

# **Good Governance and Social Responsibility**

## **Lecture 2: Corporate Governance Definitions**

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## Lecture Learning Objectives:

At the end of the lecture, you will be able to:

1. Define corporate governance
2. Explain the fundamental principles of corporate governance
3. Discuss what good governance promotes
4. Identify the benefits of good governance
5. Describe the concept of agency theory in corporate governance
6. Explain the goals of financial management
7. Detail the roles of the non-executive director, chief finance officer (CFO), audit committee and external auditor in governance
8. List down the reasons on the need for external auditors by corporation

### Corporate Governance, Definitions

The Malaysian High Level Finance Committee Report on Corporate Governance defined corporate governance as follows:

**Corporate Governance** is the process & structure used to direct & manage the business & affairs of the company towards enhancing business prosperity & corporate accountability with the ultimate objective of realizing long-term shareholder value, whilst taking into account the interests of other stakeholders.

The Wall Street Journal (23 June 1999) defined corporate governance as:

- **Corporate Governance** in principle refers to the joint responsibility imposed on the Board of Directors and management to protect shareholder rights and enhance shareholder value.
- In practice, the **Board** is the real representative of shareholders and acts as a check against management.
- The **Board** must ensure, among other things, that the company is accountable to shareholders, that it gives equitable treatment to all its “owners”, small as well as large, and that it acts transparently.
- **Corporate Governance** refers to a system whereby shareholders, creditors and

other stakeholders of a corporation ensure that management enhances the value of the corporation as it competes in an increasingly global marketplace (SEC Memorandum Circular No. 2, Series of 2002, Code of Corporate Governance).

- According to Sir Adrian Cadbury, **corporate governance** is concerned with holding the balance between economic and social goals and between individual and communal goals. Corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society.
- **Corporate governance** is defined as the structures and processes by which companies are directed and controlled. Good corporate governance helps companies operate more efficiently, mitigate risk and safeguard against mismanagement, and improve access to capital that will fuel their growth. It makes companies more accountable and transparent to investors and gives them the tools to respond to stakeholder concerns, including implementation of good environmental and social practices.
- **Corporate governance** also contributes to development. Increased access to capital encourages new investments, boosts economic growth, and provides employment opportunities. Businesses that operate more efficiently tend to locate and manage resources more sustainably. Better stakeholder relationships help companies address environmental protection, social, and labor issues.

### **Fundamental Objectives of Corporate Governance**

#### **(1) Improvement of Shareholder Value**

Shareholder's value can be improved by making a pre-commitment to build better relations with primary stakeholders like employees, customers, suppliers, and communities. Better relations will lead to an increase in shareholders' wealth since this would help the firms expand and develop intangibles which the firm could capitalize on and in turn become a source of their competitive advantage. A good reputation is just one example of these intangibles which could largely predict the future of the business. Better relations with employees engender employees' commitment. Good relations with customers and suppliers complete the full circle of strong alliances.

#### **(2) Conscious Consideration of the Interests of Other Stakeholders**

- When a company meets the objective of increasing the shareholder value, it will have greater internally generated resources in improving its commitment in meeting its environmental, community and social obligations. It can pay well; reward, train, and retain key staff; and enhance employee satisfaction. A key focus

area is a company's **human capital**, which is a leading indicator of success. (Principle 1, Corporate Governance Principle, ADB and Hermes Pension Management).

## What Good Governance Promotes?

### (1) Transparency

- Is vital with respect to corporate governance due to the critical nature of reporting financial and non-financial information. The aim includes maintaining investor, consumer, and other stakeholders' confidence. The lack of dedication to corporate governance policies, particularly those related to transparency will drive home the point that the company is unbalanced, and the leadership is not incorporating it to the highest level of truthfulness. Failure in transparency issues could lead to many things, scaring off of investors is just one of them; being singled out by the authority is another which could mean the watchful eyes of the agencies will be focused on the company and many other uncomfortable scenarios which no company wants to be in.
- **Information** is the currency of democracy according to Thomas Jefferson.

**Transparency** is a thing of huge concern in government settings since it entails giving out of information. It is crucial because nearly all the decisions of government officials are in the interest of the public. **Transparency** lessens the likelihood of nepotism, corruption, favoritism, and the likes. Shortage of information about how the government agencies functions can make it easy for corrupt officials to cover their tracks. It can be said that the most corrupt countries are the least transparent. Sunshine has its cleansing properties; so, let the light in.

