Role of Independent Directors - Corporate Governance

What is the issue?

- Despite strong legal framework, corporate frauds and mis-governance continue to happen - the recent ones being the PNB banking fraud case, IL&FS, DHFL, PMC Bank, CG power, and sudden collapse of Jet Airways.
- In this context, here is an overview on the current mechanisms and the reforms needed, especially as to the role of independent directors.

What is the 'independent directors' provision?

- World over, several corporate frauds and mis-governance issues are being witnessed.
- Following this, an important reform, among many, was giving statutory recognition to the position of independent directors in the overall governance framework.
- An Independent director is a non-executive director who does not have any kind of relationship, material or financial, with the company.
- Independent directors are to ensure the independence of decisions taken in matters related with the board.
- A larger say for independent directors was believed to have an effective deterrent to fraud, mismanagement, and mis-governance.

What is the case with India?

- In India, the Companies Act, 2013 defines 'independent directors' and codifies their duties and responsibilities.
- Schedule IV of the Act lays down the guidelines for professional conduct, role, functions, and duties of independent directors.
- The Directors' Responsibility Statement under Section 135 requires an affirmation by directors on the adherence to -
    i. accounting standards, accounting policies
    ii. maintenance of adequate accounting records for safeguarding of a company's assets and prevention of frauds
    iii. adequacy of internal financial controls, and their effectiveness and compliance with applicable laws
- The Listing Regulations exhaustively list out the specific responsibilities of the directors.

What does this demand from the independent directors?

- The law casts onerous duties, obligations, and responsibilities on directors and collectively on the board.
- So, a thorough understanding of the legal provisions and the various regulations is crucial to ensure compliance and discharge the responsibilities.
- These can be acquired only by a combination of formal training, experience, and knowledge sharing.

What are the common challenges?

- Directors face difficulty when a company has conflicts with society or the public at large.
- This happens when their working or the company's products/services create an issue with the interests of the public.
- Promoter-shareholders have a strong say on the selection of independent directors.
- So, it is challenging for the independent directors to function with independence and effectiveness at the board.
- Access to information remains in the hands of the promoters and the KMP (Key Managerial Personnel) reporting to them.
- This again makes it hard for independent directors to exercise independent judgment.

What are the key problems?

- Despite the exhaustive duties and regulations, the difficulties in implementation, adoption and compliance have led to many gaps.
- The evident factors across these cases are lack of integrity and fraudulent practices.
- Again, majority of the cases are in the financial sector.
- These are, in fact, regulated and classified as systemically important companies.
- Naturally, the question arises as how they escape the several layers of checks and balances some of which include -
    i. the professionals or the management running the company independent of the promoters
    ii. the audit and risk committees
    iii. the internal auditors
    iv. the statutory auditors
    v. the board
    vi. the regulators wherever applicable

- Certainly, there have been shortfalls in terms of regulations and supervision.

What are the possible measures at this end?

- The recent regulation calling for mandatory registration of independent directors and prescribing a qualifying examination for them are in the right direction.
- Besides this, meanwhile, many other things may have to be put in place.
- If audit committee, risk committee and the nomination and remuneration committee are to be strengthened, the independent directors chairing/manning them have to be strengthened.
- The eligibility, role responsibility, and the authority of the independent director need to be reformed/ strengthened.
- There need to be separate regulations governing the entire functioning of independent director.
- Currently, the rules/regulations relating to the eligibility and appointment of independent director are the same for all applicable companies. This will have to change.
- Companies in the financial sector need to have a stronger criterion.
- Systemically important companies need to have a different set of independent directors.
- Also, larger companies in terms of size, complexities need to have different criteria for choosing and appointing independent directors.
- These will have to cover key managerial personnel as well.
- Independent directors, to be effective, should possess knowledge of the regulations, working of the company and the ability to speak out.
- Training to acquire the skills shall be made compulsory.
- The remuneration structure for independent director needs to be overhauled.
- It should provide for differential remuneration as per grade in the regulations.
- Remuneration shall be commensurate with the responsibility and liability to which independent director are exposed.
- A separate body needs to be constituted under the Ministry of Corporate Affairs to oversee the functioning of independent directors.
- The funding required can be collected as an annual cess and subscription from the corporate sector.
- Notably, there might be a need for a large number of competent independent directors to meet the demand of the next decade.
- They will have to take up several positions from companies to trusts, NGOs, and organisations where public interest is involved.
- So, at least till the system gets fully established and starts functioning as intended, micromanagement appears to be the need of the hour.

Source: BusinessLine

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