

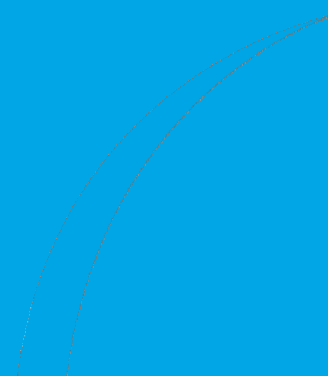
Role of Independent Directors

- CA Kartik. B. Radia

Session 1

Financial literacy for Directors

Analyzing financial health of a co., corporate fraud, application of statutory requirements, evaluation of financial health



01 Analyzing financial health of a
co.

02 Evaluation of financial health



Financial literacy for Independent Directors

“As per Schedule IV TO The Companies ACT, 2013 Independent Director’s role is to bring an objective view in the evaluation of the performance of board and management, scrutinize the performance of management and safeguard the interests of all stakeholders, particularly the minority shareholder

<i>How Independent Directors will scrutinize performance of the management</i>	
<i>1. See Assurance</i>	<i>✓ Appointing right agencies</i>
	<i>✓ Hiring Right People</i>
	<i>✓ Using Right tools</i>
<i>2. Following Compliances</i>	<i>✓ Legal Compliance</i>
	<i>✓ Compliance Management Tool</i>
	<i>✓ Accountability and Self Assessment</i>
	<i>✓ Independent Compliance Audit</i>
	<i>✓ Board Reporting</i>
<i>3. Reporting</i>	<i>✓ Financial Reporting</i>
	<i>✓ Statutory and Internal Audit</i>
	<i>✓ Compliance with accounting standards</i>
	<i>✓ Related Party Transactions</i>
	<i>✓ Accurate and complete financial statement and complete Financial Disclosures</i>

Independent Directors Need Comprehensive and Integrated Policy Framework

- While technologies, processes, and ultimately, people are the soldiers on the front lines, integrated policy framework is the strategic direction that guides the organization toward objectives and goals.
- The importance of an integrated policy framework is supported by a quick review of current regulatory issues facing companies. While regulations, whether governmental or industry driven, are typically on the "grey" side when prescribing control requirements, the need for defined policy within the organization is always included.
- However, policy is not just a 'check the box' activity for regulatory compliance. Policy defines the organization's response and posture for handling specific business processes.
- Policy definition is not a one-time activity but must be ingrained into the culture of the organization.

Objective

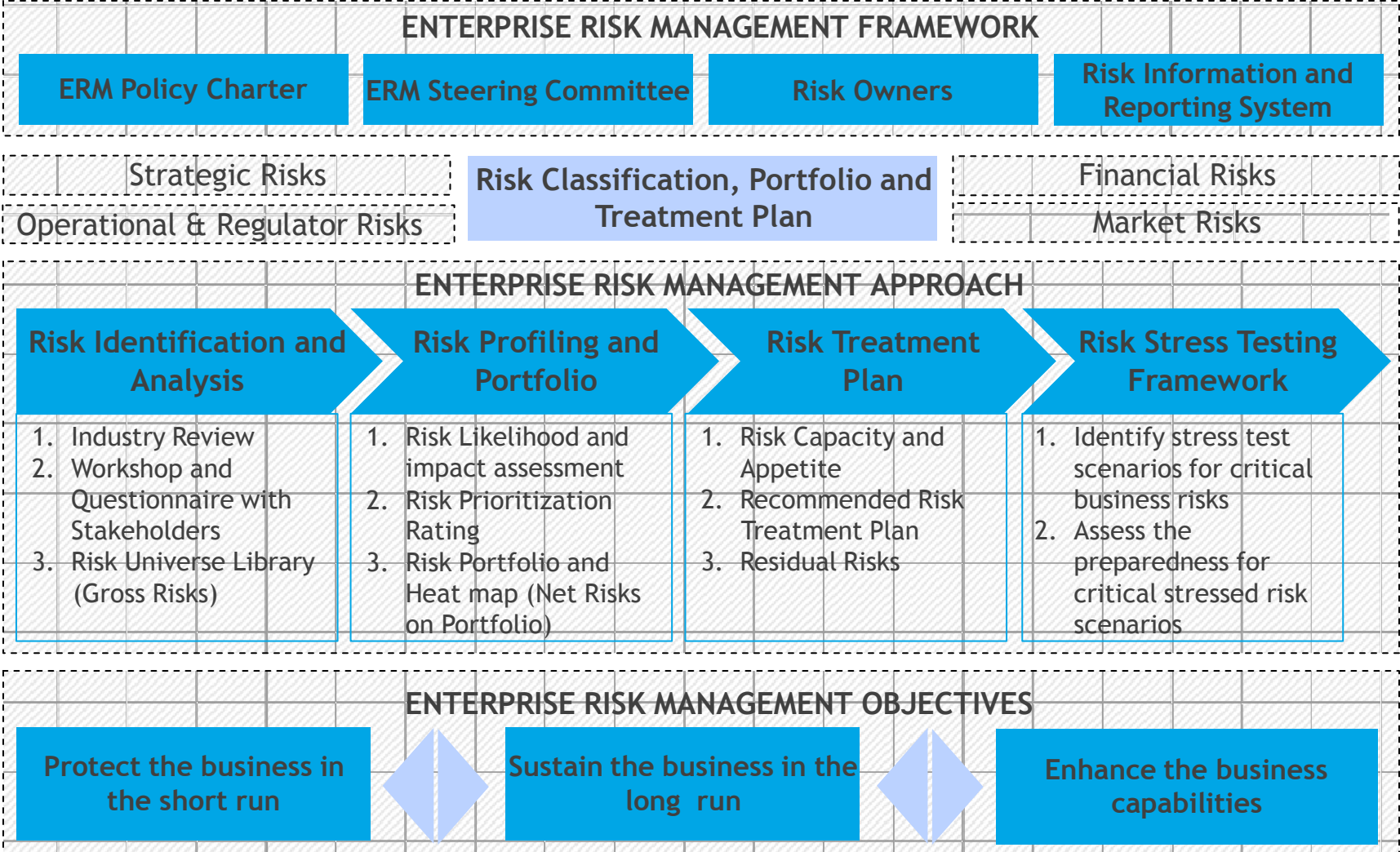
OBJ1	Establish a unified medium of communication for Top Level
OBJ2	Clarity and benchmarking of expectations from individuals
OBJ3	Ethics Awareness
OBJ4	Synchronized work management

