Myth about Independence of Directors

The effectiveness of corporate governance is demonstrated through evaluation of various measures of governance such as board characteristics, ownership structures, investor protection, duties of external auditors, controls over financial reporting, minority rights etc.

Regulators, investors, academicians, rating agencies and analysts are continually searching for tools that help to develop a pattern or metric that not only works as early warning signals but also gives insight into firms indulging in deception, fraud and corruption.

Independent directors (ID) constitute the pivot of corporate governance system originating from the Anglo-Saxon model which is replicated by codes all over the world, including India. IDs have come to symbolise the presence or absence of 'good' corporate governance to an extent that the number, status or profile of such individuals has become a proxy measure for evaluation of the company risk profile by investors, regulators and rating agencies. This measure in turn has a direct co-relation to the company's cost of capital.

Independent directors as the vanguard of good governance is designed for a market system that predominantly consists of dispersed shareholders where IDs are responsible for upholding minority rights and creating the key balance so that the majority or people in charge of management of a company do not have unfair benefit of being in control. Whether this measure of good governance works in markets with significantly higher ownership by promoters is, however, a debatable matter.

In Indian capital markets promoters on an average hold over 58 % of a listed company as determined by Bombay Stock Exchange. Further, the Companies Act requires that in order to be appointed as a director, a majority of the shareholders need to vote in favour. This means that promoters need to vote in favour of the candidate. Therefore the metric of independence of directors in India as well as in most of the emerging world, in the face of concentrated ownership is somewhat of an oxymoron. They are expected to uphold the rights of the minority and have a duty of care in relation to risk evaluation, financial reporting, managerial and ESOP remuneration etc., while their appointment and continuance is in the hands of the promoter, who more often than not is the majority owner. Many analysts question the 'Independence' of the independent director right from the moment of appointment.

The scandals over the last decade in cases like Satyam, Enron, Parmalat, Worldcom shows that the presence of highly qualified, industry veterans as independent directors has not been a deterrent for these companies to commit the biggest frauds or mis-reporting. Though rating agencies and corporate researchers place a high value on the profile of independent directors that attribute alone is no insurance for investors that their interests are well looked after.

The myth about independence of directors creating greater value for investors is further diminished as evident from the recent COSO report, the US Commission that defined the standards of organisational governance , on the review of fraudulent reporting by companies over a 10 year period says , "there is hardly any notable difference between board characteristics of fraud and no-fraud firms.''

Another metric concerning board characteristic is that of **financial expertise** especially of audit committee members.

Governments and regulators across the world believe that financial expertise amongst independent directors maintains high level of corporate governance and keeps high level of integrity of financial information. Modern companies and their business transactions are highly complex matters and to expect that an independent board member who spends a limited time on the company—whether because s/ he is an outsider or due to other demands on time—will ensure the integrity of financial information is somewhat unrealistic.

Examples abound-- Satyam had on its board of directors, a business school dean and eminent professor of Harvard, who is a leading global expert on corporate governance. Enron had on its board an accounting professor and former Stanford Business School dean, international bankers, former financial market regulars, and current financial service firm leaders. The Freddie Mac board had the world's leading financial economists, several prominent mortgage experts, and a former Big Four accounting firm CEO.

Günera , Malmendierb and Tate of Berkley, in their paper titled 'Financial expertise of Directors' say, 'The impact of board members on firm policies goes beyond mere monitoring, and is affected by director interests that conflict with those of shareholders. The overall impact of financial experts on shareholder value is difficult to assess, specific policies – like financing, investment, and compensation – do not seem to improve when financial experts join the board of directors.'

Jeffery Sonnenfeld, an eminent professor for corporate governance from Yale, in his study 'Good governance and the misleading myths of bad metrics' sums it as, "insufficient financial expertise has rarely been the point of vulnerability for firms suffering from executive corruption".

If we get concerned largely with complying with the regulations of having adequately qualified independent directors in the Board and other prescribed processes, then often the decisions taken by such board are academic in nature and mission critical decisions are often overlooked or unquestioned, leading to calamitous results for the shareholders like in the case of merger of Maytas and Satyam.

It is clear that not all information can be summarized by matrices. More worryingly, data can be manipulated to fit into expected responses—a tick-the-box approach without the underlying behaviour being incorporated. In the rush toward complying with metrics, it is the qualitative aspect of corporate behaviour that gets missed out but which is crucial to corporate performance. For instance, loyalty and trust have a significant value in terms of efficiency and effectiveness with which a business can be run; it also helps reduce costs of running a business such as costs of installing control mechanisms at various levels to minimise risk of fraud, etc.

Some of the key elements of corporate governance are significantly a qualitative evaluation of a firm's ethics, tone at the top, value system, appetite for risk etc., which can rarely be quantified or demonstrated by a process or by a system.

If the regulators, shareholders and other agencies get obsessed about metrics, which are quantitative or compliance oriented, then corporations will find a way of complying with them in letter rather than the spirit or the principles behind them.

In India, we place an unrealistic expectation from our independent directors which needs to be tempered, in the face of current laws and relying overly on one singular metric as the key gate keeper may not safeguard stakeholders' interest and is more likely to be abused by companies indulging in mis-reporting.

We continually need to remind ourselves that the only role of the independent director is to make sure that the rights of the minority and small shareholder is not abused and that is what they should be judged for.

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