

Corporate Governance In India: Is An Independent Director A Guardian Or A Burden?

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INTRODUCTION

The origin of the corporate governance problem lies in the separation of ownership and control in widely held corporations owned by a large number of small and dispersed shareholders who need to delegate the responsibility of running the day to day operations of the corporation to professional managers. Since these shareholders find it costly and lack the incentive to monitor management, managers may behave opportunistically to run the company in their interests rather than the interest of shareholders. The managerial opportunism imposes agency costs manifested in unobservable and often unverifiable actions taken by them such as expanding firm size beyond optimal level, consuming perquisites, or satisfying managerial hubris, all of which increase their private benefits and reduce the value of the firm and also the benefits to the shareholders.

The board of directors acts as one of the most important governance mechanisms in aligning the interests of managers and shareholders. The important functions of the board, were laid down in the report on the Financial Aspects of Corporate Governance issued in 1992 by the Cadbury Committee. The committee suggested that the universally accepted principle is that the board of directors act as fiduciaries of shareholders' and other stakeholders' interest to execute various functions of the independent directors.

WHO ARE INDEPENDENT DIRECTORS?

As per Clause 49 of the Listing Agreements, an 'independent director' shall mean a non-executive director of the company who:

- a.** Apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
- b.** Is not related to promoters or management at the board level or at one level below the board;
- c.** Who should not have been as an executive of the company in the immediately preceding three financial years;
- d.** Is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.
- e.** Is not a supplier, service provider or customer of the company. This should include lessor-lessee type relationships also; and
- f.** Is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

WHY IS AN INDEPENDENT DIRECTOR APPOINTED?

The independent directors are appointed by the promoters to fulfill the legal formalities. These directors serve in the organization to support and satisfy the interest of the minority shareholders.

WHO ARE TYPICAL INDEPENDENT INDIAN DIRECTORS?

✿HOME DIRECTORS

The home director's category is the most overwhelming one. These comprise persons known personally to the promoter like-relatives, friends, neighbors, ex-employees, ex-teachers etc. .Today no promoters prefer to invite a

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stranger to act as director on the board. A board position provides huge access to company information, including confidential information, that a promoter may not feel comfortable giving to a stranger, for fear of misuse. Moreover, most promoters have too much to hide and they often resort to window dressing, something that would not be possible with a stranger around. Several loopholes exist to get home people on boards.

For example: According to Companies Act, any persons from the wife's and mother's side are not considered as relatives. So a company can get on its board, for example, the promoter's father-in-law or wife's brother or mother's brother as an independent director. One can also get professional friends like lawyers, chartered accountants etc., on the board. Even the family barber or a servant can also be appointed as home directors because there is no eligibility requirements for an independent director! (unlike other jobs). As such, technically, every Indian, who is above 21 years of age, is qualified to become an independent director, which means over 60 crore Indians are eligible to become independent directors for handling such a professional and technical job.

❁VALUE DIRECTORS

Value Directors are those that either bring knowledge and expertise to the company like lawyers, finance professionals, technocrats etc or they provide networking to the company by opening doors to the government, politicians and institution. Such people are also hired to give a sense of comfort to both the institutional as well as the retail investor. Many of these would be having high integrity. Value Directors are either personally known to the promoters or have been referred by some one close to the promoters and are paid extremely well. So, despite their ability to identify promoter's wrongdoings, they would still by and large support the promoters. This category of value directors include a large number of civil servants, who have realized that post-retirement, one of the best avenues to pursue is directorship. Of course, many could have also been appointed as a quid pro quo for favors received in the past.

❁CELEBRITY DIRECTORS

This category includes film stars, lyricists, sportsmen, defense personnel, fiction writers and the like. The celebrities like Sunil Gavaskar or Field Marshall Manekshaw were given the title of celebrity independent directors. Most people of this category are having high integrity. However, they would have very little clue of the corporate world or of promoters' desire. They are just happy in renting their names. These people may not be known personally to the promoters and they neither add knowledge nor do any harm to the company, or promoters.

❁PSU DIRECTORS

This is the category which comprises of people who are appointed on the boards of listed PSUs. These people are typically appointed by the political high command or the concerned minister. Most of these people are either politicians who need to be rewarded or people who are bureaucrats who protect the interests of the dominant shareholders (the government) or individuals that the politicians would like to favour. These people either carry out the mandate of the respective ministries or simply pursue their personal agenda of benefiting from these PSU's and are clearly not concerned about the minority shareholders. Most PSUs board meetings are conducted at the pleasure of the minister or the joint secretary. In a sense, these directors are also like home directors- instead of being appointed by the dominant private promoters, they are appointed by the dominant government promoter.

