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THE ROLE OF INDEPENDENT DIRECTORS IN CORPORATE GOVERNANCE - A CRITICAL EVALUATION

MOHD. AKBAR ALI KHAN
PROFESSOR & HEAD
DEPARTMENT OF COMMERCE
OSMANIA UNIVERSITY
HYDERABAD – 500 007

A. KOTISHWAR
HEAD
DEPARTMENT OF MASTER OF BUSINESS ADMINISTRATION
CMR COLLEGE OF ENGINEERING AND TECHNOLOGY
HYDERABAD

ABSTRACT

As a system arrangement in corporate governance, implementation of the independent director will help improve structure of corporate governance, maintain interests of all stockholders, and protect rights and interests of small-and-medium size of investors. There exist such many issues as insufficient information of independent directors, weak independence, low enthusiasm, and shortage of talents in the practice of the independent director system in India. Therefore, we should strengthen and optimize the independent director system with case study Satyam case of unethical conduct and fake audit.

KEYWORDS
Corporate governance, Independent director.

INTRODUCTION

The top management should identify the "bread winner of tomorrow." **Peter Drucker**

Big houses (companies) usually have an apex policy-making body. The body is known as Board of Directors (BoDs). The members of any BoDs have collective authority and responsibility for the functioning of the enterprise. If the members of the BoDs are having professional credentials and commitments, it will definitely have a profound impact on the fortune of enterprise. The corporate governance process focuses on the role of the board of directors. Directors have been considered as the "brain and soul of the organization" (Pearce and Zahra, 1991).Fama and Jenson (1983) describe the board as the "apex of the firm's decision control system". Forbes and Milliken (1999) characterize boards of directors as providing the "formal" link between the shareholders of the firm and its managers. However, not much is known about their contributions to the board process and strategy. Since the 1990's more and more professional non-executive directors (NEDs) have come into existence, Chief executives are beginning to realize the importance of the role of these highly experienced individuals.

An independent director is an independent person appointed to the board to ensure that his view is not internally focused. Independent directors are taking a higher profile role than ever before in balancing shareholder and management interest.

Since the 1990's more and more professional non-executive directors (NEDs) have come into existence, Chief executives are beginning to realize the importance of the role of these highly experienced individuals. An independent board of directors in public listed companies is seen as an integral element of a country's corporate governance norms. Board independence has taken on a pivotal status in corporate governance that it has become almost indispensable. Consequently, governance reform in recent years has increasingly pinned hope as well as responsibility on independent directors to enable higher standards of governance.

Although the institution of independent directors has been the subject-matter of debate lately, the concept itself is hardly of recent vintage. Independent directors were introduced voluntarily as a measure of good governance in the United States (U.S.) in the 1950s before they were mandated by law. Thereafter, owing to sustained efforts by the Delaware courts and stock exchanges in deferring to decisions of independent boards, independent directors took on greater prominence. Following the Enron cohort of scandals, independent directors were recognized by statute as well. A similar, but more recent, trend is ascertainable from the United Kingdom (U.K.) as well. The requirement for board independence there was triggered by the Cadbury Committee Report in 1992.

With these developments, board independence became well-entrenched in the U.S. and the U.K.

The turn of the century witnessed a proliferation of independent directors beyond the borders of the U.S. and the U.K. to several other countries around the world. This is due to the profound impact that corporate governance reforms (culminating with the Sarbanes-Oxley Act in the U.S. and the Cadbury Committee Report in the U.K.) have had on corporate governance norm-making around the world, particularly in relation to the appointment of independent directors as an essential matter of good governance. The Cadbury Committee Report has led the development of corporate governance norms in various countries such as Canada, Hong Kong, South Africa, Australia, France, Japan, Malaysia, and India, just to name a few. Similarly, the U.S. requirement of independent directors has also resulted in readjustment of corporate governance norms in various countries. This was a reaction primarily to ensure the prevention of corporate governance scandals such as those involving Enron and WorldCom in their respective countries.

More specifically with reference to independent directors, Dahya and McConnell find that during the 1990s and beyond, "at least 26 countries have witnessed publication of guidelines that stipulate minimum levels for the representation of outside directors on boards of publicly traded companies."15 This demonstrates the significant impact of Western-style corporate governance norms (particularly the independent director) on other countries within such a short span of time.

In India, about 40% of the companies have less than one-third independent directors of their board.30% of the companies are fulfilling the requirement of the Committee for the minimum number of the independent directors on their board while about 31% have better practices of appointment of independent directors on their board. Independent directors bring in independent thinking and rich experience in their respective fields. It can be concluded that independent directors help maintain an ethical climate in the organization.

Several frauds and scandals have surfaced in the corporate world in recent days.

CORPORATE CORRUPTION AND FRAUDS IN INDIA

Company	Type of Scandal
1. Mundhada 1957 Scam	Mundhada Scam involving LIC in 1957
2. Rajendra Sethiya Scandals 1985	Raj Sathiya scandal involving PNB
3. Securities Scam (1992) by (Harshad Metha)	Large numbers of banks were involved and stock market swindle. Harshad Mehta's involving UTI, SBI and other instructions.
4. Vanishing Companies	Cases of price manipulation, distribution insider trading and cheating investors. 3911 companies that raised over Rs 25,000 crore vanished or did not set up their projects.
5. Plantation companies scam (1995-96)	About Rs 50,000 crore were mopped up from gullible investors who were after high returns from plantation schemes.
6. Non-banking finance companies scam (1995-97)	About Rs 50,000 crore were raised from high return seeking investors by the companies which vanished.
7. Unit Trust of India's two episodes 2001	• When Mr Phewani was chairman • When Mr Subramanium was chairman
8. Ketan Pareekh's Fraud in 2002	Involving bank of India & Gujarat Cooperative bank
9. Global Trust Bank (2002-03)	Audited accounts showed profit of Rs 40 crore while RBI inspection report revealed negative net worth. The bank was forced to merge with Oriental Bank of Commerce. It was a case mismanagement of banks assets for personal gains by the top officials, fraudulent financial reporting and a failure on the part of statutory auditor (Rs 13,000 crore were involved)
10 Telgi's Stamp paper scam 2004	He began printing fake stamp paper. He appointed 300 people as agents who sold the fakes to bulk purchasers, including banks, FIs, insurance companies, and share-broking firms. His monthly profits have been estimated as being in the neighborhood of Rs 202 crore The size of the scam was estimated to be more than 43,000 Cr Rupees
11. Satyam Computers 2008	

