Independent directors as pillars of good governance: Role and expectations

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Background

Independent directors occupy a fundamental position as proponents of corporate risk mitigation.

In recent years, corporate governance has taken centre stage and become a hot topic of debate in India. Lack of effective corporate governance has come to the fore in a host of situations, creating an urgency for businesses to reconsider their governance mechanisms. Given the extent and propensity of risks in the present business environment, and the case for tighter governance being echoed from regulators, shareholders and other stakeholders alike, the subject can no longer be brushed under the carpet or merely treated as a check-in-the-box exercise.

The board of directors and audit committee play a critical role in the overall corporate governance of any organisation and related investor confidence in the capital markets. This fundamental belief is shaken every time a fraud is detected or when independent directors overlook or fail to see apparent red flags and identify misconduct by senior management. Independent directors occupy a fundamental position as proponents of corporate risk mitigation. They act as guardians of the board's role in governance and oversight of an enterprise, and a check against potential conflict of interest by other board members.

Independent directors remain indispensable

With increased emphasis on governance and independence of the board, the concept of independent directors in corporate India has gained momentum over the years. The subject is detailed in Section 149 (6) of the Companies Act, 2013. In general, an independent director is a non-executive director and – as a part of the board of directors – referred to as the person who does not have any material or pecuniary relationship with the company. As the name suggests, independent directors are supposed to be independent of the management and promoters, and are expected to provide objective judgement and a critical lens to the strategic affairs of the company.

Further, various regulators in India have discussed on a few occasions that a certain percentage of the board composition should comprise independent directors to help enhance the overall corporate governance and ensure that companies follow ethical rules of conducting business. This helps bring independence in character and judgement to the art of corporate governance, and introduces transparency and accountability.

Independent directors are expected to bring in vast experience in diverse fields and a different perspective to the boardroom. They find a prominent place as members of the critical board committees including audit, remuneration, risk and compliance. As specialists and often luminaries in their field, their collective experience better equips management to respond to a range of challenges.

Critical success factors for the role

Subject-matter and industry expertise

Independence in letter and spirit, and power to act as a custodian of corporate governance

Professional skepticism

Emotional intelligence and personal ethics

Independent directors bring invaluable experience by working in various organisations and being exposed to different work processes, cultures and environments. Collectively, this brings immense value in terms of experience, foresight and varied perspectives to rightly question the management, voice concerns and engage in constructive deliberations. In a nutshell, the significance of this role in upholding and further elevating standards of ethics and governance can hardly be understated.

Key considerations for independent directors

In today's corporate environment, it is imperative for the board members and independent directors to be vigilant and fully understand their role, as key internal and external stakeholders count on them to provide the right balance at the board level. There is no defined blueprint of key considerations that independent directors should keep in mind. However, they should take steps to ensure that a company has a sound internal control environment to mitigate fraud and misconduct, and related compliance programme in place to prevent violations of law.

Some of the key considerations in this direction include:

i. Understanding the role

- It is imperative for independent directors to understand their role with utmost clarity. Audit committees tend to be the appropriate forums for independent directors to contribute their skillset and experience. Independent directors should consider whether or not the company wants them to perform functions that are typically found across established and highly regulated capital markets like setting remuneration for senior management, oversight and approval of significant related party transactions, etc. It is critical to assess if they are being appointed primarily for check-in-the-box responsibilities to fulfil regulatory requirements, or if the company is truly committed to getting independent perspective and oversight.
- Independent directors must very clearly understand the requirements and related expectations to assess the proportionate time needed to adequately fulfil the role. This should not be driven solely by a pre-defined framework, but also imbibe nuances of the role in current times.
- Independent directors must also bring their objective judgement to impart collective value for good governance. This aspect is very significant in averting situations that may become a potential roadblock in managing crisis or those involving potential misconduct.
- Incoming independent directors should enquire of outgoing or past directors about their reasons for departure, and exchange leading practices that might help them serve their role better.
- Enhanced communication and engagement with the board and majority shareholders/promoters can help outline a vision for the role of the independent directors, including establishing an environment for objectivity and candour.

ii. Assess fundamentals of the business

- Independent directors should make the effort to understand company activities, including the current business environment in which the company operates.
- This includes reviewing previously published financial statements, calling for additional information where the accounts show less than the complete picture, and having independent in-depth conversations with auditors of the company, CFO and internal auditors.