WHY ARE INDEPENDENT DIRECTORS NEEDED?

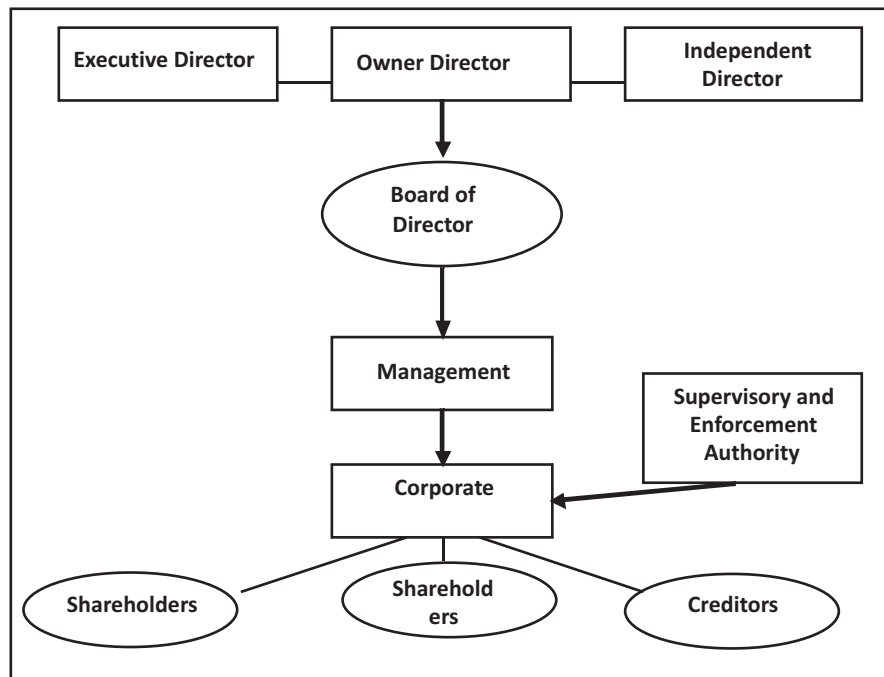
Corporate governance places great responsibility on the directors. The presence of an Independent Director on the board is widely considered as a means of protecting the interest of shareholders and other stakeholders. That's why, companies of all sizes are recognizing the substantial benefits of having independent directors on the board.

WHAT ARE THE ROLE, DUTIES AND RESPONSIBILITIES OF INDEPENDENT DIRECTORS?

It is suggested that independent directors are not just for the shareholders; their role is protection of interest of all stakeholders. The following are the main role of independent directors in the company:

- ✿ Contribute to the development of company strategy. Scrutinize management performance.
- ✿ Ensure that financial information is accurate and also robust risk management is in practice.
- ✿ Convene the shareholder's meeting once a year without the chairman or executive directors - and there should be a statement in the annual report stating that such meetings have taken place.
- ✿ Be prepared to attend AGMs and discuss issues relating to their roles (especially chairmen of committees).
- ✿ Have information on major shareholders (particularly, the senior independent director).

Figure 1 : Basic Design Of Existing Corporate Governance System



WHAT IS THE POSITION OF INDEPENDENT DIRECTORS IN BOARD COMPOSITION?

Under Clause 49 of the Listing Agreement, all listed companies are required to have no less than half of its board comprising of non-executive directors. Additionally, regulations require the constitution of independent boards, the structural rules for which were firmed up over a period through successive amendments of Clause 49.

SEBI DATA ON INDEPENDENT DIRECTORS

- ✿ There are 6443 individuals serving as independent director the boards of 2,213 listed companies.
- ✿ Out of 6,443 directors, 162 directors are women.
- ✿ 245 independent directors are the blow the age of 35 with 20 being even less than 25.
- ✿ 3,033 (48%) of independent directors are above the age of 60 - significantly of these, 1380 are above the age of 70, as many as 199 are past 80 and 8 are even beyond 90.
- ✿ The percentage of figures are : Home directors (75%), value directors, (15%) celebrity (5%) and PSU directors (5%).
- ✿ 21% of the companies have just one or two independent directors in their boards.
- ✿ As many as 2,960 independent positions have been held for more than 6 years, out of which as many as 1,974 have been held for more than 9 years.

