

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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