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How Much Independent Is Independent Director on Board of Directors: A Study of Pakistani Listed Companies

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Abstract

The field of corporate governance has garnered increasing attention over the past five decades. Since the mid-1970s, extensive discourse has ensued regarding its relevance in both developed and developing economies. Independent directors have become indispensable members of corporate boards, wielding significant influence over board functionality for maintaining good governance. This research predominantly focuses on assessing the autonomy of independent directors within corporate boards. Literature underscores a historical dearth of studies probing the role of independent directors, particularly within the context of Pakistani firms. Consequently, this study endeavors to delve into the responsibilities of independent directors and their "independence" in decision making. Employing a structured questionnaire, data was collected from independent directors representing 15 Pakistani listed companies. Data analysis involved frequency distribution and average percentage methodologies. Findings indicate that while independent directors exhibit a degree of independence in the company Act 2017 but company's constraints hinder their ability to fully discharge fiduciary duties. Despite being mandated to oversee financial and other reports, practical autonomy appears compromised, raising questions about their genuine independence in fulfilling regulatory obligations.

Keywords: Corporate Governance, Independent Directors, Board of Directors, Conflict of Interest, Functions of Independent Directors.

1. Introduction:

Governance pertains to the methodology of pursuing a purpose or conducting an activity. The term "Governance" finds its roots in the Latin word "gubernare" and the Greek word "kybernan," both signifying the concepts of "guiding," "directing," or "steering" (Talat Afza, 2014). The "Code of Business Conduct, 2002" regulates the roles, responsibilities, and conduct of boards of directors and is obligatory for all publicly traded companies. In 2019, legislators enacted "The Listed Organizations (Code of Corporate Governance) Principles." The Securities and Exchange Commission of Pakistan (SECP) is empowered to establish a framework ensuring the adoption of effective corporate governance practices, regulations, and related matters for companies or specific types of organizations, as delineated in Section 156 of the Companies Act, 2017. The SECP is credited with introducing the concept of independent directors to Pakistan. This concept was subsequently incorporated into Rule 49 of the Listing Regulations under the Companies Act, 2017. Independent directors, as defined by the criteria established by the board's Nominating and Governance Committee, are individuals who, besides receiving director's compensation, do not possess any material connections or agreements with the company, its owners, management, or associates that could compromise their ability to exercise judgment without interference.

Mishra, S. fu(2020) further elaborated on the roles, duties, and compensation of independent directors. The concept of Independent Directors was extensively defined by the Companies Act of 2017, and regulatory bodies have instituted stringent standards for their independence. It is noteworthy that prior to 2016, independent directors were absent in Pakistani companies. However, under the 2017 Companies Act, the Securities and Exchange Commission of Pakistan (SECP) mandates the appointment of independent directors in accordance with the law. The concept of "independent directors" is relatively recent in Pakistan, particularly when compared to other nations. Additionally, no research has been conducted to assess and quantify the level of independence demonstrated by independent directors in Pakistan.

2. Literature Review:

Corporate governance entails mechanisms aligning the interests of finance providers with those of company managers. It encompasses internal mechanisms such as the functioning and ownership structure of the board of directors (BOD) Afza & Nazir (2014). Weak corporate governance can lead to financial disasters and bankruptcy, while robust corporate governance reduces agency conflicts and information asymmetry, thereby fostering proper managerial behavior. Corporate governance is a pivotal aspect of a corporation's structure and function, revolving around the BOD. Almashhadani & Almashhodani (2023) The BOD plays a crucial role in safeguarding stakeholders' interests, making significant decisions, and formulating corporate policies. Extensive research has examined the relationship between governance structures and a firm's commercial performance, yielding notable findings on the positive impact of BOD interlocks and female managers on board efficiency and performance Afza, T. & Nazir, M.S. (2014).

Effective corporate governance aligns stakeholders' expectations and relies on shared responsibility for operational and strategic decisions. BOD composition significantly influences corporate governance and innovation. Separating the roles of Board President and CEO mitigates agency issues and enhances long-term decision-making. Board diversity, particularly gender diversity, is expected to correlate positively with sustainability performance, as women directors tend to prioritize addressing social and environmental concerns. The BOD's role in corporate governance and its connection to sustainability and innovation are crucial areas of study with significant implications for businesses and stakeholders.