WHAT ARE THE BURNING ISSUES ON INDEPENDENT DIRECTORS?

Many Indian firms are owned or controlled by the business families and this it poses huge challenge to corporate governance. By addressing the following issues one can understand the role of independent directors:

Table 1: Major Revisions Of Clause 49 Of Listing Agreement With Respect To Board Compositions

Clause 49 (original) Feb. 21, 2000	Clause 49(revised) October, 29,2004	Clause 49 (Revised) April8, 2008
Board Composition The company agrees that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors would depend on whether the Chairman is executive or non-executive. In case of a non-executive, at least one third of the board should comprise of independent directors and incase of an executive chairman, at least half of board should comprise of independent directors.	Board Composition Board Composition Similar as February, 2000	Board Composition Additional qualification for boards with non-executive chairman "If the non-executive Chairman is a promoter or is related to promoters or persons occupying management positions at the board level or at one level below the board, at least one-half of the board of the company should consist of independent directors."
Determination of Independence 'Independent Directors' means directors 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 director.	Determination of Independence Revised for the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who: a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its director's, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director; b. is not related to promoters or person occupying management positions at the board level or at one level below the board; 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 or judgment of the director.	Determination Of Independence Similar as Oct.2004

❖ **APPOINTMENT BY THE PROMOTER**

Many Indian companies with a few exceptions are owned or controlled by business families. This poses a special challenge for corporate governance. The crucial issue here is family members who head the company appoint independent directors. In well managed companies, independent directors are viewed as partners of management and as outside guardians whose job is to make sure that the management stays focused on delivering shareholder value. Other companies, however, might consider independent directors to be a burden that has to be borne mainly to satisfy regulatory rules for compliance.

❖ **QUALITY OF INDEPENDENT DIRECTORS**

Good corporate governance dictates that the board be comprised of individuals with certain personal characteristics

and core competencies such as recognition of the importance of the board's tasks, integrity, a sense of accountability, track record of achievements, and the ability to ask tough questions. Besides, having financial literacy, experience, leadership qualities and the ability to think strategically, the directors must show significant degree of commitment to the company and devote adequate time for meeting, preparation and attendance.

✿ **CLEAR DEFINITION OF INDEPENDENCE ON DIRECTORS**

In considering the independence, it is necessary to focus not only on whether a director's background and current activities qualify him as independent but also whether he can act independently of the management. In other words, the independent directors must not only be independent according to the legislative and stock exchange listing standards, but also independent in thought and action i.e. qualitatively independent. Such qualitative independence will ensure that directors think and act independently without regard to management's influence.

✿ **COMPOUNDED BY LACK OF KNOWLEDGE**

The IDs would as such; in most cases have a handicap versus the promoters in terms of knowledge and confidence. It is well known that scams can be perpetrated by the promoters in almost all areas of a company's operations-sales, purchase, inventory, personnel, expenses. In each of these areas, there are literally under reads of ways a promoter can siphon off money or present a false picture. Most IDs do not, on the other hand, even understand the basics of finance, and have no noteworthy corporate qualification or experience.

✿ **HIGH REMUNERATION**

Survey by primedirectors.com finds, each meeting of the board or a committee can fetch an ID Rs. 20,000. On top of this the law allows 1% of profits to be distributed among the IDs. Further, there is no limit on ESOPs (Employee Stock Option Plan) that can be granted to the IDs. Then, an ID can be on the boards of subsidiary companies and derive remuneration from there. Finally, expenses on travel, boarding and lodging etc can be substantial. The law prescribes that an ID should not have pecuniary relationship with the company.

✿ **COMPOUNDED BY LACK OF TIME**

Independent directors are mandated to be on some committees; but they get on to various other committees as well. Pressure of time typically sees several committee meetings being held on the same day of the board meeting, resulting in little time for any serious deliberations.

✿ **COMPOUNDED BY LACK OF PERSONAL MOTIVATION**

Independent directors are supposed to protect other people's money, not their own. It should, therefore, not be expected that they would watch over it with the same diligence and vigilance.

✿ **COMPOUNDED BY THE INDIAN CULTURE**

Independent directors are invitees; they are like guests and guests who are also being paid. In the Indian culture, the guests will always be polite to their hosts, and in this case, such hosts who are also paying them.

