

# The Role of Independent Directors in Ensuring Good Corporate Governance

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**Abstract:** For a long time, independent directors have been playing an important supervisory role in the operation and management of the company, protecting the interests of the owners of the enterprise and maintaining the balance of interests between the management of the company and the shareholders. The research in this paper aims to explore the positive role and problems of independent directors in good corporate governance, such as the positive role of independent directors in constraining and supervising directors, protecting the interests of small and medium-sized shareholders, and some problems such as the independence of independent directors being questioned. Through the establishment of some British committees, the independent directors have conducted in-depth studies to verify the problems of independent directors, published some insightful reports and comments, and put forward some suggestions for improvement. These debates have affirmed the supervisory function played by independent directors on the one hand, and pointed out the existing problems on the other, but it is undeniable that the existence of these problems can not erase the positive role played by independent directors in good corporate governance and their developmental future. Therefore, continuous improvement of independent directors to highlight their advantages in good corporate governance is the direction for independent directors to move forward in the new era.

**Keywords:** Independent Directors, Corporate Governance, Independence, Supervision.

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## 1. Introduction

A director who does not work within the company but is able to make independent judgments about the company's affairs and is independent of the company's shareholders, and has no significant business or professional ties to the company or its management. Independent directors are a means of reducing agency costs between the proprietor and the owner of a company, acting as a link between the right to allocate resources and the ownership of resources, and between the majority and minority shareholders, and supervising that the company's decisions do not deviate from the interests of the investors[1]. This is how agency theory looks at independent directors. The independent director is a product of the differentiation of the monolithic structure, and its core purpose is consistent with the agency theory, both of which play a supervisory function, according to the theory of differentiation of board functions, the independent director is a product of the differentiation of the monolithic structure, by reducing moral hazard and adverse selection in order to serve the owners of the enterprise. In essence, independent directors play a significant role when there is a conflict of interest between corporate management and shareholders[2].

Understanding the complexity of independent directors on corporate governance is vitally important if we can attach importance to the functional role of independent directors, it will have a good effect on corporate governance. Understand the origins and changing roles of independent directors. Second, the functional role of independent directors is discussed in detail, especially its role in good corporate governance[3]. Thirdly, it critically analyzes the defects of independent directors in corporate governance and gives suggestions. Finally, it can be found that the defects always exist in the development process of independent directors are difficult to avoid. However, it cannot be denied that the emergence of independent directors is of positive significance to corporate governance, especially in terms of restricting and

supervising directors and protecting the interests of minority shareholders[4]. However the issue of the existing defects of independent directors cannot play the role of ensuring good corporate governance has been a controversial and much disputed subject within the field of corporate governance. This paper has four key aims. Firstly, understand the origins and changing roles of independent directors. Second, the functional role of independent directors is discussed in detail, especially its role in good corporate governance. Thirdly, it critically analyzes the defects of independent directors in corporate governance and gives suggestions. Finally, it can be found that the defects always exist in the development process of independent directors are difficult to avoid. However, it cannot be denied that the emergence of independent directors is of positive significance to corporate governance, especially in terms of restricting and supervising directors and protecting the interests of minority shareholders[5].

The system of independent directors originated in the United States, and it is mainly used as part of the governance structure to perform the supervisory function with the characteristic of independence, the most essential characteristic of independent directors is that they do not have any interest in the company and its major shareholders, emphasizing that independent directors have the independence of identity and the objectivity of judgment. About the role of the company and the responsibility of directors in the United States around 2003 and in the 1930s There have been important writings and heated debates, Initially the concerns of the 1960s movement were not considered to be about 'corporate governance', a phrase that had not yet emerged[6]. However, the period beginning in the late 1960s, with the rise of the corporate social responsibility movement, the numerous corporate scandals arising from the Watergate scandal and the failure of boards of directors to act as insider advisory teams, led to a change in the way corporate boards were perceived in the United States as a primary function. The board system underwent an important

transformation from a friendly, trusted advisor group to the CEO to an independent watchdog that focused on the internal workings of the company, questioned the company's decision-making process and aimed to monitor the CEO and senior management[7].

