

“INDEPENDENT DIRECTORS – A REQUIRED FORCE FOR CORPORATE GOVERNANCE”

BACKGROUND

Independent directors are the cornerstones of good corporate governance. The presence of independent representatives on the board, capable of challenging the decisions of the management, is widely considered as a means of protecting the interests of shareholders and, where appropriate, other stakeholders. Theirs is the duty to provide an unbiased, independent, varied and experienced perspective to the board. Corporate scandals of ENRON & Worldcom have revealed how this independence has been compromised by a cosy relationship between the CEO even with the so-called independent directors.

The Board is a group of individuals appointed by the owners of the company to run the company in the interest of the stake holders. A company is a combination of various stake holders such as investors, employees, vendors, customers, governments and society at large. The management of the daily affairs of the company is given to the Board of Directors. The representatives on the Board should run the affairs in a transparent manner to all its stakeholders. This is the triggering point for independent behavior of the people on the Board for the common good. Globally, many times in the past, it has been observed that the members of the Board have taken decisions prejudicial to the interests of the stakeholders at large and ran the corporations for the material benefits of the few. This called for independent members on the Board in the process of adopting fair and transparent business practices.

The purpose of identifying and appointing independent directors is to ensure that the board includes directors who can effectively exercise their best judgment for the exclusive benefit of the Company, judgment that is not clouded by real or perceived conflicts of interest. In each case where a director is identified as “independent” the board of directors will affirmatively determine that such director meets the requirements established by the board and is otherwise free of material relations with the Company’s management, controllers, or others that might reasonably be expected to interfere with the independent exercise of his/her best judgment for the exclusive interest of the Company. In each case, the Company should consider changes tailored to those sorts of relationships that would impair a director’s independence, taking into account the circumstances of the particular Company.

Due to the absence of external market control mechanism and inefficient internal monitoring system in, management tends to have stronger autonomy in business operation and decision-making. As agency theory argues that individual is driven by opportunistic behavior, thus, managers would engage in self-interest serving instead of maximizing shareholders’ returns. The importance of independent directors as a governance mechanism to protect shareholders’ interests and safeguard managerial employment contracts is recognised worldwide. For instance, the OECD Principles of Corporate Governance suggests that company’s board should provide independent and objective judgments on corporate issues, apart from the management. The Combined Code and the Higgs report believe independent directors are essential for protecting minority shareholders and can make significant contribution to firm’s decision-making. They indeed recommend that half of the board members, excluding the chairman, should be independent.

INDEPENDENCE- PERFORMANCE MODEL

Clause 49 of the listing agreements defines independent directors as follows: "For the purpose of this clause the expression 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the directors."

Independence, when it comes to boards, allows a director to be objective and evaluate the performance and well being of the company without any conflict of interest or the undue influence of interested parties. There are five important factors that need to be considered in the independent directors' performance model.

Firstly and most importantly, is the 'independence' of directors. For independent directors to monitor firm's major related transactions without minority shareholders' interests being infringed, the basic element of 'independence' must be fulfilled. Directors should be independent not only from the management, but also from the controlling shareholder. If independent directors have close relationship with any of them, they are not truly independent. Consequently, independent judgment or fair opinion is unlikely to be delivered, and interests of minority shareholders are less likely to be well protected. Therefore, 'independence' is the prerequisite in order for the whole independent director system to take off.

Secondly, from the perspective of motivation theory, money is often equated with the lowest level of needs, or important hygiene factor to prevent dissatisfaction. But others argue that money is important and it has a direct impact on satisfaction. The more income an independent director receives from his job, the more efforts he is likely to put in. A sufficient incentive is necessary in order to attract good candidates and better align independent directors' interests with those of shareholders.

Thirdly, sufficient knowledge is required in order for independent directors to make sensible judgement. With independent directors' responsibility of handling company's related party transactions, their understanding of business know-how, product and financial knowledge is essential. Otherwise, they can be easily manipulated by the company or making irresponsible decisions.

Fourthly in the absence of D&O liability insurance, it is very difficult to expect independent directors to play an active role. In fact, with increased job responsibilities, insurance becomes more important to indemnify directors from negligence, error, breach of duty and so on. To encourage independent directors to provide objective opinion, it is possible that they may need to stand up and against management's decisions, so sufficient assurance must be given.