REVIEW OF LITERATURE

The WorldCom and Enron stories at the beginning of the century and Satyam very recently exposed the lacunae in good corporate governance. While all this opened up a fresh debate on the meaning of good corporate governance and its standards, it also ended up in a host of researches investigating the reasons for failure of corporate governance. Corporate Governance is now an issue and important factor that can be used as tool to maximise wealth of shareholders of a corporate. In changing world, the word 'corporate governance' has expanded its meaning **Sapovadia (2002).**

While most organizations are interested in evaluating their corporate governance practices, they're quite ignorant on how to do it **Garret (2003)**. Thus the very basis for failure of corporate governance is formed. A solution to this is provided as **Branston et al (2006)** suggest a strategic decision-making perspective that makes corporate governance a central policy issue. Investigating further, they point out several factors that lead to failure of corporate governance.

Analyzing the reasons behind the failure of the Australian firm RAMS Home Loans Group as a public company**, Walter (2006)** has pointed out a lack of diversity on the board of directors and potential shareholders. A diverse board may not be the solution but still in crucial for good corporate governance. Adding some more dimensions, **Kiel & Nicholson (2005)** point out lack of proper control mechanisms and ethical standards amongst corporate. Elaborating these reasons, they claim failure to cope with interpersonal relations is the reason behind the above.

While the regulations by state, regulatory bodies and their role has constantly been under attack, the role of independent directors has come under a scanner too, particularly in India **Kochhar (2008).** Suggestions have been made to make amendments in both these aspects. Yet another reason has been listed as existence of a dominant director that renders all others as passive players while non executive directors do not give sufficient time to company affairs **Sexton (2001)**. Similar thoughts had been echoed earlier by **Davis (1993)** when examining the establishment of a Corporate Governance Panel as a voluntary proxy for a Securities and Exchange Commission in Great Britain.

While good corporate governance in Indian organizations like ICICI and HDFC have been examined and listed **Bhat & Kumar (2008),** the Satyam fiasco has opened it all up. Poor corporate governance has been the bane of Indian industry and the erosion of investor confidence and it is now clear that certain key IT, media and entertainment scripts are being brazenly manipulated on the stock exchanges **(Chemical Business, 2002)**

Kriplani (2009) in a study with reference to Satyam states poor governance can lead to disaster, and India has seen plenty of that in recent years. Before Satyam, Mumbai brokerage First Global estimates, shareholders had lost some $2 billion from scandals and bad governance since 2003. Corporate ethics and accounting have been traditionally poor in India, despite the exposure of many companies to international standards **(Range & Lublin, 2009)**

Some researchers have been optimistic in their approach. **Chakrabarti et al. (2008)** claim the Indian corporate governance system has both supported and held back India's ascent to the top ranks of the world's economies. Still, Indian corporate governance has taken major steps toward becoming a system capable of inspiring confidence **Rajagopalan & Zhang (2008)** have also highlighted several reasons for failure of corporate governance in India and China.

OBJECTIVES OF THE STUDY

The objectives of this study are as follows**:**

1. In the light of Clause 49 of SEBI, to study the composition and extent of independence, the Independent Directors have in the Board;
2. To examine the circumstances where Independent Directors are not independent; and
3. To critically study the effectiveness of Independent Directors of Satyam Computers

ADOPTION OF INDEPENDENT DIRECTORS BY EMERGING ECONOMIES: LESSONS FROM INDIA

Although concepts in corporate governance originated in the outsider systems of the U.S. and the U.K., they have been transplanted to several other countries in the last decade. The transplantation has occurred even in insider systems that possess shareholding structures and other corporate governance norms and practices that are entirely different from those in the outsider systems. This phenomenon can be ascribed to number of reasons. First, several developments in the outsider systems of corporate governance have had a profound impact around the world. These include legislation such as the *Sarbanes-Oxley Act* in the U.S. and recommendations such as those of the Cadbury Committee in the U.K. Second, several emerging economies had opened up their markets to foreign investments during the last decade of the 20th century. Their requirements of developing their own corporate governance norms seamlessly coincided with the explosion of corporate governance norms in the outsider systems at the turn of the century. Third, concurrent with the opening up of emerging economies to foreign investment, particularly from the leading investing countries of the U.S. and the U.K., there was a need to develop corporate governance systems that were familiar to investors from those countries. Transplantation was found to be a convenient response to this need. Among all the transplanted concepts, the independent director presents some of the greatest number of challenges both from a theoretical and practical standpoint.

