A STUDY

ON

'Independency of Independent Directors in Corporate Governance'

by

Meenu Gupta
(ACS, MBA (F))
Company Secretary, Noida

A-27, Sector-27, Noida, UP-201301
Contact No: 91-9910739467

guptameenu90@gmail.com

Independency of Independent Directors in Corporate Governance

Abstract

Even though corporate governance practices in India can be back dated to as early as the era of Kautilya's Arthashastra, it has gained its prominence in early 1990's when liberalization took place and in view of major corporate scandals occurring since liberalization. In last 10-15 years, corporate governance has become a widely-discussed subject and a very important consideration for investors around the world. Investors and governments have started demanding better governance practices from all companies particularly after the wide publicity over corporate scandals such as Enron, Parmalat, Xerox, World Com and many others during early parts of this century. Basically, the whole edifice of good corporate governance is dependent on efficacy and effectiveness of independent directors. Independence of Board is critical to ensure that Board fulfills its role objectively and holds management accountable to company. The paper seeks to highlight how the independence of independent directors is significant to ensuring corporate governance.

Keywords: Independent Directors, Corporate Governance, corporate scandals.

Introduction

Numerous studies conducted by reputed universities over years have shown a strong link between good corporate governance and corporate financial performance. Recent studies conducted by Harvard and the University of Pennsylvania have found out that portfolios of companies with strong shareholder rights protections outperform portfolios of companies with weaker protections by 10-12 % per year. This is obvious reason why investors prefer companies that are known for superior corporate governance practices. Particularly at a time when we are seeking a greater engagement of foreign investors in our market, we need to be conscious of the need to promote corporate governance best practices amongst our listed companies.

The whole edifice of good corporate governance is dependent on efficacy and effectiveness of independent directors. Independent Directors are considered as mentors of management and as supervisor who will ensure that management action creates value to shareholders, responsible for protecting minority shareholders' interests as well. However, their role has been questioned after four independent directors of Satyam Scandal resigned and the recent case of removal of Chairman from Tata Sons.

Independence, when it comes to boards, allows a director to be objective and evaluate performance and well-being of company without any conflict of interest or undue influence of interested parties.

i. A Board with a majority of Independent Directors can bring expertise and objectivity which assures owners that the company is being run legally, ethically, effectively for best interests of its owners.
ii. And that they have 'representatives' who are objective and have no "ax to grind".
iii. Who will look at issues with no vested interest or "hidden agendas".

Having a majority of Independent Directors allows outside directors to feel they have support in raising contrary points of view. Otherwise, it may be difficult for a single outside director to raise an issue that may be sensitive to family or founder.

Independent directors (ID), as name suggests, are expected to be independent from the management and act as trustees of shareholders. This implies that they are obligated to be fully aware of and question the conduct of organizations on relevant issues. After some of the largest corporate scams in country hit the market in recent years following the increase in number of resignations by IDs, there is a heightened focus on their role and responsibilities as custodians of stakeholders' interests.

The critical reason for breakout of these scams is that most Indian companies are controlled by promoters and independent directors are only independent on paper. They are individuals familiar to a promoter or from a known close group. This familiarity between promoters and independent directors disturbs the true independent role of directors. Though the Code for Independent Directors specified in Companies Act, 2013 underlines the role, functions and duties of Independent Directors, concerns are being raised over their real independence and effectively discharging their duties, role and responsibilities.

When chairman of Satyam Computers suspected of falsifying company's books of accounts over several years, it is the responsibility of independent director that is questioned for not identifying the misrepresentation made in company's books. Similarly, some concerns relating to independent directors were raised in the boardroom war between Ratan Tata and Cyrus Mistry as well. Further, recent is the case of Infosys which is seen as benchmark for good corporate governance practices in India, whose board come under regulatory scanner wherein SEBI Chairman raised his concerns and stated "Auditors' committee is not working, independent directors are not independent and there is no stewardship code.

Literature review and theories on Corporate Governance revealed that board's role is to direct the management's actions towards company, analyse, review and approve company's strategies, hiring and removal of top management, and deciding its compensation, however, an independent director is responsible for adequacy and effectiveness of internal control and risk management system, they should protect the interest of minority shareholders, and should act as watchdog in identifying improvement areas. Though adequate independent directors have their presence in Enron, WorldCom and Satyam's Boards, their role has been inadequate in stopping these disasters occur. The governance codes underlines that independent directors should ensure individual views on various key company board issues including setting strategic objectives and codes, appointment and remuneration of key persons. Further, it is research-proven and considered that board that consist independent directors at their decision tables well improves quality of its deliberations ensuring good governance practices in the company.

