Recent Corporate Scandals: Lessons Learnt?

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ASNAF Conference 2006, 10-11 November, 2006
Outline

- Profiles of recent corporate scandals in Singapore
- Key lessons
- Current problem areas
- What more needs to be done
The Good News…

- Doing Business 2007 (World Bank)
  - Singapore ranked No. 2 globally in protection of investors’ interests
  - Singapore included among the countries that protect investors the most in terms of disclosure, extent of director liability and ease of shareholder lawsuits

- CG Watch 2005 (CLSA-ACGA)
  - Singapore ranked no. 1 among 10 Asian countries)
Profiles of Recent Corporate Scandals


- 5 were incorporated in Singapore, one in Bermuda

- 2 are foreign listings (i.e., with operations/management largely overseas)
Profiles of Recent Corporate Scandals

- 1 listed in 1993; others listed from 2001
- All 6 involved some form of accounting fraud
- All 6 involved failures in internal control/risk management
Profiles of Recent Corporate Scandals

- All 6 involved the CEO; 3 also involved Chairman, and 3 involved the CFO; 2 involved other employees.

- Ownership – CAO was stated-controlled; in the others, directors/management were substantial/controlling shareholders.

- Board of directors - all had 3 to 4 “independent” directors.
Profiles of Recent Corporate Scandals

● Audit committee:
  ● 3 had wholly independent Audit Committees; others had majority independent
  ● 4 had accounting/finance expertise or experience for at least 2 members; 2 did not appear to have any accounting/finance expertise or experience

● 5 out of 6 had Big 4 auditors
## Enforcement Actions – 2005-2006

<table>
<thead>
<tr>
<th>Party charged</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company</td>
<td>1 (Auston)</td>
</tr>
<tr>
<td>Chairman</td>
<td>2 (Informatics, CAO)</td>
</tr>
<tr>
<td>Non-executive directors</td>
<td>2 (CAO)</td>
</tr>
<tr>
<td>Independent directors</td>
<td>0</td>
</tr>
<tr>
<td>CEO</td>
<td>4 (1 missing)</td>
</tr>
<tr>
<td>CFO</td>
<td>3 (CAO, Citiraya, ACCS)</td>
</tr>
<tr>
<td>Other employees</td>
<td>17</td>
</tr>
<tr>
<td>Others (suppliers, etc.)</td>
<td>10</td>
</tr>
</tbody>
</table>

Mak, Y.T., Lan, L.L., Buang, A.B., Implementation and Enforcement of Rules in Singapore and the Case of China Aviation Oil, OECD Asian Corporate Governance Roundtable, September 2006. [Note: No action on Daka Designs yet]

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Common Features?

- All involved the top (Chairman/CEO/CFO)

- All involved accounting fraud and internal control/risk management, and arguably, AC failures

- “Structural” features (form) do not seem to make a difference (e.g., number of IDs, IDs on AC, expertise on AC)

- No independent director was charged
Lesson 1: Tone at the Top

Tone at the top is absolutely critical

We look for three things [in our managers]: intelligence, energy and integrity. If they don’t have the latter, then you should hope they don’t have the first two either. If someone doesn’t have integrity, then you want him to be dumb and lazy.

Warren Buffett
Lesson 1: Tone at the Top

- How many boards would actually fire their CEO for breaching their code of conduct if he is otherwise doing his job well?

- How many boards actually place integrity at the top of the list when hiring senior management or board members?
Lesson 1: Tone at the Top

Boeing fires CEO over relationship (www.cnn.com, 7 March 2005)

Boeing has ordered its Chief Executive Harry Stonecipher to step down because of what the U.S. aircraft giant said was an improper relationship with a female executive. The company said the female executive, who has not been identified, did not report directly to Stonecipher and that the relationship was consensual and had no effect on the conduct of the company's business. But it said the relationship violated Boeing's code of conduct… "the board concluded that the facts reflected poorly on Harry's judgment and would impair his ability to lead the company," …"The resignation was in no way related to the company's operational performance or financial condition, both of which remain strong," Boeing said in a statement. "However, the CEO must set the standard for unimpeachable professional and personal behavior. And the board determined this was the right and necessary decision under the circumstances.”.(emphasis added)
Lesson 1: Tone at the Top

Gu Yanfei tipped to be new CAO head [Business Times, 19 October 2005]