BOARD COMPOSITION

The board of directors, which acts as the brain of an organization, requires the right balance between shareholders, directors, auditors and other stakeholders. The Kumar Mangalam Birla committee has recommended a board containing at least 50% independent directors if the chairman is an executive director, and alternatively, a board with at least one-third independent directors if the chairman is a non-executive director.On October 29, 2004 SEBI announced the revised Clause 49,the changes in corporate governance norms as prescribed in this clause are as follows: Two-Third of the members of the audit committee shall be independent directors, all the members of the audit committee shall be financially literate and the minimum number of meetings of the committee in a year will increased to four. The Naresh Chandra Committee has recommended that the minimum size of the board of all listed companies as well as unlisted companies with a paid up capital and free reserves of Rs. 10 cr and above, or a turnover of Rs. 50 cr and above should be 7 members, of which at least 4 members should be independent directors. However, this does not apply to:

1. Unlisted public companies not having more than 50 shareholders and without debt of any kind from the public, banks or financial institutions, as long as they do not change their character.
2. Unlisted subsidiary of listed companies. All the directors are required to meet once a year without the Chief Executive Officer and discuss all issues without any bias. A well-defined and open procedure must be in place for reappointment and for appointment of new directors. All new directors should be provided with a letter of appointment setting out in detail their duties and responsibilities.

WHO IS AN INDEPENDENT DIRECTOR?

An independent director is an independent person appointed to the board to ensure that his view is not internally focused. The actual role varies among the most common roles such as: part time chairman, confidant of the chief executive, expert with specialist knowledge, a community conscience, a contact maker, conferrer of organization status. The actual role performed by the independent directors depends upon background and experience, company situation, current composition of the board, relations between the chairman and independent directors, board leadership structure, recruitment process and training and development.

CLAUSE 49 AND INDEPENDENT DIRECTORS

It is necessary at this stage to examine the specific provisions in Clause 49 relating to independent directors.

BASIC REQUIREMENT

Boards of listed companies are required to have an optimum combination of executive and non-executive directors, with at least half of the board comprising of nonexecutive directors. As regards the minimum number of independent directors, that varies depending on the identity of the chairman of the board. Where the chairman holds an executive position in the company, at least one half of the board should consist of independent directors, and where the chairman is in a non-executive capacity, at least one third of the board should consist of independent directors. Another condition was imposed in 2008 to determine the number of independent directors. Where the nonexecutive chairman is a promoter or a person "related to any promoter" of the company, at least one half of the board should consist of independent directors. The insertion of this condition was necessitated due to the then prevailing practice. Chairmen of companies retained themselves in a non-executive capacity, but were often relatives of the promoters (in case of individuals) or controllers of parent/holding companies (where promoters were other companies). For example, in family-owned companies, the patriarch or matriarch of the family would be the non-executive chairman, while the day to- day management (in executive capacity) would be carried out by persons from the subsequent generations such as children and grand-children. Promoter-related chairmen were thus able to exert significant influence. With this amendment to Clause 49, chairmen are required to be truly independent to justify the composition of the board with one-third being independent rather than one half.

ROLE OF INDEPENDENT DIRECTORS

Much as Clause 49 does not specify to whom the independent directors owe their allegiance, it also does not contemplate any specific role for them. There is no separate task or function assigned to independent directors. The most prominent among such functions in the context of the majority-minority agency problem could have been for independent directors to consider and approve related party transactions that involve self dealing by controlling shareholders. But, there is nothing of the kind envisaged. Independent directors are treated like any other director for purposes of role and decision making and there is neither a specific privilege conferred nor a specific duty or function imposed on independent directors, in either case specifically by law, on the\ board.

However, as regards board committees, there are some specific requirements pertaining to independent directors. All companies that satisfy a minimum size are mandated by the Indian Companies Act to constitute an audit committee. The audit committee must be comprised of at least two thirds non-executive directors, but no reference is made to independence. In case of listed companies, however, Clause 49 provides that an audit committee shall be constituted consisting of three directors, with at least two-third of them (including the chairman) being independent directors. In case of audit committee members (unlike for independent directors on the board), there is a need for positive qualifications regarding competence: all members shall be "financially literate" and at least one of them must have "accounting or related financial management expertise."

Unlike the case of independent directors on the entire board, the audit committee's mandate is fairly clear and elaborate. These include oversight of the company's financial reporting process, recommendations regarding appointment of auditors and review of their performance, review of financial statements before submission to management and the like. As far as related party transactions are concerned, the audit committee is required to verify the disclosures made in that behalf in the financial statements. Curiously enough, the audit committee only has a disclosure obligation regarding related party transactions. It has no approval rights. Hence, independent directors have not been conferred any roles or responsibilities to monitor transactions that may cause erosion of value to the company and its shareholders while enriching one or more groups of insiders such as managers or controlling shareholders.

Apart from the audit committee, there is only one other board committee, *i.e.*, the "Shareholders/Investors Grievances Committee" that is required to be constituted as a mandatory matter. This committee is not required to comprise any independent directors, although in practice they do carry a number of independents on them. The role of this committee is insubstantial in the overall scheme of things as it is required to "look into the redressal of shareholder and other investor complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends, etc."210 Many of these matters have now become insignificant with the advent of dematerialized trading in shares and the use of modern technology to track investor communication.

As far as the remuneration committee is concerned, that is only a non-mandatory requirement. It is for the companies themselves to decide whether to include such committees or not, although in the case of large listed companies, it is almost always the case that such companies have a remuneration committee where independent directors play a significant role.

Finally, as we have seen earlier, the nomination committee generally plays an important role in corporate governance. But, India does not impose a mandatory requirement to constitute nomination committees to nominate independent directors. For this reason, the controlling shareholders are able to significantly influence the process of nomination and appointment of independent directors. The absence of a nomination committee presents a significant obstacle to the protection of minority shareholder interest as controlling shareholders are able to determine the identity of individuals who occupy the position of independent directors and they are likely to ensure the appointment of such individuals who will be sympathetic to the perspectives of the controlling shareholders with complete allegiance in fact towards them.

