

The
Management
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UNDERGRADUATE UNIVERSITY EXAMINATIONS

SCHOOL OF MANAGEMENT AND LEADERSHIP

DEGREE OF MASTER OF MANAGEMENT AND LEADERSHIP

MML 5108: CORPORATE GOVERNANCE

DATE: 13TH DECEMBER 2016

DURATION: 3 HOURS
MAXIMUM MARKS: 60

INSTRUCTIONS:

1. Write your registration number on the answer booklet.
2. DO NOT write on this question paper.
3. This paper contains FOUR (4) questions.
4. Question ONE is compulsory.
5. Answer any other TWO questions.
6. Question ONE carries 30 MARKS and the rest carry 15 MARKS each.
7. Write all your answers in the Examination answer booklet provided.

QUESTION ONE

Read the case study below and answer the questions that follow;

LEHMAN BROTHERS HOLDINGS INC.

Lehman Brothers Holdings Inc. was started in 1844 as a small grocery and dry goods store established by Henry Lehman, two decades later they traded cotton, moved to New York and established New York Cotton Exchange. After this events, Lehman continued on the road of success and became the fourth-largest American investment bank before declaring bankruptcy in 2008.

On September 15, 2008, the firm filed for Chapter 11 bankruptcy protection following the massive exodus of most of its clients, drastic losses in its stock, and devaluation of assets by credit rating agencies, largely sparked by Lehman's involvement in the subprime mortgage crisis and subsequent allegations of negligence. Lehman's bankruptcy filing for bankruptcy is thought to have played a major role in the unfolding of the late-2000's global financial crisis. It was surely a big surprise for a lot of company stakeholders and shareholders, but when we look closer to this case, it was not unpredictable. Lehman Brothers had very weak corporate governance arrangements. The main areas of weakness were the board of directors, corporate risk management, remuneration scheme and nomination committees.

Lehman Brothers' Board of Directors was composed of ten members. The Chairman and CEO was Richard S. Fuld, Jr. and included eight independent directors according to NYSE. However, nine out of ten directors were retired. Moreover, their average age were 68.4 years (four of them were over 75 years), only two of them have direct experience in the financial service industry and only one of them had current financial sector knowledge. In addition, one was U.S. Navy officer, another theatrical producer. The board members were paid for their services extremely well, since the range was from \$325,000 to \$397,000 plus very high annual bonuses. However, this wasn't enough for Mr. Fuld who rewarded himself with nearly half a billion dollars between 1993 and 2007.

Since Lehman Brothers were a leading investment bank, it was inherent that risk was a part of their day-to-day business. Financial markets are, by the principles, uncertain and face variety of risks – credit market, liquidity, legal, reputation and operational risk. As per the policy manual on quantitative risk management in Lehman Brothers, the overall risk limits and risk management policies were established by the company's Executive Committee and the Risk Committee which consisted of the company's Executive Committee, the Chief Risk Officer and Chief Financial Officer, was required to meet weekly to discuss all potential threats and risk taking activities. Sadly these were only pure statements, in reality, this committee met only twice annually. Besides that, Lehman had started high-risk business years before its bankruptcy which included exposures to risky subprime lending, structured products, commercial real estate and high-risk lending for leveraged buyouts, but they had not considered enough that the loans were less liquid than its usual investments and had more vague prospects.

According to the Valukas report (report composed by court-appointed bankruptcy investigator for Lehman Brothers, Anton Valukas), Lehman Brothers exceeded internal risk limits and controls to pursue higher earnings, what was the start of the end. The Valukas report further showed evidence that top officers of the Company violated their duties by exposing the company to potential liability by filing misleading reports and financial statements.

Lehman Brothers misleading transactions was "Repo 105" through which the company could remove billions of liabilities off the balance sheet. The existence and misuse of the "Repo 105" is very questionable and goes beyond corporate governance, concerning from accounting to legal issues of its use. According to the report, Lehman Brothers removed securities inventory from the balance sheet for seven to ten days and made misleading appearance of the company's overall situation in 2007 and 2008. They accounted for Repo 105 transactions as "sales", by which they removed the inventory from the balance sheet. A number of the Repo 105 transactions were regularly raised before the closure of the reporting period

which allowed the company to borrow billions of dollars and use them to pay other liabilities. Few days later, they repaid the cash borrowings plus interest, repurchased the securities and restored the assets on the company's financial statement. The main reasons for these "creative accounting" procedures were mainly lowering the publicly reported net leverage and balance sheet. Namely, the net leverage had become an important indicator for the rating agencies and of bank risk. However, the "Repo 105" operations were not completely legal under the U.S. law, and therefore Lehman Brother had to do all of these transactions in the UK under their London unit.

In this situation, the most important question is, who knew about these operations? and who is responsible for them? Valukas report also stipulates the evidence against three Lehman Brothers CFOs. But, they defended themselves with statements, that almost all financial firms practice the window-dressing to adjust their balance sheet at the end of the accounting period. Weak corporate governance arrangements allowed officers to find a way to accumulate unearned profit and specifically increase their personal wealth.

Extracted from Lehman Brothers Holdings Inc. case study by Simona Tothova

Required:

- a) 'Lehman Brothers' Board Chairman and CEO was Richard S. Fuld, Jr.' By describing the distinct roles of each position, explain why it is fundamentally wrong to have the Chairman as also the CEO. (8 marks)
- b) With reference to the 'Lehman Brothers' case above, discuss the short comings of the Board of Directors composition. (5 marks)
- c) Describe the ideal recruitment procedure of Directors and their would be competencies in the Lehman Brothers case (5 marks)
- d) As a board member and corporate governance expert at Lehman Brothers, discuss;
 - i. Some of the risk management policies you would have put to mitigate risk. (8marks)

- ii. How you would ensure that proper accounting standards and procedures are followed? (4 marks)

QUESTION TWO

- a) Discuss the relevance of corporate governance in shaping the economy of a country. (9 marks)
- b) Describe the characteristics and benefits of having good corporate governance in your organization. (6 marks)

QUESTION THREE

As a Consultant, you have been appointed to facilitate a strategy developing training for the board of Makutano Ltd. Highlight the principles of Strategic Planning Models and the key drivers of a strategy that you would take the board through. (15 marks)

QUESTION FOUR

- a) Describe the role of the board in a modern organization. (6 marks)
- b) Describe the internal and external dimensions of Corporate Social Responsibility. (9 marks)