Focus is not only on setting the standards, but it is also to verify the effectiveness of its implementation

Independent Directors Need Compliance Enabling System

- Compliance Management is an area of practice which demands expertise and specialised and comprehensive knowledge of legal universe on one hand while keeping a track of key amendments/ notifications on the other.
- Compliance Enabling System is required in order to eliminate or reduce the risks arising out of non-compliances of various Central and State laws, statutes and legislations. Under Various Act, Rules and Regulations, responsibility has been vested on the Board of Directors to ensure the compliances of all the Laws. Managing Directors/ Directors/ Secretary are included in the definition of “officer in default” under the Companies Act,1956. Therefore implementation of a proper compliance management system is required to safeguard the interest of company officials as well as stake holders.
- Regulators are better equipped and Agile in tracking the non-compliance. The Stakeholders proactively seek information and are better informed. There is no hesitation in undertaking punitive action against the company both by regulators and stakeholders.
- Legal non-compliance is seen as unpardonable and can have far reaching implications, even closure. Also, media is technology driven and dissemination of information is instantaneous across the world.

Independent Directors Need Risk Management Framework



Independent Directors Role - Corporate Governance

What is independent Director role to play

Role of advocacy

Oversight

Direct

How ?

Right kind of agencies are appointed

Right kind of reports and information

Information required by Independent Directors

“ In order to discharge duty as per Code of Conduct for Independent Director, they need information, which shall be provided by CFO or CS of the company”

1). What information is required by Independent Director”

- ✓ Profit & Loss Statement
- ✓ Balance Sheet
- ✓ Secretarial Audit Report
- ✓ Corporate Governance Report

2). Purpose to require above information by Independent Directors

- ✓ Evaluate the financial health of the company
- ✓ Evaluate operations of the company
- ✓ Evaluate internal control system
- ✓ Business Strategy
- ✓ Decision Making
- ✓ Best Governance Policy

GRC Cultural Infrastructure

Success story of Today's Enterprise is driven by Soft Infrastructure, i.e. Cultural Infrastructure, and not alone by the hard infrastructure

The Soft Cultural Infrastructure is the most important entrepreneurial asset

Soft Cultural Infrastructure is enabled by following components

- | | |
|---|--|
| 1. Board Effectiveness | <ul style="list-style-type: none">- Leadership Governance- Board Oversight- Clarity of Righteousness |
| 2. Strategic - Wisdom & Vision | <ul style="list-style-type: none">- Value Proposition |
| 3. Governance and Ethics - Wisdom and Vision | <ul style="list-style-type: none">- Policy Environment- Guidelines- Do's and Don'ts- Awareness- Business Behavior and Corporate Behavior |
| 4. Performance - Development and Growth | <ul style="list-style-type: none">- Capabilities and Competencies- Economic growth- Human Resource development (career profile and path) |
| 5. Information Enabling | <ul style="list-style-type: none">- Rightful and timely information for correct decisions- Crafted Information Links |

GRC Cultural Infrastructure (Contd..)