Moreover, at a broad level, the absence of any specific role for directors creates difficulties at a practical level. Neither independent directors themselves nor the corporate community in general are able to comprehend what is expected of independent directors. For instance, at least a majority of the independent directors in India that we interviewed for the purposes of this Article believed their role to be one of advising management from a business or strategic standpoint rather than to act as monitors of management or the controlling shareholders. In the absence of any such clarity in regulatory intentions in the Indian context, one cannot expect any meaningful level of monitoring from independent directors

As we have seen in the previous Part, Clause 49 is altogether silent when it comes to the roles and responsibilities of independent directors. It is not clear if they are to be involved in strategic advisory functions or monitoring functions. It is also not clear if they are to owe their allegiance to the shareholder body as a whole, to the minority shareholders specifically, or to other stakeholders. It is somewhat surprising, therefore, to find that survey results report a great level of confidence among independent directors about knowledge of their own roles. The *AAH Report* states that 62.5% of the respondents "believe that the roles and responsibilities of the non-executive directors are clearly defined and documented." In the *FICCI GT Report*, a slightly larger proportion of 69% respondents expressed satisfaction with the outline of the current role and responsibility of the board members in general. If participants in the corporate sector seem quite conscious of their own role, what exactly is that role – strategic advisory or monitoring? This is an important question which the surveys do not readily answer. The only guidance available is that 59% respondents to one survey believe that independent director involvement in annual planning and strategy development of the company of the company is moderate, while 22% believe it to be substantial and 13% minimal. But, the monitoring function, which has been the mainstay of the evolution of the independent director in the U.S. and the U.K., appears not yet to be a key part of an independent director's role in India. While the surveys themselves do not track the monitoring function, interviews with practitioners suggest a greater involvement of independent= directors in business strategy formulation than on monitoring.

In the context of persistence of the majority-minority agency problem, there is no general tendency on the part of independent directors to bear in mind the interests of minority shareholders. One survey finds that "over 20% of firms have a director who explicitly represents minority shareholders or institutional investors."However, the survey does not identify the types of minority investors. Based on practitioner interviews and a broad overview of minority investors in Indian companies, it appears that these independent directors are usually appointed by institutional investors who take significant shareholdings in public listed companies. The investors enter into contractual arrangements (though subscription and shareholders' agreements) with the company and the controlling shareholders to identify the *inter se* rights among the parties. The so called independent directors, who are otherwise nominees of the investors, are appointed to oversee the interests of the investors appointing them and do not have any explicit mandate to cater to the interests of minority shareholders as a whole. Such an independent director selectively takes into account the interests of one minority shareholder, and cannot be said to aid in the resolution of the majority-minority shareholder problem in general.

This discussion points us towards a remarkable outcome indeed: while Clause 49 is silent as to the interests the independent directors are to protect and there is no clarity regarding that in practice either, independent directors and other corporate players appear confident about what they believe is the role of independent directors

Finally, independent directors can play an impactful role only when board systems and practices enable such role. One of the key obstacles to the proper functioning of independent directors relates to availability of information. Although the amount of information being shared with independent directors has been increasing over the years, surveys find that there is a need for drastic improvement both in terms of the timeliness and quality of information provided. Furthermore, independent directors can be effective only if they are provided adequate training and their performance is properly evaluated. As far as training is concerned, although there is no mandatory training requirement in Clause 49, one survey suggests that 57% of the respondents are taking steps to provide training to their directors. Independent directors will have an incentive to carry out their roles diligently if their performance is periodically evaluated. However, performance evaluation of independent directors has not evolved sufficiently in India as a common practice. One survey indicates that only a quarter of responding firms have an evaluation system for non-executive directors, while another survey indicates that about 39% companies surveyed had a formal board evaluation process (which perhaps covers the entire board rather than just the independent non-executive directors). This suggests that independent directors are often brought on boards merely to comply with the legal requirement rather than with a view of obtaining any significant contribution (either in terms of strategic value-add or monitoring).

As per the scheme of the company law, shareholders appoint directors to manage the affairs of the company. They are the agents of the company and have a fiduciary duty to act in the best interest of the company. The board of directors comprises of optimum number of executive and independent directors for the smooth functioning of a company. Independent directors bring in independent thinking and rich experience in their respective fields. They represent divergent viewpoints on issues brought before them. They bring in an element of objectivity to company board process in the general interest of the company and to the benefit of all stakeholders, including minority and small shareholders. They are capable of resisting the influence, the pulls and pressures of the company on the one hand and the particular group of shareholders who appointed them, on the other hand. Moreover, they justify and take responsibility for their decisions. They are independent in their judgment especially on issues of strategy, performance and resources, including key appointments and standards of conduct. They also ensure that a proper, efficient and effective monitoring system exists in the company. In fact, their role becomes critical in determining the composition and functioning of the board of directors.

In fact, truly respected and valued independent directors are those who are competent, committed and have an independent 'state of mind' to challenge and ask the right/uncomfortable questions. In fact, they govern the functioning of the board with a long-term vision and perspective of the company.

INDEPENDENT DIRECTORS IN INDIAN COMPANIES

All the codes of corporate governance deal with who should and who should not be on the corporate board. Any corporate unit can run and control its operations properly if the balance of the directors is proper. Every person in the board should be clear about his role and responsibility. For good governance, it is very important to have clear direction, i.e., what is the role of the board and management and of the executives? There should be a proper mix of executive and non-executive directors in the board. This has the advantage of combining the executives' in-depth knowledge of the day-to-day affairs of the company with the wider experience of non-executive directors. Almost all the codes play an important role in selection of the board member, whether executive or non-executive. They should be selected based on their merit and for the greater good of the corporate unit. The Combined Code (1998) states: "The board should include non-executives of sufficient caliber and number for their views to carry significant weight in the board's decisions," According to this Committee, independent non-executive directors continue to be defined as those non-executive directors that are, "Independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment."For good governance, it is very important to maintain an independent element in the board. All the codes relating to corporate governance provide clear guidelines about the proportion of the board to be maintained as independent. In the UK, it is recommended that non-executive directors should comprise not less that one-third of the board size and that the majority of the non-executive directors should be independent.

