VALUE DYNAMICS OF CORPORATE GOVERNANCE

BY

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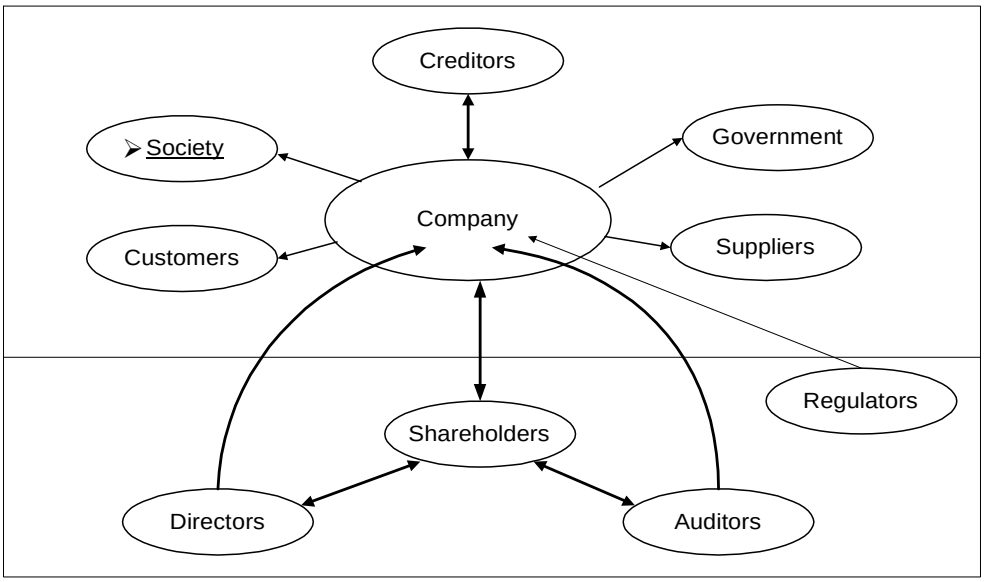
"Corporate Governance is……..holding the balance between economic and <u>social</u> goals……. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources…… The incentive to corporations is to achieve their corporate aims and to attract investment. The incentive for <u>states</u> is to strengthen their economics……..." (Sir Adrian Cadbury – 1999)

<u>VALUE DYNAMICS</u>

Value dynamics of corporate governance is progressive increase in value creation through the corporate culture developed from time to time - that is the Stone Age to the Iron Age and then the Agriculture, Industrial, Technological phases leading to what is known as the Knowledge Age.

In the context of an organization, the stakeholders who contribute to the value dynamics of a strong corporate culture include customers, employees, shareholders, suppliers, creditors, the government and the society at large. In order to strengthen and sustain good corporate practices, the shareholders directly and through the board of directors guide and support managements to follow such practices. This is complimented by the regulators and the auditors who play the pivotal role to enforce the law and the rules in letter and spirit, briefly explained in the following table:

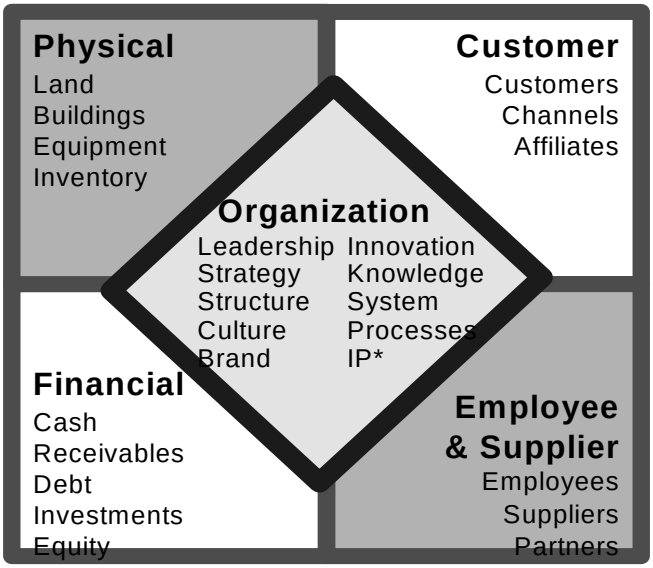
Constituents of Corporate Governance - Major Stakeholders



A good corporate culture aims to maximize the efficiency of its resources. Thus, ideas and objectives developed within an organization need strong leadership to carry them through. A well thought out strategy needs to be executed through a structure with an all pervasive culture. In the current environment, the organizations have to be in step with both current knowledge and anticipated changes, relying on innovation wherever possible with commitment and effort to be ahead of their competitors. All this can however only happen if they employ the latest and the most efficient system processes and guard their intellectual property rights.

