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Issues of Independence of Board of Directors in India

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Abstract:
In companies, the board of directors acts as one of the most important governance mechanisms in aligning the interests of the managers and the owners/shareholders of the company. We analyzed 241 NSE listed companies to understand the level of independence of the board of directors. We observed that although many companies have minimum one third members as an independent member, there are companies who have less than one third independent members on the board. India has proactively implemented corporate governance norms and guidelines; however the bigger challenge lies in the effective implementation and enforcement of these rules. The certainty of punishment in case of non-compliance would go a long way in augmenting disclosures, thereby improving the corporate governance standard in the country.

Key words: *Board of directors, Independent directors, corporate governance*

1. Introduction

The standard definition of corporate governance among economists and legal scholars, refers to the defence of the shareholder's interest (J. Tirole, 2001). The board of director's acts as one of the most important governance mechanisms in aligning the interests of the managers and the owners/shareholders of the company. The important functions of the board are to define the company's purpose, to strategies and draw plans to achieve the purpose, to appoint the Chief executive officer, to monitor and assess the performance of the executive team and last but not the least to assess their own performance. In executing these functions, the board of directors is expected to act as protectors of the interests of the shareholders of the company. (Sarkar and Sarkar, 2012)

As per clause 49, the board of Directors of the company shall have an optimum combination of executive and non executive directors with not less than 50% of the board of directors comprising of non-executive directors. The number of independent directors would depend whether the chairman is executive or non-executive. In case of the non executive chairman, at least one third of the board should comprise of independent directors and in case of an executive chairman, at least half of the board should comprise of independent directors.

For the purpose of Clause 49, the expression, 'Independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationships or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect independence of judgment of the director.

As per clause 49, the board meeting shall be held at least 4 times a year with a maximum time gap of four months between any two meetings. It further states that the director shall not be a member in more than 10 committees or act as chairman of more than five committees across all companies in which he is a director. It is the mandatory annual requirement of every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.(SEBI Report, 2003)

This Paper tries to explore the independence of the board of directors in India by studying the composition of the board of directors of the NSE listed companies for the year 2012. The focus of the research is mainly on practices followed by Indian companies in keeping the board compositions in line with clause 49 and whether there is any difference in these practices based on the size of the company and nature of ownership.

2. Development of corporate governance Practices in India

Prior to the adoption of clause 49, India was considered a laggard in corporate governance. From 1947 (independence) through 1991, the Indian government pursued socialist policies. The performance of the governance agencies that provided capital to private firms was assessed based on the amount of capital invested rather than return on investment. This created little incentive for managers of private firms to voluntarily adopt good governance practices. At many firms, government funds were basically

stolen. Indian corporate governance, which was considered to be comparable to that of British firms at independence deteriorated.(Bernard and Khanna, 2007)

In 1991, the government faced fiscal crisis. It responded by enacting a series of reforms, including reduction in state provided financing, bank privatization, and general liberalization of the economy. SEBI, India's security market regulator was formed in1992. By the mid-1990s, the Indian economy was growing steadily, and Indian firms began to seek capital to finance expansion into the market spaces created by liberalization and the growth of outsourcing.

The need for capital, among other things, led to corporate governance reforms. The first major step was the CII's promulgation in 1998 of a voluntary corporate governance code. CII proposed that the Code's core provisions would apply only to large Indian firms. A few major firms voluntarily adopted the CII principles, but general opinion was that the voluntary approach was probably insufficient to persuade outside investor to invest in Indian firms. (Bernard and Khanna, 2007)

A year later, SEBI announced the formation of the Kumar Mangalam Birla committee (KMBC), which was tasked with proposing corporate governance reforms. These reforms became "Clause 49", named because they were implemented through a new clause 49, which was added to stock exchange listing requirements. The adoption of Clause 49 was viewed as a watershed event in Indian corporate governance.