The Table 1 illustrates that in India, about 39% of the companies have less than one-third independent directors of their board.30% of the companies are fulfilling the requirement of the Committee for the minimum number of the independent directors on their board while about 31% have better practices of appointment of independent directors on their board

TABLE1:PERCENTAGE OF INDEPENDENT DIRECTORS ON THE BOARD

Independent directors less than 33%	33% to 50%	51% to 100%	Total
39	30	31	100

Source: Hitesh J Shukla, Separation of Chairman and CEO in the Organization, Indian Corporate Governance and Board Structure, the Accounting World, July 1995, P.15

While appointing independent directors, every company should keep in mind the representation of each and every stakeholder, for looking after the interests of the company better. As per Clause 49-I (B), all pecuniary relationships or transactions of non-executive directors with the company should be disclosed in the Annual Report." Pecuniary Relationship Transaction" refers to any relationship or transaction of a director with the company that gets him any monetary benefits, reward, or recompense.

Independent directors are taking a higher profile role than ever before in balancing shareholder and management interest. A director can only be true if shareholders rather than management nominate him. A director who is conscious about his responsibilities will always raise the right questions at board meetings, whether or not he holds the independent status.

Executive and non-executive directors have overall responsibility for leadership and control of the corporate units. Executive directors should have varied and complementary skill to perform their duty effectively. In order to sustain stakeholders' confidence, all the corporate units should disclose the skills and backgrounds of their directors. Even at the time of appointment and or reappointment, corporate units are required to disclose the contribution of the directors to the shareholders. Such a provision is found in the Combined Code of UK. In the Indian corporate world, out of 100 companies, 61% have less than 33% of executive directors on their board, while 39% have 33%-50%, and no company in this sample has more than 51% of executive directors on their board.

TABLE 1.5: PERCENTAGE OF EXECUTIVE DIRECTORS ON THE BOARD

Less than 33%	33% to 50%	51% to 100%	Total
61	39	NIL	100

Source: Hitesh J Shukla, Separation of Chairman and CEO in the Organization, Indian Corporate Governance and Board Structure, the Accounting World, July 1995, P.15

The concept of "independent director" has, of late, assumed significant importance in India. The recent Concept Paper on the New Company Law and the JJ Irani Committee Report highlighted the role of independent directors as conscious keepers of the board of directors.

HOW INDEPENDENT ARE INDEPENDENT DIRECTORS IN INDIA

An independent director is expected to act as watch dog of the board and protect the interest of shareholders. Since they are handpicked by the promoters himself so they prefer to be a friend of the promoters rather than be the watch dog of the board. Though independent director is paid by the company, it must be borne in mind that the company is not only owned by its promoters but all share holders so they are supposed to represent the interest of the minority shareholders. There are circumstances where independent directors are not independent, which broadly includes:-

- their selection procedure
- no age limit
- no specific qualification is required
- no right to interfere in the day-to-day operations
- no time limit for replacement of an independent director

Independent directors are still the only hope to instill discipline in the murky world of corporate finance, provided their independence is not being compromised. If they are no more independent then their appointment in a company will be meaningless. This position deserves to be corrected by empowering SEBI and the Indian government.

a) Selection procedure

A lot of emphasis is placed on the "independence" of independent directors their selection is still in the hands of owners of the company. No process of selection has been prescribed for the independent directors, as they are directly handpicked by the promoters. Promoters in control may take decisions that are not in the interest of small shareholders, an independent director must keep in mind the interest of all stakeholders. Such procedure for their selection raises question on their independence at the board. They can not be as independent as they are expected to be, if they are going to be appointed by the owners. This procedure has to be changed for the independence of directors. As long as they are appointed by management, the concept of independent directors is a myth, for truly independent directors, they have to be nominated by the SEBI which is a regulatory authority. If they have a right to regulate, then surely they have a right to even suggest the appointment of directors[8].

b) No age limit

There is no age limit has been prescribed under Companies Act, 1956 and by the SEBI. According to Indian companies Act a minor can become a director since no age limit is prescribed. This point must be rethink as a person who is under 18, as surly cannot acquire enough experience to become an independent director of a company[9]. It's not the quantity of Independent Directors but the quality of Independent directors that make difference. There must be an age limit which can justify the position of an independent director.

c) No specific qualification is required

There is need to focus on the quality of independent directors who are going to be appointed. They should be qualified enough so that they can ask right questions at the right time when they are at board. The most important requirement is his ability to stand up for minority shareholders, who are not represented on company boards. They need to be sound in judgment with an inquiring mind. Clause 49 of the Listing Agreement of the stock exchanges and the Companies Bill, 2008 introduced in Lok Sabha's last session does not prescribe the minimum qualification or experience essential. Presence of independent director on the board makes sense only if they are well-educated, can add value to the company, and represent minority shareholders' interests. The government and SEBI must review the qualification for independent directors.

d) No right to interfere in the day-to-day operations

An Independent director has no right to interfere in the day-to-day operations of company. They have right to intervene in any misgivings or misdeeds. They are supposed to support the management in getting the delivery of what the objectives of the company are to its shareholders. If a director can not get into a company's day-to-day operations, he can not understand how it is governed and will not be in the position to fulfill his responsibilities. There is no separate law under which an independent director operates; he has no legal protection from the management so that he can raise his voice fearlessly. For the involvement of independent director in day-to-days operations of company they must be given authority so that they can intervene in the day-to-day operations of company and may be able to raise their voice.

e) No time limit for replacement of an independent director

There is no guideline prescribing a time limit for replacement of an independent director in case there is a resignation or removal or death of an existing one and promoters are taking a plea that they have not been able to find a replacement, which could stretch for indefinite period. The fees or remuneration of an independent director has grown so substantially in the last three years that an individual is often tempted to have an extended stay in the organization. Most of these directors would go by the decision of the promoters of the company without examining the details of company[10]. To retain the independence of director there is need to rotate such directors periodically or by any other method whereby the independence of independent director is secured.