`She is the only one, at this point, who can effectively handle relations between CAOHC and the Singapore team - a matter which is key to CAO's future survival,’ a source told BT. `No one can manage the concerns of both sides as well as she can.’ Sources, however, also told BT that Gu may not be appointed chief executive immediately or in the near future as she still faces criminal charges relating to the CAO scandal. She was charged in June for breaching her fiduciary duties as a director and for failing to disclose CAO’s huge options trading losses of US$550 million to the Singapore Exchange. The maximum penalties are a fine of up to $250,000 and/or jail of up to seven years. Sources say it’s likely that an interim CEO will be appointed first, with Gu taking over only when her charges are resolved - even if that means she will only become CEO a year from now.
Lesson 1: Tone at the Top

Brilliant boss faces insider trading charges
[Business Times, 7 September 2005]

Brilliant said yesterday that Koh will continue with his current duties as executive chairman and managing director. `The board wishes to emphasise that the charges pertain to Mr Koh in his personal capacity and do not affect the operations of Brilliant which is not under any investigation,’ it said.
Lesson 2: Audit Committee, Internal Controls and Risk Management

Audit Committee, Internal Controls and Risk Management are important

- 20-25% of AC chairmen do not appear to have accounting/financial management expertise
- 50-60% of AC members do not appear to have accounting/financial management expertise
Lesson 2: Audit Committee, Internal Controls and Risk Management

- 8% of mainboard and 26% of SESDAQ companies do not include statement of adequacy of internal controls
- 2% of mainboard and 0% of SESDAQ provided details about their internal controls and risk management, and the basis or framework for assessing their adequacy
- Most talk only about financial risk management
Lesson 3: Substance versus Form

- Substance is more important than form

  - “Independent” directors may be independent in form only (and some are even not) rather than independent-minded

  - “Independent” directors may not have the competencies and commitment necessary to do a proper job
Lesson 4: Independent Directors

- It’s quite safe being an independent director
  - no regulatory sanctions for merely breaching duties (especially duty of care)
  - no shareholder suits
  - resignation after a scandal is the usual outcome
  - no evidence that it affects getting/keeping directorships
Current Problem Areas

- Two important areas of weakness in Singapore CG rules:
  - Independence of directors
  - Remuneration of directors and key executives
Independence of Directors

Do you know that in Singapore....?

- Almost any person can be called an independent director.
- The controlling shareholder can often pick the whole board, including the independent directors.
- No independent director has been sanctioned for breaching director duties.
Independence of Directors

“Mr Riady [Chairman of Lippo Group, the controlling shareholder of Robinsons]…said that they were interviewing candidates to fill the position of independent directors back in September and were looking to interview more.” (ST, Nov. 8, 2006)

- Board/NC did not appear to be involved
- even in cases where a board/NC is involved, it is often controlled by the controlling shareholder

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PCCW Board (H.K.)

1. Richard Li – Executive Chairman; Chairman/CEO Pacific Century Group
2. Jack So, Managing Director; **Non-Executive Director of HSBC**
3. Francis Yuen, Deputy Chairman; Deputy Chairman Pacific Century Group
4. Peter Allen, Executive Director; ED and CFO of Pacific Century Group
5. Alexander Arena, Executive Director; Director of Pacific Century Group
6. Mico Chung – Executive Director; Executive Director of Pacific Century Group
7. Robert Lee – Executive Director
8. Fang Xingcha, Executive Director
9. David Ford – Non-Executive Director
10. Zhang Chungjiang – Non-Executive Director
11. Tian Suning – Non-Executive Director
12. Chang Hsin-kang – Independent Director; Independent Director of Related Companies
13. Victor Fung – Independent Director; former Non-Executive Director of HKT
14. David Li – Independent Director; former Non-Executive Director of HKT
15. Roger Lobo – Independent Director
16. Aman Mehta – Independent Director; ex-CEO of HSBC
17. Raymond Hardenbergh – Independent Director; former Non-Executive Director of PCCW/HKT
Independence of Directors

What can we do?

- impose sanctions on independent directors who breach their duties, perhaps through disqualifications or fines, to reinforce their duty to act in the interests of the company
- ensure that companies disclose the search and nomination process for directors as recommended by the Code
- improve access to potential independent directors and encouraging bodies such as SIAS or IMAS (and other minority investors) to propose suitable candidates
Independence of Directors

What can we do?