The characteristics of Indian companies along with their sources of financing and ownership structure reveals the continuation of past into present. This is in terms of the continued dominance of family business groups in the corporate sector despite a growing number of standalone firms, as well as a critical dependence of companies on external sources of finance and the persistence of concentrated ownership structure.

With significant insider ownership and control throughout the years, the governance of companies by external investors has remained a critical issue throughout. This has become increasingly relevant in view of the liberalization and globalization of the Indian economy, the growth of the financial markets and the growing clout of institutional investors. Governance Reforms in India, therefore, have become imperative, and as the discussion of such reforms has revealed, continued efforts have been made by the government and regulatory agencies to fine tune the regulatory and legal framework, sometimes proactively to keep ahead of the changes in the operating environment, and in light of experiences on the ground. (Bernard and Khanna, 2007)

3. Role of the Companies Act, 1956

The Companies Act of 1956 is the single most important legislation for corporate India. It encompasses the functional aspects of the public limited companies. The recommendations of various committees on corporate governance focus on amending the Act to incorporate specific governance provisions related to independent directors and audit committees. Ministry of Corporate Affairs had proposed the Companies Bill, 2009 with an aim to improve corporate governance by focusing on the powers given to shareholders. The Ministry also brought out the Corporate Governance Voluntary Guidelines 2009 to provide policy direction to the Indian companies on the issues of disclosure and accountability. (Neeti S. and Sangeeta Y. (2011)

3.1. Role of SEBI

SEBI, the securities market regulator in India, works towards protecting the rights of the existing and prospective shareholders. At its inception, the primary role of SEBI was to monitor stock trading. In the recent past, however, SEBI had worked towards augmenting standards of corporate governance in the country. Two committees constituted by SEBI under Kumar Mangalam Birla and Narayana Murthy have played a pivotal role in the Indian corporate governance landscape. Through Clause 49 of the Listing Agreement, SEBI regulates corporate governance practices of the listed Indian companies. (Neeti S. and Sangeeta Y. (2011)

3.2. Role of Accounting Standards

Institute of Chartered Accountants of India (ICAI) plays a pivotal role in laying down corporate accounting practices and standards. Although the Indian accounting principles are moving towards harmonized international accounting practices, certain gaps still need to be filled in. Indian accounting standards still differ from the International Financial Reporting Standards (IFRS) but in many ways are inspired by the US GAAP. The ICAI has introduced a concept paper recommending a full switch to IFRS for the Indian companies by 2011. But till 2013, there is very little progress in that direction. (Neeti S.and Sangeeta Y. (2011))

3.3. Corporate Governance and SEBI Clause 49

Since its establishment in 1988, SEBI has introduced several corporate governance reforms. One of its major reforms has been through Clause 49 of the Listing Agreement. Clause 49 introduced a number of key measures in governance and disclosures in all the listed companies. An amendment to Clause 49 in 2003 made it mandatory for every public company listed on the Indian stock exchange to sign the Listing Agreement. Clause 49 was further revised in 2004 and came into effect in 2006. The key features of Clause 49 regulations deal with composition of the board of directors, composition and functioning of audit committee, governance and disclosures regarding subsidiary companies, Chief Executive Officer/Chief Financial Officer certification and reporting on corporate governance as part of annual report. Further, it is mandatory for the listed Indian companies to file with SEBI, the corporate governance compliance report and shareholding pattern along with the financial statements. Clause 49, India's answer to Sarbanes-Oxley Act of the US, is clearly a defining point in the evolution of corporate governance practices in India. (Neeti S. and Sangeeta Y. (2011))

The distinction between officers and outside board members can be important for several reasons. Although it is the fiduciary duty of all directors to represent the interests of shareholders, outside directors in particular must oversee the performance of the firm's officers. But monitoring the performance of top officers requires time and effort. In addition, an outside director serving on a

board dominated by Officers with more expertise and influence over votes risks losing his position if he objects to those officers' choices. (Randall Morck et al. (1987))
The largely shared wisdom regarding the optimal board size is that the higher the number of directors sitting on the board, the less is performance. This leans on the idea that communication, coordination of tasks, and decision making effectiveness among a large group of people is harder and costlier than it is in smaller groups. The costs overwhelm the advantages gained from having more people to draw on. (Mohamed B. (2006))

4. Objectives of the Study
The objectives of the research are

- To study the board composition of the companies on the basis of size of the company.
- To assess whether the board composition is as per clause 49 of listing agreement.
- To find whether nature of ownership has any relationship with independence of board.