These practices would help independent directors understand the overall strategy of the company, including underlying economic and other factors affecting the business as a whole.

iii. Evaluate enterprise's anti-fraud and compliance programme

Often the most overlooked of all, the ethics and compliance programme of a company, including a fraud risk management programme, is the bedrock of a sound internal control environment and ethical culture.

- Independent directors should be aware of the adage 'Culture eats strategy for breakfast', and should pay close attention to this aspect. This includes evaluating the roadmap that the organisation has adopted to move beyond the check-in-the-box approach to manage the risk of fraud and misconduct.
- Independent directors play a critical role in understanding the parameters of the desired culture in an organisation, and reviewing efforts to develop that culture.

Some of the key questions to ask here would include:

- Does the company segregate roles and responsibilities and provide necessary authority across the three lines of defense as it relates to fraud and misconduct?
- What sort of training and communication initiatives are undertaken to enhance a culture of ethics and compliance across the company?
- Does the company have an independent whistleblower mechanism that encourages employees and third parties to anonymously report potential fraud, misconduct and related internal control weaknesses without the fear of retaliation?
- Does the company get the adequacy and/or effectiveness of the programme independently assessed on a periodic basis?
- Is the fraud risk management programme formalised and kept current with respect to change in the fraud risk profile?
- Is the fraud risk assessment process documented and forward looking?
- How is the board kept informed of the results of the assessment including key gaps and remediation plan?
- Is there a crisis management plan in place for the board to continue overseeing and enable management to manage during crisis in the interest of the shareholders?

Some may argue that having such conversations before joining as an independent director might be too onerous on the company, but it is these conversations that begin a dialogue about creating a sustainable compliance programme and culture. These conversations also help understand structures and environmental factors that influence senior management to mitigate the risk of fraud and misconduct, including the importance of monitoring and incorporating feedback.

iv. Consider protection mechanisms

Before agreeing to serve on the board, independent directors should consider all available indemnification, exculpation and insurance protections. Directors and officers liability insurance may provide much-needed comfort to independent directors to act in good faith. But this does not take away the duty of care and oversight that independent directors need to fulfil while overseeing any company. Independent directors can potentially reduce personal liability if they are able to demonstrate proactive measures undertaken to meet and document the duty of care, including some highlighted in this document.

Lastly, continued oversight and professional scepticism relating to the affairs of a company might help independent directors demonstrate commitment to the role, thereby potentially mitigating personal enforcement action.

v. Continuous learning and feedback loop

Independent directors need to continually reorient and refresh their skillset. It is recommended to regularly interact with industry and subject-matter experts and other independent directors through sessions steered by external experts. This will help independent directors understand strategy and associated risks, including strengths, weaknesses, opportunities and threats posed by the competitive landscape for the enterprise in a particular industry. This will also help them monitor the management's performance in executing strategy and managing risk. The pool of professionals aspiring for the role can be strengthened by conducting formalised training programmes on risk, finance and strategy (including digital and analytics).

Strengthening the institution

Recommendations to walk the talk for companies

While the role of independent directors has been extensively discussed, attention to specific areas by companies can act as a catalyst to safeguard that governance talk is taken seriously.

Some of these are discussed below:

i. Start right with selection and onboarding

Effective hiring and robust onboarding are important to strengthen the institution of independent directors. Credibility and skillsets are crucial dimensions that must be paid adequate attention to attract potential independent directors and ultimately fortify the board to add value and impart strategic insights.

- **Hiring:** The manner in which independent directors are vetted is crucial. Imparting objectivity at this stage is vital to recruit individuals with the right skillset and expertise. Further, critical aspects such as value systems, character, attitudes, mindset and environment must also be duly considered.
- **Onboarding:** This needs to be a well-planned and structured exercise and must provide independent directors with the information about the company and shareholders, and its strategy for risk, compliance and ethics. This must not be a one-time effort and needs to be revised in the light of a dynamic business environment.

