

A Note on Lessons from Past Corporate Governance Failures

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ABSTRACT

Corporate governance serves as a control and guideline for an organization. The objective of corporate governance is to direct the management and staff of an organization towards the same goal of protecting the organization's value, hold accountability and conduct business ethically. Having good corporate governance ensures stakeholders and investors that their interests are kept in mind as the goal of a firm is to increase shareholders' wealth.

This paper looks at a number of cases of corporate governance failures of the recent past, as a reminder of possible outcomes from lack of good corporate governance practices. Some of these cases had acted as a jolt to strengthen corporate governance practices. This paper hopes to reinforce the lessons learnt from these cases and remind readers of the significance of sustaining and strengthening current corporate governance practices.

Keywords

Corporate Governance

Cases

Board Responsibility

INTRODUCTION

Corporate governance is the set of rules, processes and laws that an organization is operated, controlled and regulated by. Good corporate governance will benefit all stakeholders by ensuring that the organization is functioning in a lawful and ethical manner with accordance to the best practices and regulations. On the other hand, defective corporate governance could cause corporate scandals and affect organization's value. Defect corporate governance includes misuse of

firm's resources, unethical behaviors, inappropriate executive remuneration, and conflict of interests.

In response to the numerous corporate scandals of the 1990s, the USA implemented "Sarbane-Oxley Act 2002" and Singapore's MAS¹ regulated with "code of corporate governance". Under Sarbane-Oxley Act 2002 organizations must have independent directors on the board. In Singapore, under code of corporate governance every organization should have at least one-third of independent directors on the board.

This paper looks at a number of cases of corporate governance failures of the recent past, as a reminder of possible outcomes from lack of good corporate governance practices. Some of these cases had acted as a jolt to strengthen corporate governance practices. This paper hopes to reinforce the lessons learnt from these cases and remind us of the significance of sustaining and strengthening current corporate governance practices.

In Accaglobalcom (2008), the functions of good corporate governance are listed as:

1. A clear understanding on the purpose of corporate governance for the board of directors, shareholders and stakeholders.
2. Board of directors should set good leading example.
3. Board of directors should set clear goals and ensure sufficient resources are in place for the organization to meet goal congruence.
4. Board of directors should establish a strategy and adequate measures for risk management so as to protect shareholders' interests and organization's resources.

¹ Monetary Authority of Singapore.

5. The board should incorporate with both independent non-executive and executive members. Independent directors could challenge the 'insider' executives if their management are not appropriate. They should possess different skills and experience so that they could provide knowledge and good judgment.
6. Executive's remuneration should be in order with the organization's performance and must be disclosed. Hence, the stakeholders will be able to access whether the remuneration is appropriate.
7. Internal and external audit's findings play an important role in the organization. They are to detect inadequate accounting practices and professional judgment in the control.
8. In the audit committee, at least one member should hold an accountancy qualification so as to make good financial judgment.

The board in the organization mainly manages corporate governance. They are to protect the organization's value, hold accountability to the organization and commit to conduct business in a moral manner. The board are to ensure there are sufficient resources to prevent operation risk, preventive measures are implemented for unethical behavior by the executive, stakeholders' interest and organization's assets are well protected and guidance are provided to the organization.

Corporate governance is one of the golden rules that investors would rely on. With good corporate governance, it assures the stakeholders and investors that their interest are kept in mind as the goal of an organization is to increase shareholders' wealth. It also influences the share price and reputation of the organization. Good corporate governance can be a preventive tool for corporate failures

The Cases of Corporate Governance Failures.

The purpose of this section is to study cases of failures in the corporate governance. A number of well publicized cases of corporate governance are looked at to better understand the failures of corporate governance and learn from them.

