

Role of Independent Directors

Issues and Challenges

AUDIT COMMITTEE INSTITUTE





Foreword

The introspection that followed the Satyam episode has resulted in some major changes to India's corporate governance regime. We are on the threshold of adopting a new Companies Act, which has shareholder rights and democracy as its cornerstones. The Companies Bill envisages a much bigger role for independent directors as independent directors are seen as the crucial interface between promoters/ management on the one hand and the minority shareholders/ stakeholders on the other. Separation of the CEO and Board Chair roles, enhanced roles for nomination and remuneration committees, independence criteria and attributes, restrictions on directorships, tenure for directors and board evaluations are some of the provisions relating to independent directors in the draft bill. Whether these would result in better functioning boards is a question that only time will answer.

When it comes to corporate governance, regulations are at best a good starting point, thereafter it is up to every company to decide the structure of governance that will best serve its objectives in terms of sustainable growth and value creation. Effectiveness of the board and its ability to add value is not determined by *who is on the board* but by *what board does*. From this point of view, the linkage between regulation and the effectiveness of boards / independent directors can be as far apart as chalk and cheese.

It is tough for a single independent director to make a difference all by himself/herself. His/Her ability to add value hinges on how the group of independent directors, as a whole, are able to focus the energies of the board in the right direction.

Effective boards do certain things better than others, i.e., focus on the really important big picture issues through highly prioritized agendas, be prepared to challenge management on its strategy, guide the management team to enhanced organizational performance by sharing diverse perspectives,

work constantly to improve the dynamics of the board's overall approach and functioning and spend a significant amount of time addressing succession issues.

Achieving effectiveness is a 'must-do' process for many Indian boards today and this process involves addressing several challenges which are set out below:

- Availability of good independent directors to meet the requirements of board service
- Aligning the independent directors' remuneration to their performance
- The support that independent directors require from company management to discharge their duties
- The lack of clarity around the extent to which independent directors can be held liable
- The availability and commitment on the part of independent directors to understand the company, industry and business and be able to ask incisive questions
- The ability to challenge within the board room.

The purpose of this paper is to explore the issues that independent directors have to contend with and define the broad contours of essential elements that need to be in place if independent directors have to perform their roles effectively in safeguarding the company's long term interests and its stakeholders. We are thankful to KPMG's Audit Committee Institute for its insights on these issues. The perspectives provided herein are not the answers but should act as a good first step in making boards more effective.



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Introduction

The introduction of the Voluntary Guidelines on Corporate Governance in December 2009 was the first sign of things to come in terms of making the independent director's task more demanding. Within the draft proposed Companies Bill, a number of requirements relating to independent directors and their functioning have been proposed that includes:

- Segregation of the CEO and Board Chair roles
- Certificate of independence
- Requirements relating to the nominations and remuneration committees
- Limits on the tenure and number of directorships
- Performance evaluation of board of directors, committees and individual directors
- Specific responsibilities for the Audit Committee with respect to related party transactions and appointment of auditors (internal and external)
- Requirement for independent directors to act as whistle-blowers.

Today the independent director's role has become more challenging due to intense scrutiny from stakeholders, greater demands imposed by regulatory requirements and an increase in overall complexity of the business environment in which Corporate India functions. The rights and wrongs of these proposed provisions including the extent to which the law should prescribe the corporate governance practices of an organization is a subject of intense debate amongst Corporate India and its policy makers.

Within this paper, we deliberately steer clear of debating the pros and cons of these proposed provisions. Instead, we have attempted to focus on some of the cultural and behavioral aspects of the independent directors' functioning that we believe are essential to enhancing their performance and, consequently, the board's overall performance. For an independent director to be effective, certain important elements need to be in place. These are set out below:

1. The perception about independent directors amongst the promoters (including family-owned businesses, public sector corporations and multi-national companies)
2. Understanding the concept of true independence and what it entails
3. Taking concrete measures to diversify the available pool of independent directors rather than lament on their non-availability
4. True empowerment of independent directors – developing the ability to proactively assist management make the right decisions
5. Developing and acquiring skills to do their jobs effectively – the importance of training and induction
6. Addressing the issue about what is the right remuneration for independent directors.