### (2) Accountability

**Accountability** Is the recognition and assumption of responsibility for the decisions, actions, policies, administration, governance and implementation of programs and plans of the corporation and people involved, including the obligation to report, explain and be answerable for its resulting consequences. It is acknowledging and taking charge of and being transparent about the impacts of the company's policies, decisions, actions, products, and its associated performance.

It is based on the premise that an accountable organization will take action to:

- **Set a policy** based on a comprehensive and balanced understanding and response to material stakeholders' issues and concerns; the emphasis on this premise is the overall broad philosophy and operating style of the entity itself.
- **Set goals and standards** against which strategy and associated performance can

be measured and evaluated. This highlights the deliverables by the people to the organization.

- **Disclose credible information** about strategy, goals, standards and performance to those who base their actions and decisions on this information. In this way, there will be goal congruence in the organization.  
Recall that the above premises are actually the fundamental objectives of corporate governance: (1) improvement of shareholders' value and (2) conscious consideration of the interests of other stakeholders.

### **(3) Prudence**

**Prudence** is defined within the Code of Governance as “care, caution and good judgement as well as wisdom in looking ahead.” It is the management committee, which is in corporate setting, the **board of director**, who will be the body responsible in safeguarding the interests of the organization through good planning and management of finances and other resources of the organization.

#### **Benefits of Good Governance**

To put it into perspective, Arthur Levitt (former chairman of the US Securities & Exchange Commission) once said:

- “If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere“. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country suffer the consequences.
- From the investors' perspective a simple question can be raised, will you invest in a region or a country the track record of which in governance is questionable? If yes, how long?

It is a well-established reality that investors would behave differently in settings in which good governance, both in political and corporate setting, is not seriously practiced. Investor's concern will be more on short-term prosperity instead of long-term stability. There are many countries in the world where investors are so speculative. One piece of evidence of these speculative behaviors is the fact that they are now more flexible in terms of locations. For instance, HSBC, in Hong Kong, has a collapsible building; that is it can be dismantled, shipped out, and assembled at a place of choice. A better example is in utility services, there was a time in Nigeria when utility companies providing power are having their main supply of power on barges for them to easily get out of the country if something goes wrong.

- It can be deduced that good governance immeasurably benefits not only a specific company or industry but also the country.

**The following are the specific benefits of good governance:**

- (1) Reduced Vulnerability** - Adopting good corporate governance practices leads to an improved system of internal control. This leads to greater accountability, protection of corporate resources, and eventually, better profit margins. Good corporate governance practices will also pave the way for probable future development, diversification, including the capability to attract investors, both sourced nationally and abroad. Good corporate governance will also reduce the cost of loans or credits for corporations since companies with good corporate governance can be considered low risk companies in the eyes of debt investors.
- (2) Marketability** - Embracing principles of good corporate governance can also play in enhancing the corporate value of companies. This leads to easy access to capital in financial markets, which helps the company survive in an even more competitive environment. Good corporate governance will also make the company more attractive in an open market. This attribute will be beneficial and will place the company at the finer end of the bargaining in times when strategic alliances are needed. Examples of these strategic alliances are mergers, acquisitions, corporate absorptions, and buy outs, partnerships, joint ventures, and other risk mitigating initiatives.
- (3) Credibility** - There are a good number of benefits when an entity embraces good corporate governance, one of which is the company need not spend more resources in compliance with the regulatory and other financial institutions' requirements necessary since all these things are already integrated in company's operating approach.

Companies that are known for good governance practices do not need to sell themselves so that it is hard for the investors to fuse-in their investment either as equity or as debt investors. In the context of investment, everything could raise and fall in credibility and reputation. When a company is credible, investors' trust comes next; where investors' trust is in, money follows; when there is money, there is flexibility. It is in having that flexibility in a competitive world that could spell out the difference between failure and success.

- (4) Valuation** - Observed evidence and studies conducted in recent years back the idea that it pays to have good corporate governance. It was found out that more than 84% of the global investors are willing to pay a higher price or a premium for the shares of a well- governed company over one considered poorly governed given all financial figures comparably equal.

The issue is reliability of company provided information. This is one convincing fact that embracing corporate governance principles and practices affects corporate financial and non-financial value of the enterprise.

### **Agency Problem in Corporations**

In traditional (neoclassical) approach, corporation is treated as a single entity, it is often called **holistic approach**. It is one of the features of a sole proprietorship. Owner-managers have no conflicts of interest. In big companies, we almost always have the separation of owners and managers. **Financial managers** should work in the best interests of the owners by taking actions that increase the value of the company. However, we've also seen that in large corporations' ownership can be spread over a huge number of stockholders.

