

INDEPENDENT DIRECTORS – ARE THEY REALLY INDEPENDENT?

BASIC INTRODUCTION FOR INDEPENDENT DIRECTOR

Independent directorship has gained considerable significance in modern corporate governance, especially in developed economies. A basic feature of corporate governance codes in most jurisdictions is the use of non-executive directors who are usually independent of management. The non-executive director is a member of the board who does not have any executive management role. Thus, he is not involved in the day to day running of the business and has no contract of employment other than that by which he is appointed as a director hence he is referred to as an 'outside director'. Independence broadly connotes the absence of interest in the enterprise which could affect the exercise of objective judgement.



In this Write-up we would be give more emphasis on the overall act of an individual who is appointed as an independent director of a Company and whether he act in the interest of the Management or in the interest of the Company and the Shareholders (i.e. whether he acts independently or not).

Our discussion would be based on the overall act of an Individual who is appointed as an independent director of a Company and whether he act in the interest of the promoters or in the interest of the Company and the stakeholders (i.e. whether he acts independently or not).

The expression 'independent director' shall mean a non-executive director of the company who:

- 1. Apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;*
- 2. Is not related to promoters or persons occupying management positions at the board level or at one level below the board;*
- 3. Has not been an executive of the company in the immediately preceding three financial years;*

4. *Is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:*
 - *The statutory audit firm or the internal audit firm that is associated with the company, and*
 - *The legal firm(s) and consulting firm(s) that have a material association with the company.*
5. *Is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director;*
6. *Should not hold more than 2% of Shareholding in company.*
7. *Is not less than 21 years of age.*

• DECISION OF INDEPENDENT DIRECTOR ARE REALLY INDEPENDENT?

Independent directors, apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director.

But in reality who appoints these Directors? No doubt that the shareholders appoint the independent director. But if we see the process of selection of the independent director, it is the existing directors who nominate the independent candidates for the post of the independent non-executive director that too in consultation with the promoters and the shareholders accepts the nomination on the basis of the recommendation of the Board.

In major scenario most of the stake of company with Promoter who control the composition of the Board. Even the shareholder can vote on the appointment of director the dominance of the majority ensures that their most favoured person will appoint as Director. It's practically difficult to accept that Independent director will impartially apply his or her mind against the wishes of majority shareholder because tenure of Independent director will depend upon the other director.

EXPECTATION OF STAKEHOLDER FROM INDEPENDENT DIRECTOR AND FROM COMPANY:

Individual director attributes:

- Works well with others;
- Possesses the required business/industry Knowledge;
- Is available when needed;
- Prepares for and attends meetings; especially
- Is alert and inquisitive;
- Asks hard questions;
- Challenges management assumptions.

Company attributes:

- Have a diversity policy;
 - Appoint directors through an independent and objective process;
 - Establish appropriate board committees;
 - Share information in a timely fashion,
- With independent Director;
- Develop and follow a code of conduct;
 - Adopt a consultative approach in setting of Meeting agenda items;
 - Record and share minutes of the meeting.

Managing societal expectations & creating shareholder value



SPECIFIC QUESTIONS THE BOARD SHOULD CONSIDER REGARDING A POTENTIAL CANDIDATE:

- Has the board identified the skills required in terms of expertise, background and types of personalities?
- Has the board ensured that a wide net has been cast for directors?
- Does the candidate understand the business/ industry of the company?
- Can the candidate work as part of the board?
- Can the candidate work effectively with a diverse group of people – can he disagree without being disagreeable?
- Does the candidate demonstrate a high level of integrity and honesty?
- Is the candidate able to commit sufficient time to discharge board duties?

Are companies facing a shortage of independent directors? If so, what are the measures to overcome this shortage?



- ❖ Today when we discuss about independent directors, there is an expectation that they are required to play the role of watch dogs and nothing more. In that sense, the independent directors are expected to play the role of whistle-blowers on the board. Needless to say, this thinking has brought in an element of sameness to Indian boards with a greater focus on compliance. What is required is a diverse group of individuals who can examine issues from diverse perspectives and add value to overall performance rather than merely examining issues from a compliance angle.
- ❖ Unfortunately, there is a perception that a company with marquee names on its board is better governed. There is also a perception that there is a severe dearth of good candidates and hence there is a tendency to go back to the same names repeatedly. But having marquee names on the board does not guarantee better standards of corporate governance.
- ❖ There is a need to adopt a more professional, independent and transparent approach to appointing independent directors. It is important for companies to align their strategic priorities to skills required in the board room and accordingly seek candidates for non-executive positions on the board. For instance, a company which has embarked on a strategy of growth through acquisitions will need someone on the board with good experience in post-acquisition integration. Similarly, a company with a strong domestic presence and expanding internationally will need someone on its board with experience of growing businesses internationally.
- ❖ One practice that Indian companies have not adopted is that of having senior management executives in large diversified groups, other than CEOs/ MDs / promoters, taking up non-executive positions in other company boards. This is so because employing organizations are reluctant to give their senior executives the leeway to undertake such roles outside of their regular employment.
- ❖ In recent times, the idea of having a panel of independent directors maintained by an independent body has been mooted. However, there is no certainty that nominating an independent director from such a panel will result in better governance. Ultimately, the decision as to who should be an independent director on the board is as much the prerogative of the company and its CEO as much as it is the responsibility of the board. In order to ensure that board composition is right, it is important for the Board Chair, CEO and the rest of the board to work cohesively to identify as to what is the mix of skills that

is required to take the company to the next level. Board succession planning is a process that the full board should own.