Finally, for independent directors to function properly, great autonomy and resources are necessary. And the autonomy can only be useful provided the outside directors are truly independent. Without independence, higher the autonomy may lead to worse the performance. To assure independent directors' autonomy, job description need to be clearly defined, job-overlapping need to be avoided and company's interference need to be minimised.

Independence also comes from the character and values of the director. A director who is truly independent does so because of:

- Commitment to serve shareholders with due diligence and integrity
- Good judgment and common sense
- Sufficient self-esteem and confidence to stand up for an independent point of view.

Overall, through the accomplishment and satisfaction of the five factors, independent directors will be better motivated, high sense of responsibilities will be resulted, and better performance will be achieved.

INDEPENDENT DIRECTORS IN BOARD- SIGNIFICANCE

Independent directors endowed with expertise and an independent disposition can bring about the much-needed transformation in boardrooms and board meetings can become effective strategy sessions rather than remain as occasions where form supersedes substance.

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 and in the best interest of its owners
- And that they have “representatives” who are objective and have no “ax to grind “
- look at issues with no vested interest or “hidden agendas.”

Having a majority of independent directors (or at least a critical mass) 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 the family or founder.

For a family business, independence is even more important. The independent director can help with issues where the family tends to lacks objectivity and independence such as:

- Hiring, firing, promoting, and compensating family members as well as determining succession plans;
- Bringing expertise and perspective to a business which is run on tradition and sentimental loyalty (“this is the way dad did it”) rather than by current best business practices;
- Acting as a neutral bridge between family owners and non-family managers.

There are several distinct benefits that an independent board of directors can bring to a company, ranging from long-term survival to improved internal controls. Independent directors in the board can:

- Counter-balance management weaknesses in a company.
- Ensure legal and ethical behavior at the company, while strengthening accounting controls.
- Extend the “reach” of a company through contacts, expertise, and access to debt and equity capital.
- Be a source of well-conceived, binding, long-term decisions for a company.
- Help a company to survive, grow, and prosper over time through improved succession planning through membership in the nomination committee etc.

- Bringing an outside perspective on strategy and control.
- Adding new skills and knowledge that might not be available within the firm.
- Bringing an independent and objective view from the family.
- Making hiring and promotion decisions independent of the family ties.
- Acting as a balancing element between the different members of the family and, in some cases, serving as objective judges of disagreements among family-member managers.
- Benefiting from their business and other contacts and connections

The reason for introduction of the independent director system in corporate governance, on one hand, was that the director should express his opinions when an independent director makes a decision, especially some significant decisions about enterprise merger, connected transaction, stock repurchase, and interest conflict between large and small stockholders. This can prevent stockholders from conducting any behavior that is unfavorable to the company and its medium and small stockholders, and can weaken contradictions of large stockholders and medium and small stockholders in the aspect of interest conflict. On the other hand, the independent director is not subject to the controlling shareholders and the top management, so he can observe, assess and supervise the top management by means of his transcendent position, so as to effectively check and balance the controlling shareholders and supervise the operators, ensure that the Board of Directors considers interests of all shareholders, reduce insider control and large shareholder manipulation, and to effectively protect interests of medium and small shareholders. In addition, the independent director can promote scientification of decisions of the Board of Directors with his professional knowledge and independent judgment, improve transparency of the Board of Directors, make his decision-making process easily understood by other external parties, and attract excellent partners and potential investors, so as to upgrade the value of the enterprise.

CONCLUSION

Corporate India is at a strategic inflexion point in this regard. Future competition is going to be based not only on hard factors of business but mainly on soft factors like corporate credibility and governance standards. That is where the independent directors come in. Corporate India would do well to adopt a stiffer prescription on independent directors as a wise preparation for a challenging but rewarding future. Corporate India should have a vested interest in preventing and minimizing corporate frauds and scams. One effective tool in this regard is to reinforce the institution of audit.

A sure way of reinforcing the institution of audit is effective oversight provided by audit committees. Independent directors on audit committees provide one of the best ways of reinforcing both internal audit and annual statutory audit. However, it should be kept in mind that independence alone without competence can hardly make for a good independent director.

If Corporate India is serious about raising the bar on governance standards, it should appoint highly competent independent directors after a thorough, even global, search.

In conclusion, having a board that has a majority of independent members, that is directors who are neither members of the family, employees of the company, advisors, customers or suppliers, will add great value to a business and the family who owns it.