If we assume that stockholders buy stock because they seek to gain financially, then the answer is obvious; good decisions increase the value of the stock, and poor decisions decrease the value of the stock. Given our observations, it follows that the financial manager acts in the shareholders' best interests by making decisions that increase the value of the stock. The goal of financial management is to maximize the current value per share of the existing stock.

The separation of stockholders and management has some advantages. It allows share ownership to change without interfering so much with the operations of the business. It allows the company to hire professional managers. This dispersion of ownership means that managers, not owners, can control the firm. But it brings problems if the managers and owners' objectives are not the same and whether management really acts in the best interests of the owners.

The goal of maximizing the value of the stock avoids the problems associated with the sometimes-conflicting parochial goals. There is no ambiguity in the criterion, and there is no short-run versus long-run issue. We explicitly mean that our goal is to maximize the current stock value. By this, we mean that they are only entitled to what is left after employees, suppliers, and creditors (and anyone else with a legitimate claim) are paid their dues. If any of these groups go unpaid, the stockholders get nothing. Because the goal of financial management is to maximize the value of the stock, we need to learn how to identify those investments and financing arrangements that favorably impact the value of the stock.

### **Agency Relationships and Costs**

The connection between owners and managers is called a **principal-agent problem** and the conflict is called an **agency relationship**. Such a

relationship exists whenever someone (**the principal**) hires another (**the agent**) to represent his interests. The **shareholders** are the principals; the **managers** are their agents. Shareholders want management to increase the value of the firm, but managers may have their own axes to grind or nests to feather.

**Agency costs** are incurred when (1) managers do not attempt to maximize firm value and (2) shareholders incur costs to monitor the managers and influence their actions.

- More generally, the term **agency costs** refer to the costs of the conflict of interest between stockholders and management. Of course, there are no costs when the shareholders are also the managers.
- Agency costs can be indirect or direct. An **indirect agency cost** is a lost opportunity such as the one we have just described.
- **Direct agency costs** come in two forms.
  - \* The **first type** is a corporate expenditure that benefits management but costs the stockholders. Perhaps, the purchase of a luxurious and unneeded corporate jet would fall under this heading.

\* The **second type** of direct agency cost is an expense that arises from the need to monitor management actions. Paying outside auditors to assess the accuracy of financial statement information could be one example.

### **Goals of Financial Management**

Assuming that we restrict ourselves to for-profit businesses, the goal of financial management is to make money or add value for the owners. This goal is a little vague, of course, so we examine some different ways of formulating it in order to come up with a more precise definition. Such a definition is important because it leads to an objective basis for making and evaluating financial decisions.

If we were to consider possible financial goals, we might come up with some ideas like the following:

1. To survive
2. To avoid financial distress and bankruptcy
3. To beat the competition
4. To maximize sales or market share
5. To minimize costs
6. To maximize profits
7. To maintain a steady earnings growth

What would be the management goal if they have no control at all? One of the main answers comes from outside the mainstream economy. It is the idea that managers prefer the company to be bigger than more profitable. So, manager's left to themselves would tend to maximize the amount of resources over which

they have control or, more generally, corporate power or wealth. This goal could lead to an overemphasis on corporate size or growth.

Our discussion indicates that management may tend to overemphasize organizational survival to protect job security. Also, management may dislike outside interference, so independence and corporate self-sufficiency may be important goals.

### **Do Managers Act in the Stockholders' Interests?**

Principal-agent problems would be easier to resolve if everyone had the same information. That is rarely the case in finance. Managers, shareholders, and lenders may all have different information about the value of a real or financial asset, and it may be many years before all the information, the perfect information, is revealed. Financial managers need to recognize these information asymmetries and find ways to reassure investors that there are no nasty surprises on the way.

When managers will, in fact, act in the best interests of stockholders depends on two factors. **First**, how closely are management goals aligned with stockholder goals? This question relates to the way **managers are compensated**. **Second**, can management be replaced if they do not pursue stockholder goals? This issue relates to **control of the firm**. As we will discuss, there are a number of reasons to think that, even in the largest firms, management has a significant incentive to act in the interests of stockholders.