Around all these intangibles are the tangible assets of the company comprising of its customer base and the channels through which these customers are serviced. These channels may take the form of associates and affiliates who need to be influenced in order to follow the best corporate practices as well. Other elements of an organization are its employees and its suppliers or business partners. Their behavior and actions are extremely important in that they reflect the culture of the organization and help in setting the standards to be followed.

Value Dynamics Detailed Framework - Most Significant Assets



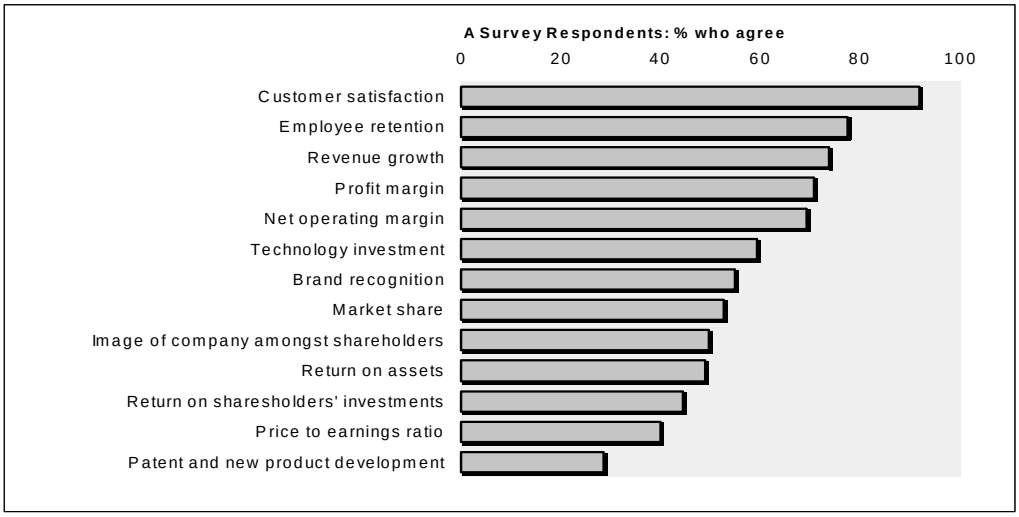
In seeking the best corporate culture that maximizes the potential of companies there are certain aspects which may be invisible at first sight but are extremely valuable in promoting good governance. This implies awareness and understanding of a company's customer base, its employees, its supply chain, its shareholders, its systems and processes and most importantly its leadership qualities and values. The success of the company is in proportion to its investment in a corporate culture which nurtures values inherent in such a culture.

McKENZIE CRITERIA

The McKenzie criteria determines that the company's strategy and its structure are considered urgent short term priorities with systems although being urgent, are of a long term nature. Likewise staff and style are vital in the short term but shared values and skills are equally vital in a longer term perspective. On the other hand, the BCG model identifies the correct positioning of a company with reference to the industry growth and its corresponding market share.

In order to achieve sustainable value creation an organization needs to continuously focus upon its business model, devise ways and means to master risks associated with it, effectively manage the asset portfolio so created and lastly fairly measure and report all its assets. In dealing with risk there are inherent uncertainties. All strategies entail risk and operational processes need to have built in tools to counter these risks through information. Business risk models define sources of uncertainty such as environmental, process and information for decision making. These cover the viability of the business model, its execution and relevance and reliability of information used in decision making. In this respect, a general survey conducted to determine the ranking of performance measures rated *customer satisfaction* as the highest indicator of a good corporate culture. This was followed by employee retention, revenue growth, profit margin, technology investment and brand recognition.

