Corporate Governance failures in suppliers/clients : Implications & Examples

FAMILY GOVERNANCE ASSOCIATES

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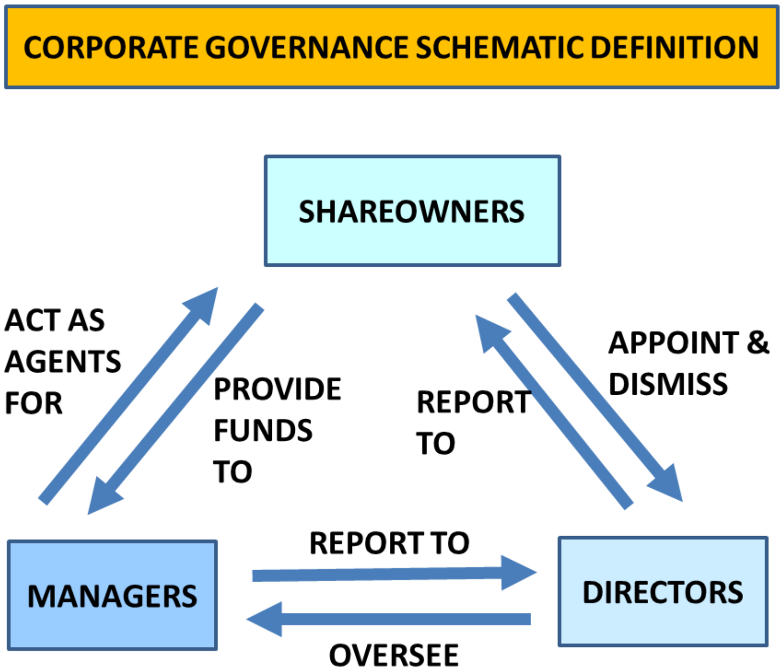
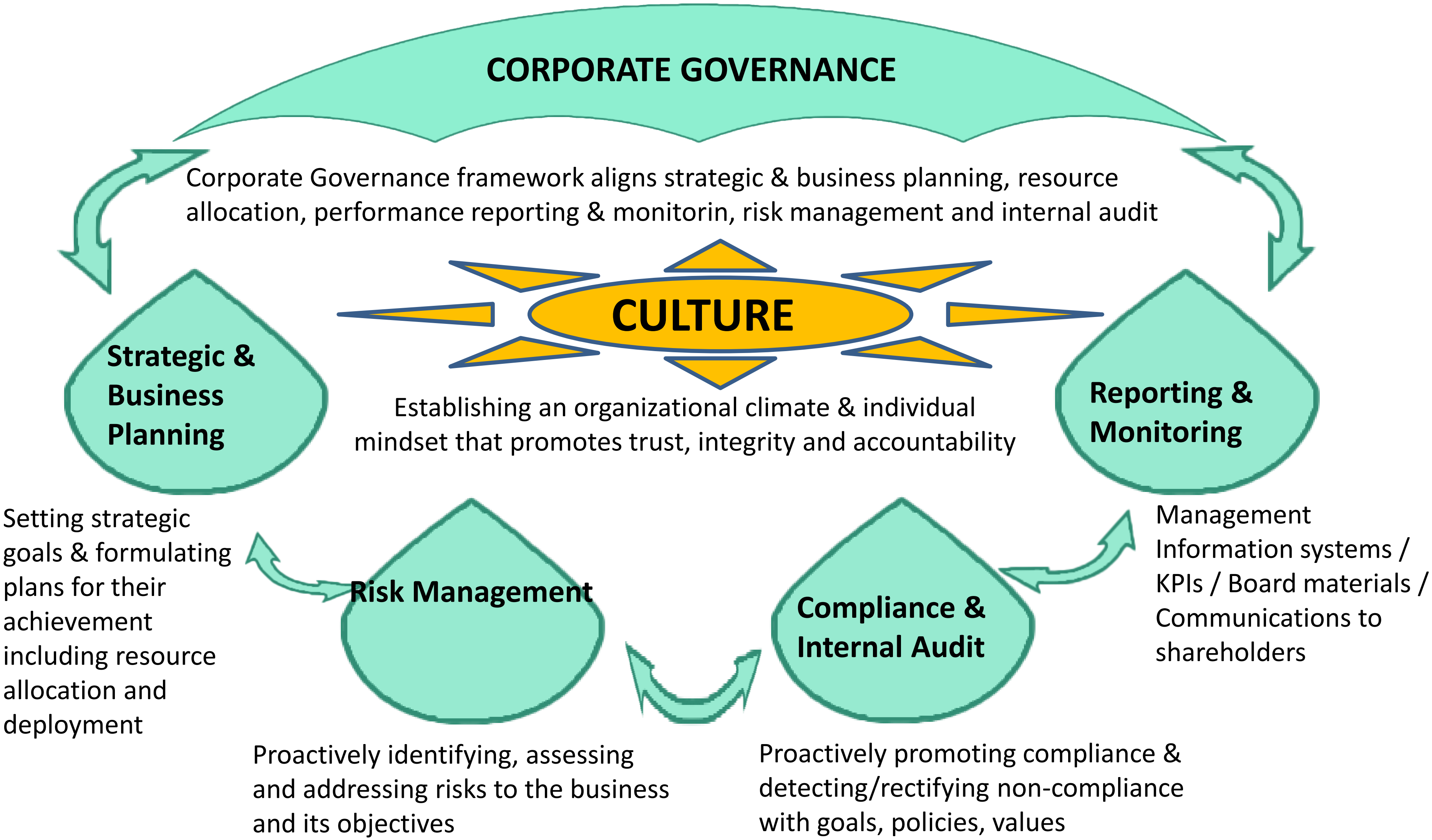
Governance including shareholder level tends to be associated with agency issues