Provisions under Companies Act, 2013

Companies Act, 2013 is focusing on independent directors under section 149 (4) i.e. every listed public company shall have atleast one-third of total number of directors as independent directors but still it is not directly addressing most triggered issue of corporate governance that is CEO duality. However, as per Regulation 17 of SEBI (Listing Obligations and Disclosure Requirements) Regulations states that the Board of a listed entity shall have an optimum combination of executive and non-executive directors with at least one woman director and 50% of Board shall comprise of non-executive directors. In case the chairperson of Board of Directors is a non-executive director, then 1/3rd of Board shall comprise of independent directors and where the Chairperson is an executive director, ½ of Board shall comprise of independent directors. In case the non-executive chairperson is a promoter or related to the promoter or any other person occupying management position in the Board of Directors or at one level below the Board of Directors, at least ½ of the Board of Directors shall comprise of independent directors. Report of the CII task force on corporate governance (2009) chaired by Mr. Naresh Chandra in its recommendations no. 7 highlighted that wherever possible separate the office of Chairman from that of CEO.

Changes introduced in Companies Act, 2013 wrt. IDs

1. Performance evaluation of Board, non-independent directors and members of company should be conducted as per Companies Act, 2013.
2. To ensure better corporate disclosure with respect to legal compliances, corporate social responsibility, whistle blower policy, women directorship, independent directors are required to hold chairmanship in various board committees, ie. Audit Committee, Nomination and Remuneration Committees, etc.
3. Atleast one meeting of independent directors to be convened in a year and it should be ensured that no independent directors and members will be present in the meeting.
4. The procedure for appointment of ID asks for a declaration of his independency and to disclose whenever there is a change that may affect his independence.

The collapse of international financial markets, commitment breaches by directors, governance failure, corporate frauds, witnessed in the last decade mandated appointment of independent directors in companies to prevent shareholders and stakeholders interest, however, the provisions have been followed just in paper, not complying with adequate qualification and experience required to ensure good governance practices.

It is strongly accepted that Board has not been succeeded in their monitoring role to the top management of company and are unable to develop alternative strategies after serious deliberations with the CEO as has been witnessed in high profile corporate disasters. It is here, that independent directors perform as an advisor to the top board rather than monitoring the board.

In family owned Indian companies, promoters' control the business undermining the interest of shareholders and the appointment and removal of independent director is as per the will of majority shareholders. Even Nomination and Remuneration Committee consisting of non-executive directors with the majority comprising of independent directors while making its recommendations has always at the back of its mind that it is the will of directors holding controlling interest which will prevail.

Though Companies comply with independence requirements for directors as per Companies Act and SEBI Regulations, but will not consider its competencies and knowledge required to ensure duties cast on him. Rather the appointment should focus on his skills and experience that will add to board diversity, providing objective and independent board evaluation, leadership abilities required to present the company to the World at large.

For facilitating corporates to pick persons with right skill set, there is need for a robust and reliable database of persons available to take on the role. Unfortunately, no such credible database is currently available and companies undertake their own search and diligence without being able to have an opportunity of access to a wide database to pick up persons as per company specific requirements. There is an urgent need to think of institutionalization of appointment of independent directors.

1. Tata Sons Case

Decision to remove Mr. Cyrus Mistry from position of chairman of Tata Sons has created some sort of a crisis and has threatened the perceived ethically numero uno position enjoyed by house of Tata in India Inc. Independent Directors on IHCL (Indian Hotels Company Limited) Board have unanimously reposed faith in Mr. Mistry. Since Boards have collective responsibility so the independent directors along with Mr. Mistry are equally responsible for mis-governance as well. Mr. Cyrus attributes all problems as legacy problems and hotspots. On what basis, independent directors of IHCL and Tata Chemicals have decided to back Mr. Mistry? Do they know the truth? If yes, why they kept mum for all these years and allowed problems to persist? Why are they supporting Mr. Mistry when they are collectively responsible for affairs of IHCL from year 2000 onwards? Does the decision of independent directors to support Mr. Mistry fulfills the objective of good governance? Is their action protecting shareholders value? Can a divided board enhance shareholder value or it destroys the same.

The corporate structure of Group which prevailed under the leadership of Mr. J. R. D. Tata for over 50 years and thereafter Mr. Ratan Tata for over 20 years, exemplified the best corporate governance practices. Mr. Mistry consciously dismantled this long established corporate structure by identifying himself as the only Tata Sons representative on boards of Tata operating companies. It is relevant to mention that under Governance Guidelines Framework which Mr. Mistry himself introduced in 2015, there is a clause to the effect that all employees of a Tata company should, after their employment ceases, immediately resign from Boards of all Tata companies where they are functioning as Non-Executive Directors. Therefore, Mr. Mistry, on ceasing to be the Executive Chairman of Tata Sons, should have immediately resigned from Boards of all other companies under his own guidelines. Yet he has chosen not to do so in willful breach of Governance Guidelines Framework.