Case 1: American International Group Inc. (AIG)

The corporate governance failing factor in AIG is the risk management. AIG ignored the risk factor on the mortgage loan, they believed that the borrower would not fail to pay back the loan and believed the "too big to fail" concept. AIG created a portfolio of credit-default swaps and provided risky securities to banks (eg. Goldman Sachs). The swaps were insurance policies on the mortgage securities. If the securities went down in value when mortgage default, AIG would have to pay the investors on the policy value. The mortgage default was a result of over-stretched loans. This was partly a result of the George Bush administration policy of encouraging ALL Americans to own their own home. The (political) objective of creating a nation of home-owners was to be achieved by relaxation of lending regulations and providing easy credit (Friedman and Friedman 2010). The intention was to help low-income earners to own a home. Hence, the people in America rushed to purchase their home without ensuring that their income was able to repay their loan. Consequently, it caused mortgage default and the resulting housing bubble.

Credit rating companies create impact to the share price. They influence the investors by rating an organization whether is an AAA stock to trade. Once the stock is downgraded, investors will lose their confidence and followed by selling off their stock. As a result, the share price will decline. Standard & Poor downgraded AIG due to their bad performance in mortgage securities, causing AIG's share price to decline dramatically. This situation will not take place if good corporate governance is practiced; particularly in risk management.

Looking at AIG's stock chart in Figure 1, it dramatically slid from USD597.80 in 5 August 2008 to USD41.00 by closing on 17 September 2008 after Standard & Poor's downgrades credit rating due to inability to meet collateral needs and residential mortgage losses. The downgrade forces AIG to collapse and putting shareholders confident level to extremely low.

Figure 1: Stock Chart Of American International Group Inc



Source extracted from: Yahoo! inc. 2017.
American International Group, Inc (AIG) Stock Chart.

[Online]. [24 May 2017]. Available from:
<https://finance.yahoo.com/chart/AIG>

High remuneration was paid to the executive, the guardians of AIG had failed their role for being board of directors. While AIG was suffering from huge losses from the mortgage securities, the executive cash out big bonuses without considering the ethics and reputation risk. As board of directors, they should make sure that the governance and management in the organization are account appropriately to its stakeholders. They have to make sure that the performance of the organization is justifiable to pay executive with high remuneration. AIG should apply corporate governance to prevent unethical action and protect taxpayer's money used in the bailout from the government.

In the case of American International Group Inc, the top executive was paid a bonus of USD165 million with the government aid of USD180 billion after the failure of credit default swaps. What were the board, shareholders and government doing at that time? Why were there no queries on the executive package if the organization needs funding from the government? As the Federal Reserve is taxpayer's money; the excessive

executive's remuneration has provoked public outcry.

Attention paid to risk management was not sufficient. AIG believed that the borrowers would not default their loan and have the concept of "too big to fail". Risk factor on the mortgage loan default was not considered. The board of directors should ensure the mortgage securities provided to the banks are not risky. They should look at the risk of mortgage default will cause housing market to collapse and causing the securities to decrease their value.

Case 2: Fannie Mae and Freddie Mae

Fannie Mae and Freddie Mae contributed to the housing bubble and collapse. They are government owned organizations, whose business model was to buy mortgages from banks or lenders and provide mortgages to the homebuyers. In order to achieve President George Bush's goal of home-ownership for every American, Fannie and Freddie reduced the required down payments for the low-income earners.

Fannie and Freddie disregarded 'ability-to-pay' and the risk of default mortgages. Their focuses seemed to be on achieving government goals and on the earnings; the riskier loan will pay a higher fees. The fees collected would offset any impairment from the mortgage default. If all the homebuyers are not able to pay any fees or down payment, there will be no earnings generated and the mortgage lenders will face problem. That occurred in 2004. The subprime market grew from USD160 billion in 2001 to USD540 billion in 2004 following with accounting fraud at Fannie and Freddie, a misstatement of USD5 billion earnings.

Fannie Mae and Freddie Mae did not apply risk management and control. Low-income earners had reduced down-payments on the mortgages and were charged high fees in the loan repayment. The borrowers were unable to repay the loan and the lenders incurred huge bad debts. A too high risk level was taken on.

Case 3: Enron Corporation

There were numerous roles of corporate governance misconducted in Enron, causing the

world's largest energy trading organization to face bankruptcy. Enron abused the funds that were generated from Citigroup Inc. and created false accounting named as "creative accounting". It is a crime to create fraud activity, hence the Chief Executive Officer Jeffrey Keith Skilling was put to jail for committing the accounting fraud. Skilling provided falsification of accounting figures to inflate earnings and attract investors' interests. Enron misrepresented their loan component as earnings in the income statement instead of liabilities in the financial position. It had misled the investors in looking at the earnings of the organization.