Corporate Governance prescribes rules of engagement between

- owners as providers of capital
- managers as executors of business strategy with owners' capital and
- directors as formulators of strategy and supervisors of managers but answerable to owners

Governance below shareholder level focuses inter alia on interaction of planning, allocation and monitoring



Why does absence or failure of corporate governance matter ?

- What is Corporate Governance ?

⇒ Corporate Governance including shareholder level associated with agency issues (interaction between shareholders, directors and management) and below shareholder level focused on interaction between planning, allocation and monitoring

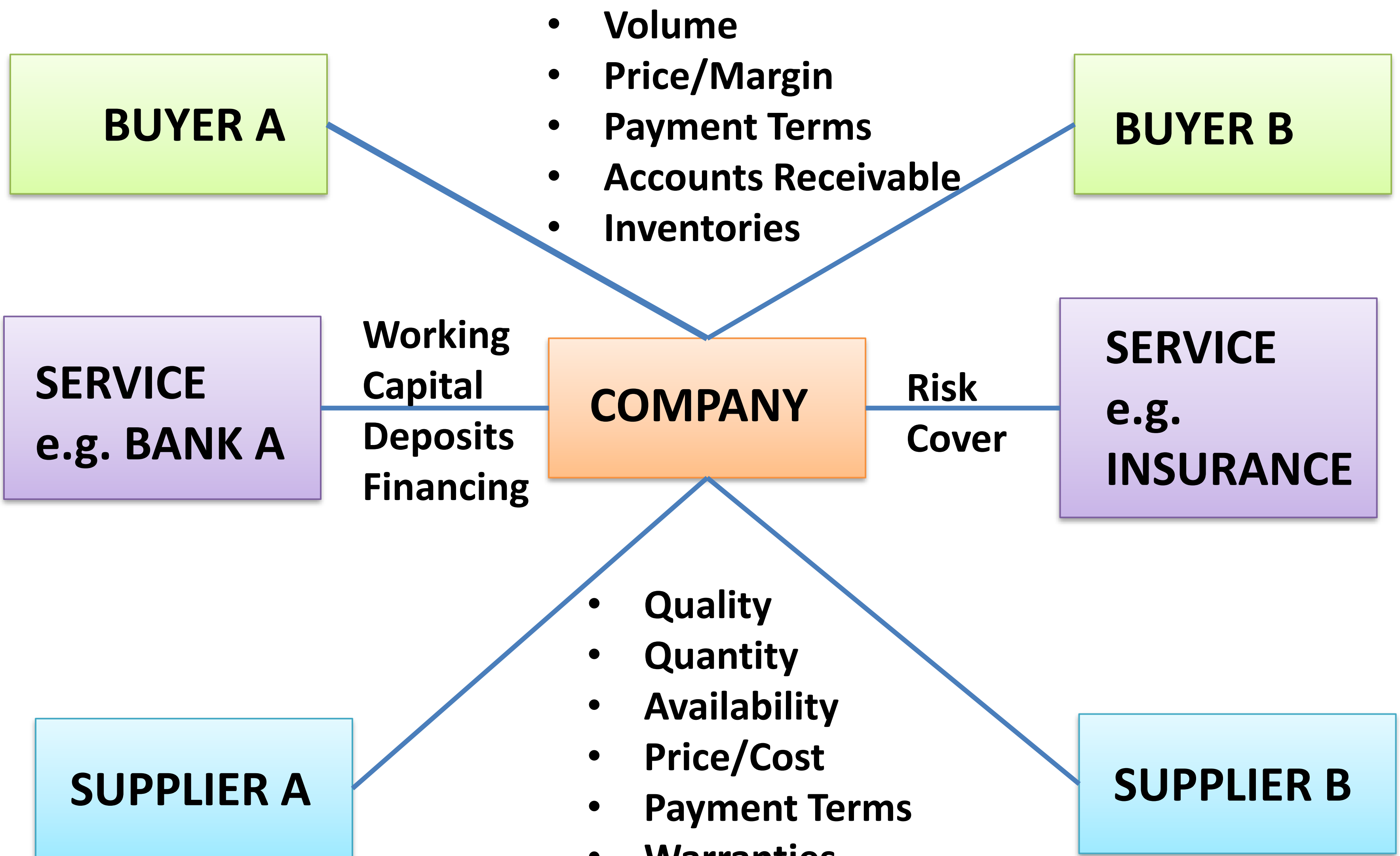
- What is the **utility of Good Corporate Governance** ?

