before the shareholder for approval the reference could be drawn from the US practice where it works efficiently.

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[169]<http://www.weil.com/wgm/cwgmhomep.nsf/Files/CorpGovGuide_Am_Eu_As_Af/$file/CorpGovGuide_Am_Eu_As_Af.pdf> (last accessed July 14, 2010).

[170]<http://freerisk.org/wiki/index.php/Executive_compensation> (last accessed September 22, 2009).

[171]<http://aci.kpmg.com.hk/docs/CG%20in%20HK/aci_rev_comb_code18.pd> (last accessed January 31, 2008).

d) The concept of Mandatory Disclosure could be a good addition in the Companies Ordinance, whereby it should be made compulsory for the companies to disclose the salaries/remuneration packages for the Directors and Executives. This could be a good tool for the stakeholders by using which they could decide whether or not the remuneration is fair. Reference could be made to UK where such practice is adopted in shape of the Directors' Remuneration Report Regulations, 2002 said regulation is now codified in the Companies Act 2006 similar requirements also exist in most countries, including the U.S., Germany, and Canada.

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