Soft Cultural Infrastructure is enabled by following components

6. The Connect

- Top to bottom connect
- Talk the same language across the organization
- Unity of vision and action at all the levels
- Top connects to the bottom via participatory programs, messages and email communiqués

7. Compliance Regime

- Corporate Compliance Framework to ensure religious compliance in spirit to all applicable regulations

8. Political Wisdom

- Political wisdom for sustainability
- Cannot be straight in all actions
- Straight trees are cut first
- Complete straightness can open up vulnerabilities
- Governance demands to be politically correct
- Should be well governed and appear to be well governed

The Soft Healthy Company can absorb the stressful shocks and jerks, adapt to changes and lead thorough a sustainable core.....

Transposing to the DNA view of a Soft Healthy Company



Crafting and Mutation is required at the DNA level to build a Sustainable and Governed Structure.....

DNA is the Core.....

Financial literacy for Independent Directors

- Should there be formal training Program or Minimum Education criterion for Independent Director?*
- What is the extent of depth independent Director should have- in order to have a grip over the understanding the operation of company?*
- Should Independent Director be entitled to ‘profit related commissions’?*
- Are quarterly board meeting enough?*

Key Functions of the Board

- ❑ Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestments.
- ❑ Monitoring the effectiveness of the company's governance practices and making changes as needed.
- ❑ Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- ❑ Aligning key executive and board remuneration with the longer term interests of the company and its shareholders.
- ❑ Ensuring a transparent board nomination process with the diversity of thought, experience, knowledge, perspective and gender in the Board.

Key Functions of the Board

- ❑ Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- ❑ Ensuring the integrity of the company's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
- ❑ Overseeing the process of disclosure and communications.
- ❑ Monitoring and reviewing Board Evaluation framework.

Independent Directors - Subjectivity on Liability and Disqualification

- ❑ The law only recognizes the concept of an executive and a non executive, the concept of independent has not yet recognized.
- ❑ What is the effectiveness of the Independent Director's Machinery? Frauds and irregularities are coming to light
- ❑ There are no penal or performance based disqualification (based on negligence). Nothing in Companies Act where the Independent Director who is guilty or who has failed is further de-barred. SEBI can de-bar from accessing Capital Market.
- ❑ Which means, independent directors with a **silent conscience, those who turn a blind eye to mismanagement**, can escape **without punishment**.

Remuneration - Independent Directors

Companies Act 2013 Section 149(9)

- ✓ cannot be remunerated by way of stock options,
- ✓ can receive fee, reimbursement of expenses, profit related commission as may be approved by the members

Companies Act 2013 Section 197

Except with the approval of the company in general meeting, the remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed,—

- ✓ 1% of the net profits of the company, if there is a managing or whole-time director or manager;
- ✓ 3% of the net profits in any other case.
(exclusive of any fees payable to directors for attending the meeting of the board/committees or for such other purposes as decided by the board.)

