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Keeping the Bad Directors at Bay
By Adrian Chan

Very few companies would think that they have bad directors on their boards. Bad directors are often recognised in hindsight – when their neglect or wrongdoings hit the headlines. Some of the largest corporate failures and scandals may be attributable to weak boards and non-performing directors.

Lehman Brothers

Take the case of the ill-fated Lehman Brothers, whose collapse in 2008 precipitated the global financial crisis.

The makeup of Lehman's board could hardly be said to be the epitome of good board composition. About half of Lehman's 11 directors were aged over 70. They had been on the board for almost 15 years on average. The directors included a theatrical producer, the former CEO of a Spanish-language television company, a retired art-auction company executive, a former rear admiral who headed the Girl Scouts, and until two years before Lehman's downfall, an 83-year-old actress.

In a 2008 conference call announcing its third quarter loss of US$3.9 billion, Lehman CEO Dick Fuld told analysts: "I must say the board's been wonderfully supportive." This must have been true because the board had earlier awarded Mr Fuld US$71.9 million, putting him among the top 2 per cent of American CEOs by pay. Four days later, Lehman filed for the largest bankruptcy in US history.

The Lehman board was not just asleep at the wheel - they were singularly ill-equipped to oversee a complicated financial entity. Just one of its 10 non-executive directors had any recent banking experience and had joined the board just five months before Lehman went bust.

Satyam
Sadly, Asia has not been spared from such corporate malfeasance, board complicity and governance failures.

The Satyam scandal in India is one example that highlights how difficult it is for independent directors to completely safeguard the interests of stakeholders. In one of the biggest frauds in India's corporate history, Ramalinga Raju, founder and CEO of Satyam Computers (then India's fourth-largest IT services firm), announced in 2009 that his company had been falsifying its accounts for years, overstating revenues and inflating profits by US$1.47 billion. Raju was forced to make this public admission following an attempt to have Satyam invest US$1.6 billion in Maytas Properties and Maytas Infrastructure ("Maytas" is actually Satyam spelled backwards) - two firms controlled by his family. Satyam's board had approved the investments, sparking a negative reaction by shareholders, causing its stock on the New York Stock Exchange to plummet. The board hurriedly reconvened the same day and reacted to the public sentiment, aborting the proposed investments.

Within the next 48 hours, resignations streamed in from four of Satyam's non-executive directors, which included a Harvard professor of business, an adviser to Harvard's Kennedy School of Government and the dean of the Indian School of Business in Hyderabad.

One wonders if the Satyam directors who resigned did the right thing. Instead of staying the course, facing the problem and tightening governance within the company, they seemed to have bailed out at the first sign of trouble. It turned out that Raju was able to steer the fabricated accounts through his board for six years.

Olympus and Toshiba

In Japan, the twin accounting scandals at Olympus and Toshiba have shone the light on a boardroom culture that puts pressure on management to inflate profits.

The US$1.7 billion accounting fraud at Olympus in 2011 was one of Japan's worst ever. The directors at Olympus were found to have covered up losses on ill-judged investments that had gone awry years earlier. The board did not challenge this behaviour, nor did the firms' auditors. After the revelations at Olympus, investors lodged a US$240 million lawsuit relating to the accounting issues in 2012.

Likewise, about half of Toshiba's board, including the president and vice-chairman, resigned in July 2015 in the wake of allegations that top executives had put pressure on underlings to overstate profits, since 2008, by about US$1.2 billion. The board, under pressure from the global financial crisis and then the 2011 earthquake and subsequent Fukushima nuclear disaster, held back losses and impairments in order to inflate profits and hit targets over seven years.

An independent report found senior managers complicit in the affair. Although the firm had hired four external directors, the report found that the pair of former diplomats on its audit committee was not up to the task. It was viewed that only one of the three external directors on the audit committee was well versed in financial matters.

A case for continuing scrutiny

Warren Buffett has pointedly asked: "Why have intelligent and decent directors failed so miserably?" His answer: "The boardroom atmosphere" of fellow directors not having the moral courage to question management and their actions.

Bad directors are usually not fundamentally bad to start with. They may have some shortcomings. However, it is often that they become too comfortable in their jobs and fail to exercise sufficient diligence and responsibility in their stewardship of the company.

Companies and their shareholders should therefore ensure they renew their boards and continually scrutinise them so that board members stay on their toes and meet performance expectations.

The writer is the first vice-chairman of the Singapore Institute of Directors. This article first appeared in BTInvest,