

Role of Independent Directors in the Changing Business Scenario in India

CA Vijaya Batth, Dr. Bhagirathi Nayak, Dr. Pratima Sarangi

Email: vijayabatth@srisriuniversity.edu.in

Email: bhagirathi.n@srisriuniversity.edu.in

Email: pratima@srisriuniversity.edu.in

Department of FMS, Sri Sri University, Cuttack, Odisha

Abstract

The literature on corporate governance and various codes emphasis that the Board of directors should provide direction to the company, evaluate and approve strategies, appoint and remove the chief executive officer and decide the compensation for him and other members of the top management. While an Independent Director should focus on the adequacy and effectiveness of the internal control and risk management systems, they are expected to protect the interest of non-controlling shareholders, should be watchful to identify weaknesses and should act tough only when required. Despite Enron, World Com and Satyam's Boards having many Independent Directors, their presence could not avert the major corporate disasters. The challenges of Independent Directors are many folds and growing day by day. The government expects Independent Directors to bring an independent judgment to bear on the Board's deliberations especially on the issue of strategy, performance; risk management, resources, key appointments and standards of conduct and bring an objective view in the evaluation of performance of Board and management. The public outrage in many corporate failures suggests that there is a huge expectation gap between what Independent Directors can do and what stakeholders expect to do. This gap is created because all the stakeholders have hyped the role of Independent Directors under the code of corporate governance. In order to be effective, they need to understand they can effectively protect the interest of non-controlling shareholders even when the Board is devoid of certain critical responsibilities. This paper attempts to find out "the ultimate measure of Independent Directors not where they stand in moments of comfort, but where they actually stand and should stand at the time of challenges and controversy."

Key words:Independent Director, Corporate Governance, CEO, Board of Directors, and Stakeholders.

Introduction

It is widely accepted that the presence of Independent Directors in the Boardroom improves the quality of corporate governance. Accordingly, corporate governance mechanisms all over the globe, including in India, focus on Independent Directors. The Independent Directors are expected to protect the interest of non-controlling shareholders. They should be watchful to identify weaknesses before they surface in the product market. But, they should not be over reactive. After the passing of the Companies Act, 2013 and India getting a modern Companies Act, the

expectations from all fronts are high. The history of corporate India suggests that in spite of having vested power under clause 49 of the Listing Agreement with stock exchanges enforced by market watchdog SEBI, Independent Directors were forced to act like lame ducks. The code for Independent Directors included in schedule IV to the Act, requires a number of provisions, which are expected to be fulfilled by the Independent Directors (IDs). The objective of the paper is to highlight the journey of the Independent Directors from its gestation period up to the enactment of Companies Act, 2013 and the change in the role

of the IDs in the changing business scenario since the year 2013.

Who are independent directors?

As per Section 2(47) of the Companies Act, 2013, an 'Independent Director' means a Director as referred to in sub-section (5) of section 149. The new Act along with the definition of ID's also provides the criteria for appointing, qualifications, tenure, remuneration and liability of ID's.

As per sub-section 6 of Section 149 of the Act, ID means a director other than a managing director or whole time director or a nominee director,

- a) Who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;
- b) - 1. Who is or was not a promoter of the company,
2. Who is not related to promoters or directors in the company
- c) Who has or had no pecuniary relationship with the company
- d) None of whose relative has or had pecuniary relationship or transaction with the company.
- e) Who, neither himself nor any of his relative :
 - i. Holds or has held the position of a key managerial personnel
 - ii. Is or has been an employee or proprietor or a partner, in any of the three financial years preceding.
 - iii. Holds together with his relative two per cent or more of the total voting power of the company; or
 - iv. Is a Chief Executive or director, of any non-profit organization, or who possesses such other qualifications as may be prescribed.

Concept of Independent Director

Independence is a quality that can be possessed by individuals and is an essential component of professionalism and professional behaviour. It refers to the avoidance of being unduly influenced by a vested interest and to being free from any constraints that would prevent a correct course of action being taken. It is an ability to 'stand apart' from inappropriate influences and to be free of

managerial capture, to be able to make the correct and uncontaminated decision on a given issue.

Responsibilities and Duties

An Independent Director is a person having many years of experience and acts as a guide for the company. The role they play in a company broadly includes improving corporate credibility and governance standards, function as watchdog, play a vital role in risk management. Independent Director plays an active role in various committees to be set up by a company to ensure good governance. Listed companies are required to set up audit committees of minimum three directors, on which, two-thirds should be Independent Director.