Economic growth is commonly believed to result directly from good governance (Ruwani & Assih (2019). Independent board members are frequently cited as a hallmark of responsible corporate management. Non-executive directors (IndDirs), also known as independent directors, are board members without a financial or personal stake in the company's success Masulis, R.W & Zhang E.J. (2019). They do not receive compensation from the organization and have no other financial relationships with it Tang & Yang (2018). This includes not being bankers, attorneys, or relatives of management or shareholders. Being independent of management, they are better positioned to advocate for shareholders' interests (Fogel & Morck (2021).

Agency theory and resource dependence theory underpin the appointment of independent directors. Establishing independent non-executive directors and separating the roles of CEO and chairman are mechanisms essential for effective governance and monitoring managers' performance (Zamal et. al. (2018), Shi & Zhang (2018).

Before 2016, the concept of independent directors was nonexistent in Pakistan. However, after the resolution passed under the Companies Act 2017, it became mandatory for every company to have independent directors on its board (Jiraporn P & Lee (2018), Jiraporn P et. al. (2018).

Arora, P. (2018) narrates that an independent director is any board member who is not an executive director, whole-time director, or nominated director. They provide objectivity and independence to the company's deliberations. Section 149(6) of the Act 2017 outlines criteria for determining director independence, including evaluation of promoters, holding companies, subsidiaries, associates, family transactions, shareholding, and audit firm appointments. Shareholder approval is required for independent directors, and a letter of appointment formalizes their role, responsibilities, fiduciary duties, and liabilities (Gul & Lenng (2004).

Naciti, V. (2019) argues that independent director's role is very crucial in evaluating and setting compensation for executive directors, key managers, and senior management. They also serve as mediators in conflicts between management and shareholder interests, disclosing promptly any suspicions of wrongdoing, fraud, or breaches of the organization's code of conduct. Their liability is more limited than that of executive directors.

Similarly Lamoreaux et.al. (2019), Luan & Tang (2007) are of the opinion that independent directors contribute significantly to a company's sustainability across various aspects, including corporate governance, productivity enhancement, and efficiency. They actively engage in overseeing organizational matters through participation in all committees. The Cadbury Report in 1992 introduced the concept of independent directors globally, following the US model. However Jiraporn et.al. (2018) says that various major factors are influence the independent directors their performance process & their selection and removal which mostly in the hands of Executive Directors.

2.1. Research Gap

After extensive review of various research papers, it has been noted that there exists a research gap concerning the evaluation of directors' levels of independence. While numerous studies have addressed the importance, roles, and various factors related to independent directors, none have delved into the actual circumstances affecting their independence and particularly in Pakistan. Therefore, this research aims to explore the performance of independent directors and the degree to which they are valued in the decision-making processes of the company, whether in board meetings or otherwise in the context of Pakistani Companies.

3. Research Methodology:

3.1. Population

This paper population comprises independent directors from diverse manufacturing and non-manufacturing listed companies in Pakistan. To gather data, a questionnaire was distributed in person to each independent director of large companies. The independent directors themselves completed the questionnaire, providing their respective positive or negative responses.

3.2. Sample Data

The primary data collected pertains to a sample comprising 20 independent directors from 15 manufacturing and non-manufacturing limited companies in Pakistan.

Table 3.1 List of Sample Companies

Sr.	Names of companies	Sr.	Names of companies
1	Din textile mills limited (1)	2	Toyota Indus motor company ltd (2)
3	Gul Ahmed textile mills limited	4	Kohat cement limited
5	Din textile mills limited (2)	6	Ismail industries limited
7	Reliance Weaving Ltd.	8	Shabir tiles & cermics Ltd.
9	Fazal Clothes Mills Ltd.	10	Arif Habib Corporations Ltd.
11	Pak Arab Refinery Ltd.	12	Fauiji fertilizers Ltd.
13	Hi-tech lubricants Ltd.	14	Millat tractors Ltd.
15	Attock petroleum limited Ltd.		