Performance Measures For Decision Making



GLOBAL VALUE DYNAMICS

People around the globe are more connected to each other than ever before. Information and money flow more quickly than ever. Goods and services produced in one part of the world are quickly available in all other parts of the world. International travel and communication is more frequent and commonplace. This phenomenon is best known as "Globalization". The new economy is founded upon the forces of new technologies, globalization and increasing importance of intangible assets, such as, brands,

relationships and knowledge. Globalization refers to one world concept with world citizenship mind set. The growing integration of societies, politics and economies is fast turning the world into a frontier less society.

Globalization and free trade has been a major challenge for the developing countries. In order to combat these challenges, the focus of developing economies has been on the economy of scale. The economy of scale demands quality of management, products and services, which results in lower cost. The economy of scale can be ensured by providing investment incentives and safeguarding the economy against dumping, under invoicing, smuggling and unfair competition from the developed world and moreover from some of the fast developing countries like India and China, which have different rules of the game for themselves and for the rest of the world. Without protection, neither industry nor any trade of any magnitude will develop with India and China as the leading examples of the approach which resulted in their achieving tremendous growth by providing right kind of incentives and protection to their indigenous industries.

MULTINATIONAL VALUE DYNAMICS

On the other hand, the role of the international finance institutions, such as, the World Bank, IMF and others is quite opposite to this. They are charged with developing the world economy only and not of any of their client states. An IFI, for example, once, recommended that we "Phase out existing industries which are internationally uncompetitive – steel, refineries, fertilizers, chemicals, pharmaceuticals, engineering and sugar, imposing high cost on the Pakistan economy" (Dawn 23.04.02), a report reportedly prepared at the request of the Ministry of Commerce and Industries, Government of Pakistan, for reasons only known to them. As if, it was not enough, the same IFI further recommended to fill in the temporary gap in supply and demand of automobiles and parts through import of reconditioned automobiles and used parts in addition to import of reconditioned machinery and equipment and other engineering goods in order to provide jobs to artisans, mechanics and minor illiterate apprentices learning repair works. They recommended further reducing the incentive for the indigenous industries.

What is then left! One wonders why such reports prepared by those who do not understand the genesis of the national economy and the aspirations of the people mostly poverty stricken as they are and the ever growing size of the so called "reservoir of the unemployed, both the educated and the illiterates". It is in this context that Prof. Sen, a Nobel Laureate from India, emphasizes that IFIs policies must be dovetailed with national interests that India does and Pakistan does not! And the World Bank President also says: "Gone are the days when development can be done behind closed doors in Washington or western capitals or any capital for that matter". Where does lie the contradiction then! Whatever the case, development of country's economy is its own responsibility in all circumstances and of none else!

PROSPERITY OR POVERTY!

In this context, safeguarding the indigenous trade and industry from dumping, under-invoicing and smuggling is imperative, as is safeguarding it against the multi dimensional WTO which stands for world trade and industry, and not for any individual country. This means that incentives have to be provided to promote investment, protect indigenous industry and generate employment.

The World Bank, IMF and WTO can no longer hold their meetings peacefully anywhere in the developed or developing world with Washington and Prague as examples. This is because they have failed to address the main issue of poverty alleviation. Whether, the World Bank has encouraged prosperity or increased poverty is a question being asked. About Pakistan, the World Bank President, Mr. Wolfensohn, himself says, "While poverty has grown in Pakistan over the past decade, the proportion of people living in extreme poverty globally has been reduced by half, over the past 30 years". He further says "1/3rd of world population lives on $1 to $2 a day and that there were five billion people in developing countries and one billion in the developed world but it was the developed world that held over 80 percent of the world's wealth" (Dawn 26.5.04).