#### **Managerial Compensation**

- Management will frequently have a significant economic incentive to increase share value for two reasons.
- **First**, managerial compensation, particularly at the top, is usually tied to **financial performance** in general and oftentimes to share value in particular. For example, managers are frequently given the option to buy stock at a bargain price. The more the stock is worth, the more valuable is this option. In fact, options are increasingly being used to motivate employees of all types, not just top management.
- The **second** incentives managers have is related to **job prospects**. Better performers within the firm will tend to get promoted. More generally, those managers who are successful in pursuing stockholder goals will be in greater demand in the labor market and thus command higher salaries. In fact, managers who are successful in pursuing stockholder goals can reap enormous rewards.

#### **Control of the Firm**

- Control of the firm ultimately rests with stockholders. They elect the board of directors who in turn hire and fire management. An important mechanism by which unhappy stockholders can act to replace existing management is called a **proxy fight**. A **proxy** is the authority to vote for someone else's stock. A **proxy fight**

develops when a group solicits proxies in order to replace the existing board and thereby replace existing management.

Another way that management can be replaced is by **takeover**. Those firms that are poorly managed are more attractive as acquisitions than well-managed firms because a greater profit potential exists. Thus, avoiding a takeover by another firm gives management another incentive to act in the stockholders' interests.

### **Stakeholders**

- Management and stockholders are not the only parties with an interest in the firm's decisions.
- Employees, customers, suppliers and even the government all have a financial interest in the firm. Taken together, these various groups are called **stakeholders** in the firm.

In general, a **stakeholder** is someone other than a stockholder or creditor who potentially has a claim on the cash flows of the firm. Such groups will also attempt to exert control over the firm, perhaps to the detriment of the owners.

### **Agency Theory in Governance**

- **Agency theory** suggests that the firm can be viewed as a loosely defined contract between resource providers and the resource controllers.
- It is a relationship that came into being occasioned by the existence of one or more individuals, called **principals**, employing one or more other individuals, called **agents**, to carry out some service and then entrust decision-making rights to the agents. **Agency theory** argues that in the modern corporation, in which share ownership is publicly or widely held, managerial actions sometimes depart from those required to maximize shareholder returns. In **agency theory** language, the **owners** are principals, and the **managers** are agents, and there is an agency loss necessary, the extent of which, is the benefits that that should have accrued to the owners had the owners been the ones who exercised direct control of the corporation.

This agency loss can be reduced through the installation of some mechanism like providing financial incentives for executives and managers for their efforts of putting priority on maximizing the shareholders' wealth. This system includes **shares options** for senior executives at discounted prices. This way the senior executives' interest will be aligned to that of the shareholders. Other similar systems tie executive compensation and levels of benefits to the shareholders' returns and have part of executive compensation deferred to the future. This is to provide executive rewards for the long-run value maximization of the corporation. This system would deter the short-run executive mentality of "harvest and enjoy while available" and other actions which harm corporate value.

In similar terms, the **related theory of organizational economics** is concerned in anticipating managerial “**opportunistic behavior**” which includes policy skirting and indulging in excessive privileges at the expense of shareholder interests. The key structural mechanism to restrain such managerial opportunism is the **board of directors**. This body should provide a monitoring of managerial actions on behalf of shareholders. Such impartial review will only take place when the chairman of the board is independent of executive management. Where the **chief executive officer** is also chairman of the board of directors, the objectivity of the board will possibly be compromised. Agency and organizational economics theories predict that when the CEO also holds the dual role of chair, then the interests of the owners will be sacrificed to a certain degree in favor of management, that is, there will be **managerial opportunism** and **agency loss**. This loss is way above the owners’ normal benefits had they been the ones performing the agents’ functions of running the day-to-day corporate activities.

### **Effects of Agency in Governance**

#### **(1) Conflict of Interest**

Principal and agent have diverse interests, and the separation of ownership and control provides potential for different interests to surface. **Shareholders** lack direct control of corporations, especially those which are publicly traded corporations. **The board of directors**, on the other hand, has direct control on the activities of these enterprises being the ones entrusted by the shareholders to decide on corporate affairs. In the above situation, it can never be avoided that sometimes problems arise when the agent makes decisions that result in the quest for goals that conflict with those of the shareholders.

#### **(2) Managerial Opportunism**

Refers to the act by the agent of taking advantage of things that are within his control by virtue of the rights given to him by the principal. Sometimes, the uncalibrated and unchecked enjoyment of corporate resources and capabilities contradicts the idea of increasing the shareholders’ and firm’s value. **Excessive monetary benefits** like bonuses, and privileges, routine efforts of trying to secure comfortable position like undue diversification to increase compensation and to reduce employment risk, are just some of the examples of managerial opportunism.