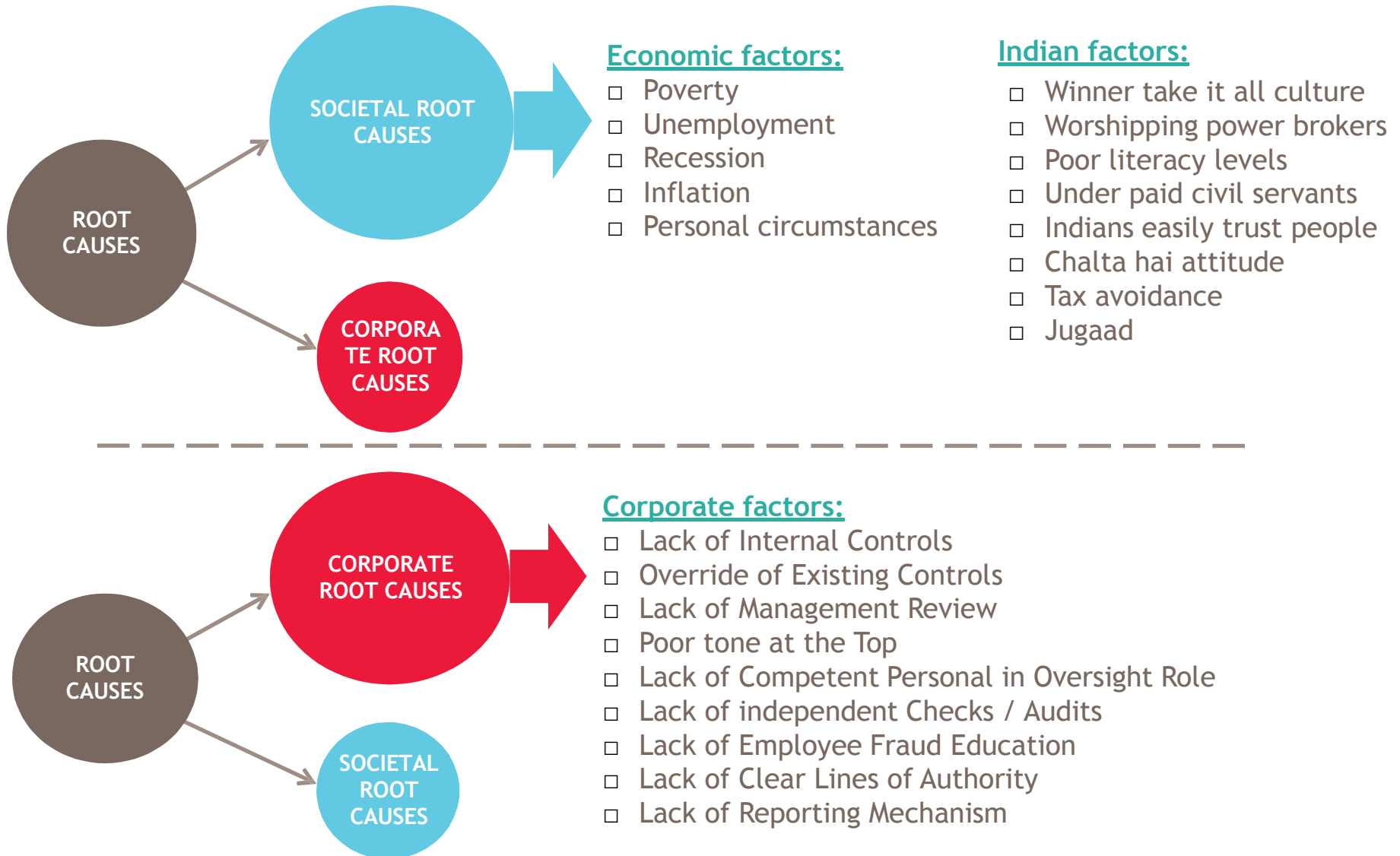
Top Paying Companies

Company	Average yearly pay (Per ID FY 2012)	No of ID
Ranbaxy Labs	102.26	4
Infosys	84.75	9
TCS	82.66	6
Dr Reddy's	74.98	8
RIL	51.83	7
Cairn	38.3	4
HCL Tech	35.33	9
L&T	35.1	6
Bharti Airtel	32.1	9
Siemens	26.2	6
Tata Motors	25.23	6
JSW Steel	24.28	7
Ambuja	20.64	5

3 Corporate Fraud



Root Causes for Frauds



Fraud Cluster



"Fraud" means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with intent to deceive another party thereto his agent, or to induce him to enter into the contract;

- (1) the suggestion as a fact, of that which is not true, by one who does not believe it to be true;
- (2) the active concealment of a fact by one having knowledge or belief of the fact;
- (3) a promise made without any intention of performing it;
- (4) any other act fitted to deceive;
- (5) any such act or omission as the law specially declares to be fraudulent.

Source: Indian Contract Act

Fraud - Cluster (Detailed Types)

Third Party:

- ❑ Fraud related to third party of the organization i.e. suppliers, customers, and agents
- ❑ Fraudulent round-trip transaction
- ❑ Cartel Activities
- ❑ Commission Payback
- ❑ Counterfeiting
- ❑ Piracy

Financial Statement Reporting:

- ❑ Improper revenue recognition
- ❑ Manipulated asset valuations
- ❑ Inappropriate judgments regarding the capitalization of development costs
- ❑ Concealment of liabilities
- ❑ Related party transactions
- ❑ Misstatement of acquisition accounting

Misappropriation of Assets:

- ❑ False expense claims
- ❑ Cash / materials theft
- ❑ Theft of trade secrets / I.P.
- ❑ Procurement fraud
- ❑ Theft of customer data