Subsequently, at the request of the US Securities and Exchange Commission, the New York Stock Exchange amended its listing rules to require all listed companies to have an audit committee comprised of directors independent of management. While US courts did not require independent directors on the board, they did support the board-as-oversight-committee model through jurisprudence, and those directors independent of management laid the foundation for the US corporate governance model to become central[8].

For the UK, in the late 1980s, the collapse of some well-known UK companies such as Blue Arrow, Coral Rolls and Polly Peck after years of prosperity led to a discussion of corporate governance in the UK. Shareholders felt that the directors were not doing their job as supervisors and had no idea what was going on in the companies they were responsible for. This has had a significant impact on investor confidence in company boards and has led to calls for reform of the current corporate governance structure[9]. In order to ensure fair and transparent board operations and to restore investor confidence, the UK took a cue from the US and introduced independent directors to its board of directors. Although the initial version of the UK Corporate Governance Code largely adopted the US concept of independent directors, i.e. it did not explicitly require independent directors to be independent of major shareholders, the first revision in 2003 began to require independent directors to be independent of management and significant shareholders, thus parting ways with the US-style definition of independence[10].

## 2. Benefits to Corporate Governance:

To discuss the role of independent directors in good corporate governance, the first thing to understand is the functionality of independent directors themselves. Firstly, the establishment of independent directors can oversee the prevention and containment of insider control and safeguard the legitimate interests of shareholders. The UK relies on its highly developed capital markets for much of its financing, and its capital structure is dominated by equity and supplemented by debt. The high degree of fragmentation of shareholding makes it impossible for each single shareholder to achieve an effective exercise of their shareholder decision-making role in the affairs of the company, and the company's shareholders are a highly mobile group, lacking regular and close ties between them[11]. Shareholders often have little incentive in practice to protect their rights and interests, preferring to participate more in the stock market and leave the company as the only means of protecting their interests[12].

Although institutional investors in the UK have grown rapidly in recent years, they have not fundamentally changed the highly fragmented nature of shareholding. Institutional investors hold shares mostly for the purpose of generating returns from the spread between the purchase and sale of shares, rather than to establish a long-term investment relationship with the company. This has led to a lack of incentive for institutional investors to stabilise long-term shareholdings in a particular company, and as a result institutional investors' holdings remain relatively fragmented[13]. This high degree of fragmentation and

liquidity of shareholdings leaves shareholders in general, and small and medium-sized shareholders in particular, in a state of information asymmetry with the company and its proprietors. Based on the cost of participation, shareholders exercise their rights not by voting with their hands at general meetings, but by voting with their feet on the stock market. In short, it is difficult for a single shareholder in the UK to form a controlling shareholder position in a company, and shareholders cannot effectively unite to exercise shareholder power against management, thus creating a "weak shareholder, strong management" corporate governance structure in the UK, which has led to the problem of insider control[14].

Insider control can easily get out of hand, as managers have the incentive and desire to expand their power, as well as the means to do so. This loss of control can lead to a loss of corporate interests and ultimately infringe on the interests of shareholders. There is therefore a great need to monitor the business conduct of insider management managers. The introduction of independent directors marks a reduction in the proportion of insider directors on the board of directors, thereby reducing the overlap between the decision-making and operating powers of the company and enhancing the supervisory function of the board of directors[15].

The establishment of independent directors can check the dominance of one management and also improve the level of decision-making by the board of directors. According to the traditional company law theory, the management objective of a company is to maximise the interests of shareholders, and directors are regarded as the agents or trustees of shareholders, and the interests of shareholders are their highest and only objective. The directors are dependent on the shareholders, and the will of the two is united, and the directors have no independent will[16]. However, since the beginning of the 20th century, the structure of shareholdings in common law countries has undergone significant changes, with shareholdings becoming more and more fragmented and the separation of ownership from management, and the board of directors gradually being manipulated by management, led by the managing director, with the will of shareholders diverging from that of management. In response, common law countries have introduced independent directorships, the primary purpose of which is to counterbalance management's de facto control over the company and to expand the board's vision by including external members, thereby achieving a diversity of decision-making interests. The introduction of independent directors can improve the quality structure of the board of directors and enhance the board's vision and decision-making ability. Professor Clark of the United States believes that the duty of independent directors is not to make specific business judgments, but to monitor the work of insiders, especially to review decisions made by insiders with a stake in the company, who are prone to fall into stereotypes in their thinking and actions, while outsiders can offer unique and novel opinions on the company, preventing the key to repeating the same mistakes. Secondly, not only do independent directors come from outside, they are not employed by the company and have no hierarchical relationship with the inside directors, so they are less subject to the constraints of the inside directors, and they are not involved in the management, so they can make an objective evaluation and supervision of the management decisions[17].