✿ **MOST IDs HOLD TOO MANY BOARD POSITIONS**

There are hundreds of individuals who hold directorship in a large number of companies. The Companies Act puts a ceiling of 15 directorships of public companies. However, among public companies, it is beyond debate that the listed ones demands a much greater degree of commitment from an ID, including attending at least four board meetings and several meetings of one or more of the many committees during a year.

✿ **RETIRED GOVERNMENT SERVANTS ON BEING ON BOARDS**

Several senior government officials have accepted Independent director's position after the retirement.

✿ **LESS NUMBER OF WOMEN AS IDs**

Women in India have made rapid strides in almost all walks of life, and have not only excelled but also demonstrated a higher degree of governance. But not when it comes to directorship positions. As per SEBI data, there are 6,443 independent directors, out of which only 162 are the women IDs.

✿ **CONTINUING VACANCIES AND REPLACEMENT**

In case of resignation, removal or death of independent directors, the replacement time suggested by the SEBI is 180 days, which is unfortunately too long a period. Many companies remain non-compliant, and take a plea that they have not been able to find a replacement, which could stretch for indefinite periods. Many companies have too few

directors in number. As many as 21% companies have just one or two IDs on their boards.

❖ **POOR BOARD PRACTICES**

Many promoters purposely create voluminous agenda items, laying the critical ones at the end which would then get rushed through due to paucity of time. Moreover, the agenda is often sent very late and several items could actually be placed only at the table. Minutes of the meeting too are sent very late, and are drafted to suit the promoters' will.

❖ **WEAK ENFORCEMENT**

A majority of the companies take compliance of Clause 49 very lightly. All of them are trying to use the loopholes of the law. This is very casual in all the levels of management. Many companies appointed new directors but did not fulfill their obligation to inform the stock exchange. The regulator also does not seem to take non-compliance very seriously.

❖ **SECURITIES EXCHANGE BOARD OF INDIA (SEBI) VS. DEPARTMENT OF COMPANY AFFAIRS (DCA)**

Independent directors are playing a very crucial role in good corporate governance system, especially in the Indian context, where one third of the publicly listed companies are promoted, controlled and managed by families. But there are theoretical debates on how independent the independent directors are. Besides this, dilemma prevails on who should monitor the board structure- Securities Exchange Board of India (SEBI) or Department of Company Affairs(DCA)? Both of them come up with different recommendations and guidelines for corporate governance. As a result, there is confusion regarding the number of independent directors in the board.

WHAT COULD MAKE INDEPENDENT DIRECTORS MORE EFFECTIVE?

❖ **INDEPENDENCE OF THOUGHT**

The promoters should act as trustees on behalf of all shareholders and should concentrate on the good of the company and not just on their own interest - what has to be kept in mind is that independence should be independence of thought and practice, and not merely structural independence. For example, Infosys corporate governance philosophies try to satisfy the spirit of the law and not just the letter of the law is notable.

❖ **RECRUITMENT OF INDEPENDENT DIRECTORS**

Selecting of independent directors is a most serious job as it introduces fresh talent and skill to the organization. Legislation has been developed with the growing demand for transparent and independent board with the compliance of those (legislation) matters- besides this, directors should have insight into the unique nature of the company including its people, products, philosophy and strategy. Before recruiting the independent directors, there should be a through systematic assessment of needs in accordance with the company's strategic plan.

❖ **TRAINING**

After an elaborate and scientific recruitment process, the directors should undergo an induction programme under the senior independent directors to enrich themselves with the knowledge that is necessary. A formal comprehensive induction should always be provided to ensure early contribution of these directors on their boards.

❖ **TENURE OF INDEPENDENT DIRECTORS**

The SEBI has prescribed non-mandatory requirement that independent directors shall not serve for more than a continuous period of nine years on the board of the company. It is also recommended that each term of appointment should not exceed three years. This is also helpful to maintain independence in the true sense.

❖ **MAKE REGULATION PRINCIPLE BASED**

In response to the present crisis, some voices are emerging to suggest that regulation is not the answer, self-regulation is base and this is unworkable at that time regulations are inevitable.

❖ **ACCESS MORE INFORMATION**

The independent directors should have access to information other than that provided to them by the chief executives. This is easier said than done. In any case, the functional heads would be more loyal to their employer (promoter) than to the independent directors. Moreover, the functional heads like CEO, CFO could be suitably tutored by the promoters.