The relevance of independent directors to promoters

Is there a need to have independent directors only from a stakeholder and minority shareholder perspective or is it equally important for the promoters?

Corporate governance is not just a compilation of norms and procedures, it is the way in which companies conduct business. Further, it ingrains the principles of transparency, ethics and accountability into the day-to-day operations. This would have a positive effect on the company's employee and customer value propositions.

Several Indian companies have high quality boards and have implemented governance practices that are way beyond the stipulated regulations. It is important to reflect on how promoters have gained from adopting such practices. Promoters who have gone the extra mile by having independent directors with diverse profiles on their boards argue that the adoption of an inclusive approach to governance that takes cognizance of the needs of employees, shareholders, customers and communities results in organizations becoming better in their businesses over the longer term. But to derive this benefit, it is important to clarify what is expected of independent directors on the board.

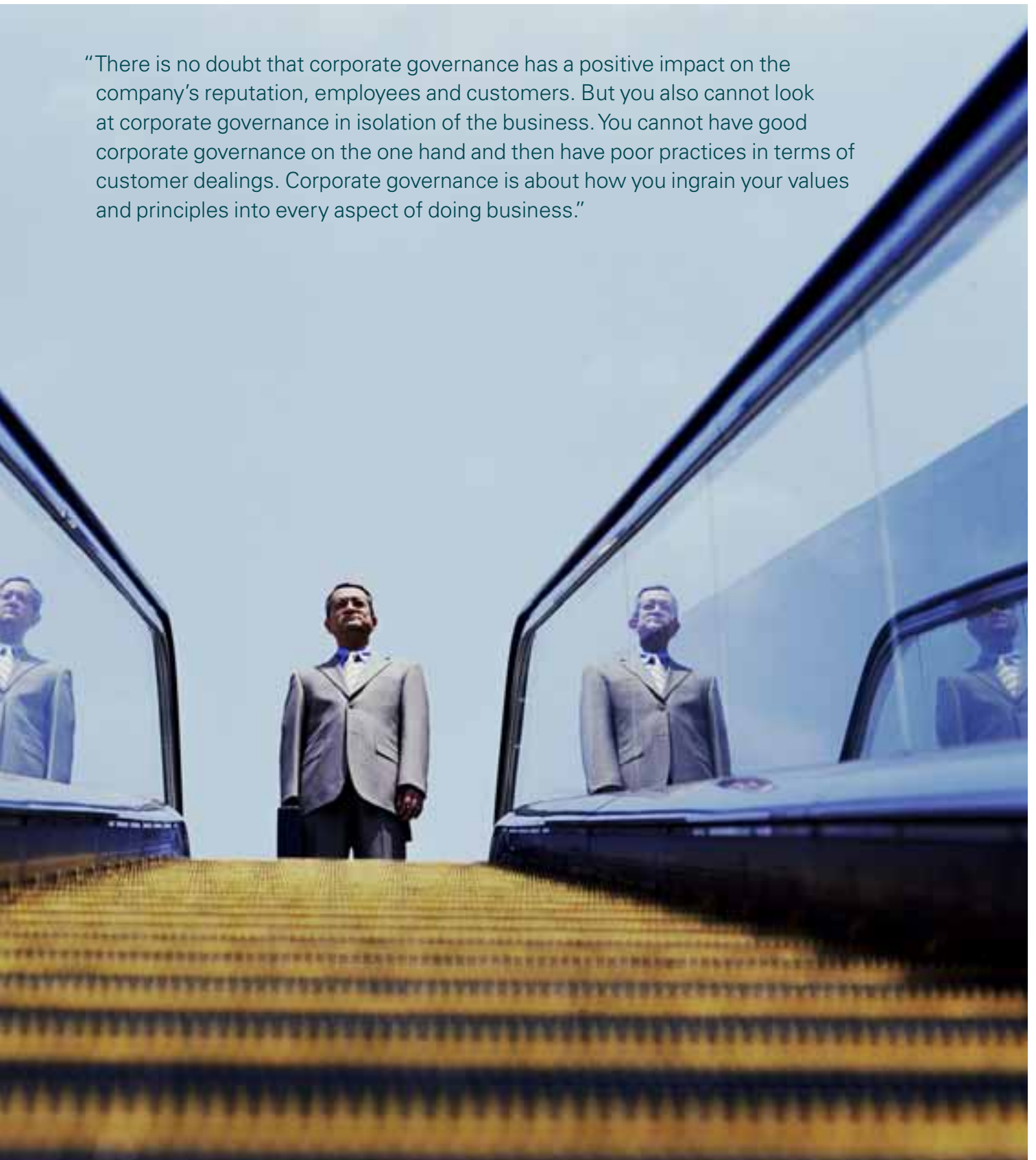
It is also equally important to set the right tone at the top in terms of ethical leadership of the board.