1. He should furnish information in the prescribed form to the company about disclosure of General Notice of directorship, membership of body corporate and other entities.
2. He should also inform the company about any change in the details submitted subsequently.
3. He should provide a list of his relatives as defined in the Companies Act and their directorship and interest in other concerns.
4. The Director shall have fiduciary duty to act in good faith and in the interest of the company.
5. It is the duty of the independent director to acquire proper understanding of the business of the company.
6. He should act only within the powers laid down by the Memorandum of Association and Articles of Association and by applicable law and regulations.
7. He should not be a Director of more than fifteen companies.

Such an independent director could be working as member of Audit Committee prescribed under Section 292A of the Companies Act. In such situation he has to look into the obligations of Audit Committee and perform the duty.

Key role of an independent director in a company

- Board structure and objectivity of the Board
- Protection of minorities
- To build up shareholder's confidence in the company
- To improve relations with investors
- To make coordinated strategic decisions
- To resolve conflicts
- To enhance management transparency
- To increase company's value
- Role of other stakeholders in management
- System of reporting and accountability
- Audit and internal control
- Effective supervision and enforcement by regulators
- To encourage Sustainable Development of the Company and its stakeholders.

Independent directors under listing agreement in India are regulated with regard to :

1. Composition of the Board

Not less than 50% of the board to be non-executive directors , Independent Directors

- If the chairman executive, At least half of the board should comprise of independent directors
- If Chairman non-executive , At least one- third of the board should comprise of independent directors

2. Non-executive directors remuneration to be approved by shareholders

Committees of Directors

- Audit Committee: requirements other than those u/s 292A shall have minimum 3 members all of them being non-executive and majority of them being independent
- Chairman of the committee shall be an independent director
- To meet at least thrice a year
- Company Secretary to act as secretary to the committee

Liabilities under other laws

- The basic directorial liability apart, being a corporate director may invite liabilities under myriad Central, State and Local laws.
- Most often, notices, summons etc. are addressed to all directors sometimes. IT searches are also unable to distinguish between working directors and independent directors.

Changes in the role of the Independent Directors pursuant to changes envisaged in the Companies Act, 2013

1. The Companies Act, 2013, requires all the ID's to meet at-least once in a year. The meeting must be convened without the presence of the non-independent directors and members of the management.

2. An ID would also evaluate the performance of the chairperson of the company. Also, the Act, 2013 requires an ID to review the performance of the non-independent directors and the Board as a whole of the company. These measures would immensely aid in ensuring the smooth and proper functioning of the Board of Directors of a company.

3. The Act, 2013 has also emphasized on the appointment of an ID as a member or as a chairperson in various committees. For instance in the Audit committee which shall comprise of minimum three directors, ID's should form a

majority. In the same way, the Nomination and Remuneration Committees which shall consist of three or more non-executive directors, ID's should not be less than half of the total number of members. For the Stakeholders Committee, the Board of Directors of the Company which consist of more than one thousand shareholders, debenture-holders, deposit-holders and any other security holders at any time during a financial year shall constitute a Stakeholders-relationship Committee consisting of a chairperson who shall be a non-executive director and such other members as may be decided by the board.

4. In connection with increased liability the amended legislation has sought to balance the wide nature of the obligations, functions and duties imposed on an ID. The Act, 2013, restricts and limits the liability of IDs to the matters which are directly relatable to them. Section 149 (12) limits the liability of an ID "only in respect of acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or where he had not acted diligently".

5. Nominee directors, despite not being considered as 'independent' under the new definition, would nevertheless be eligible for immunity, as long as they are non-executive.

6. The process of identification and appointment of an ID itself provide hints about the likelihood of the person acting independently. A good way to identify and appoint an ID is to involve a nominations committee of the board, or involve the entire board. This will ensure that prejudice and proximity to management, or a majority shareholder, do not influence the selection of ID.

7. At the time of appointment, the ID has to declare to the board that he is independent and also whenever there is a change that may affect his independence. Both the company and the ID shall abide by the provisions of the act. Also the appointment of ID shall be approved at the meeting of the shareholders and the explanatory statement attached to the notice of the meeting for approving the appointment of an ID shall include a statement that in the opinion of the Board, the ID's proposed to be appointed fulfils the conditions specified in the Act, 2013 and the

Rules and the proposed director is independent of the management.

8. An ID shall hold the office for a term up to five consecutive years, but shall be eligible for re-appointment on passing of a special resolution by the company and disclosure of such appointment in the board's report. He is not entitled to any stock option or any remuneration, but he may receive sitting fee and any profit related commission as approved by members.