CASE STUDY OF CRITICAL ISSUES OF SATYAM EPISODE

Even where there is a stellar independent board of directors, it may not be possible for them to perform their role effectively if the conditions that facilitate proper performance do not exist. The Satyam episode demonstrates some of the reasons why the effectiveness of independent directors in India may continue to be in doubt.

i) Satyam Computer Services Limited (recently renamed Mahindra Satyam) is a leading information technology Services Company incorporated in India. Satyam's promoters, represented by Mr. Ramalinga Raju and his family, held about 8% shares in the company at the end of 2008, while the remaining shareholding in the company was diffused. Its securities are listed on the Bombay Stock Exchange and the National Stock Exchange. Furthermore, the company's securities are cross-listed on the NYSE. This required Satyam to comply not only with Clause 49 but also the requirements of the *Sarbanes-Oxley Act* as well as *NYSE Listed Company Manual*. Satyam took immense pride in its corporate governance practices.

At the relevant time (end 2008), Satyam had a majority independent board, thus over-complying with the requirements of Clause 49. Its board consisted of the following:

Executive Directors

(a) B. Ramalinga Raju, Chairman;

(b) B. Rama Raju, Managing Director and Chief Executive Officer;

(c) Ram Mynampati, Whole Time Director;

Non-Executive, Non-Independent Directors

(a) Prof. Krishna G. Palepu, Ross Graham Walker Professor of Business Administration at the Harvard Business School

Independent

a. Dr. Mangalam Srinivasan, management consultant and a visiting professor at several U.S. universities;

b. Vinod K. Dham, Vice President and General Manager, Carrier Access Business Unit, of Broadcom Corporation;

c. Prof. M. Rammohan Rao, Dean, Indian School of Business;

d. T. R. Prasad, former Cabinet Secretary, Government of India; and

e. V. S. Raju, Chairman, Naval Research Board and former Director, Indian Institute of Technology, Madras.

The board consisted of 3 executive directors, 5 independent directors and 1 grey (or affiliated) director. Amongst the non-executives, 4 were academics, 1 was from government service and the last was a business executive. At a broad level, it can be said that very few Indian boards can lay claim to such an impressive array of independent directors.

ii. The Maytas Transaction:

On December, 16 2008, a meeting of Satyam's board was convened to consider a proposal for acquisition of two companies, Maytas Infra Limited and Maytas Properties Limited. Two sets of facts gain immense relevance to the transaction. One is that the Maytas pair of companies was predominantly owned in excess of 30% each by the Raju family, thereby making the proposed acquisition deal a related party transaction. The other is that the Maytas companies were in the businesses of real estate and infrastructure development, both unrelated to the core business of Satyam. The transactions were also significant as the total purchase consideration for the acquisition was Rs. 7,914.10 crores (US$ 1,615.11 million). It is important to note that, if effected, the transaction would have resulted in a significant amount of cash flowing from Satyam, a publicly listed company, to its individual promoters, the Raju family.

The board meeting on December 16, 2008 was attended by all directors, except for Palepu and Dham who participated by audio conference. On account of the related party situation and unrelated business diversification, it is natural to expect a significant amount of resistance from the independent directors to the Maytas transactions. After the company's officers made a presentation to the board regarding the transactions, the independent directors did raise some concerns. For example, "Dr. Mangalam Srinivasan,

Director enquired if there are any particular reasons either external or internal for this initiative and timing of the proposal" and "suggested to involve the Board members right from the beginning of the process to avoid the impression that the Board is used as a rubber stamp to affirm the consequent or decisions already reached." Other independent directors such as a Rao and Dham were concerned about the risks in a diversifying strategy as the company was venturing into a completely unrelated business. Yet others opined that "since the transactions are among related parties, it is important to demonstrate as to how the acquisition would benefit the shareholders of the company and enhance their value" and that there should be "complete and justification" regarding the valuation methodology adopted, which "should be communicated to all the concerned stakeholders."

The independent directors cannot be criticized for failing to identify the issues or to raising their concerns at the board meeting, for that is precisely what they did. Surprisingly, however, the final outcome of the meeting was a "unanimous" resolution of the board to proceed with the Maytas transaction, without any dissent whatsoever. As required by the listing agreement, Satyam notified the stock exchanges about the board approval immediately following the board meeting. This information was not at all accepted kindly by the investors. The stock price of Satyam's American Depository Receipts collapsed during a single trading session by over 50% due to massive selling, and the company was compelled to withdraw the Maytas proposal within eight hours of its announcement.

This episode gives rise to a number of questions regarding the role of the independent directors. If the transactions were ridden with issues, why were they approved "unanimously" by the independent directors even though they voiced their concerns quite forcefully? Why were the interests of the minority public (institutional and individual) shareholders not borne in mind by the independent directors when the transaction involved a blatant transfer of funds from the company (which was owned more than 90% by public shareholders) to the individual promoters that is tantamount to siphoning of funds of a company by its controlling shareholders to the detriment of all other stakeholders? Why were the independent directors unable to judge the drastic loss in value to the shareholders by virtue of the transactions and stop them or even defer the decision to a further date by seeking more information on the transactions? How was it the case that the investors directly blocked the transaction when the independent directors were themselves unable to do so? These questions do not bear easy answers, but it is clear from this episode that shareholder activism (exhibited through the "Wall Street walk") performed a more significant role in decrying a poor corporate governance practice than independent directors. If independent directors are to be the guardians of minority shareholders' interests, as they are expected to be in the case of insider systems such as India, Satyam's directors arguably failed in their endeavors.