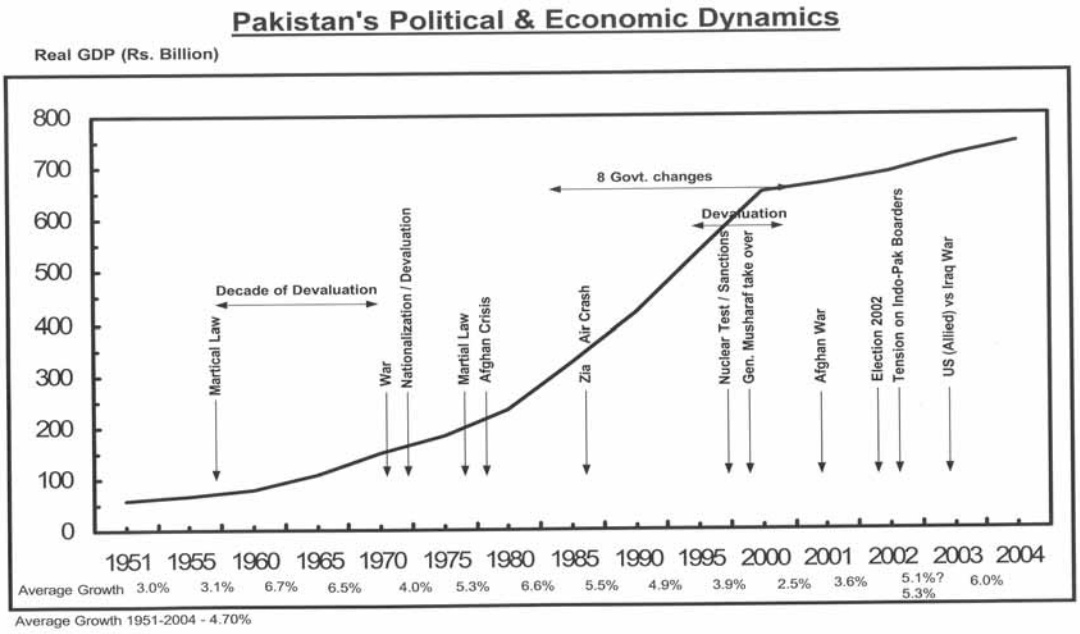
About the IMF, Michel Camdessus, says: "……. its concept, systems and practices must be reviewed", while Stiglitz, former World Bank advisor and Novel Laureate says, its "Policies (are) made elsewhere…." and that "country reports are prepared in 5 star hotels rather than on ground realities – under influence reports - not in harmony with local expectations…". George Shultz, William Simon and Walter Wriston say **"**Abolish IMF".

According to the Economist, WTO represents "1000 largest corporations or 0.01% of the richest corporations and individuals in the world control 4/5th of the world's industrial output. The last decade saw an increase of wealth of 70% to 85% in the richest 20 countries as against 2% decline in the 20 poorest countries of the world."

France, Japan, India and Malaysia's experience have proven IMF/WB wrong. Contradictions in terms of the application between developed and developing countries challenges the creditability of the process. It thus falls in the realm of individual countries and none else to protect their interests. Even the developed world – USA – and regional alliances, such as, EC and NAFTA, which are now the world's leading protected markets are glaring examples of nationalism, regionalism and protectionism in direct contrast to globalization.

PAKISTAN VALUE DYNAMICS

Despite varying political and economic value dynamics the economic growth on average in Pakistan has been 4.7% from 1951 to 2004. This period covered Ayub's decade of development, Zia's Marshall Law and his "air crash", "Afghan crises", eight government changes in a short period during early 80s to late 90s, Bhutto's nationalization, nuclear explosion and Musharraf's current reform agenda. This progress is lower than fast developing countries like Malaysia, India and China, but compared with all the developing countries show inherent strength of economy despite political lapses.



Economic growth and good corporate practices demand higher national focus; global investors are seldom interested unless “medieval” corporate practices are shed and replaced by these modern practices. Corporate governance is a set of relationships between a company’s management, its boards, its shareholders and other stakeholders that provides a structure through which the objectives of the company are set and the means of attaining those objectives and the monitoring of their performance are determined. Good corporate practices enhance corporate creditability. The result of the survey of IFC’s Global Private Equity Conference held on 9-11 May 2001 conducted by Mckinsey & Co., has revealed that 89% of the respondents would pay more for the shares of a well governed company than those of poorly governed company with comparable financial performance.