The role of board of directors is to ensure that the organization is managed and governed appropriately as to protect the shareholders' interests and organization's assets. Board members had failed their role on the board of directors. They approved the fraudulent activities that were demonstrated by Skilling. In spite of protecting the shareholder's interests, the board of directors waived the conflict of interest and allowed Chief Financial Officer Andrew Fastow to have partnership with a firm and conduct business with Enron in 1999. The partnerships were masked with debts and liabilities that had impacted on the Enron earnings.

Ken Lay held two positions in the Enron that were Chairman and Chief Executive Officer after Skilling's resignation. There is a conflict of interest in the Board to govern the organization. The two positions should be separated to prevent abusing power in the board and practice unethical conduct; in accordance with ACCAGLOBAL recommendation.

Enron's auditor, Arthur Andersen LLP has committed an error in their judgment in treating Enron's debt as off-balance-sheet vehicles. These vehicles misled to overstating earnings by almost USD600 million over the years from 1997 to 2000. Enron was Andersen's second largest client and received audit fees of USD25 million. Anderson was Enron's auditor since 1983. In these two findings, Anderson had misconducted with conflict of interests. Audit fees were too huge to be justified and there were no rotation of auditor. Anderson was once a big five accounting firm

having high standards of accounting and practices. Anderson had failed their profession by misleading the stakeholders. Due to Enron's accounting fraud, USA Securities and Exchange Commission revoked Anderson's CPA licenses.

Enron's stock slid from USD90.75 in August 2000 to USD0.26 in November 2001 after resignation of Chief Executive Officer Jeffrey Keith Skilling. Skilling sold off huge numbers of stock and created huge losses to Enron. Enron's board of directors did not perform their due diligence to check whether the stock sold off by Skilling will impact on the organization's financial position. They did not protect their stakeholders' interest. After Skilling sold his shares in Aug 2001, Ken Lay influenced his employees to buy Company shares. His unscrupulous behavior had caused Enron's employees and shareholders lost their funds, and employees lost their employment. Ken as an inside board did not practice ethical code of conduct in the corporate governance. Thus, an independent board is essential to monitor the unethical activities within the organization.

The board members had failed their role on the board of directors to approve the fraudulent activities that were carried out by CEO. Their purposes were to inflate Enron's earnings so that investors were attracted to place their investment with Enron. The board of directors did not protect shareholders' interests and organization's assets by allowing their CFO to have partnership with a firm and hold business with Enron. The partnerships were masked with debts and liabilities that had impacted on the Enron earnings.

Executives are the main players in corporate failures. Their greed and aggressiveness triggered them to go beyond the ethical principles. Fraud cases, inappropriate remuneration, corruption, false accounting, immoral actions and conflict of interests are always the killers of organization. Hence, good standard and practice of corporate governance is important to the organization as to prevent the killers of organization.

The board of directors and auditors should ensure and monitor the financial transaction are accounted correctly according to the accounting standard as to prevent "creative accounting". There should be

independent directors to perform diligence check as to assure the stakeholders' interests and organization's assets are well protected.

Ken Lay should not hold two positions in the Enron. The powers of Chairman and Chief Executive Officer should be separated as to comply conflict of interest in the role of corporate governance. It is to prevent abusing of power in the board and unethical conduct practices.

Enron's CEO sold off huge numbers of stock and created huge losses. What are the Enron's board doing at that time? They should establish compliance check for shares trading in order to ensure that there was no impact to the organization's financial position and share market. Enron's chairman influenced his employees to purchase company shares after CEO sold off huge numbers of stock. As an inside board, he should not abuse his power to practice unethical code of conduct and destroying the role of corporate governance in Enron. Thus, an independent board is important as to stop unethical activities within the organization.