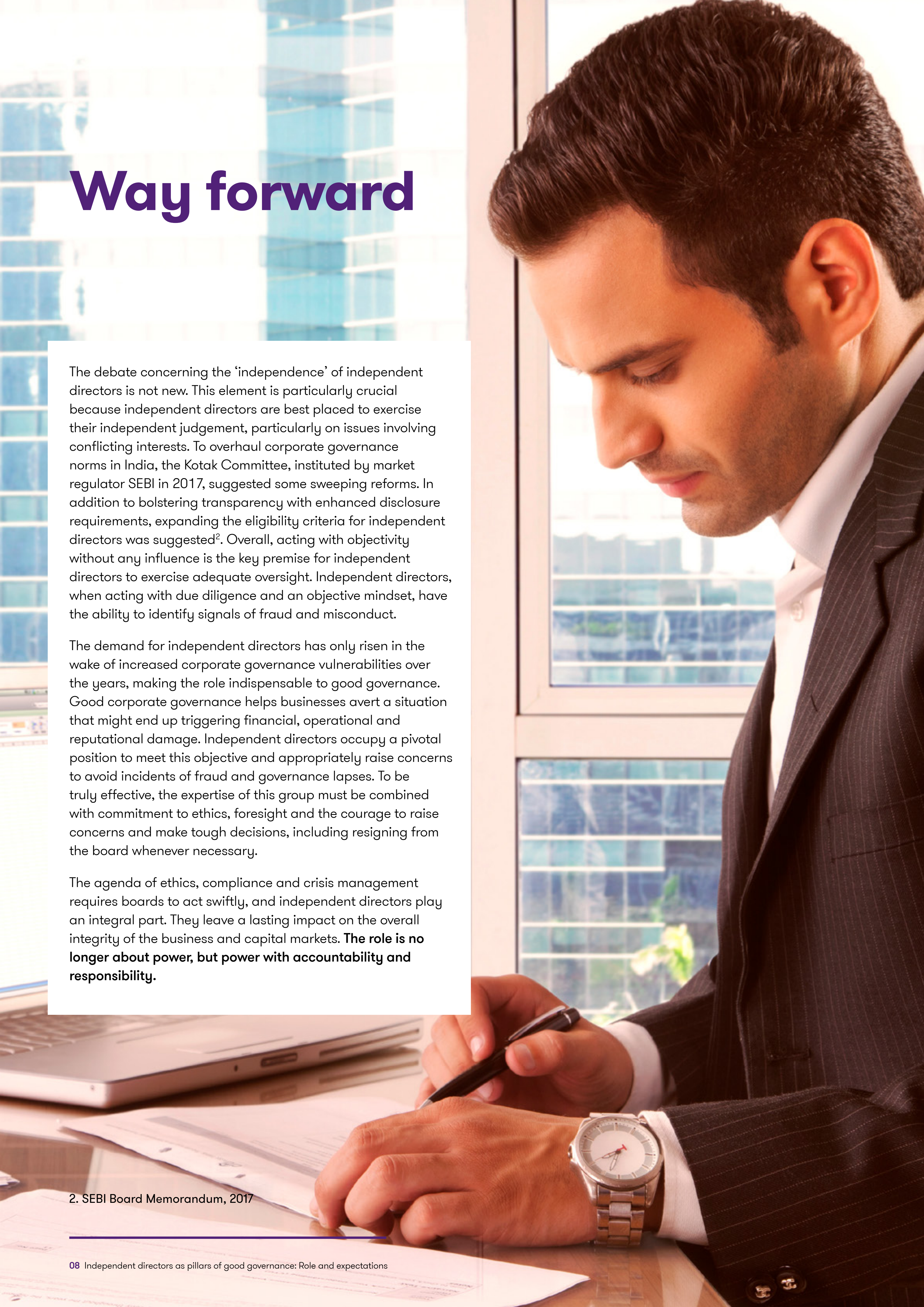
ii. Make boards diverse

Bringing varying perspectives to the boardroom provides a competitive edge as it prepares the company to respond to a range of issues stemming from rapidly changing business environment in a high-tech global economy.

- Consider a range of competencies from an industry or sector perspective, including skillsets like digital expertise to keep pace with the demands of the business.
- Aim for gender diversity in your board for better and inclusive governance. In an endeavour to promote gender parity, SEBI directed the induction of at least one woman independent director on the board for certain class of companies[1]. This was one of the recommendations put forward by the Kotak Committee instituted to promote and strengthen corporate governance.