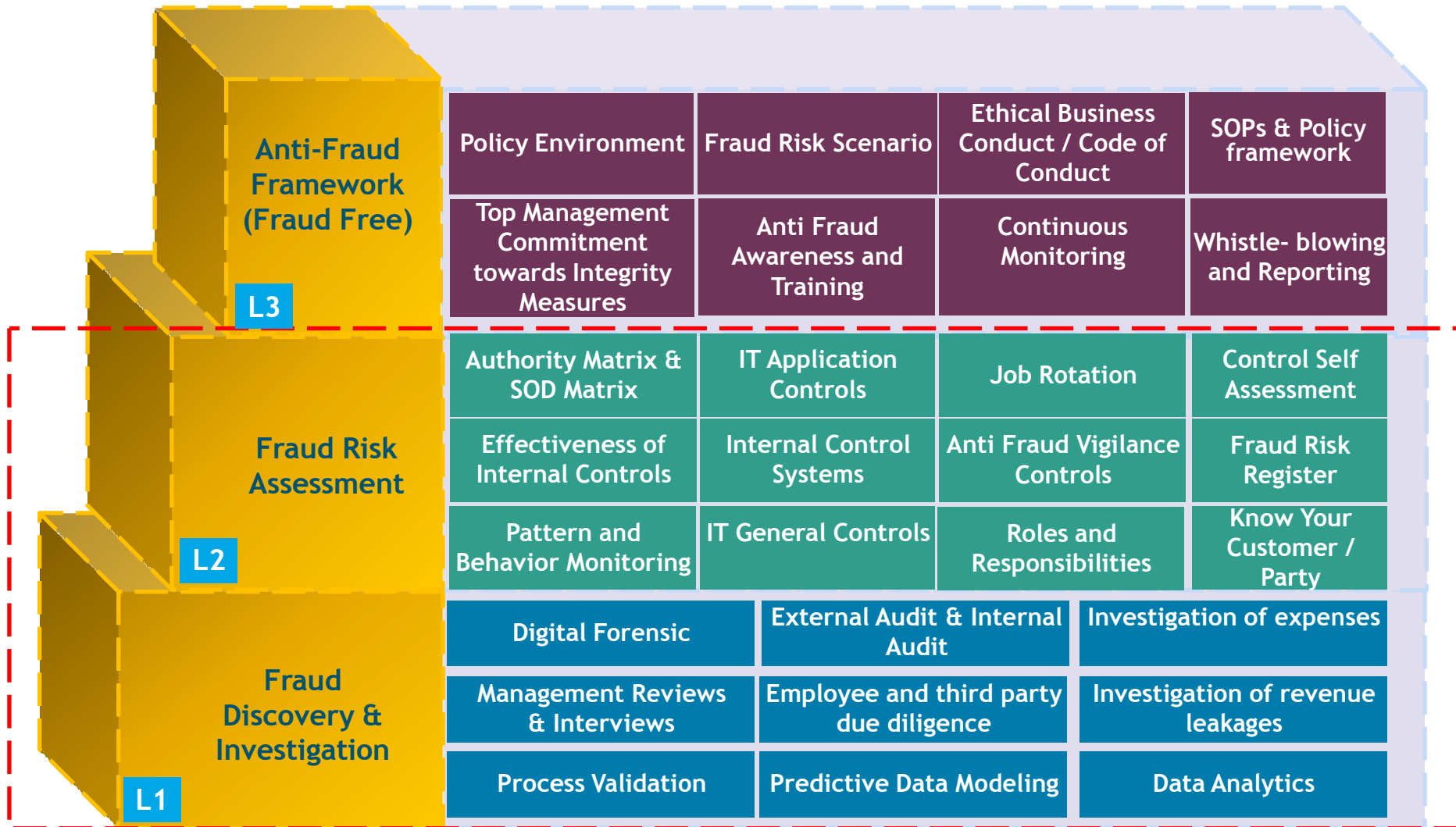
Corruption & Abuse of Position:

- ❑ Management override of controls
- ❑ Conflicts of interest
- ❑ Inappropriate use of company assets
- ❑ Contrivance against fair competition

Disclosure Fraud:

- ❑ Omission or misstatement financial / non-financial information
- ❑ Misrepresentation regarding undertakings to regulators / and third parties such as banks

Anti- Fraud Control Framework



Role of Independent Directors in Satyam's Case

Expectations from independent director

- ❑ Expected to apply due diligence
- ❑ Expected commitment from Independent directors, at least collectively.
- ❑ Ensuring independence
- ❑ Safeguarding stakeholder interest

How independent directors failed to meet expectations?

- ✓ Accounting fraud was perpetrated over a long period of five to seven years and that DSP Merrill Lynch, who were hired to identify some partners for the company could within a week smell accounting fraud
- ✓ As reported in many news papers, some customers, including the World Bank, were complaining of fraudulent and unethical practices by the company. Directors negligent in not investigating sufficiently
- ✓ The company in its corporate governance report for 2007 did not name Palepu as independent director, perhaps because he received Rs 87 lakh from the company towards consultancy fees
- ✓ Shareholders have lost Rs 13,600 crore in Satyam shares in less than a month. Investors in USA have initiated tawo class action suits against the company for its American Depository Receipts.