#### **(3) Incurrence of Agency Cost**

As mentioned earlier, agency presents conflicts of interest because agents might do things which are detrimental to the maximization of shareholders’ wealth. To counter this, the principal needs to sacrifice resources for him to closely monitor and control the agent’s behavior.

These costs are called **Agency Cost**, which refers to the sum of incentive

costs, supervision and monitoring costs, enforcement costs and other agency losses incurred by principals in trying to ensure that the agent's operating style is consistent with the aim of maximizing the shareholders' and the firm's value.

#### **(4) Shareholder Activism**

Shareholders can call together to discuss the corporation's direction. They can vote as a block to elect their candidates to the board. **Institutional activism** will also offer a premium on companies with good corporate governance since this type of activism carries with it the capability to give incentive when agents perform well. Another issue that is well connected to shareholder activism is **share ownership**. Having some board members, executives and managers that are at the same time shareholders may cause alignment of their interests with plain shareholders. This is especially applicable with institutional investors. The increasing pressure and power of institutional owners to discipline ineffective top-level managers will now definitely influence the firm's choice of strategies to be employed in internal governance.

#### **(5) Managerial Defensiveness**

- This is in relation to issues of takeovers whereby management will employ some tactics to discourage **takeovers** and **buyouts**.
- These tactics may involve asset restructuring via termination of investments, changes in the financial structure of the firm such as acquisition of own shares in the open market, presenting bad takeover scenarios to shareholders for them not to approve takeover. Normally, in a **take-over**, the non-performing executives and managers are dismissed from their jobs. These anti-takeover tactics are discussed in another lecture.

### **Concept of Goal Congruence**

**Goal congruence** is the harmony and alignment of goals of both the principal and the agent which is consistent with the overall objectives of the organization. While it is true that in agency relations, the presence of self-interested behaviors is a given, nevertheless, managers can be encouraged to act in shareholders' best interest by giving **incentives** which will compensate them for good performance on one hand at the same time give them **disincentives** on their poor performance on another .

### **Performance Incentives and Disincentives**

#### **(1) Pay Dependent on Profit Level**

When management is rewarded based on the level of profits made, naturally members of management will make every effort to achieve high profit levels for them to earn more. This system is the most effective way to increase not only the value of shareholders' wealth but also the value of the firm, both in a tangible and intangible context.

The flip side of this scheme, however, is that it encourages the use of creative accounting and reporting practices to attain certain profit objectives. For example, the infamous scandal corporate scandals, the mark to market accounting used by Enron Corporation is one of the most glaring of these creative practices.

## **(2) Shares Incentives**

This can be done when a company is a publicly listed company, and managers are given a chance to subscribe shares of the company at a discounted price. Managers will have something to protect, and it can be naturally expected that they will venture into projects which will improve the firm's value. In this system, there is commonality of stake between the plain shareholders, and those executives and managers that are at the same time shareholders. The duality of capacities of executives and managers is not without disadvantages, intricacies on shareholders at the same time agents will be discussed further in agency problem, in a succeeding lecture.

## **(3) Shareholders' Intervention**

There is now a visible shift of character of shareholders on a large scale. Shareholders of today are now more active than before. They now dip their hands more unlike before when some of them will just wait for what the board will present on the table. Some shareholders are now active institutional investors who will definitely exercise a more direct influence over the performance of an enterprise. They are now taking an active role by scrutinizing the performance of the company and are very swift in their efforts of lobbying with other small shareholders when they believe poor service or any mismanagement by the directors is happening.

It is the above characteristics that will make the board, executives, and managers more conscious on the way they manage and decide things. It will make their decisions more leaning in favor of shareholders knowing that somebody is watching over their shoulders. Somebody keenly monitoring on the operating philosophies they employ.

## **(4) Threat of Being Fired**

The shareholders who have ultimate control over of the corporation can take a straight and hostile approach by threatening the board, executives, and managers with removal from office if they place their personal interests over that of shareholders' and that of maximizing the value of the firm. The increase in numbers of institutional investors has enhanced the shareholders' powers to discharge directors since they are able not only to dominate but also lobby other shareholders in decision making.

## **(5) Takeover Threat**

It is but normal for the board, executives, and managers to move heaven and earth to avoid or discourage corporate takeovers as they are aware that their job would at least be at risk if not be lost totally if takeover takes place.