- look into the possibility of having one or more independent directors being voted in by non-controlling shareholders
- review the definition of “independent directors”
- incorporate the definition of “independent directors” into the listing rules
Executive and Director Remuneration

Do you know that in Singapore?
- Fees and remuneration of individual directors and key executives do not have to be disclosed
- Fees and remuneration of directors and executives are not covered by IPT rules
- Even if controlling shareholders or their associates are on the board and are senior management, neither their individual directors fees nor executive remuneration is subject to approval by or disclosure to shareholders
Executive and Director Remuneration

Controlling shareholder

Can appoint all directors, including independent directors

Can be executives

Oversight?

Management

Approves executive remuneration

Participates in approving NED fees
“Tunneling” of assets through remuneration

Parent company/major shareholder

Appoints senior management, pays high salary/bonus

Senior management “excess” pay goes to parent company/major shareholder

Partly-owned subsidiary

Less dividends for minority shareholders
Do you know that in Singapore?

- Only share schemes that involve issue of shares are subject to shareholder approval.
- Stock option or share grants do not have to be announced when granted – backdating issue.
Timing of Stock Option Grants

Cumulative Risk-Adjusted for Variable and Fixed Schedule Grants

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Executive and Director Remuneration

Do you know that in Singapore?

- Only 31% of SGX-listed companies stated in their annual reports about having bonuses payable after 12 months or shares/share options with a vesting period of more than 12 months.

- Almost every IPO firm has a bonus based on short-term profit sharing as the only variable remuneration.
Profit-Sharing Schemes: Examples

Table: Profit-sharing scheme for Ms Zhu Biqing and Mr Cui Zhongwei

<table>
<thead>
<tr>
<th>PAT</th>
<th>Zhu Biqing</th>
<th>Cui Zhongwei</th>
</tr>
</thead>
<tbody>
<tr>
<td>PAT &lt; RMB22 million*</td>
<td>No bonus</td>
<td>No bonus</td>
</tr>
<tr>
<td>RMB22 million ≤ PAT ≤ RMB34 million**</td>
<td>3% of (PAT less Minimum Threshold 1)</td>
<td>2% of (PAT less Minimum Threshold 1)</td>
</tr>
<tr>
<td>PAT &gt; RMB34 million</td>
<td>3% of RMB12 million (ie. equivalent to RMB360,000) plus</td>
<td>2% of RMB12 million (ie. equivalent to RMB240,000) plus</td>
</tr>
<tr>
<td></td>
<td>6% of (PAT less Minimum Threshold 2)</td>
<td>4% of (PAT less Minimum Threshold 2)</td>
</tr>
</tbody>
</table>

Notes:
* RMB22 million denotes “Minimum Threshold 1”.
** RMB34 million denotes “Minimum Threshold 2”.

Source: China Great Land Holdings Prospectus, 1 Feb 2005
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Pursuant to his Service Agreement, the Appointee will receive an annual salary of $480,000.00. The annual salary of the Appointee shall be reviewed annually and shall be adjusted by an amount as may be determined by our Remuneration Committee. The Appointee, who has an interest in the subject matter, will abstain from the participation in the review and from making any recommendation in relation to himself. The Appointee is also entitled to an annual wage supplement equivalent to three month’s salary for every 12 months of service. In addition, Mr Chen is also entitled to a share of our profits, to be calculated as follows:

Our Company’s profits before tax
(based on audited consolidated profits of our Company before profit sharing and tax and after minority interest and extraordinary items)

<table>
<thead>
<tr>
<th>Percentage of profits (per year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>First S$12 million (Up to S$12 million)</td>
</tr>
<tr>
<td>Next S$8 million (More than S$12 million and up to S$20 million)</td>
</tr>
<tr>
<td>Next S$15 million (More than S$20 million and up to S$35 million)</td>
</tr>
<tr>
<td>Thereafter (More than S$35 million)</td>
</tr>
</tbody>
</table>

Incentive scheme for CEO of CAO (Source: CAO Prospectus)
Profit-Sharing Schemes: Examples

- Bonus
- Minimum profit to earn bonus
- Profit before tax

12m  20m  35m
Executive and Director Remuneration

What can we do?