5. Research Methodology

5.1. Research Design
The findings of this study are based on a detailed analysis of data obtained from Prowess software. The study relies on secondary data as disclosed by the companies in the annual reports under corporate governance disclosures. We collected following information from the reports on corporate governance and the annual reports of the company.

- Size of the company as measured by Total assets of the company.
- No. of members of the board of directors.
- Classification of members on the basis of independent and non- independent.
- No. of board meetings held during the period of study.
- No of board meetings attended by board members.

5.2. Sample Size and Selection
We selected S&P CNX 500 index companies as our sampling universe. S&P CNX 500 Index is a diverse representative of the companies from various industries. From these 500 companies, we excluded companies for missing data inputs. After removing such companies form the sampling universe, we finally got 241 companies as a part of our sample.

5.3. Period of Study
We studied 241 companies for the financial year 2011-12.

6. Data analysis and Interpretation

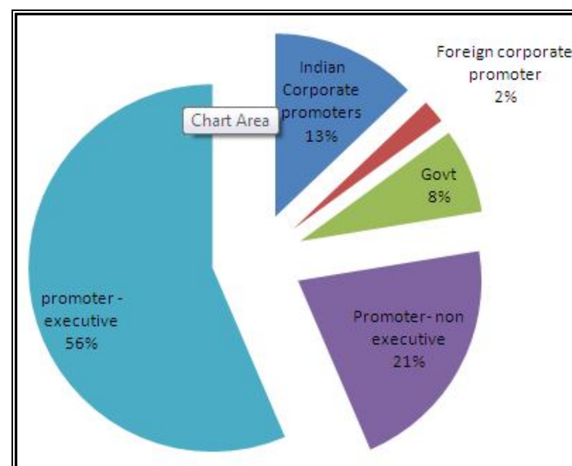

Figure 1: Distribution of the companies by presence of promoters on the Board of Directors
Source: Authors' calculations based on data from annual reports available in the Prowess database

Fig -1 captures the distribution of the companies in the sample by presence of promoters on the board of directors in the sample. Our sample had 8% companies promoted by the government of India, wherein the promoter is the President of India. Two percent of the companies are promoted by the foreign corporate promoters.Indian corporate promoters are present in 13 % of the sample. Companies where corporate ownership is evident, presence of an individual as an insider is difficult to trace on the board of directors. Companies where Indian individual promoter is non-executive member of the board of directors are 21 % of the sample. Majority of the sample companies are those where Indian individual promoter is an executive member of the board of directors

and acts as Managing Director of the company. It clearly indicates that in Indian companies, Board of directors is occupied heavily by the insider (promoter cum manager).

Nature of Promoter	No. of members on the board		No. of Independent Directors		Independence of Board in %		Board meetings in a year	
	Min	Max	Min	Max	Min	Max	Min	Max
Government	6	26	4	16	28	61	5	20
Foreign corporate promoter	5	12	2	5	33	57	4	5
Indian Corporate Promoter	5	23	3	12	31	70	4	12
Indian Individual Promoter (Non-executive member)	5	22	3	10	21	72	4	12
Indian Individual Promoter (executive member)	5	22	2	11	17	72	4	14

Table 1: Details of Board of Directors on the basis of Nature of Promoter of the company
(Source: Authors' calculations based on data from annual reports available in the Prowess database.)

Table 1 shows the details of the Board of Directors composition on the basis of nature of promoters of the company. Independence of the board is highest in companies where promoters are Indian corporate promoters. Independence of the board is lowest in companies where promoter is the individual Indian promoter and also the executive member of the board of Director. It is also observed that independence of the board is less than one third in case of companies where Indian promoters are non-executive board members. In case of government companies, some companies have less than one third independent board. These are evidences of clear violation of clause 49 requirements.