What do ethical leaders do differently?

- Do not hide from debate
- Welcome alternative suggestions
- Believe institutional sustainability comes first
- Foster a climate of trust and candor
- Establish board room relationships based on integrity
- Establish individual accountability

Sources: Ronald Berenbeim 'Why Ethical Leaders are Different', The Conference Board, May 2005; 'The Company Director's Tool Kit', KPMG, 2008

“There is no doubt that corporate governance has a positive impact on the company’s reputation, employees and customers. But you also cannot look at corporate governance in isolation of the business. You cannot have good corporate governance on the one hand and then have poor practices in terms of customer dealings. Corporate governance is about how you ingrain your values and principles into every aspect of doing business.”



True independence


What constitutes true independence and does independence need to be codified within the legislation?

- Most independent directors are 'independent' from a legal standpoint; however, independence in substance is a different ballgame.
- The lack of 'true' independence also stems from the fact that most companies utilize the promoters' or other board members' personal network to search and appoint independent directors.
- When a non-executive director is identified, there are two broad parameters applied – relationships with the promoters and their skills and the ability to add value.
- Regardless of the underlying parameter, it is up to the individual concerned to determine how independent he or she would like to be. For instance, personal friendships outside the board room does not necessarily lead to independence being compromised within the confines of the board room if the individual is prepared to challenge and ask the right questions. Independence therefore is a state of the mind and depends upon the individual's ability to challenge and ask the important questions.
- Promoters who believe in the value that a good board can bring do seek candidates who can challenge them and thereby improve the overall functioning.
- Independence stems from professionalism both at a corporate level in terms of how the company approaches the subject of board composition and processes at an individual level in terms of how an independent director gears himself or herself for effective board service.

Professionalism at both the company and director level is essential

Individual director attributes	Company attributes
<ul style="list-style-type: none"> • Works well with others • Possesses the required business/industry knowledge • Is available when needed • Prepares for and attends meetings • Devotes quality time to oversee company affairs • Is alert and inquisitive • Asks hard questions • Challenges management assumptions 	<ul style="list-style-type: none"> • Have a diversity policy • Appoint directors through an independent and objective process • Establish appropriate board committees • Share information in a timely fashion, especially with independent directors • Develop and follow a code of conduct • Adopt a consultative approach in setting meeting agendas • Record and share minutes of the meeting

Sources: 'Corporate Governance Handbook', The Conference Board, 2009; KPMG ACI Research

A close-up photograph of a man with dark hair and a blue shirt, looking thoughtfully to the side with his hand near his chin. A semi-transparent globe is overlaid on the image, with its grid lines visible over the man's face and the background. The background is a soft, out-of-focus blue sky.

“Independence is a state of mind and cannot be codified through a statute. A lot of promoters bring someone on the board whom they have known for long. The chosen individual is either expected to add value or toe the line without constructive challenge. However, if the non-executive director chooses to engage in constructive challenge within the board room, that is real independence. In the long run, such constructive dissent is bound to result in more effective decision making.”

Widening the talent pool

A majority of the independent directors on Indian boards are retired professionals with a fair proportion of accountants and legal experts. Furthermore, a closer examination reveals that there is a small group of people who hold five or more directorships. With the demand for independent directors only set to increase as a result of some of the clauses of the Companies Bill, it is pertinent to ask:

Are companies facing a shortage of independent directors? If so, what are the measures to overcome this shortage?