Overall, directors from diverse backgrounds can foster engaging discussions and support management in areas where it might lack domain expertise.

1. SEBI wants one-woman independent director in top 500 listed companies, Moneycontrol, 2018



Way forward

The debate concerning the 'independence' of independent directors is not new. This element is particularly crucial because independent directors are best placed to exercise their independent judgement, particularly on issues involving conflicting interests. To overhaul corporate governance norms in India, the Kotak Committee, instituted by market regulator SEBI in 2017, suggested some sweeping reforms. In addition to bolstering transparency with enhanced disclosure requirements, expanding the eligibility criteria for independent directors was suggested[2]. Overall, acting with objectivity without any influence is the key premise for independent directors to exercise adequate oversight. Independent directors, when acting with due diligence and an objective mindset, have the ability to identify signals of fraud and misconduct.

The demand for independent directors has only risen in the wake of increased corporate governance vulnerabilities over the years, making the role indispensable to good governance. Good corporate governance helps businesses avert a situation that might end up triggering financial, operational and reputational damage. Independent directors occupy a pivotal position to meet this objective and appropriately raise concerns to avoid incidents of fraud and governance lapses. To be truly effective, the expertise of this group must be combined with commitment to ethics, foresight and the courage to raise concerns and make tough decisions, including resigning from the board whenever necessary.

The agenda of ethics, compliance and crisis management requires boards to act swiftly, and independent directors play an integral part. They leave a lasting impact on the overall integrity of the business and capital markets. **The role is no longer about power, but power with accountability and responsibility.**

2. SEBI Board Memorandum, 2017

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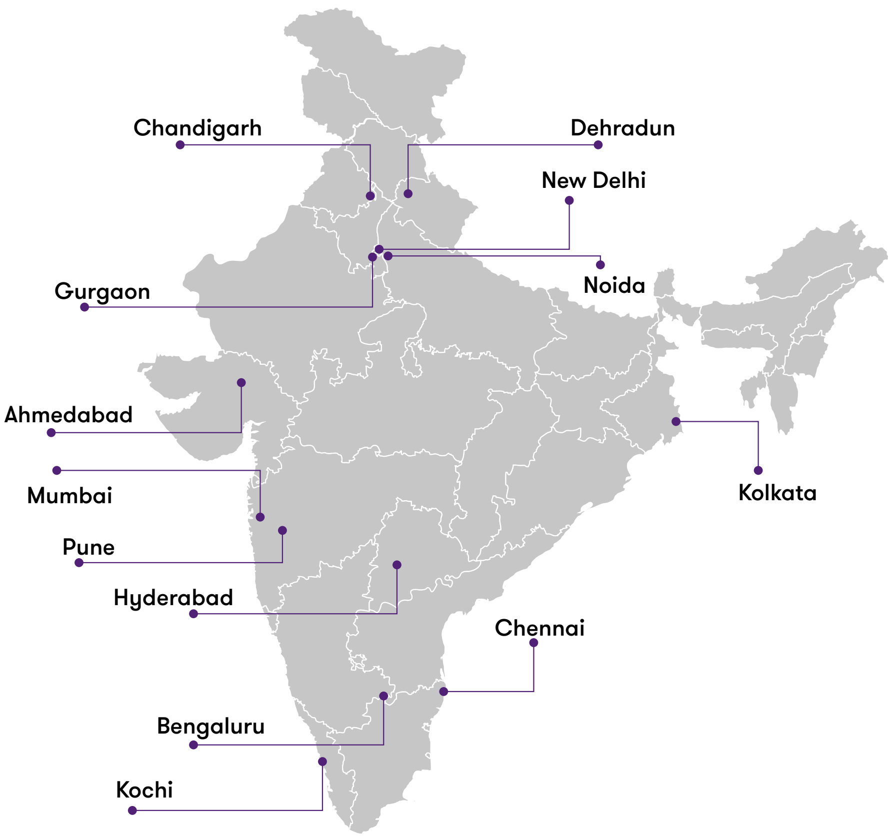

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