To push for goal congruence, that is to have things in accordance with welfare of stakeholders and enhancement of firm's value, the shareholders can easily make a threat to accept takeover proposal if their set objectives are not met by the agents (board, executives, and managers) in general.

### **Roles of the Non-executive Directors**

A **non-executive director** is a member of the board of directors of a company who does not take part in the executive function of the management team. This **director** is not an employee of the company or connected with it in any other way. He is separate from the inside directors who are members of the board who also serve or previously served as executive managers of the company.

Fundamentally, the non-executive director's role is to give a meaningful contribution to the board by providing objective criticism. At present, it is widely accepted that non-executive directors have an important contribution to make to the proper administration of companies and, therefore, to the economy in a larger context. Non-executive director "should bring an independent judgment to bear on issues of strategy, performance, and resources including key appointments and standards of conduct" (taken from The Cadbury Report).

#### **Non-executive directors have the responsibilities in the following areas:**

##### **(1) Strategy**

As an outsider, the non-executive director may have an impartial, clearer, and wider view of external factors affecting the company and its business environment than the executive directors. The normal role of the non-executive director in strategy development is therefore to offer a creative contribution and to act as a constructive reviewer in looking at the goals and plans developed by the chief executive and his executive team.

Non-executive directors should continually face and contribute to the development of the company's long-term goals and visions. Together with the other directors and officers of the company, he is expected to participate in setting long-term broad operational principles and policies that benefits the stakeholders in areas that concerns on company stability, increasing the firm's value, and ultimately, in increasing shareholders' value.

##### **(2) Establishing Networks**

One of the important functions of the **non-executive director** is to represent the company in some external corporate undertakings. It is the job of the non-executive director (NxD) to connect the company to the outside world and

in the process, gain benefit from networks of businesses. This network of businesses is no doubt beneficial to the organization since this could spark certain avenues for alliances, which is the most effective way to survive in a very competitive environment.

### **(3) Monitoring Performance**

Non-executive directors should take responsibility for monitoring the performance of executive management, more particularly for matters relating to the progress made towards realizing the established company strategies. Non-executive directors should not be concerned only with strategy alone. Included in his responsibility is to monitor and examine the performance of management in meeting agreed goals and objectives of the company. **Succession planning** is also part of his responsibilities but taking into consideration the sensitivity of the matter he should do it more carefully with the concurrence of the other directors and officers.

### **(4) Audit**

It is the duty of the whole board to ensure that the company reports properly to its shareholders, this can be done by presenting a true, fair, and real reflection on how the company was administered at any given time. Included in this report are financial performance and highlights that are deemed necessary, including the assurance that the internal control systems are in place and monitored routinely and thoroughly. A non-executive director has an important role to play in fulfilling this responsibility whether or not a formal audit committee of the board has been established.

### **Roles of the Chief Financial Officer (CFO)**

The **Chief Financial Officer (CFO)** is a corporate officer principally accountable for managing the financial risks of the corporation. This officer is also responsible for financial planning and record keeping, as well as financial reporting to higher management. He will be the one who will direct the corporation's finances. In corporations large and small, a CFO is needed to handle both the cash inflow and outflow and to create reports about the corporation's spending. Keeping track of the working capital requirements of the company to meet short-term and daily requirements on operation are also the responsibilities of the CFO.

In large corporations, the primary duties of the CFO may be to supervise and manage a large accounting department, while coming up with ways to maximize profit to the company. A CFO might, for example, evaluate the way in which employees work to determine the way to most efficiently get work done for the least amount of money. These responsibilities, however, can be shared with other corporate heads or with general managers or lower-level supervisors.

CFOs have different specific roles depending on so many things: industry peculiarity, corporate structure, profile of investors (e.g. majority family-owned), government intervention, and whether the company listed or not both in local stock exchange and international exchanges.

**The following roles cut across Corporate CFOs around the world:**

**(1) Implements Internal Controls**

A **CFO** will be the one responsible for conveying the important financial controls to a company. These controls features should include the effective administration of cash flow and overhead expenses, establishing credit policies for customers and working with major vendors to attain more favorable payment terms, and implementing measures for assessing and evaluating optimal inventory levels. At a higher level, a CFO should also develop effective controls that provide supervision against fraudulent activities.

**(2) Supervises Major Impact Projects**

Outside of implementing and monitoring company controls relating finance, an effective **CFO** also handles and supervises those projects that require significant quantitative and qualitative interpretations and analysis in order to reach an understanding of the options that are available. For example, a CFO will take responsibility for developing a company's annual budget, work together with the business owners and division or department managers to ensure that the final financial product accurately and objectively projects the real requisites of the business. A CFO might also carry out a meticulous analysis of a company's future capital investment requirements as a prerequisite in securing additional financing.

