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Conducting Due Diligence before Accepting a Directorship

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Congratulations! You have been invited to join the board of a company that fits your profile and interests. However, on no account should you jump into a particular directorship without doing your own due diligence.

Read up all available reports such as annual reports, press articles and filings with the stock exchange. And search the Internet – it's surprising what it can throw up.

Take some time to visit the company to get a better idea of operations and meet other board members (in particular, outgoing directors) and senior management. By asking the right questions, you should be able to get some sense of their competence and the culture of the company.

Ask your friends and contacts whether they have any inside knowledge or know of any adverse issues concerning the company. Usually word-of-mouth checks with friends and contacts can reveal nuggets of information and adverse issues that may go unnoticed.

SID's "So, you want to be a director?" course covers many of the risks and areas you should consider before taking on a directorship. I shall focus here on just two key areas of potential concern: company financials and board dynamics.

COMPANY FINANCIALS

You should always make it a point to look at the financial reports and examine the key financial ratios and trends. Be careful with loss-making companies and those with financial problems. In time, a loss-making company may find itself on the Singapore Exchange (SGX) watch list. Avoiding an eventual delisting can result in board members having to spend significant effort and time finding solutions to turn around the company.

Look out for complicated financial structures and understand why they exist. The structures may be hiding losses or moving liabilities off the balance sheet. They could also reflect tax avoidance schemes which tax authorities frown upon.

Competent auditors can give a director some added comfort. Thus, examining the quality and adequacy of the audit is important.

If there is only one or no internal auditor for a significant-sized operation, this should set off alarm bells.

Similarly, you should ascertain if the external audit firm has the expertise to handle the audit.

For example, in the Bernie Madoff investment scandal, the external auditor of the multi- billion-dollar hedge fund was a two-person accounting firm.

On the flip side, when there are many different audit firms involved in a conglomerate, it could be that the group is trying to ring-fence issues and hide them from the parent company's auditor.

A necessary step is to review the statutory audit reports and see if the accounts are qualified. If they are, you will have to make your own assessment on their severity and if it affects your decision to be a director. If possible, you should seek to view the more recent management letters from the external auditors and the latest internal audit reports.

BOARD DYNAMICS

To be an effective member of a board, board culture and board dynamics are important.

You should meet up with the chairman and as many of the other board members as possible. You need to make sure that you can work with them.

It is useful to assess how dominant (if at all) the chairman or CEO is. A dominant chairman may stifle discussion at board meetings.

A dominant CEO may push his or her ideas through the board without allowing time for directors to contribute their views. In all cases, there is the matter of loyalty to board decisions once reached, even if there is individual disagreement, and the risks associated with that.

In family-controlled companies, it can be a problem to challenge the family directors without being deemed a troublemaker. If you anticipate that this situation could arise, then you may not want to join such a board.

Another challenging feature to contend with is when the culture of the board or company is too gung ho. As a director, you need to decide whether this is a risk to you.

ASSESS RISKS BEFORE DECIDING

No company is perfect. It will be up to you to assess the risks that may be latent in the board that you may be interested in.

In my view, it is generally better to be cautious. Having to deal with a problem company can be quite traumatic and your reputation as a director may suffer.

Even if you avoid any legal problems, you could be left holding the baby as the last remaining Singapore resident director, after all the other directors have resigned. ■