Why is a formal on-boarding program needed? How can it be made effective?

- ❖ Although companies have been slow to put in place robust orientation/induction and training programs for independent directors, it is also true that independent directors have not taken this aspect seriously.
- ❖ At a time when independent directors are being given additional responsibilities, it is essential for new members to get up to speed quickly on the key issues facing the company. The need is often more pronounced when directors are new to the company.
- ❖ Companies do tend to have a general on-boarding process that involves meetings with the Board Chair, CEO, CFO, Chief Internal Auditor, Legal Counsel, etc. However, most believe that these processes are ineffective in terms of giving independent directors a solid overview of the industry, the company and its key challenges.
- ❖ It is essential to educate the independent directors on the company's business model, industry, competitive landscape, as well as its recent history of successes or problems with financial reporting.
- ❖ A leading practice is to create a director manual for on-boarding purposes. Among others, the manual could provide a broad overview of the board's oversight processes as well as the company's critical financial, operational and other risks.
- ❖ Research by KPMG's Audit Committee Institute indicates that business unit updates are important in assisting independent directors in understanding the unit's strategy and operational results, as well as the significant financial and non-financial risks. External auditor, internal auditor, or Legal Counsel could also be called upon to discuss these risks in more details.
- ❖ The on-boarding program should also address the unique legal and regulatory compliance issues facing the company and its industry. Often, the company can call upon outside professionals to discuss these issues with the audit committee and independent directors on the board either during formal meetings, in case time permits, or during special in-house educational sessions.

- ❖ Ultimately, the effectiveness of an on-boarding program would largely depend on whether the program was customized to the individual needs of a director considering his or her current expertise and role expectations.

Characteristics of an effective on-boarding program:-

- ❖ **Timely:** The Orientation must be timely – preferably held in the first month. In order to speed up the learning curve, some boards are beginning to deliver board orientation on a ‘just-in-time’ basis.
- ❖ **Tailored:** The elements of the orientation program should be tailored according to the appointee’s knowledge and experience. It will vary depending on the company structure, processes and major issues faced.
- ❖ **Effective combination of methods:** There should be a combination of written materials with presentation, meetings and site visits, aimed at providing a realistic picture of the company’s position and challenges.
- ❖ **Led by a Chairman:** The Chairman should take a lead role in ensuring the delivery of a tailored and properly balanced induction program.
- ❖ **A follow-up meeting with the Chairman:** There should be a follow-up meeting between the new director and Chairman to discuss any issues and provide feedback to improve the program.

Recent caselaws:

❖ Order passed against Independent director for not performing his duty.

On March 11, 2011, SEBI passed an order in relation to Pyramid Saimara Theatre Limited (PSTL) restraining three of its independent directors (Mr. K.S. Kasiraman, Mr. K. Natarahjan and Mr. G. Ramakrishnan) from being independent directors or members of audit committees of any listed company for a period of two years from March 11, 2011.

The order was passed on the ground that these independent directors of PSTL failed to perform their role in preventing false and misleading disclosures made by the company in its accounts, which were found to contain inflated profits and revenues through fictitious entries. SEBI refused to accept the independent directors’ arguments that they were not responsible for day-to-day affairs of the company and that they participated at board meetings where only broad policy matters were discussed.

In its order, SEBI has made strong observations regarding the role of independent directors on listed companies:

❖ Independent director in TATA Group differs in decision with the Management.

The seven independent directors of Indian Hotels Company (IHCL) strongly backed Cyrus Mistry, (who was the chairman of Tata Group,) the company’s chairman, more than a week after he was dumped from the top job in the group. The decision by independent directors will complicate a likely push by Tata Sons to oust Mistry from his position as chairman of Tata Group firms.

“Taking into account board assessments and performance evaluations carried out over the years, the independent directors unanimously expressed their full confidence in the

chairman, Cyrus Mistry, and praised the steps taken by him in providing strategic direction and leadership to the company,” the independent directors of IHCL, that runs the Taj chain of hotels, said in a statement to stock exchanges. The independent directors on the IHCL board are Deepak Parekh, Keki Dadiseth, Ireena Vittal, Nadir Godrej, Vibha Paul Rishi, Jagdish Capoor and Gautam Banerjee.

“After deliberations, the independent directors came to a view that being a listed company, it was imperative for the independent directors to state their views to the investors and public at large, such that those who trade in securities of the company make an informed decision,” added the statement sent to BSE.

Conclusion:

- ❖ The concept of the institution of IDs is simple. They are expected to be independent from the management and act as the trustees of shareholders. This implies that they are obligated to be fully aware of and question the conduct of organizations on relevant issues.
- ❖ After the break out of some of the largest corporate frauds in the country in recent times and the subsequent increase in the number of resignations by IDs, there is a heightened focus on their role and responsibilities as custodians of stakeholders’ interests.
- ❖ The IDs can play the crucial role of bringing objectivity to the decisions made by the board of directors by playing a supervisory role. While they need not take part in the company’s day-to-day affairs or decision-making, they should ask the right questions at the right time regarding the board’s decisions.
- ❖ Raising the appropriate red flags at the right time would help them in avoiding the occurrence of unwanted situations and their consequences largely.

HOW DO WE HELP???

- ❖ Being a practising company secretary, we assist the independent director by ensuring time based and event based compliance and to highlights the areas with needs to be look upon as an independent director.

CONTRIBUTED BY

- ❖ **Mr. Raj Purshottam Pokar & Mrs. Jaya Sharma-Singhania,
M/s. Jaya Sharma & Associates, Practicing Company Secretary Firm, Mumbai.**

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