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Case 4: Aldephia

Aldephia was one of the five biggest United States cable companies before its bankruptcy in 2002. Its accountancy fraud scandal was considered to be one of the greatest organization fraud suits, alongside those of Enron and WorldCom. Aldephia was founded by John Rigas with his brother, Gus, in 1972. This business model was similar to that of a family business, where the Rigas held major voting rights, and were majority members in the board of directors. The father, John was the founder and Chairman, while his three son and son-in-law, Tim, Michael, James, and Peter Venetis respectively, were the CFO, EVPs and board members of this business. The Rigas family held five out of a total of nine seats in the board of directors (Jerry Markon and Robert Frank, 2002). Corporate governance mentioned board of directors cannot be mainly family members.

The Rigases were alleged to have abused company funds for personal purpose. Some of the accusations against them included using the

company's private jet for personal outings, stealing \$252 million of company reserves to buy back company stocks as private stocks, and withdrawing company money to cover personal debts. Besides these, the Rigases also consumed an estimated amount of \$12.8 million from company reserves to build a golf course. In the years 2001 and 2002, Rigases announced to their shareholders that the family would be buying back company stock in order to reduce pressures caused by company debts. However, this purchase involved funding that exceeded \$400 million, which was taken from company reserves. Tim, as the CFO, had requested his employees to create false receipts that displayed payment made by the family to purchase the stocks (Jerry Markon and Robert Frank, 2002).

This case is a classic example of the board being controlled by family members who were also the executive decision makers. The lack of independent board members contributed to making the mismanagement/fraud possible. Independent board members could have acted to prevent the misuse of funds. The case also highlights possible outcomes from having concentrated power. It is a classic example of where the founder(s) have excessive powers; be it de-jure or de-facto.

Case 5: National Kidney Foundation (NKF Singapore)

There were various numbers of corporate governance failed in National Kidney Foundation that had created the financial scandal in 2005. The topmost causes were the NKF board delegated their authority to the executive committee and the committee re-delegated the authority to the chief executive officer, T.T. Durai. With the authority, Durai misused his authority and the NKF Funds. Every dollar and cents used with the NKF funds should be accountable and transparent as NKF is a non-profit charitable organization. The purpose of charitable organization is to aid the kidney patients to cope with their fees. However, the funds were misused to pay Durai's large amount of remuneration. He was paid for a salary of SGD25,000 per month and annual bonuses of SGD1.8 million between 2002 and 2004. His remuneration was not revealed to the Public. The board of directors failed in their role to ensure the

executive's remuneration is account appropriately here.

NKF failed to comply conflict of interest. Durai engaged an unusual SGD3 million contract to Forte Systems and SGD4 million contracts to Protonweb Solutions. Forte Systems was an information technology firm that developed software for NKF. Durai's personal friend, Pharis Aboobacker, owned Forte Systems. Another unusual relationship with Forte Systems, Protonweb Solutions was a subsidiary of Forte Systems. Matilda Chua Li Hoon, a former NKF Director managed Protonweb Solutions that was a telemarketing firm. The two projects were not successfully completed and yet both firms were paid. There was no enforcement taken against the two firms for the incomplete projects.

Durai used the NKF funds inappropriately. In KPMG's audit findings, SGD0.10 out of SGD1 donations collected were spent for dialysis expenses in 2003. In 2004, SGD0.52 out of SGD1 was funded to its beneficiaries. Looking at those figures in the audit findings, stakeholders would want to find out where are the remaining funds? T.T. Durai spent the NKF funds for his first class airfares and private car expenses. He also spent the funds on a fleet of 8 chauffeured cars for both official and private used. Durai misused the NKF funds to pay SGD20,000 to his designer friend, David Tan for some unknown interior design work. He installed unnecessary expensive glass-paneled shower, gold-plated tap and toilet bowl in his office bathroom for his own use.

Remuneration is always the main concern that stakeholders would look at. Why is the CEO paid with huge amount of bonuses for a charitable organization? NKF is not a profit organization, how can a CEO be paid with high bonuses? The board become sleeping partners, not ensuring the executive's remuneration is appropriate in a charitable organization. Remuneration should be transparent to the stakeholders so that they are able to help and monitor the inappropriate remuneration.

Executives ignore conflict of interest repeatedly. CEO misuses his power to engage services from companies that belongs to friends. Due to their relationship, no legal action was taken for the

incomplete contracts. To prevent conflict of interest, independent board of directors should be appointed as to monitor unethical behaviors and conflict.