✿IDS SHOULD REGULARLY MEET THE FUNCTIONAL MANAGERS

Independent directors should meet the functional managers at regular intervals by which they can get into depth on varied perspectives. However, in reality, when most of independent directors do not even have the time to attend the board and committee meetings, how can they find time to talk independently with the management team? Moreover, they are considered to be as intruders. In some cases, they are incompetent to ask right questions from the management team.

✿COMPANIES SHOULD BE RATED FOR CORPORATE GOVERNANCE

Corporate governance is very subjective and cannot be measured through check boxes. Credit rating agencies, at best, can look at some visible aspects of CG-the quality of board members, their company/industry knowledge, the attendance records, quality of agenda items, minutes of the meetings, and other board room practices, but this all about the letter and not the spirit.

✿QUORUM SHOULD BE REDEFINED

It has been suggested that the quorum of a board meeting should necessarily require presence of majority of Independent directors, or that for certain agenda items, the presence of all or at least two-thirds of all independent directors should be mandated.

✿ALLOCATE BUDGET FOR INDEPENDENT DIRECTORS FOR THE EXPENSES

Independent directors hire the outside services to secure expert help from lawyers, chartered accountants and consultants. However, since the funds would be provided by the company, there could be a conflict of interest. So, separate allocation of budget is to be made to the IDs to meet this expenditure.

✿GIVE IMPORTANCE TO QUALITY, NOT QUANTITY WHEN APPOINTING THE INDEPENDENT DIRECTORS

Clause 49 suggests that 50% directors should be independent directors. Some experts suggest this clause should be dropped as the more important is that to have good quality independent directors, not the number of directors. Now the question is how to get good independent directors. Even if they are appointed - are they independent in their functioning? When are they to be selected by the promoter?

✿CONTRIBUTION OF INDEPENDENT DIRECTOR

The independent directors could effectively and substantively contribute to an organization if they are empowered to meet at regularly convened executive sessions without the participation of the management or employee directors so that they could openly and freely discuss the affairs of the company. There has always been a conflict of opinion as to whether the combination of the position of Chairman and CEO is preferable or two different persons should hold these positions independent of each other. Each has its own merits and demerits and it is for the Board to decide the best alternative that is suited to the company.

✿NOMINATION COMMITTEE

The requirement to have a Nomination Committee constituting entirely of independent directors, which, among other functions, would be responsible for identifying candidates who would be qualified to become board members and oversee the evaluation of the board and management. The appointment of a Senior Independent Director whose responsibilities as specified in governance code include meeting with other members of the board in the absence of the CEO/Chairman.

✿INDEPENDENT DIRECTORS SHOULD BRING DIVERSIFIED KNOWLEDGE

Presently, most of independent directors are from the field of finance and they should actually be from diverse fields like finance, law, academics, humanities etc. The issue is the dilution of the meaning of independent directors. Is their primary role bringing value to the company or is the protection of minority shareholders? If value indeed is the requirement, it is better to hire professionals instead of appointing the independent directors.

✿METHOD OF EVALUATING INDEPENDENT DIRECTORS

Accountability is an important element of Board effectiveness. There should be some mechanism for evaluating the performance of the directors. Perhaps, a system of 3 tier director evaluation mechanisms could be evolved by which the performance of the Board as a whole, the performance of each committee and performance of each individual director is assessed.

✿ **ACCOUNTABILITY OF INDEPENDENT DIRECTOR**

There are two types of director's liability. One relating to statutory compliance and the other is in relation to their fiduciary obligations. The Companies Act and other Acts lay down various requirements on the part of the company and most these provisions provide for penal action against the directors. The extent of liability of a director would depend on the nature of his directorship. The full time directors being offices in default have to be fully liable while part time directors may not be so liable.

✿ **LEGAL SAFETY IS TO BE GIVEN TO INDEPENDENT DIRECTORS**

Independent directors should not be responsible for every wrong doing in a company as they have no control over or knowledge of it. However, they are accountable for decisions that in that they were the part, with negligence being also treated as connivance. They want only the upside-fee, commissions, ESOPs and the perquisites-but not any downside.

WHAT IS TO BE DONE IMMEDIATELY?

✿ **REVIEW ALL REGULATIONS**

There are so many regulations that exist already. The need of the hour is for a comprehensive review of all regulations and making the regulations without any loopholes.

✿ **MANDATE BETTER CORPORATE DISCLOSURES**

There is already huge amount of information that corporates have to disclose. In today's scenario, the focus should be on quality of information not on quantity. In the initial stages the companies are disclosing more information and in the later part, they are very weak. Those who indulge to hide or avoid the disclosure of information should be mandated for severe punishment.