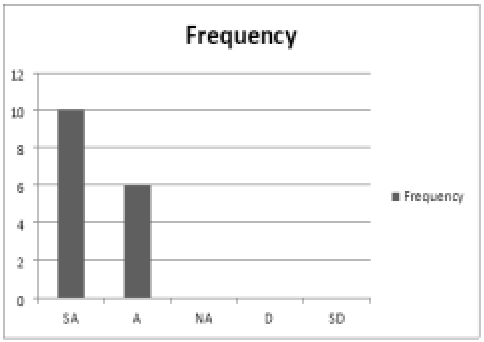
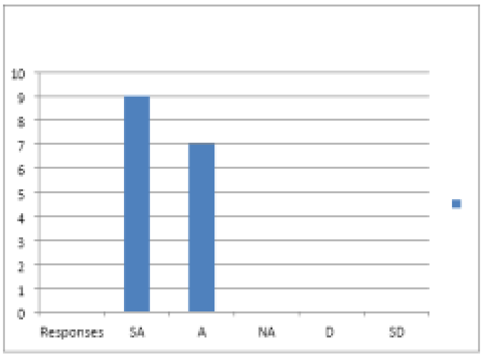
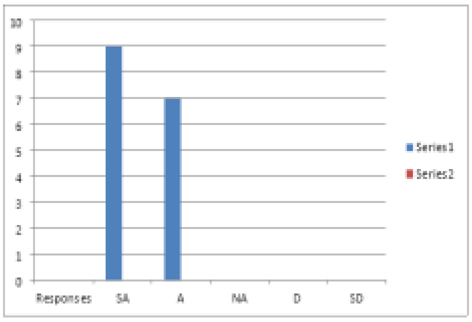
3.3. Data Collection Technique

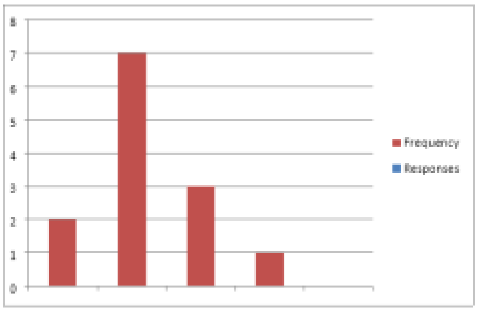
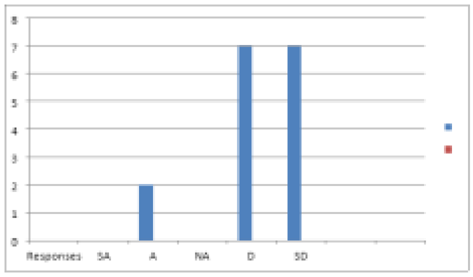
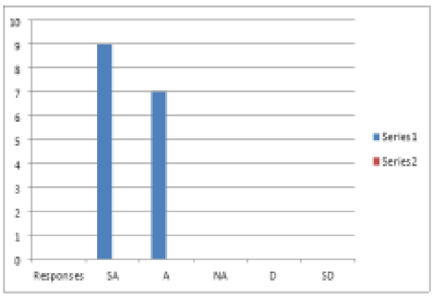
In this study, a self-administered questionnaire was employed due to its cost-effectiveness. The questionnaires were designed using a Likert scale. They were distributed to independent directors in both hard and soft formats. Soft copies were sent via email using platforms like Gmail, while hard copies were delivered through a courier service and face-to-face interactions. The directors completed the questionnaires themselves and returned them to the researcher within various time frames, ranging from a few days to several weeks.

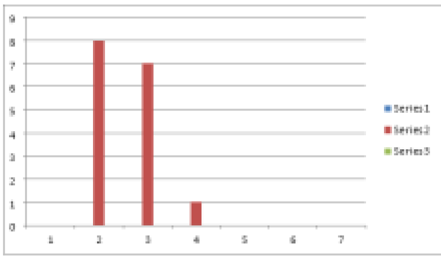
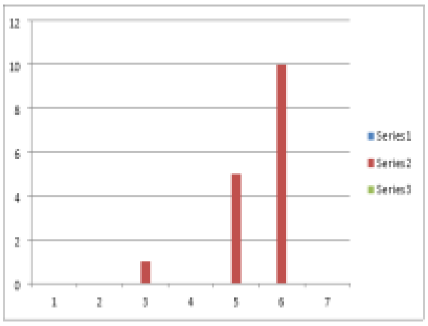
4. Data Coding and Analysis Techniques