2. Satyam Case

Eight years ago, B. Ramalinga Raju confessed to Rs.7,000 crore fraud on its balance sheet, which he had hidden from IT company's board, employees and auditors for several years, the largest accounting fraud in history of corporate India and dubbed India's Enron, a reference to American Energy company that collapsed due to a mammoth accounting scandal. It laid bare many alarming truths about inadequacies of Country's corporate governance standards.

Despite Satyam being crowned India's IT jewel and won numerous corporate awards and coveted with prestigious Golden Peacock Award for global excellence in corporate accounting and the Country's fourth-largest company with high profile customers, it has embroiled in nation's biggest scam within months of winning the award. It has stunned corporate India and damaged its reputation with its investors. The scam brought to focus multiple flaws in corporate governance practices-unethical conduct, fraudulent accounting, dubious role of auditors, ineffective board, failure of independent directors and non-disclosure of pledged shares.

Importance of Independency of Independent Directors

Director's role in Company's board is to ensure safeguarding of interests of shareholders and to mentor the management's actions to maximize shareholders' wealth. To ensure fulfillment of such objectives, critical factor is board composition in underlying independent and objective performance of board. However, the literature review revealed that Board of directors are unable to protect the shareholders' interests due to poor transparency and disclosure in board practices, majority shareholding of promoters, etc.

Board composition should consist of independent members to ensure smooth and proper functioning of running of board. It is further proved that board independence and firm performance are related in the sense that independent board with improved corporate disclosure practices adds to increased interest of investors in company, improved corporate image, thereby enhancing value to shareholders'.

The high profile scandals being Enron, WorldCom has brought into focus the lack of commitment of board towards shareholders and expressed greater concern over the role of independent directors towards monitoring the policies undertaken by management is in sync with long-term strategic objectives of company. Independency of independent directors will assist in connecting the management's interests with that of shareholders' and improve the quality of judgement in decision-making. Also since independent directors will be individuals unknown to the management, an objective analysis of firms performance will ensure good corporate conduct and governance practices across the globe.

1. Impact on Financial Performance on account Boards Independence

In the aftermath of global financial crisis, the role of board of directors have been more demanding with emerging issues of shareholder activism, board diversity, related party transactions, reputational risk and shareholder relationship, technological innovation, corporate ethics, management evaluation followed by the regular regulatory reforms and continued pressure from shareholders. CEO duality, one individual in the role of both Chairman & CEO of company, is a triggered issue in corporate governance since it empowers one person to perform both management and supervisory duties and controls the decision making powers.

Literature theories revealed that companies without CEO duality perform better than the companies having CEO duality as per (Robinson et al. 2013). Board will have opposing objectives when CEO is also its chairperson. Though organization theory says CEO duality establishes strong, unambiguous leadership but as per agency theory, duality promotes

CEO entrenchment by reducing board monitoring effectiveness. It was found that separating CEO and board chair roles is beneficial in terms of shareholder returns when family ownership is low. (Braun and Sharma, 2007) says different persons occupying the CEO and board chair positions is a useful governance control as the risk of family entrenchment increases.

An analysis has been undertaken under the study to understand whether the separation of position of Chairman and CEO impacts the Return on Equity (ROA) and for the same, the study compared separation of position in BSE 500 companies in Year 2009-10 with 2014-15. It measured changes in Return on Equity (ROA) of those companies which had separated the position of Chairman and CEO from 2009-10 to 2014-15. To examine the impact on ROA, following hypothesis was evaluated.

H1 – There is no impact of separation of position of Chairman and CEO on ROA.

Ho – There is an impact of separation of position of Chairman and CEO on ROA.

Table 1: Paired Sample Tests

	Paired Differences					t	df
	Mean	Std. Deviation	Std. Error Mean	95% Confidence level of Difference			
				Lower	Upper		
Difference	1.758	0.84	0.37	0.723	2.777	4.75	4

To evaluate the hypothesis, a Paired sample T-test was conducted. Paired Sample T-test shows that the difference in ROAs between years 2009-10 and 2014-15 is not significantly impacted by separation of role of Chairman and MD/CEO, though it is positively related to firms performance.

Independent Directors are essentially considered on board tables as are select professionals from an experienced pool who have wide industry experience and are qualified to sit on boards of companies. Since Independent directors can bring the much needed perspective that is objective and do not have hidden agenda as are not connected to company nor its management, regulators made their appointment mandatory.

