Hiring 'problem directors' can knock up to 64% off a firm's value

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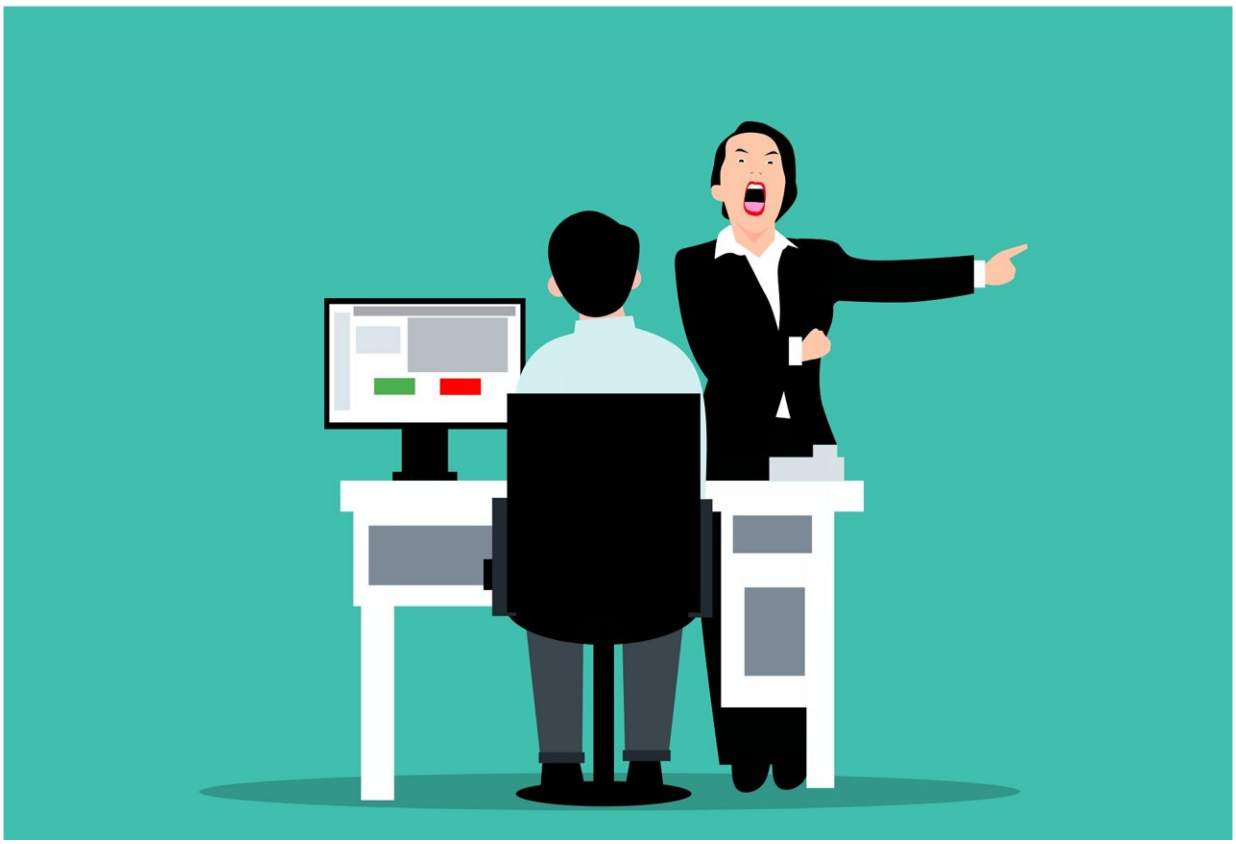

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Companies that appoint directors with a track record of questionable professional conduct cause an increase in reckless corporate risk-taking and could see up to 64 percent of a firm's value knocked off, a new study has found.

The research, published in the *British Journal of Management*, identifies "problem directors" as board members with past involvement in bankruptcies, litigation, corporate misconduct, or major accounting restatements and scandals, or who have nodded through over-generous CEO compensation packages.

Conducted by a team of academics from the Universities of Portsmouth and Salford in the UK, in collaboration with Massey University in New Zealand, the study investigates the effects of appointing "problem directors", as they are prone to pursue high-risk corporate projects, causing their firms to lose significant value.

An analysis of 8,926 US companies between 2004 and 2018 revealed the appointment of problem directors almost doubled the amount of questionable decision-making within the firm through reducing financial reporting quality and a lack of transparency (2.33 percent to 4.17 percent).

Professor Jia Liu, Director of the University of Portsmouth's Centre for Innovative and Sustainable Finance (CISF), said, "These directors are rotten apples that we've shown can spoil the whole barrel."

"These individuals are rarely dismissed because of their misconduct, but instead, the incidents are brushed under the carpet to maintain the firm's reputation."

"We've also seen numerous examples of managers moving on to higher positions with 'golden hellos' and increased compensation and benefits, even though their previous firms have got into serious financial difficulties."

Previous research has demonstrated that 34 percent of CEOs lie to the board or shareholders over drunk-driving offenses, undisclosed criminal records, or falsified credentials. Twenty-one percent engage in inappropriate relationships with subordinates, contractors, or consultants, and 16 percent misuse corporate funds.

Behavioral traits, including overconfidence and narcissism, are known to influence decision-making on policies for innovation, investment outcomes, financial reporting quality, and risk-taking.

Most worryingly for shareholders, though, the study finds that firms led by CEOs who also serve as "problem directors" tend to take even greater risks. They abuse their power by making significant reckless decisions, and their presence also encourages similar behavior among other managerial staff.

The data also shows the negative impact of corporate risk-taking continues even after the problem directors leave, emphasizing the long-term economic consequences.

The team was able to quantify the impact of "problem directors" on a company's worth, with their value loss ranging from 12.03 percent to 64.20 percent.

"Regulation is clearly failing the corporate sector, as tainted directors are still being hired despite mounting evidence that they negatively impact firms," added Professor Liu.

"And this lack of transparency affects the value of not only the problem director's current organization but also of firms they might join in the future."

The paper says the findings must prompt policymakers and regulators to redress weaknesses in corporate governance and the management of corporate risk.

It says, at the very least, a director's professional misconduct should be transparently disclosed so that stakeholders and shareholders can evaluate the risks they face.

Importantly, membership of organizations such as the Institute of Corporate Directors and the National Association of Corporate Directors should be a professional requirement, with certificates issued validating a director's fitness to practice and adherence to proper codes of ethics.

Professor Borhan Bhuiyan, from Massey University, said, "Many of the greatest financial crises have been instigated by high-risk decision-making. Highlighting our findings to the policymakers could potentially help protect national and global economies."

"This timely research makes it clear that the detection and exclusion of tainted directors should be a priority for corporate regulators and professional bodies and regulatory bodies. In a globally interconnected world, the consequences of unchecked malpractices can be devastating for us all."

More information: Md. Borhan Uddin Bhuiyan et al, Problem Directors and Corporate Risk-Taking, *British Journal of Management* (2023). DOI: 10.1111/1467-8551.12770

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