In the ensuing furor that this episode generated, four of the non-executive directors resigned from Satyam's board. However, most independent directors defended themselves stating that they had raised their objections to the Maytas transactions as independent directors should. While the markets were still recovering from the purported corporate governance failures at Satyam, evidence of a bigger scandal emerged during the first week of 2009 raising further questions about the role of independent directors.

iii. Fraud in Financial Statements:

On January 7, 2009, the Chairman of the company, Mr. Ramalinga Raju, confessed to having falsified the financial statements of the company, including by showing fictitious cash assets of over US$ 1 billion on its books. The confession also revealed that the proposed Maytas buy-outs were just illusory transactions intended to manipulate the balance sheet of Satyam and to wipe out inconsistencies therein. The stock price of the company reacted adversely to this information and fell more than 70% thereby wiping out the wealth of its shareholders, some of whom are employees with stock options. Minority shareholders were significantly affected as they were unaware of the veracity (or otherwise) of the financial statements of Satyam, and hence this exacerbated the majority-minority agency problem.

This episode invoked fervent reaction from the Indian government. Several regulatory authorities such as the Ministry of Company Affairs, Government of India and SEBI initiated investigations into the matter. While several independent directors of the company had resigned, the remaining directors were substituted with persons nominated by the Government. Certain key officers of Satyam, being the chairman, the managing director and the chief financial officer were arrested by the police within a few days following the confession, while two partners of Price Waterhouse Coopers, Satyam's auditor, were arrested thereafter. The investigations by the various authorities, which are likely to be time-consuming, are ongoing and it is expected that their outcome will be available only in due course. The only significant investigation that has been completed is that of the Ministry of Company Affairs conducted through the Serious Frauds (Investigation) Office. At a broader level, the Satyam episode has triggered renewed calls for corporate governance reforms in India, and some of the reforms are already underway.

As for the company itself, it witnessed a remarkable turnaround of fortunes under the leadership of its new government-nominated board of directors. The new board and their advisors took charge of the affairs of the company, appointed a new chief executive, and undertook tireless efforts to retain clients and employees. Finally, the company itself was sold through a global bidding process to Tech Mahindra, another Indian IT player in a transaction that received uniform adulation for the alacrity with which the various players (particularly the new board of Satyam) acted to resuscitate the company and protect the interests of its stakeholders

iv. Lessons from Satyam

In the meanwhile, it is necessary to examine to how misstatements in Satyam's financials were made possible in the first place despite the applicability not only of Clause 49 (as Satyam was listed on Indian stock exchanges), but also of the Sarbanes- Oxley Act (as the company was also listed on the NYSE). Satyam had seemingly complied with all the onerous requirements imposed by Clause 49 and the Sarbanes- Oxley Act, such as the appointment of an impressive array of independent directors, an audit committee, and the audit of its financial statements by a "Big Four" audit firm, but these corporate governance failures nevertheless occurred. This episode raises serious questions about implementation of corporate governance norms in India, and points towards the lack of success of transplanted concepts.

More specifically, several key questions arise with reference to the role of independent directors in such situations. Satyam's independent directors were unable to prevent the falsification of financial statements. Various reasons can be attributed to this failure. No doubt, the Satyam board was largely independent and also comprised distinguished and reputable individuals. But, independent directors cannot generally be expected to uncover frauds in companies as the decisions they make are generally based on information provided to them by management. Even in Satyam's own case, the Chairman's Confession itself concedes that "[n]one of the board members, past or present, had any knowledge of the situation in which the company is placed." Since independent directors do not get involved in the day-to-day management of the company, it is virtually impossible for them to unearth such frauds. Hence, even when monitoring functions are imposed on independent boards, it is impractical to expect independent directors to exercise watchdog functions as their role is necessarily limited. In addition, independent directors are busy individuals who spend little time each year tending to matters pertaining to each company on whose boards they serve. This also limits their ability to delve deeper into financial, business and other matters involving the companies.

At a structural level, as discussed earlier, independent directors are subject to nomination, appointment and removal, all at the hands of the controlling shareholders, and hence may be subject to influence by the controlling shareholders. Although Satyam was subject to the listing requirements of NYSE, it did not have an independent nomination committee that could have potentially brought the appointment of directors outside the purview of the controlling shareholders. In the present case, it is evident that the independent directors were not willing to fiercely oppose the proposals of the management and promoters, as they may have implicitly owed allegiance to the promoters of the company who were in a position to influence their appointment and continuance on the board.

In addition, the Indian corporate governance norms do not specify the roles of independent directors. Such lack of clarity in their roles could result in less desirable outcomes from independent director action as we have witnessed in Satyam's case. More importantly, there is no special role for independent directors in related party transactions with the controlling shareholders. For instance, if there is a requirement that all such related party transactions are to be approved by a vote of independent directors only, then such office bearers are likely to take on greater onus and responsibility for their decisions. Again, there is no such specific role envisaged for independent directors in the Indian corporate governance norms.

The Satyam episode is also symptomatic of a signaling problem with the role of independent directors. That is, the corporate governance norms bestow too much (and somewhat misplaced) importance on the role of independent directors than is justified. In epitomizing independent directors as a guardian of various corporate interests, including possibly minority shareholders, the corporate governance norms create a false sense of security among corporate stakeholders. However, as the Satyam episode has demonstrated, the independent directors are constrained in the extent to which they can be effective in unearthing frauds, even when they exercise a fair amount of diligence in their action.