Thirdly, the establishment of independent directors can monitor the collusion between the board of directors and the

managers and avoid the moral hazard problem of collusion between the directors and the managers. Theoretically, the general meeting of shareholders is the highest authority of the company, but as mentioned above, the actual power of the company in the UK is held by the management. In addition, there is no separate supervisory body in UK companies, and the board of directors exercises supervisory authority over the top management of the company, making the executive and supervisory bodies of the business one and the same. This 'monolithic' framework is also a logical consequence of the developed external control model in the UK and US[18]. The existence of an effective external control model has weakened the internal control system of the company. However, the impartiality of the board of directors is often questioned when they also hold management positions and are their own judges[19]. This is particularly the case when the chairman of the board is also the CEO, which can easily lead to problems of insider control. It was in response to this problem that the independent directorship was established, hoping to create checks and balances on the internal body of the board of directors, introduce objective judgement independent of the management and check arbitrary collusion between the board and the management.

In the early studies of the independent directorship, research focused on the board of directors as a whole. Scholars examined the effects of independent directorships by examining the impact of the introduction of independent directorships on the level of operations or quality of governance of companies, or the relationship between the proportion of independent directors on the board and the characteristics of the company. Previous literature has found that when the proportion of independent board members to the total number of board members is higher, companies disclose more information related to corporate strategy, the more transparent the information of listed companies, the higher the content of surplus information, the higher the firm's performance. In addition, the ratio of independent directors to the total number of board members is negatively associated with financial fraud, and capital appropriation by listed companies[20].

On the other hand, there is also literature that questions the role of independent directors. In terms of a company's innovative R&D activities, a more independent board is more likely to focus on familiar and competitive areas rather than steering the company towards riskier innovation strategies. According to the "mutual benefit" theory, excessive cash remuneration of independent directors may undermine their independence by compromising their oversight function[21]. Due to the cost constraints and limited rationality of independent directors in an informationally disadvantaged position, it is difficult for independent directors to play a timely and effective role in business decision-making and monitoring. Due to the difference in status hierarchy within the board, in order to avoid hostility from high-status directors and ostracism from other directors, independent directors with low status tend to choose to follow the advice of high-status directors. Studies have found that independent directors' social connections with company directors and management can also have a negative impact on their performance behaviour[22].

### **3. Problems with the uk Independent Directorship**

The UK's independent directorship system has also experienced a number of problems over its long history of operation. These problems have attracted the establishment of a number of committees in the UK: the Cadbury Committee, the Greenbury Committee and the Hampel Committee, as well as the Derek Higgs Chair and David Walker. These committees have conducted in-depth studies of the independent director system, identified problems and weaknesses in the independent director system, published influential reports and reviews, and have made a number of recommendations for the improvement of the independent director system.

#### **3.1. Independence of independent directors**

Independent directors are expected to provide their independent views to the company and the Cadbury Committee report emphasises that the function of independent directors is to provide their independent judgement. Because independent directors are not involved in the day-to-day operations of the company, they are able to provide an objective and impartial perspective on the company's affairs[23]. However, most independent directors are elected through the executive directors and may have had previous business dealings with the company. Some independent directors are executive directors of other companies or have previous management experience. As such, they share similar backgrounds and interests with the executive directors of the company. They also rely on the executive directors to provide them with the information they need to carry out their duties. They therefore need to maintain a good relationship with the executive directors in order to perform their functions better. As a result, their "independence" is questionable.

#### **3.2. Limited access to information**

Independent directors rely on managers to provide information in order to carry out their functions. If the executive directors block their sources of information, the independent directors will not be able to carry out their duties. Without sufficient authority and information, it is difficult for independent directors to effectively monitor companies[24].