9. The Act, 2013 has described the manner or procedure for selection of ID's under section 150. This section says that selection of an ID shall be done from a Data Bank maintained by anybody, institute or association, as may be notified by the Central Government, containing names, addresses and qualifications of persons who are eligible and willing to act as ID. It also says that the appointment of an ID shall be approved by the company in general meeting and the explanatory statement indicating the justification behind appointing such person, attached with the notice of general meeting.

10. The role of an ID is considered to be of a great significance. The guidelines, role and functions and duties and etc are broadly set out in a code described in Schedule IV of the Act, 2013. The code lays down certain critical functions like safeguarding the interest of all stakeholders, particularly the minority holders, harmonizing the conflicting interest of the stakeholders, analyzing the performance of management, mediating in situations like conflict between management and the shareholder's interest and etc.

The code also lays down certain important duties like keeping themselves updated about the company and the external environment in which it operates, not disclosing important and confidential information of the company unless approved by the board or required by law, actively participating in committees of the board in which they are chairperson or members, keeping themselves update and undertaking appropriate induction and refreshing their knowledge, skills and familiarity with the company, regularly attend the general meetings of the company and etc.

Failure of Independent Directors in Business

The decade of 2000-2010 for business and society around the world has been a bagful of corporate scams, witnessed the virtual breakdown of international financial systems, massive state bailouts even in the so-called free market economies, enormous environmental disasters, unbelievable breaches of business trust and reputational loss, blatant grabbing and expropriation of natural resources from the world's poor—the decade had it all.

The large corporation as an organisational format that was already under attack for its overarching power and malefic influence came to be increasingly viewed as an instrument of individual greed and collective deceit.

The whole idea behind mandating Independent Directors was to ensure companies follow good corporate governance practices and protect interests of minority shareholders. They are required to exercise oversight to prevent willful compromise of the interest of the stakeholders. But it is unfortunate that in many instances companies have made a mockery of the statutory provision requiring of Independent Directors. Many appoint their friends and high profile names, which lack the qualification to become Independent Directors. And even those are fit for the pasts in number of occasions failed to perform.

Since in a professionally managed company the CEO formulates the strategies, the Board finds it difficult to propose alternative strategies or to audit the strategy proposed by the CEO due to knowledge gap between the CEO and Independent Directors. Another very important function of a monitoring Board is to set the 'tone at the top'. In practice the CEO sets the 'tone at the top' and Independent Directors do not get the opportunity to change the organization culture. It cannot be discarded the fact that the Board as an institution, has failed in its monitoring role. Strong arguments can be added in this regard. Although, as law, shareholders in practice appoint directors, the incumbent management appoints Independent Directors. Usually, an enlightened CEO desires a strong advisory Board rather than a strong monitoring Board. Monitoring might require Independent Directors to break the 'Board room decorum'. Presence of individuals, who are respected for their work in other fields, does not necessarily improve the corporate governance.

This has been established time and again by corporate governance failure in companies like Satyam, Enron, World Com and so on.

Conclusion

Globally, the issue is the same on independent directors. The mind set of the person getting appointed, as director must be of one to act without fear or favor. If in your professional capacity, you feel the company is not acting in the interest of the stakeholders, the independent directors must question such actions and ensure that they are recorded in the minutes. It may not overcome the problem overnight but to slowly get over this issue.

The new concept of having ID is a welcome step for corporate governance in India. The Act, 2013 has conferred greater empowerment upon ID's to ensure that the management & affairs of a company is being run fairly and smoothly. But, at the same time, greater accountability has also been placed upon them by making them have a definite 'say' in the management of a company, which would thereby immensely strengthen the corporate governance. In the same context, it is also important to keep in mind that good corporate governance is not just the outcome of appropriate selection and effective functioning of ID's. Every director, whether independent/non independent, executive/non-executive has a distinct role in the functioning of the company. It is only when the entire board functions effectively which results to good corporate governance and benefit minority as well as majority shareholder in its long term which maintains a good corporate image in the market.

References:

1. Kota. Ravindranadh, "Role of Independent Directors in Corporate Governance", Indian journal of applied research, 374-376, volume: 5, issue: 11, 2015
2. <http://www.uniassignment.com/essay-samples/finance/role-of-independent-directors-in-the-changing-business-finance-essay.php>

3. Paul W. Macavoy & Iran M. Millstein, "The recruitment crisis in corporate Governance" 22-23 (2003)
4. As available on the website of NSE and BSE
5. Schedule IV , Code for Independent Directors , Companies Act, 2013