There also exists the larger issue of promoter control in Indian companies that affects the functioning of independent directors. Promoters (who are controlling shareholders) exercise significant influence on matters involving their companies, even though such companies are listed on stock exchanges and hence have public shareholders. Indian law confers some distinct roles for promoters. This largely holds good even for companies that have controlling shareholders with small percentage holdings in companies. For instance, the Raju family who were the promoters of Satyam held only about 5% shares around the time when the Chairman's confession was made on January 7, 2009. A company with a 5% promoter shareholding will usually be considered as belonging to the outsider model in terms of diffused shareholding, and hence requiring the correction of agency problems between shareholders and managers. However, the gradual decrease in controlling shareholders' percentage holdings coupled with the concept of "promoter" under Indian regulations makes the distinction between an insider-type company and outsider-type company somewhat hazy in the Indian context. The Raju family, as promoters, continued to wield significant powers in the management of the company despite a drastic drop in their shareholdings over the last few years. This was aided by the diffused nature of the remaining shareholding within the company. The Satyam episode illustrates that a company with minimal promoter shareholding could still be subject to considerable influence by the promoters, thereby requiring a resolution of the agency problems between controlling shareholders and minority shareholders even at those shareholding levels. The transition of companies from the insider model to the outsider model through constant dilution of shareholding by controlling shareholders can be difficult, as Satyam demonstrates. Corporate governance regimes in emerging markets such as India which are likely to witness such transition from insider to outsider regimes through dilution of controlling shareholding need to provide mechanisms to tackle undue control by promoters with limited shareholding.

The Satyam case clearly demonstrates the inability of the existing corporate governance norms in India to deal with corporate governance failures in family controlled companies, even where the level of promoter shareholding is relatively low. Any reforms to the independent director regime that spring from this case ought to take into account the vulnerability of minority shareholders in such companies that lie at the cusp of insider and outsider systems.

CONCLUSION AND SUGGESTION:

Independent directors or non-executive directors of the company monitor and control the chairman/chief executive; they serve as a link with external environment and provide an international perspective. Apart from this independent directors try to improve board processes and bring in specialist knowledge, they provide continuity, help identify alliance and acquisition. It can be concluded that independent directors help maintain an ethical climate in the organization.

A company should have a clearly laid out policy where there should be specified role played by him at board, their tenure and age limit, qualification required etc. The focus must be on the quality of person who is going to be appointed. Selection of independent directors by SEBI and government would be fair and bring transparency in the selection procedure as well as can secure their independence to some extend. So far as age limit is concerned which must be review, minor should not be considered eligible for the chair of independent director; the minimum age limit for an independent director must be between 30-35. The person must be well-educated with required experience so that he can justify the role of an independent director. Company must clearly laid down qualification and experience required for the post of independent director in the policy. The appointed director must be rotated periodically to ensure the transparency and fairness in their decision. Legal protection must be provided to independent directors so that they can raise their voice against the management and force their views in the interest of shareholders.

If independent director does not fulfill their duty as a watch dog then it would amount to committing an offence. As Supreme Court in *Municipality of Bhiwandi & Nizampur v. Kailas Sizing Works* has observed that "the authority is not acting honestly where an authority has a suspicion that there is something wrong and does not make further enquiries. Being aware of possible harm to others, and action in spite thereof, is acting with reckless disregard of consequences. It was worse than negligence, for negligent action is that, the consequences of which the law presumes to be present in the mind of the negligent person, whether actually it was there or not." So, an independent director can not escape from his liability. They will be held liable equally if they do not take any action against the wrong committed/wrong decisions taken, in his knowledge.

Satyam episode is proven to be tragic for the Indian corporate world, but it should be considered as a wake-up call to many. The Satyam case brought out the failure of the present corporate governance structure, in which independent directors failed to perform their responsibility effectively. As in Satyam case independent directors lacked commitment, they failed to live up to the stakeholders' expectations. The only way independent directors can stop wrong doing by acting collectively.

Across the world companies have appointed luminaries to the boards, secure in the knowledge that their presence would lend a badge of respectability to the boardroom. Satyam scam was no exception, its board included noted academics such as Harvard professor Krishna Palepu and ISB dean Rammohan Rao, but the manner of its unraveling has triggered an intense soul-searching across corporate circle[12].

There is no need to implement new laws; all we need to do is to renew existing laws. Independent directors may not be in a position to stop management fraud perpetrated at the highest level, but with high level of commitment and due diligence they should be able to identify signals that indicate that everything is not going right.

What are factors that should receive attention for this to change? Reputable management scholars are providing invaluable advice on this. If Boards are to truly play a leadership role in future they require to:

a) Ensure independence from management. Many regulations provide for this by separating the CEO from the Board and creating two tier boards with supervisory and administrative boards. Strengthening committee form of management by creating leadership positions for independent directors.
b) Must hold themselves accountable for the performance of their boardrooms through rigorous annual evaluations.
c) Build knowledge capabilities in areas of strategy, implementation and globalization.
d) Must harness power of information technology more successfully to ensure ready access to critical information.
e) Move their mandate from serving solely shareholders to serving broader set of constituents.
f) Tenure of IDs should be fixed. It is suggested that IDs should compulsorily retire after six years from the board of directors.
g) There should be corporate governance rating: The Credit rating agencies should rate the company on the following aspects: Quality of board members, Knowledge of IDs of company or industry, the attendance records, Quality of agenda items, minutes of the meetings, and other board room practices.

It is by adopting the above that society will see the role that boards need to provide – "that of real leadership".

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