**(3) Develops Relations with Financing Sources**

One of the most important responsibilities of an effective **CFO** is to institute good working relationships with banks and other financial institutions that may impact on the company's ability to finance its operations. Specific activities in this area may include regular meetings with officers of the company's bank(s) to review ongoing operations, discussing possible future loan transactions, revisiting loan covenants if there is any, negotiating more favorable terms for bank lines of credit, and discussions with private investors on how additional capital might be invested into the enterprise.

**(4) Advisor to Management**

An effective **CFO** is also an important member of the management team of some emerging companies. Because of his financial sharpness and general business knowledge, a good CFO can facilitate and help the business owners, executives, and other top managers make the substantial connection between a company's operations and its financial performance that are reflected in the actual figures and also with that of projections.

### **(5) Drives Major Strategic Issues**

A good **CFO** can also be expected to take part in the important role of getting involved in some major strategic issues that will have an impact on the company's long-term future. These issues include the hatching of the company's additional growth. Keeping an eye on diversification of a particular product lines, business activities, and portfolio is also part of the CFOs concern. A CFO would also play a significant role in any endeavor the purpose for which is to seek investment from the public or financial markets especially in times when the company is having an initial public offering (IPO)

### **(6) Risk Manager**

The **CFO** is in the best position to foresee risks considering that they have this rare perspective on how the company operates. **CFOs** are close to the internal control system and financial reports which pass through many operational areas. **CFOs** are high ranking officers doing real and actual things in the infantry. Their views are not just "treetops", their views are real, and they are in proximity of hard figures that could back their decision.

The CFO viewpoint on risk can be a helpful source to the board of directors and the CEO as well as other senior officers as they manage the corporate affairs. The **CFO** may be in the best position to anticipate high risks transactions and the adverse consequences of a changing external environment. This is unique capability of CFOs, however, is only valuable if the CFO is communicating well with the CEO, the board, and the other officers of the organization.

### **(7) Relationship Role**

More often, the **CFO** is the nucleus in an organization with many connections. The CFO will work together with the CEO, the board of directors, the audit committee, the internal auditor, and the external auditor. Strong verbal and written communication skills are indispensable if the nucleus is to support the connections effectively. **CFO** serves as the bridge between these a variety of parties within the organization.

### **(8) Objective Referee**

**CFO** needs to demonstrate impartiality such as when advising the CEO or the board of directors on accounting matters. The skill to present important financial issues is an invaluable resource but it should always be in the context that it is not being done to favor somebody. **CFOs** are not valued by the board of directors or audit committees on attributes or tendencies of boosting financial figures with sacrificed transparency.

In consonance with the principle of good corporate governance, boards of directors, audit committees and CEOs need to understand all sides of a financial accounting or disclosure issues so they can make an informed and rational decision. The **CFO** can and should be a trusted adviser in matters of financial reporting.

## Roles of the Audit Committee

- The **Audit Committee** is an essential component in the overall corporate governance system.
- The objectives of this committee should be geared toward carrying out practical, progressive changes in the functions and expectations placed on corporate boards. One of the fundamental principles of an effective audit committee is that committee members should be independent from the operational aspects of the company. This means that a company's senior management, however, has to be given the opportunity for important communication with the audit committee.

## Understanding the Audit Committee's Responsibilities

- An **audit committee** should be engaged mainly in an oversight function and ultimately is responsible for the company's financial reporting processes and the quality of its financial reporting. For the committee to carry out the said responsibilities, the committee must have a working knowledge of the company's goals and its long-term plans and vision including the issues the company is facing in trying to achieve these objectives.

Examples of issues that the audit committees should consider:

- Risk identification and response.
- Pressure to manage earnings.
- Internal controls and company growth

## Risk Identification and Response

To be effective, an audit committee must have an understanding of the risks the company faces, and more importantly, the company's internal control system for identifying and mitigating those risks.

**Risks that could affect the company and that the audit committee should be conscious about include:**

### External Risk (independent)

- Rapid technological changes

The **Audit committee** should always be on the lookout for the company not to be left behind due to advancement of technology. The new rule in this modern time is embrace things brought about by technology and be a survivor.