Concluding Remarks.

Corporate governance is important to an organization, as it is a key element for an organization to be succeeded. Corporate governance acts as a centre to interact with the management, board of directors, shareholders, lenders and stakeholders. With corporate governance, the board's accountability, responsibility and commitment to conduct business ethically will assure investors and stakeholder's confidence. Corporate governance will also influence an organization's share price and reputation.

Table 1 (below) displays a summary of the cases findings. It shows that situations of conflict of interest could lead to fraudulent misrepresentations. This is particularly where there is concentration of decision making which also leads to misuse of funds. The lack of 'effective' independent directors contribute to these failures.

The board in the corporate governance is important. They mainly handle the roles of corporate governance and should be balanced with 'executive' and independent directors. Independent board act independently to ensure the organization is managed appropriately, the resources are ensured sufficient to prevent operational risk, preventive measures are implemented, protect stakeholders' interest and organization's resources and provide directions to the organization. The mere presence of independent directors in the board is not sufficient. These independent directors need play an active role in overall oversight for effective corporate governance. The board should have board committees, like the audit committee, that consists of board members and some non-board members for expertise. These board

committees report direct to the board and assist the board in corporate governance.

Independent board's percentage has been increasing, from 73% in year 2003 to 78% in year 2008 and at the same time the board size decreased from 13.3 to 12.4 (Minton 2010). This represents that the independent board has indeed become important in corporate governance over the years. Independent board has the ability to increase and protect firm value. Independent directors has the ability to monitor immoral behaviours and prevent entrenchment. They also act as an insurer and warden for the shareholders. Independent directors oversee firm performance and financials whether they are accounted appropriately. They also bring benefits to the organization with their human and social capital. Together with their capitals, they provide good judgement and knowledge to the organization. For example, an independent director with accounting background would be able to provide excellent financial report analysis when releasing of company performance. In information technology, independent directors will have a pool of IT networks for better IT solutions.

The executive remuneration is always a concern in the organization. If the organization is not performing, it is not appropriate to pay the executive with large amount of remuneration. It will incur high expenses with low revenues and create losses to the organization. AIG is one of the relevant cases on high remuneration paid to the top executive after the USA federal bailout. The public found it unacceptable to use public funds to bail out AIG so that the top executives can be paid huge sums.

Mismanagement within the organization reflects serious problem like misuse of power, eg. NKF's CEO, T.T. Durai abused his power to assign two contracts to two firms that were owned by his friends without considering conflict of interests. The two vendors were paid even though the projects were not completed. Durai took no actions for breach of contracts. NKF was a classic example of a 'weak' board that seemed to be controlled by the CEO. NKF is a non-profit organization that

relies on donations. The abuse of power resulting in lavish expenses and conflict of interest transactions coupled with the huge bonus paid to CEO dented NKF reputation with the donors. Funds donated to NKF was to help beneficiaries.

The board of directors' composition is another area that the corporate governance of an organization should be concerned with. Some organizations' board are filled with majority family members as was the case with Adelphia. An organization without independent directors may result in covering up fraudulent activities.

These cases provided a reminder of possible outcomes with weak corporate governance. Most countries have implemented a 'code of corporate governance'. We need to continuously review the codes of practice and enhance on them to sustain and further improve our corporate governance. Without proper corporate governance, there is no guideline or standard of practice to be performed in the organization. Thus, corporate governance has an important role to play although episodes of corporate failures and scandals will continue appearing.

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Table 1
SUMMARY OF CASE STUDY FINDINGS

<u>Corporate Governance Failure</u>	<u>AIG</u>	<u>Freddie Mae</u>	<u>Aldephia</u>	<u>Enron</u>	<u>NKF</u>
Fraudulent Misrepresentation		YES	YES	YES	YES
Excessive remuneration	YES			YES	YES
Conflicts of Interest		YES	YES	YES	YES
Excessive power with CEO (concentration of decision making)			YES	YES	YES
Misuse of funds	YES		YES	YES	YES
Lack of Risk management	YES	YES		YES	
lack of independent directors			YES	YES	YES

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