The Code of Corporate Governance in Pakistan is applicable to all listed companies including non-listed insurance companies and the asset management companies which are managing mutual funds. Private limited companies, firms & proprietorships, Govt. organizations, such as, WAPDA, KWSB, Railways, regulatory authorities, charitable trusts and others falls outside the preview of the Code of Corporate Governance, which however reinforce the corporatization of value dynamics on the whole.

The broad objectives of this Code are:

- Establishment and implementation of sound internal control systems.
- Risk management
- Greater accountability.
- Transparencies and fairness.
- Ethical standards
- Safeguard the rights and interests of stakeholders including of minority shareholders (individuals, institutions – public/private).
- Reliability and integrity of information.
- Compliance with policies, plans, procedures, laws & regulations.
- Safeguarding of assets.
- Economic and efficient use of resources.

The scope of the Code of Corporate Governance broadly covers the following areas:

- Appointment / role & responsibilities of the Board of Directors.
- Corporate & financial reporting framework.
- Frequency of financial reporting & meetings.
- Disclosure of interests by Directors, CEO or Executives holding company's shares.
- Role & responsibilities of Chairman, CEO, CFO, CS and Executives.
- Audit Committee & Head of Internal Audit.
- External Auditors.
- Divesture of shares by Sponsors/ Controlling Interest.
- Compliance with the Code of Corporate Governance.

THE REGULATORS

Securities & Exchange Commission, as a regulator, has a major role to play in monitoring compliance to the Code by the corporates in Pakistan. There is a strong emphasis on accountability in all the sectors and the companies not complying with the Code are to be de-listed. Reforms have been initiated in the public sector companies by inducting

professionals, persons of known integrity and of good reputation in the board of directors. Likewise, in the Stock Exchanges, boards have been reconstituted through induction of non-members as directors and appointment of a professional as the managing director; also proposals for de-mutualizing and integration of stock exchanges are seriously being considered for better governance and transparency.

Application of Code of Corporate Governance as a whole is by no means an easy task and requires a great deal of commitment, resources and thoughtfully implemented processes. The administrative cost – in time and monetary value – associated with undertaking such actions will at times outweigh these benefits. Likewise, cost of implementing and communicating corporate governance policies throughout the organization need expertise on part of the directors. Another problem could be that the directors may not be able to manage high profile chief executive officers, chief financial officers, company secretaries and heads of internal audit besides the fact of high cost to the organization. Also, the secrecy which is an important factor for incorporating private limited company may not be available in case outside directors are appointment.

VAGUE STANDARDS OF EVALUATION

The standards of evaluation, monitoring and implementation of corporate governance are vague, so are the sanctions and the process of imposition of sanctions for non-compliance. Despite reforms and reconstitution of boards of stock exchanges, the role of bourses in regulating the stock markets are far from being perfect. An important aspect of corporate dynamics is that it follows the government dynamics – a function of effectiveness of management of the state. With consistent policies and stringent implementation of rule of law and of regulations by the government, the improvement in corporate culture will follow. Judiciary has a critical role in implementing the rule of law, which unfortunately has not happened in Pakistan. Some jurists are considered indispensable and are able to successfully turn what is legal into illegal and illegal into legal. Courts invalidate their own judgments with change in political, economic and social scenarios raising serious doubts about the creditability of the whole system. Without judiciary dynamics there will be no government dynamics and eventually no corporate dynamics.

Adhocism in government, judiciary and corporate dynamics have far reaching effects on the social, political and economic sectors of a country. It leads to an investment shy environment for both foreign and local investors, spreading default culture with industries declared sick so as to get away from defaults – reward for bad management. In short, it creates a culture where the norm is that regulations are for those who follow the regulations.