Size of the Company (total assets in Rs. Millions)	Total No. of Companies	Size of the Board (Total no. of members)			Independence of board in %			No. of Independent directors			No. of Board Meetings in a year		
		Min	Max	Mode	Min	Max	Mode	Min	Max	Mode	Min	Max	Mode
<=10,000	22	5	14	8	27	66	50	2	8	4	4	12	4
>=10,000 and =<20,000	33	5	17	10,12	17	72	50	3	8	5	4	9	4
>=20,000 and <=50,000	62	5	17	11	27	71	50	2	8	5	4	11	4
>=50,000 and <=100,000	40	6	19	11	34	72	50	2	11	5	4	15	4
>=100,000 and <500,000	53	6	23	10	21	70	50	3	12	5,6	4	14	5
>=500,000	31	5	26	14	28	66	50	4	16	6	4	20	6
Total no of companies	241												

Table 2: Details of Board Composition on the basis of Size of the company
Source: Authors' Calculations based on data from annual reports available in the Prowess database

Table-2 shows the details of board composition on the basis of size of the companies. It shows that size of the board varies with minimum 5 members to maximum 26 members with majority of companies having 10-12 members on the board of directors. But the relationship between size of the board and the size of the company is not evident as minimum no of members is almost same across all the sizes of the company. Independence of the board is found to be less than 33.33% in some companies across all the sizes except those falling in the range of Rs 50,000 to Rs. 100,000 asset size bracket. But the mode is 50% which indicates that majority of the companies are meeting the requirement of clause 49 across all the brackets of sizes.

The number of independent directors on the board varies between minimum 2 directors to maximum 16 directors. The mode for number of directors shows that 4 to 6 members are normally independent members on the board across all the categories.
All the companies are meeting the requirement of minimum four board of directors meetings in a year as per clause 49.The maximum meetings were observed in large companies with number as high as 20 which was the government run company. So it is evident that companies are meeting the requirement of minimum number meetings in a year but some companies are failing to keep the independence of the board as per the minimum requirement of one third. Lack of independence of the board might lead to inadequate protection of the minority shareholder's interests.

7. Summary and Conclusion

Independence of the board of directors is an important issue as far as the protection of the interests of the minority shareholders is concerned. Our Analysis show that independent of the board is less than one third in some of the companies while majority of it as adhering to the requirement of Clause 49.We also observed that size of the company and the size of the board of directors has no relationship with each other. An assessment of the quality of governance in India show that in terms of laws in the book or substantive law, India is at par with major developed countries, particularly with key elements of governance, namely, investors and creditors rights. The problem lies with respect to implementation and enforcement of Laws on the ground. Thus, even if best practices are adopted at the regulatory level, the adoption of best practices at the company level may be constrained, or benefits from best practices may remain unexploited in the absence of effective implementation and enforcement. In an environment where companies have little impetus to disclose information voluntarily, setting up rules and regulations is an important first step towards enhancing financial disclosures. India has proactively implemented corporate governance norms and guidelines; however the bigger challenge lies in the effective implementation and enforcement of these rules. The main challenge in India lies in streamlining the process of corporate governance disclosures. As a legacy of the British rule, we have one of the world's best governance regulations but poor implementation of these regulations takes away the desired impact of such laws. The study recommends that market regulators such as SEBI should have the power to prosecute top management of companies involved in frauds, and penalties should be made more stringent. The certainty of punishment in case of non-compliance would go a long way in augmenting disclosures, thereby improving the corporate governance standard in the country.

8. Limitations of the Study

The study covered only the index stocks which is a basket of all the industries. Findings might change if industry specific practices are incorporated in the study and the period of observation is changed. Also there are many other dimensions like remuneration of independent directors, maximum number of companies for which each person can act as an independent director which were not taken into consideration and it gives scope for further research.

9. References

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