Role of Independent Directors - current litigation matter of an Indian real estate player

DLF made interest-free loans to a politician's son-in-law from which purchased at least 31 properties mostly in New Delhi worth more than Rs.300 crore

Defense by Independent directors of the company

1. It was not brought to our notice
2. Auditors never raised the issue
3. The matter was not flagged off at any board meeting. We have not come across any such instance where favours have been done
4. It is not possible to look at each and every sale transaction. But we try to ensure that all transactions are done at market prices

Stakeholder questions on defense and role of independent directors

1. Do independent directors have to act only when something has been *brought* to their notice?
2. Does it not strike them that they should be asking the management for details incase they get such information via media or other sources?
3. Though it is auditors job to confirm to shareholders that what is stated in the balance-sheet reflects the true state of affairs in the company but is there no accountability with ID's

Whistle blowing cases - SEC or SEBI approach ?

Clause 49 Clause IV. A. “Company should annually affirm that it has not denied any personnel access to the audit committee of the company and that it has provided protection to “whistle blowers” from unfair termination and other unfair or prejudicial employment practices. Shall affirmation be a part of board report on corporate governance.”

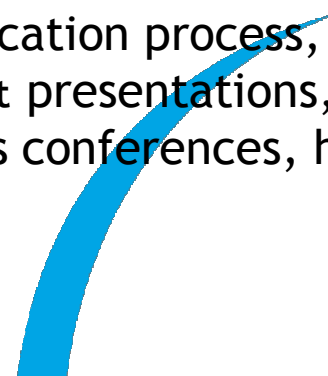
However there is no requirement of reporting whistle blowing cases to SEBI (security Exchange Board of India).

In US companies are required to report whistle blowing cases to SEC (Security Exchange Commission)

Session 2

Organizational dynamics, communication, business negotiations & Influential skills for board room.

Role of critical & creative thinking, communication process, business ethics, strategy to develop reports & presentations, art of board room communication, conducting press conferences, handling whistle blowers.



Role of creative and critical thinking



Why Independent Director's should have critical and creative thinking?

1. *Mandatory compliance requirement - (personal liability, governance pressure etc.)*
2. *Rise in stakeholder expectations*
3. *Wave of Corporate Frauds & Scandals*
4. *Changing business landscape - technology evolution, mergers and acquisitions, globalization etc.*
5. *To play a strategic role - to provide input on strategic calls like business growth and expansion, product diversification etc.*



How should Independent Director's develop critical and creative thinking?

Keys to critical and creative thinking

Share and implement experience and best practice used by other boards

Putting oneself as representative of various stakeholders

Enhance ability to draw conclusions/inferences

Recognize relationships

Deal in business context

Recognize Assumptions
- ability to separate fact from opinion

Use the art of evaluating arguments

Independent directors can rely on a few well established and proven techniques to develop develop critical and creative thinking

1. Six Thinking Hats Approach
2. Pearson's RED Critical Thinking Model
3. Paul-Elder Critical Thinking

02

Business ethics



Business ethics & Independent Directors

“Ethics & Corporate Governance” are not just **Moral or Compliance Issues**. In the long term they are **Essential Behavioural Traits** for the Organisation, that strengthen the Organisation’s “**Brand Equity**” and help ensure **Stable Sustainable Growth**. Independent Directors & Promoters need to come together to Build a strong Ethical Culture for the Company, that would ensure **Correct Behaviour/ the Right Behaviour**, **when policies are either unwritten, unclear or are unenforced**.

Often independent directors are held under the scanner and questioned with respect to their contribution towards business ethics awareness and monitoring. Business ethics dilemma include:

1. Do independent directors quit when they are most needed (at the time of poor business performance, scandals, litigation by shareholders etc.)?
2. Do independent directors take the extra load of transforming company/reshaping the company or they want to be visiting guests, restricting themselves to select meetings?
3. Can independent directors who are related parties, business associates, have personal relationship with individuals in organization or are drawing benefits like loans and advance etc. which are over and above the remuneration, contribute towards establishing and nurturing business ethics culture?

Business ethics & Independent Directors

How would an independent director contribute towards business ethics?

- 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

Strategy to develop reports & presentations



Why Independent Directors need a strategy to develop reports & presentations?

“An independent director can be defined as a third-party personnel, who apart from receiving director’s remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgment of the board may affect independence of judgment of the directors. (S)He plays the role of a watchdog.”