- Today when we discuss about independent directors, there is an expectation that they are required to play the role of watch dogs and nothing more. In that sense, the independent directors are expected to play the role of whistle-blowers on the board. Needless to say, this thinking has brought in an element of sameness to Indian boards with a greater focus on compliance. What is required is a diverse group of individuals who can examine issues from diverse perspectives and add value to overall performance rather than merely examining issues from a compliance angle.
- Unfortunately, there is a perception that a company with marquee names on its board is better governed. There is also a perception that there is a severe dearth of good candidates and hence there is a tendency to go back to the same names repeatedly. But having marquee names on the board does not guarantee better standards of corporate governance.
- There is a need to adopt a more professional, independent and transparent approach to appointing independent directors. It is important for companies to align their strategic priorities to skills required in the board room and accordingly seek candidates for non-executive positions on the board. For instance, a company which has embarked on a strategy of growth through acquisitions will need someone on the board with good experience in post acquisition integration. Similarly, a company with a strong domestic presence and expanding internationally will need someone on its board with experience of growing businesses internationally.
- One practice that Indian companies have not adopted is that of having senior management executives in large diversified groups, other than CEOs/ MDs / promoters, taking up non-executive positions in other company boards. This is so because employing organizations are reluctant to give their senior executives the leeway to undertake such roles outside of their regular employment.
- In recent times, the idea of having a panel of independent directors maintained by an independent body has been mooted. However, there is no certainty that nominating an independent director from such a panel will result in better governance. Ultimately, the decision as to who should be an independent director on the board is as much the prerogative of the company and its CEO as much as it is the responsibility of the board. In order to ensure that board composition is right, it is important for the Board Chair, CEO and the rest of the board to work cohesively to identify as to what is the mix of skills that is required to take the company to the next level. Board succession planning is a process that the full board should own.

Specific questions the board should consider regarding a potential candidate

- Has the board identified the skills required in terms of expertise, background and types of personalities?
- Has the board ensured that a wide net has been cast for directors?
- Does the candidate understand the business/ industry of the company?
- Can the candidate work as part of the board?
- Can the candidate work effectively with a diverse group of people – can he disagree without being disagreeable?
- Does the candidate demonstrate a high level of integrity and honesty?
- Is the candidate able to commit sufficient time to discharge board duties?

Checklist for new director appointments

- What is the business requirement going forward?
- What skills, knowledge, experience are we looking for or feel we are missing?
- What's the overall balance of the board in terms of age, profile, gender, and geographical spread?
- How does any new appointment relate to longer term succession planning?
- What is the availability of people with the right skill sets, experience and market credibility we need?
- Select the best available candidate.

Source : 'Building Better Boards', UK Dept of Trade and Industry (DTI), December 2004

Source: 'The Company Director's Tool Kit', KPMG, 2008



Empowerment

Is segregation the answer?

A question that frequently arises is that independent directors are not empowered enough to challenge the promoters. One of the solutions being proposed to redress the issue of balance of power is segregation of the CEO and Board Chair roles.

Is this the right way to go? Will it lead to better functioning on the part of the independent directors?

- Overall, over 80 percent of companies in Europe have segregated the CEO and Board Chair roles primarily due to large institutional shareholding in European companies.¹ India is essentially dominated by promoter-owned entities and promoter families continue to play a key role in management. Although many large listed groups in India have transitioned to professional management, the promoters continue to be involved at the board level and in key decisions relating to strategy. True segregation, which entails having an independent director as the Board Chair is a rarity in India. In a majority of companies, where the CEO and Board Chair roles are segregated, it is usually the ex-CEO or the founder promoter who is the Chairman of the board.
- The important question though is whether having an independent director as the Board Chair will help improve corporate governance and the overall functioning of the board. The authority that comes with the Chairman's role also entails significant responsibilities: the ability to command the respect of the entire board, pull the entire board in the same direction and be able to determine the most significant issues for the board to focus its energies on. Chairmanship also entails having a deeper understanding and knowledge of the business and being able to devote significantly more time to the company than what an individual independent director would be required to devote.
- Another aspect that is worth consideration in the Indian context is that Chairmanship of the board with an independent director at the helm could potentially lead to tension between the executive and independent directors. An alternative that is emerging therefore is that of appointing a Lead Independent Director. The Lead Independent Director leads the group of independent directors and functions as a link between them and the executive directors.