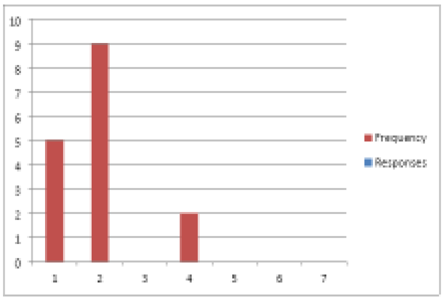
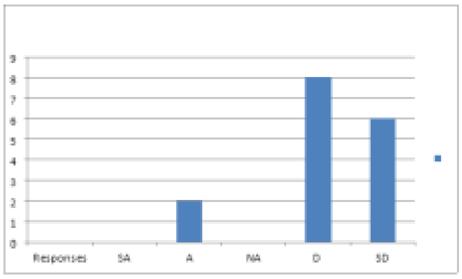
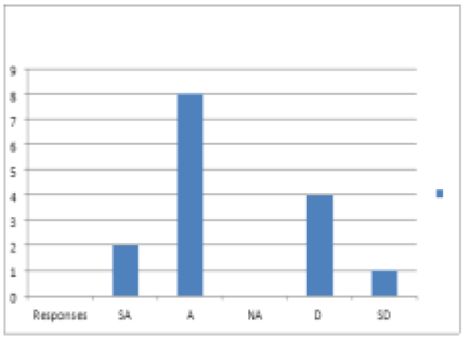
The information gathered from the survey was initially recorded in an MS Excel spreadsheet. Any missing data was completed using MS Excel. Excel's frequency distribution and average percentage were utilized for data analysis. Our aim was to evaluate and analyze the level of agreement and disagreement regarding the collected data, with the ultimate objective of achieving our study goals.

4.1. Data Analysis and Results

Questions	Responses	Figures
Q1. "Independent director are very regular to attend the meetings".	In response to this question, the researcher received a mix of answers ranging from strongly agree to agree. Specifically, 10 independent directors strongly agreed that they are very regular in attending meetings, while 6 respondents agreed with this statement.	 Figure 4. 1 Regular attendance of meeting by independent directors
Q2: "Independent directors" take curiosity in corporation's conferences.	This indicates that 9 independent directors strongly agree that they personally participate in conferences, while 7 strongly agree with representing their own company at the meetings. These findings reflect a positive trend.	 Figure 4.2 Interest of ID in meeting
Q3: Independent director take interest in corporation's performance.	This illustrates the responses to this question, and the findings indicate a positive outlook. The results reveal that 9 independent directors strongly agree that they take a keen interest in corporate performance, while 7 independent directors also strongly agree with this sentiment.	 Figure 4. 3 Selected ID by executive directors

Q4: "Independent directors are selected by executive directors".	The response to this question is presented, showing a range of opinions. Regarding the appointment of independent directors, 2% of those surveyed strongly agree, 7% agree, 33% are unsure, and 16% disagree.	 Figure 4.4 Selection ratio of ID's by executive directors
Q5. "Independent directors are selected by executive director on the basis of relations".	It presents the responses to this question, indicating a predominantly negative outlook. None of the respondents strongly agree, two respondents agree, seven respondents disagreed, and six respondents strongly disagreed with the notion, highlighting a significant negative response towards the selection of independent directors.	 Figure 4. 5 selection ratio of ID's on the basis of relations
Q6. "Independent directors are competent enough to be on this position".	The responses to this question, indicating predominantly positive feedback. 9 respondents strongly agree, and 7 respondents agree that they are indeed competent for this role, demonstrating a favorable perception of the capabilities of independent directors.	 Figure 4. 6 Competencies of independent directors

Q7. "Independent director (say) in the meetings and suggestions are honored".	The results for this question demonstrate positivity, with eight respondents strongly agreeing about the freedom of speech regarding company issues, and seven respondents agreeing overall. These results indicate that independent directors have the freedom of speech and the authority to voice their concerns about any misconduct or wrongdoing within the organization.	 Figure 4.7 Value of opinion of independent directors in meeting
Q8. "The only reason a company has an independent director on staff is to satisfy its corporate governance regulations".	It reveals negative results for this question, as the respondents' agreement contradicts the statement. One respondent provided a positive response, while five disagreed, and ten strongly disagreed. These findings indicate that the majority of defendants strongly disagree with the concept that independent directors are only involved in paperwork and instead affirm their commitment to performing their duties responsibly.	 Figure 4.8 Need for independent directors

Q9. "Independent director is chairman\member of different committees of board".	Five responders are very likely to be on a group of people, nine are likely to be on the committee, and two respondents disagree regarding their membership in different committees.	 Figure 4. 9 Independent directors are members of board
Q10. The selection of key firm executives, including the CEO, MP, GM, HR Head, and other Heads is strengthened by the presence of a director who is independent.	It indicates that the majority of respondents express a negative response to this question. It is evident that independent directors do not possess the authority to appoint individuals in the company, leading to a predominantly negative perception among the respondents	 Figure 4. 10 Ratio of selection of executives
Q11. Compensation for independent directors is based on their experience and contributions to the company.	It reveals positive results for this question. Eight respondents agree, and one respondent strongly agrees that they receive rewards for their services in the company. However, four respondents disagree, and one respondent strongly disagrees with the notion of not receiving profits despite their efforts.	 Figure 4. 11 compensation of independent directors