⇒ At least one part of the utility of Good Corporate Governance is to **prevent crises and financial distress**

- How does **absence or failure of corporate governance** affect risk of crises and financial distress ?

⇒ **Risk of crises and financial distress increases**

How can failure or financial distress of its counterparties affect a company ?



Pollypeck failure (UK, 1990)

- Large, publicly listed, FTSE 100 conglomerate (agribusiness) grew rapidly in 1980s but imploded in 1990 with debts of £ 1.3 billion amid claims of gross mismanagement and fraud
- Founder, who had fled UK in 1993, returned in 2012 and was convicted of £ multi-million theft
- Serious corporate governance failures included
  - Founder was able to transfer funds to off-shore accounts without challenge from the Board or the banks
  - Founder had transferred company assets to himself without knowledge of the Board
  - Debts had been raised with company shares used as collateral

$\Rightarrow$ One of a few scandals which prompted the 1991/92 Cadbury Committee and Code on Corporate Governance, internationally the first of its type

TESCO = Size and reputation no guarantees against corporate governance failure

- TESCO = largest retailer in UK, third largest globally
- Accounting irregularity had overinflated revenues and profits as Tesco recognized promotional rebates as revenues prior to sales of goods involved was achieved
- External auditors had flagged recognition of income at risk of manipulation but Audit Committee did not challenge executives
- Board of directors did not include non-executives with retailing experience

⇒ Executives manipulated accounts to cover slowing performance and hit margin performance

⇒ When scandal broke, 4 senior executives, including CFO, left with immediate effect and company carried on without full time CFO for 2 months as external hire was recruited in light of the nature of the nature and scale of the irregularity

Other high profile corporate crises linked to shortcomings of corporate governance

- Barings Bank (1995) (banking/trading)
  - Star rogue trader allowed to control back office,i.e. essentially being left unchecked, bet and lost the capital of the bank

  $\Rightarrow$ Should past star performance give a trader pass to be outside normal rules ?
- Waste Management (1998) (Waste management)
  - Founder/owner engineered increased earnings by lengthening depreciation period on plant and equipment with connivance of external auditors (Andersen); New CEO and management team found out and came clean

  $\Rightarrow$ Coziness of founder with auditors a factor ?
- Enron (2001) (energy trading)
  - Fraudulent accounting by clique of insiders supporting financial performance by keeping debts off balance sheet and for own gain coupled with negligence of auditors (Andersen)

  $\Rightarrow$ Performance ended up being too good to be true

Other high profile corporate crises linked to shortcoming of corporate governance

- Worldcom (2002) (telecoms)
  – Inflated assets, underreported line costs by capitalizing expenses and inflated revenues by fake accounting entries; found out by company's own internal audit
  $\Rightarrow$ Did use of shares as acquisition currency motivate accounting irregularities ?
  $\Rightarrow$ Led to Sarbanes-Oxley legislation
- Northern Rock (2008) (banking)
  – Too few deposits relative to loan portfolio placed heavy reliance on wholesale funding meant quick insolvency when markets shut down in 2008
  $\Rightarrow$ Risks associated with funding through wholesale interbank market were obvious to the institutional players but not the regular depositors
- AIG (2008)
  – Recognized loans as revenues, inflated value of portfolio holdings
  – Got caught out in 2008 financial crisis as the main underwriter of credit default swaps for i-banks and banks
  $\Rightarrow$ Was regulatory arbitrage a factor in taking on too much risk ?