CORPORATE DYNAMICS – INDUSTRY OR TRADE

A shift in the government policies with respect to preferring trade over industry has not noticeably stalled. The menace of smuggling and under invoicing continues to inflict a serious blow to the development of indigenous industry resulting in idle capacity, lower volumes and productivity, higher costs and un-competitiveness. All this is causing loss of revenues in billions (approximately US$ 5 billion) to the government annually. Trade on the whole, will lead Pakistan to being a nation of traders at the mercy of the developed countries which through protection of their own industries and by providing the right kind of investment incentives are today ruling the world. We must not concede to such pressures or otherwise there will be no incentive for future private investment, besides impairing the overall socio-economic fulfillment of objectives of more employment, more goods and services and becoming self reliant.

In so far as Pakistan's economy is concerned, the solution lies in the economy of scale in the non-traditional hi-tech industries - steel, engineering, electronics, fertilizers, refineries, pharmaceutical, chemicals, which were recommended to be 'phased out' and value addition in its traditional industries – simple manufacturers - textiles, cement, sugar or leather. Agriculture is the country's main stay and deserves the same treatment as in other countries like USA and India, highly nurtured through huge subsidies. This will help Pakistan's economy to combat challenges of globalization, trade with SAARC and lesser reliance on IFIs, which have deprived the country from its political and economic sovereignty.

پرواز ہے دونوں کی اسی ایک فضا میں
کرگس کا جہاں اور ہے شاہیں کا جہاں اور

(Let us keep the flag flying higher and higher!)

ATLAS GROUP VALUE DYNAMICS

Atlas Group came into being in 1962 with the establishment of Shirazi Investments Limited with a capital of half a million rupees and three men doing business in trading shares and real estate. Initially, the Group believed in "small is beautiful", which meant that it remain though small but well managed. The Group achieved this objective quite admirably! Two decades later, when the next generation of managers joined, they decided that the Group should be one of the best, if not the best, in all respect of management. The Group has been accomplishing this objective also quite admirably with an emphasis on economy of scale.

The Group has been practicing good corporate governance since mid 70s, much before the law was enacted a couple of years ago. The Board of Directors of the Group is headed by a non-executive Chairman. The Group President operates as the Group Chief Executive Officer. Board of Directors of each Group company comprises of non-executive directors associated with strategic planning, internal audit and remuneration committees. The Human Resource Committee of the Group is headed by the Group Chairman. The key areas of emphasis are building and retention of intellectual capital, management information system and communications. The Group strongly believes in the systems approach. It has established centralized systems with decentralized decision making process. Each company of the Group is headed by a professional CEO. His role is defined as a Performer in terms of market share, profitability, cash flow and company image. He is expected to be an Organization Builder based on McKenzie criteria of a sound structure, strategy and systems on the one hand and staff skills, style and shared values on the other. As a Strategist, the CEO is responsible for the right product, the right market, selling what the customers want and correct positioning in the market. Strong emphasis is laid on information technology and computerization. Daily statement of Group performance is prepared in addition to the monthly balance sheet and the profit & loss accounts. "Cash is King", delegation but not abdication and strong structure and systems are the guiding principles for the Group. The Group strongly believes in maintaining cordial relationship and harmony with the government, foreign and local entrepreneurs, its employees and society at large.

Human resource development has been the hallmark of the Group. Recruitment is based on intellect, integrity and character. Strong emphasis is given on education and training with key executives given international exposure through business schools including Harvard, Wharton, Stanford, IMD and INSEAD. Apart from its focus on the right recruitment of the right people, right education and training, right career planning and succession of the right people in the Group, emphasis is also on the right return to the shareholders, and sharing the gains with the society at large.

The Atlas Group deals in engineering, financial services, trading, power products and oil lubricants. It consists of seven public limited companies of which six are quoted on the stock exchanges in Pakistan, and four are private limited companies. The Group employs over 5,000 men and has an equity of over Rs. 20 billion, assets over Rs. 30 billion and current year sales forecast of over Rs. 40 billion – with one of the highest returns on equity of over 30% and earning per share of over Rs. 15. The Group last year paid taxes of about Rs. 9 billion, that is about 1.5% of the government revenue.

The Group growth has always found strength and reinforcement from the Country's political and economic dynamics, which despite socio-politico-economic lapses has registered overall GDP growth since 1951 at a rate quite comparable with the developing countries, on the whole, showing inherent economic strength of the country.