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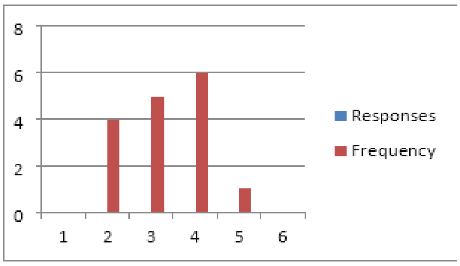
<tr>
<td>Q12. “Independent directors are independent as executive director”.</td>
<td>The responses indicates negative results. Six respondents disagree with the notion that independent directors are as independent as executive directors. However, four respondents provide a positive response, affirming that they perceive themselves as independent, akin to executive directors.</td>
<td>

Figure 4. 12 independent directors value as executives</td>
</tr>
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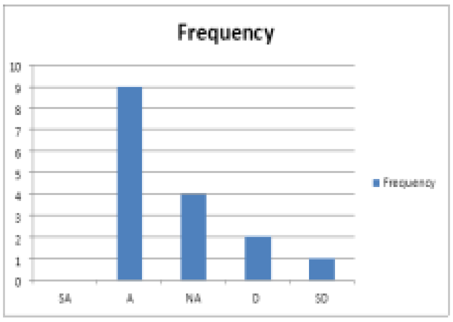
<td>Q13. The “independent director” is free to vote against the executive director's wishes at board conferences without fear of repercussions.</td>
<td>It reveals that out of the respondents, 9 express disagreements with their authority to cast votes within the organization. On the other hand, 4 respondents are uncertain and refrain from providing a definitive response, while 2 and 1 strongly disagrees. Notably, the number of negative responses is higher as compared to the positive ones.</td>
<td>

Figure 4.13 voting power of ID’s</td>
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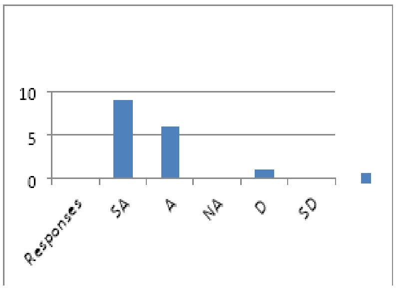
<td>Q14. The leadership team of the business pays close attention to the opinions and proposals of directors who are not shareholders.</td>
<td>Among the respondents, 9 disagree and 6 agree, indicating that the input of independent directors (IDs) holds value in meetings and their opinions are truly meaningful. Only 1 respondent disagreed with this notion.</td>
<td>

Figure 4.14 Importance given to opinions of ID’s</td>
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5. Conclusion

The significance of "independent directors" in global corporations has been underscored in numerous studies. Before 2016, the concept of independent directors was scarcely considered in Pakistan; they were either entirely absent or present in very limited numbers. However, this changed post-2016. Our analysis of Pakistani firms aimed to assess the involvement of independent directors in board decisions and to evaluate the true extent of their independence and authority. We investigated whether these directors genuinely fulfill their roles and responsibilities or simply meet legal requirements.

Our study focused on directors of 15 listed manufacturing and non-manufacturing companies, addressing gaps in the existing literature with our analytical findings. Prior to our research, no significant studies had been conducted to assess the independence of directors in the Pakistani corporate sector, making our initiative particularly pertinent.

We employed Likert scales and posed various questions to independent directors through questionnaires. The directors expressed a range of perspectives on their compensation, roles, and responsibilities within their companies. Our analysis revealed significant variability in compensation across companies, with no uniform standards followed. Additionally, directors offered differing views on other aspects of their roles. However, a majority of independent directors indicated they have limited freedom to vote against the wishes of executive directors and that their opinions are not significantly valued by the company.

Furthermore, it has been observed that independent directors sometimes face conflicts of interest with their positions in the company, leading them to withhold independent opinions. In summary, our study revealed that independent directors are not as "independent" in practice as defined by law. Their decisions are influenced by various factors, and in Pakistani companies, they are kept on board mainly to fulfill legal obligations.

The Government of Pakistan, through regulatory bodies such as the Securities and Exchange Commission of Pakistan, needs to work more diligently to implement the Companies Act 2017 in its true spirit. This involves granting independent directors more authority to ensure good governance within companies, safeguarding the interests of all stakeholders, and limiting the influence of executive directors in decision-making.

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