- If the controlling shareholder or his associates is receiving remuneration or fees as an executive or director of the company, the amount should be disclosed to shareholders.
- Share and share option grants given to directors, CEO and controlling shareholders should be announced at the time the options are offered to these individuals.
- Improve disclosures of remuneration policies (including performance measures to which variable remuneration is tied), if not remuneration amounts
Our corporate governance rules do not adequately reflect practical realities in our corporate environment
Separation Between Shareholders, Board and Management: Legal Framework
Separation Between Shareholders, Board and Management: The Reality

We introduce independent directors and IPT rules to address these situations but they do not adequately address the risks of expropriation of minority shareholders.
Current Enforcement Issues

- **Common/Company Law**
  - Duties of directors – codification of director duties?
  - Shadow/de facto directors
  - Rights of company and shareholders
    - Difficulty/costs faced by minority shareholders of listed companies in taking derivative actions
    - Lack of (cost-effective) class action means minority shareholders cannot enforce their private rights

- **Jurisdictional Issues**
  - We may find it difficult to enforce our rules and regulations for some of the foreign listings
Current Enforcement Issues

- Lack of regulatory and market enforcement of “comply or explain” listing rule for the Code has led to following problems in corporate governance reporting:
  - false or misleading disclosures
  - non-compliance with comply or explain
  - partial compliance with no explanations
  - boilerplate disclosures
Current Enforcement Issues

“…the Audit Committee, on behalf of the Board, has reviewed the effectiveness of the internal control system put in place by management and is satisfied that there are adequate internal controls in place in the Company”

Auston’s 2003 annual report
Current Enforcement Issues

The Board also did not appear to have taken the necessary steps to implement both the internal and external auditors’ recommendations which have already highlighted the internal control weaknesses in the accounting systems in the financial period ended July 2002. The timely adoption of these recommendations could have prevented or detected the misstatements in the earlier financial year/period

Deloitte’s report
CG Standards in Asia

<table>
<thead>
<tr>
<th>Countries</th>
<th>Rules</th>
<th>Enforce</th>
<th>Pol/reg</th>
<th>IGAAP</th>
<th>CG cult</th>
<th>Weighted score</th>
<th>2004 score</th>
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</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>74</td>
<td>56</td>
<td>73</td>
<td>95</td>
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<td>Korea</td>
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<td>82</td>
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<td>Thailand</td>
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<td>73</td>
<td>35</td>
<td>50</td>
<td>53</td>
</tr>
<tr>
<td>Philippines</td>
<td>53</td>
<td>22</td>
<td>50</td>
<td>82</td>
<td>31</td>
<td>46</td>
<td>50</td>
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<tr>
<td>China</td>
<td>43</td>
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<td>68</td>
<td>22</td>
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<tr>
<td>Indonesia</td>
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<td>28</td>
<td>37</td>
<td>40</td>
</tr>
</tbody>
</table>

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

CG Watch 2005, CLSA-ACGA
What More Needs to be Done - Regulators

- Improve enforcement of rules
- Hold directors, including independent directors, more accountable (consider different types of sanctions, like fines and disqualifications)
- Improve rights of minority shareholders with respect to appointment of independent directors and ability to take class action
- Put pressure on institutional investors to become more active
What More Needs to be Done – Boards

- Focus on the 3 C’s in appointing directors/CEO – character, commitment and competence
- Independent directors need to commit more time to understand the business and contribute more widely (issue of overspecialisation of independent directors?)
- “Independent” directors need to act more independently and be more sensitive to minority shareholders’ interests
What More Needs to be Done – Boards

- Independent directors/AC need to pay more attention to the quality/independence of the internal/external audit
- ACs need to give strong support to the internal and external auditors
- ACs need to have proper expertise and experience to discharge their duties adequately
What More Needs to be Done – Investors

- Understand need to pay good independent directors adequately and in appropriate ways (discontinue stock options)
- Challenge disclosures made by companies about their corporate governance
- Be more active and ask more intelligent questions at general meetings (about director appointments, remuneration policies, strategies, etc.)
- Learn their lessons
What More Needs to be Done – Accountants

- External auditors need to ensure that they act independently (remember the wider shareholders’ interests) and must be prepared to raise concerns with the AC
- External auditors need to address issue of audit quality and consistency of audit (within the same accounting firm)
- Internal auditors need to ensure that their work is up to standard (internal and external reviews of their work)
Said Also Don't Listen
Listen Also Don't Understand
Not Understand Also Don't Ask
Ask Also Don't Do
Do Also Do Wrong
Wrong Also Don't Admit
Admit Also Don't Correct
Correct Also Not Happy
Not Happy Also Don't Say
Thank you!

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