Limited Time

Bag full of information

Many hats to wear

Might not have detailed business context

Limitations of independent director

Reports and Presentations

Independent Director

Accurate, specific and timely reports/presentations act as interface between independent director and (her)his limitations, resulting in higher contribution and successful role play

Independent Director's strategy to develop reports & presentations

Questions that a strategy addresses

What tools to use to create the report?

Who creates the reports?

To whom should reports be made available?

What are the timelines set for such reporting?

How to implement the strategy?

Keys to developing reports & presentation

Purpose of developing each report & presentation

Availability and timeliness of data

Existing and anticipated technology assets for development of report & presentation

Organizations Current skill sets for development of report & presentation

Results

Overall Control over business

Simplifying complicated landscape

The ability to extract data from transactional systems to make it comprehensible

Aid to Decision making

Follow up on the progress levels

04 Communication process

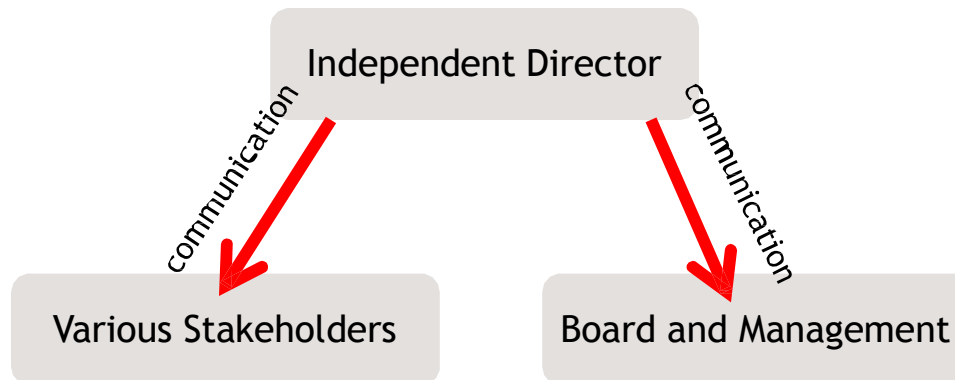


Independent Directors and communication process

As per the latest amendments in Clause 49 and the new companies Act 2013, the role of an independent director can be segregated in 2 broad areas.

1. Interface and guardian of various stake holders, in the organization i.e.
 - Safeguarding the interest of all stakeholders, particularly the minority holders
 - Harmonizing the conflicting interest of the stakeholders
 - Analyzing the performance of management
 - Mediating in situations like conflict between management and the shareholder's interest etc.
2. The role they play in a company, for the company, broadly includes improving corporate credibility, governance standards, and the risk management of the company.

Hence accurate and timely communication and participation in key communication process, by independent directors, is inevitable.



05

Art of Boardroom communication



Independent Directors and art of boardroom communication

“Independent Directors often face the challenge of (a) how to successfully obtain support for the decisions they have taken, (b) the ability to influence those around them and (c) to successfully negotiate with those who resist supporting their decisions.

The challenge is equally as difficult to bring senior support staff on the same page , who work closely with their immediate boardroom members and carry responsibility for ensuring the implementation of these decisions.

Boardroom Dynamics making communication a key factor for independent directors

Culture of the Boardroom

Every organization has a way in its it's boardroom meetings takes place. The presenter has to understand boardroom is a place where management and executives go to mull over and deliberate on burning issues and hard realities . Hence the play of offence and defense starts within the attendees.

Existing Power Play

There is always a power position at the table. Even at King Arthur's round table the strongest positions were those closest to Arthur. In the boardroom Independent Directors have to read through the signal of power play to seek maximum support to mobilize tougher decision and ensure last level implementation.

Historical influence

Members who are relatively old in to the board meeting may play their seniority card against people who are relatively new to the board meeting. For example bringing up past issues, insider jokes or unwritten rules that put new member down. These things divert attention from critical issues

Independent Directors and art of boardroom communication

1. *Understanding how to navigate the power play that occurs in most boardrooms*
2. *Developing influencing skills to build solid interpersonal relationships*
3. *Maintain confidentiality while sharing information on best practice, market developments and experience attained by attending board meetings of other organizations*
4. *Building a strong level of negotiation skills to assist their strategy*
5. *The ability to counter resistance effectively thereby adding value to the organizational objectives*
6. *Understand what motivates their fellow board members*
7. *Build strategy that taps into the deeper dynamic of interpersonal transactions within the board*



06

Conducting press conference



Independent Directors - conducting press conferences

Independent Directors in the due course of discharge of duties, have to use methods to communicate to all stakeholders in the company. Conducting Press Conferences is one of them. A press conference is mostly held for dissemination of communication about major events or announcements about the Company.