✿ **ENFORCE COMPLIANCE OF REGULATIONS**

The regulatory agencies like SEBI, Ministry of Corporate Affairs and others should strengthen their surveillance and enforcement functions to ensure compliance of all laws and regulations instead of depending upon the independent directors. In addition to that, the regulators should develop a system to punish the offenders who are in non-compliance with laws, which will act as a deterrent.

✿ **RELOOK AT THE UNIFORM 50% REQUIREMENT OF INDEPENDENT DIRECTORS**

The 50% of independent director's size is not appropriate for all corporates. The number of independent directors' appointment is to be made based on the non-promoter shareholding, as against 50% across all cases.

✿ **RECONSTITUTE THE BOARDS**

As per constitution of board is concerned, it should be of 1/3 of the promoter directors, another 1/3 of the directors should be appointed by the management and the balance should be the real independent directors who are necessarily qualified and have experience in corporate affairs are to be picked up by the companies from the pool created by the regulators like SEBI.

✿ **REVISE THE DEFINITION OF RELATIVES**

As per the companies act, all persons from the wife's and mothers side are not considered as relatives. So many promoters try to bring these relatives in their board as independent directors by using the loopholes of the law. So, the term relatives need to be expanded to include relatives from the mother's side as well as wife's side to cover more relatives.

✿ **DO NOT TREAT NOMINEE DIRECTORS AS INDEPENDENT DIRECTORS**

Those directors who are nominated by any outsider under a lender's or a shareholders' agreement should not be treated as independent directors. These directors are typically persons acting in concert.

✿ **FIX MINIMUM QUALIFICATION AND EXPERIENCE FOR INDEPENDENT DIRECTORS**

The SEBI quotes companies should ensure that the independent directors should have the requisite qualification and experience but this is too subjective. Some minimum qualification and/or experience norms should be mandated.

✿ **FIX MAXIMUM AND MINIMUM AGE LIMIT FOR THE INDEPENDENT DIRECTORS**

SEBI has mandated minimum age of 21 years for the independent directors. The minimum age limit should be 35

years and the maximum age should be capped at 65 years. In most jobs, retirement takes place at the age of 58 or 60 or 65, there is logic in it. Physically old and mentally tired people cannot be expected to be vigilant in the board meeting.

✿LIMIT THE NUMBER OF DIRECTORSHIP

No person, including retired people, should be allowed to hold independent directorship in more than 3 listed companies. This number should be brought down to only 1 for persons who are also promoters of listed companies or who are full-time employees anywhere, as they have an existing huge responsibility on hand.

✿APPOINT INDEPENDENT DIRECTORS FOR FOREIGN UNLISTED SUBSIDIARIES

Clause 49 presently requires all domestic subsidiary companies of a listed company to also have independent directors. This requirement should be extended to foreign unlisted subsidiaries of the Indian listed companies.

✿GREATER FOCUS SHOULD BE PLACED ON INTERESTS OF NON-PROMOTER SHAREHOLDERS

The promoters/management should prepare, for each board agenda item, an impact analysis on minority shareholders. This would help draw specific attention of the independent directors to any issues that unduly enrich the promoters or are against the interests of the non-promoter shareholders.

✿THE INDEPENDENT DIRECTORS SHOULD NOT BE APPOINTED BY THE GOVERNMENT OR SEBI

There are recommendations by some experts that the ID should be appointed by SEBI/ Government. But the opinion of the author is that independent directors should not be appointed by the government or SEBI. In case SEBI or the government appoints independent directors, this would lead to nepotism, corruption and unnecessary political interference. A good example of this practice can be seen in the quality of several independent directors that have been appointed to the boards of PSUs.

CONCLUSION

In India laws are in force but are not enforced in letter and spirit. Compromises are made in enforcement and ways and means are provided or compromised to overcome the laws by way of convenient norms and guidelines. With regard to corporate governance, too many expectations have been built over the years but, that has not been designed properly to deliver any thing worthwhile. The regulators in India keep imposing new regulations mainly after a major scam. Corporate governance is not a matter of regulation. It has to be in the DNA of the promoter. Good behavior will be valued and respected by the market. One should stop expecting regulations to infuse morality into people. Emphasis should be given for meaningful appointment of independent directors, strict implementations, corporate ethics and timely disclosures, and severe punishment in case of non-compliance.

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