¹ 'Boards in Turbulent Times', Heidrick and Struggles, 2009



Role of the Lead Independent Director:

1. Identify the most critical issues for the board to deal with
2. Assist the board in achieving consensus on important issues
3. Play the role of a facilitator outside the board room especially on contentious issues
4. Work with the CEO to prioritise issues, set the agenda and enable it to focus on substantive issues
5. Ensure that board conversations do not veer in the direction of certain unwanted topics / individual preferences
6. Provide candid feedback to CEO, CFO post an executive session.

Infosys Case:

Infosys Technologies has appointed a Lead Independent Director representing and acting as a spokesperson for independent directors group. The role of the Lead Independent Director as per the company's annual report is as given below:

- Presiding over all executive sessions of the board's independent directors
- Working closely with the Chairman, co-Chairman and CEO to finalize the information flow, meeting agendas and meeting schedules
- Liaising between Chairman, co-Chairman, CEO and independent directors group
- Taking the lead role, along with Chairman and co-Chairman, in the board evaluation process.

Source: Ram Charan, Owing up – the 14 questions that every board member needs to ask

Source: Infosys Annual Report, FY 2008-09



On-boarding/induction

Independent directors on the board of a company come from diverse backgrounds and more often than not, they are not from the same industry. Therefore, a formal on-boarding program for new directors is most helpful in getting new board members up to speed quickly and enabling them to contribute sooner. A recent Audit Committee Institute survey conducted by KPMG in India and globally revealed that very few companies have induction/ orientation and training programs for their directors.



Why is a formal on-boarding program needed? How can it be made effective?

- Although companies have been slow to put in place robust orientation/induction and training programs for independent directors, it is also true that independent directors have not taken this aspect seriously.
- At a time when independent directors are being given additional responsibilities, it is essential for new members to get up to speed quickly on the key issues facing the company. The need is often more pronounced when directors are new to the company.
- Companies do tend to have a general on-boarding process that involves meetings with the Board Chair, CEO, CFO, Chief Internal Auditor, Legal Counsel, etc. However, most believe that these processes are ineffective in terms of giving independent directors a solid overview of the industry, the company and its key challenges.
- It is essential to educate the independent directors on the company's business model, industry, competitive landscape, as well as its recent history of successes or problems with financial reporting.
- A leading practice is to create a director manual for on-boarding purposes. Among others, the manual could provide a broad overview of the board's oversight processes as well as the company's critical financial, operational and other risks.
- Research by KPMG's Audit Committee Institute indicates that business unit updates are important in assisting independent directors in understanding the unit's strategy and operational results, as well as the significant financial and non-financial risks. External auditor, internal auditor, or Legal Counsel could also be called upon to discuss these risks in more detail.
- The on-boarding program should also address the unique legal and regulatory compliance issues facing the company and its industry. Often, the company can call upon outside professionals to discuss these issues with the audit committee and independent directors on the board either during formal meetings, in case time permits, or during special in-house educational sessions.
- Ultimately, the effectiveness of an on-boarding program would largely depend on whether the program was customized to the individual needs of a director considering his or her current expertise and role expectations.

Characteristics of an effective on-boarding program

- **Timely:** The Orientation must be timely – preferably held in the first month. In order to speed up the learning curve, some boards are beginning to deliver board orientation on a ‘just-in-time’ basis
- **Tailored:** The elements of the orientation program should be tailored according to the appointee’s knowledge and experience. It will vary depending on the company structure, processes and major issues faced
- **Effective combination of methods:** There should be a combination of written materials with presentation, meetings and site visits, aimed at providing a realistic picture of the company’s position and challenges
- **Led by a Chairman:** The Chairman should take a lead role in ensuring the delivery of a tailored and properly balanced induction program
- **A follow-up meeting with the Chairman:** There should be a follow-up meeting between the new director and Chairman to discuss any issues and provide feedback to improve the program.

Source: ‘The Company Director’s Tool Kit’, KPMG, 2008

Constituents of an ideal on-boarding kit

Corporate information	Governance framework	Management information
<ul style="list-style-type: none"> • Strategic and business plans • Major shareholders • Regulatory frameworks • Company history • Overview of the company’s competitors and industry information • Product information • Risk profile and appetite • Financial accounts • Corporate communications 	<ul style="list-style-type: none"> • Board charter / governance statement • Annual agenda • Full details of directors • Committee structures • Board processes • Assurance providers • Resources available • Key stakeholders • Procedures for sign-off of financial statements 	<ul style="list-style-type: none"> • Names and background of senior management • Organization chart and management structure outline, etc.