SEBI and Ministry of Corporate Affairs, in the process of introducing transparency and accountability and bringing in much needed corporate governance practices, analysed that between 10-15% of composition of board must made-up of independent directors. These provisioning requirements were essential given corporate scandals like Satyam where top management itself nudged in fraud and dubious business practices. So, the overall view is that bringing in independent directors would ensure greater monitoring over the functioning of these companies and since Satyam's breakdown was due to negligence of directors when its promoters indulged in defrauding the company, Corporate Affairs Ministry is implementing this rule to introduce greater oversight over company's functioning.

2. Relationship between Independent Director and Corporate Governance

Ensuring corporate governance can attract huge capital for doing business and that every transaction in a company is fair and transparent to its stakeholders and thereby, attract investors and ensure investment in the company having an effective board of directors. Independence of Board is critical to ensuring that board fulfills its role and objectivity and holds the management accountable to the company. The practice across jurisdictions indicates that presence of independent directors is an answer to that.

The Impact of presence of Independent Director on corporate Board and their independence in discharge of duties have been examined for Infosys taking into account their Qualification, experience, remuneration received, no. of other companies in which independent directors holds position, disclosure by company, etc.

Infosys board consists of eight independent directors out of total strength of 10 board members:
R. Sheshasayee, Ravi Venkatesan, Kiran Mazumdar Shaw, D.N. Prahlad, Roopa Kudva, Dr. Punita Kumari Sinha, Prof. Jeffrey S. Lehman, Prof. John.W.

i. Experience and independent directors' qualification can get correlated to company's performance since company's having skilled directors will easily undertake challenging tasks and objectives, thereby increasing shareholders' wealth and increased investor confidence. They actually bring necessary perspective that is independent and objective leading to sustained business growth.

ii. The increase in remuneration can be linked to directors' interests and motivation to serve the board of company. They also have actively participated as chairman in various board committee meetings which proved their serious involvement in business deliberations. Is directly proportional to involvement of an individual in business employment.

iii. The Board committees wherein independent directors had served as chairman, had better disclosure in terms of risk factor and other ancillary matters like related party transactions, whistle blower policy, environmental policy, employee welfare scheme, business human rights policy and legal compliance, thereby ensuring good corporate disclosure norms.

iv. Independent directors were present in almost all Board Meetings ensuring better performance of companies through their independent deliberations and judgements.

The analysis above is apt in saying that presence of independent director in corporate board makes significant difference to corporate governance practices.

Conclusion

The role of Board of Directors, in recent years, has been in public debate due to their failure in ensuring corporate governance. The study analysed that the more independent a board is, the better it is in bringing efficiency within the company. They help in proper functioning of corporate, due to the fact they do not have a material interest with company and they will really represent interest of all investors and small shareholders. In many of cases, it is evident that CEO of company hides the real picture of company from potential investors and its stakeholders. So, the person who is knowledgeable in similar kind of business, who don't possess any relation with internal management of company will act independently for benefit of its shareholders and stakeholders.

References

- Vijaya Batth, Dr. Bhagirathi Nayak, Dr. Pratima Sarangi. (2016). Role of Independent Directors in the Changing Business Scenario in India. Retrieved from http://www.ijsrm.in/v4-i2/2%20ijsrm.pdf
- Ravi Thakur. (n.d) Post Satyam Case: A Study of impact on role of independent directors. Retrieved from http://www.internationalseminar.org/XIII_AIS/TS%201%20(B)/15.%20Mr.%20Ravi%20Thakur.pdf
- Nikita Hora. (2017). Are Independent Directors Really "Independent" in Indian Companies dominated by Promoters? Retrieved from http://www.livelaw.in/independent-directors-really-independent-indian-companies-dominated-promoters/
- Shabiya Ali Ahlam. (2014). How important is the role of an independent director. Retrieved from http://www.ft.lk/article/332212/How-important-is-the-role--of-an-independent-director
- Rica Bhattacharya & Sachin Dave. (2016). Lesson from Satyam: Corporate Governance evolves, not execution. Retrieved from http://economictimes.indiatimes.com/news/company/corporate-trends/lesson-from-satyam-corporate-governance-evolves-not-execution/articleshow/50476372.cms
- EY. (2012). Corporate Governance: Changing Regulatory scenario and the role of independent director. Retrieved from http://www.ey.com/Publication/vwLUAssets/Corporate_governance_for_changing/$FILE/Corporate_governance_for_changing_regulatory_scenario_and_the_role_of_the_independent_director_EY_FIDS.pdf