Independent directors represent practice of Good Governance. Presence of Independent Director in the Press Conference bring forth confidence for the investors and the shareholders.

When to hold a press conference

When communication involves all stakeholders internal and external both

When you have significant announcement to make

When you have to reach to large number in a short time

How do you hold a press conference

Define the key message(s)

Fix up a schedule

Pick up the site/venue

Involve media partners

07

Handling Whistle Blowing



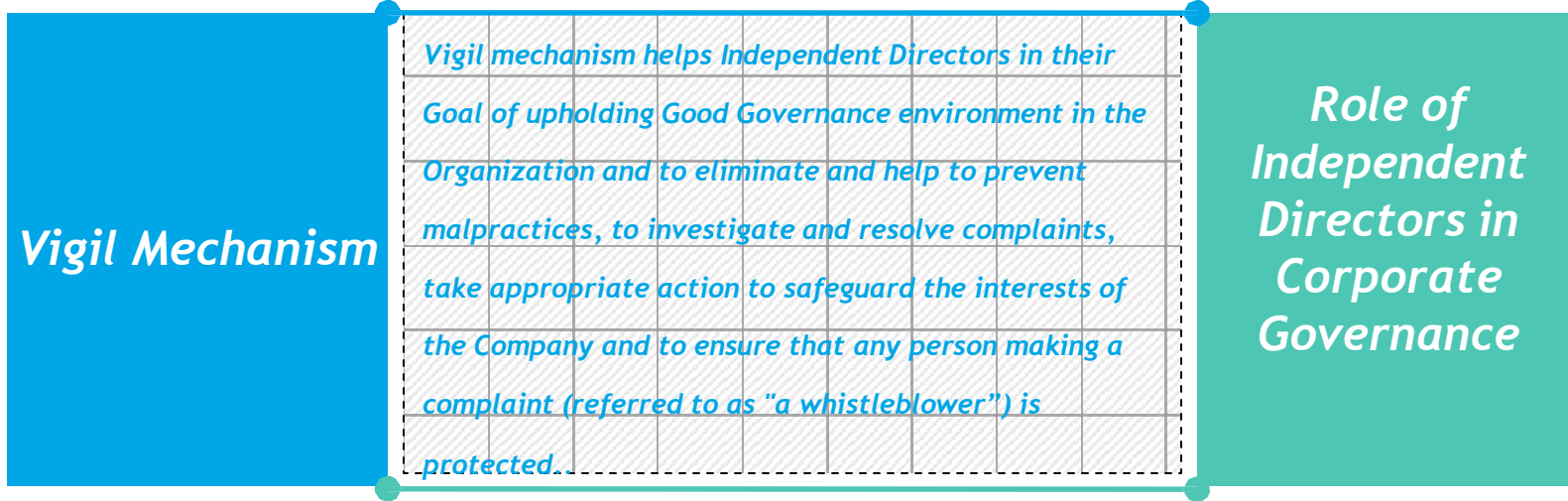
Handling whistle blowers and establishing vigil mechanism

As per Companies Act, 2013 Section 177(9) All the listed companies, Companies which accept deposits from the public and Companies which have borrowed money from Banks and PFI in excess of Rs.50 crores. Companies which required to constitute an audit committee shall operate the VIGIL MECHANISM through audit committee for others board of directors shall nominate a director to play the role of audit committee.

Why Whistle Blowing or Establishing Vigil Mechanism

- *To encourage employees to report legal and ethical violation*
- *To reduce companies exposure to the damage in cases of internal frauds*
- *To set the tone about adherence to code of conduct*

Vigil mechanism and Independent Directors



As per *Schedule IV to the Companies Act 2013 Section 148(8) "Code for Independent Directors"* it is Independent Directors duty to:

- ✓ “ Ascertain and ensure that the company has an **adequate and functional vigil mechanism** and to ensure that the interests of a person who uses such mechanism are not prejudicially affected on account of such use”.
- ✓ “Also **report concerns** about unethical behaviour, actual or suspected fraud or violation of the company’s code of conduct or ethics policy.”
- ✓ “Act within authority, assist in **protecting** the legitimate interests of the company, shareholders and its employees.”

Handling whistle blowing

How an independent director should handle Whistle Blowing?

- Timely review of process, system and controls applicable
- Ensure that “whistleblower” is protected
- Maintaining anonymity of the “whistleblower”
- Separate genuine grievances from the malicious or frivolous complaints.
- Unbiased and fair analysis of complaints
- Detailed tracking of the grievances
- Monitoring progress of complaints

Thank You