Source: ‘The Company Director’s Tool Kit’, KPMG, 2008

Remuneration

With the increasing complexity, ever increasing stakeholder expectations and regulatory pressures (e.g. additional requirements and responsibilities thrust upon independent directors by the proposed Companies Bill), it is clearly emerging that independent directors should be able to commit adequate time and energies for board service. Consequently, it is extremely important to address the question as to whether independent directors are adequately compensated.

What is the right level of remuneration and what should be the components of such remuneration?

The global scenario

- Globally, director remuneration is a hotly-debated issue. The US introduced Dodd-Frank Wall Street Reform and Consumer Protection Act in July last year, mandating non-binding vote on executive compensation, establishment of an independent nomination committee, public disclosure of compensation versus performance and a slew of other disclosures aimed at ensuring not only the independence of the remuneration committee but also that of the compensation consultants. In fact 'Say on Pay', a shareholder advisory vote on executive compensation is the 'new normal' in the US.²
- The UK Corporate Governance Code suggests that levels of remuneration for non-executive directors should reflect time commitment and responsibilities of the role and remuneration should not include share-options or other performance-related elements. If, in exceptional cases, options are granted, the code suggests that approval should be sought in advance and any shares acquired by exercise of the options should be held until at least one year.³
- Remuneration structure in other parts of Europe varies vastly with countries such as Sweden, Denmark and Switzerland having over 95 percent of the total remuneration as fixed fees and countries such as France and Germany having less than 60 percent of the total remuneration as fixed. Companies in some European countries typically include other layers of fees, the most common of which are: attendance fees, variable fees based on company performance, basic fees for committee membership and Chairmanship, and committee attendance fees.⁴

The Indian scenario

- Clause 132(6) of the proposed Companies Bill states that "an independent director shall not be entitled to any remuneration, other than a sitting fee, reimbursement of expenses for participation in the board and other meetings and profit-related commission as may be approved by the members".
- The Report of the Standing Parliamentary Committee on Finance proposes to disallow granting of stock options to independent directors. However, it permits payment of higher sitting fee to independent directors. The Central Government will be empowered to prescribe the amount of sitting fees to be paid to directors (including independent directors). The rules may provide different slabs/categories for payment of sitting fees to different class or classes of companies on the basis of net worth and/or turnover of companies.
- It may be noted that legal provisions in the UK and the Sarbanes Oxley Act in the US do not permit payment of a profit-related commission to independent directors.

² 'Dodd Frank Act', KPMG Financial Services Regulatory Practice Letter, July 2010

³ 'The UK Corporate Governance Code', Financial Reporting Council, June 2010

⁴ 'Boards in Turbulent Times', Heidrick and Struggles, 2009

- However, it may also be noted that various countries (US, UK, Canada, Australia, Singapore, Hong Kong to name a few) do not prohibit stock options for independent directors. Considering that stock options are growing in popularity, it may be more relevant to place restrictions either on the total amount of options or on the manner in which these options are exercised (stock options exercised and converted to shares by an independent director may not be sold for a certain predetermined period after exiting from the board) instead of completely prohibiting stock options.
- Given the more onerous duties and responsibilities of independent directors, it should be left to shareholders to decide as to what is the best way to remunerate independent directors and, in that context, make appropriate disclosures. It would be inappropriate for the government to regulate the quantum of sitting fees as this would involve micro-management and is likely to be counter productive in the longer term. Therefore:
 - A major proportion of director's compensation should be fixed based on the assigned responsibilities and time commitment, with the variable component linked to meeting attendance, contribution in board meetings, ability to stay abreast of industry and company developments and performance as measured by objective board evaluations.
 - As per voluntary guidelines, companies should be allowed pay stock options with delayed vesting rights to non-executive directors including independent directors.
 - Companies should be required to seek shareholders prior -approval on 'director remuneration policy' before making any payments towards compensation.
- The most important aspect with respect to remuneration is the level of accountability and transparency when it comes to determining the compensation practices for independent directors. In order to achieve this, companies should be required to make adequate disclosures not only on director remuneration policies in terms of the components of remuneration but also on the established processes for determining director remuneration.



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