#### **3.3. Ambiguity in the powers and responsibilities of independent directors**

The law plays a minor role in giving independent directors the financial incentive to carry out their duties. Directors are bound by the same laws, regardless of whether they are independent or executive directors. Issues arising in the UK:

In a unitary model board, the independent directors and the executive directors have the same responsibilities for the management of the company and are jointly accountable for the decisions made by the board[25]. Independent directors do not work full time on the board and receive a lesser salary package than executive directors, but are held to the same responsibilities as executive directors.

### **4. Good Advice Can Be Provided Around the Committee's Report:**

Firstly, with regard to the independence of independent

directors, the Cadbury Committee report emphasises the importance of independent directors providing their independent views and judgements on the company's strategic resources, including the allocation of personnel. In addition, independent directors should be independent of management and have no other relationship with the company[26]. In fact, the Cadbury report simply highlights the requirements for independent directors' independence, without providing clear criteria for determining independence. It is also common for independent directors to have a relationship with the company, which is one way in .minimum of three independent directors on the board and recommends that companies establish an appointment committee to carry out the function of selecting independent directors. An appointment committee with a majority of independent directors would encourage the company to appoint more independent directors to the board. Such a proposal assumes that an appointment committee with a majority of independent directors will ensure the independence of independent directors[27]. However, on the other hand, the number of independent directors on the board does not mean that they will be able to perform their duties well. It is in fact easy for the board to appoint unqualified independent directors to meet the required number of independent directors. It is therefore also important to raise the profile of the appointment of independent directors.

The focus on ensuring the independence of independent directors is to establish a mechanism that protects their independence in the discharge of their duties. When appointing independent directors, the issue is their ability to perform their duties rather than whether they have had a previous relationship with the company. Having appointed independent directors, they need some power to protect themselves from being able to express their views freely and without fear of being expelled from the company. They must not be afraid to use their powers in the discharge of their duties[28].

Secondly, with regard to information, the Cadbury Committee emphasized that independent directors have the same powers to access information as executive directors and recognized that the extent to which independent directors fulfil their duties is closely linked to the quality of information they obtain. However, it does not provide clear guidance to independent directors on how to obtain the information they want, and although the Cadbury Committee recognizes the importance of adequate information for independent directors, it does not provide detailed advice or suggest a way in which independent directors can obtain information quickly. Independent directors need ways to help them obtain useful information in order to make independent judgements, and having to wait for information from executive directors means that this information may have been purposefully selected by executive directors to obscure the facts and not reflect the true state of the company. Independent directors therefore need some special and powerful access to real information about the economic and transactional details of the company[29].

Thirdly, in terms of powers and responsibilities, the Cadbury Committee expects independent directors to be able to make choices in regulating the actions of the board and executive directors, and when there are conflicting potential interests. These expectations place a heavy burden on the independent director, who has to bear the same responsibilities as the executive director, regardless of which executive director is making those decisions[30]. Independent directors do not have a strong weapon when they have a heavy

burden, and the responsibilities they have to bear are not commensurate with the power they hold. The protection of independent directors and the better performance of their role require a distinction between the responsibilities and rights of independent and executive directors.

## 5. Conclusion

Through this study, the emergence of independent directors has changed the internal structure of directors, making both the board of directors and the manager subject to supervision and restriction. To a certain extent, it can avoid mutual protection of directors and better protect the interests of minority shareholders. On the other hand, it can make the decisions more diversified and more conducive to the development of the company. Undeniably, independent directors also have some shortcomings. First, they may lack the inside knowledge of a company that executive directors have, limiting their ability to make informed decisions, especially in times of crisis. Second, independent directors still inevitably have conflicts of interest because they may have other business interests or sit on the boards of competing companies. Third, they may lack commitment because they may have other commitments and may not be fully involved in the company's activities. However, the existence of these defects cannot ignore the positive significance brought by the emergence of independent directors, and the benefits they bring to the board of directors far outweigh these disadvantages. In addition, better solutions are being actively sought in the field of corporate governance. At the end of this paper, several suggestions for the existing defects of independent directors are discussed, but they still cannot fundamentally solve the problem of functional independence of independent directors, and can only provide some useful thinking. Therefore, with the rapid development of globalization and the increasing number of listed companies, the need for independent directors will become more and more urgent, and the requirements for independent directors will also be raised. Therefore, the company should strive to have a diversified and independent board of directors that can supervise the interests of stakeholders and the company's operation, so that the independent director system can continue to play a stronger role in the new period.

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