- Downturns in the industry

The product that the company is selling may have passed already its

maturity stage and it is already on its way down. The **audit committee** should have a clear picture of the “what if scenario” of the entity. A very good example, Nokia began as a textile company then went into electronics, and from electronics migrated to wireless devices (mobile phone) but they missed the next boat.

- Unrealistic earnings expectations by analysts

An **audit committee** is expected to be not just composed and collected but also, less aggressive when it comes to expectations of business outcomes. **Audit committees** should be associated with conservative and realistic information, and thus they should deal with figures from the realistic point of view. They should reasonably know how much meat within a cup of soup because this would be the real basis in putting up plans for the company’s future.

- Operating/Internal Risk

Recurring organizational changes, turnover of key personnel are some of the danger signs that the audit committee cannot afford to neglect. Things like this hamper the operational momentum of the company rendering it slow in its progress in achieving its vision.

Another internal risk worthy of consideration is the complexities of transactions, complex organizational structure, swift growth, performance-based compensation that are excessively inappropriate, exposure to currency differences on foreign currency denominated loans, and financial results that are abnormally different from that of the industry.

- Information and Control Risk

The **audit committee**, in carrying out its responsibility has to address the following concerns which are considered as perennial in most organizations: unsuitable control environment that are sometimes “toned at the top” Another is the lack of sincere management supervision and inappropriate management override of existing controls which is by description, the best habitat for **abuse**. **Timeliness** is another concern since information needs to be communicated early enough to the stakeholder for this information to be useful.

**Who is responsible for financial reporting? The responsibility for financial reporting is vested in three groups:**

- 1. The BOD**

The company’s board of directors includes the audit committee.

- 2. Finance and Accounting**

Financial management including the internal auditors.

- 3. Auditor**

The independent Auditors

While it is true that this triumvirate forms a “three-legged stool”, there is a need to emphasize that the audit committee must take the lead in the financial reporting process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process. An audit committee that functions well could definitely send a strong message and partial assurance to the other stakeholders that the system is in place, and it is protecting the organization both on a short and in long-term basis.

### **Roles of the External Auditor**

**Auditing** is a systematic process by which a competent, independent person objectively obtains and evaluates evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicate the results to interested users (American Accounting Association)

### **Need for External Auditor**

There is a need for **an independent auditor** because of the apparent separation of ownership and management. Audit services are used extensively by business organizations to cast away doubts on the information given by the management which is also generated under its direct control. There exists information risk. Business structures are becoming more complex, which increases the possibility that unreliable information might be fed not only to decision makers but more importantly to the shareholders.

### **Factors that Contribute to Information Risk**

- 1. Remoteness of Information Providers to the Information Users** - This makes first-hand knowledge difficult to obtain for some stakeholders because they are divorced from management. Complex corporate structures, less involvement by the shareholders in day-to-day operations or decisions as well as geographical dispersion are just some of the factors that widen the distance between the information user and provider.
- 2. Bias of Information Providers** - There is an assumed conflict of interest between the shareholders and management regarding financial information. Financial statements and other financial information serve as the “report card” of management of its stewardship, the only report card prepared by the one being graded. Having said this, information may be presented in favor of the provider when his goals are different with some stakeholders.
- 3. The Volume of Data** - When business grows, possibly thousands if not millions of transactions are processed daily through the use of sophisticated computer programs or via a manual system.

There is the possibility therefore that improperly recoded information may be buried in the records leaving the overall results inaccurate if not misleading, trained professionals therefore are needed in the area.

4. **Complexities in Transactions** - Changing and new relationships in business leads to some innovations in accounting and reporting processes. Transaction now a days are getting complicated and becoming more difficult to record let alone be understood by the stakeholders. Examples of these are derivatives, futures, multi-level mortgages in securities, reinsurances, different valuations, and other complex transaction in the financial markets which the board of directors and other decision makers in the company might venture into.

**Auditing** is an endeavor to assure the readers of the financial statements with confidence in the figures of financial statements. This is highlighted by the accountancy profession's meaning of an audit. Audit of financial statements which is; an exercise, the objective of which is to permit auditors to express an opinion as to whether the financial statements give a true and fair view of the affairs of an entity at a given period in accordance with the relevant frameworks and standards (lifted and reworded from International Standard on Auditing (ISA) 2000, Objective and General principles Governing an Audit of Financial Statements).

The logic behind this definition is that the auditor's opinion will lend and add some credibility to the financial statements. It is expected that the auditor, as an independent expert on financial preparation and reporting, should conduct the examination exhaustively for him to have good backings on the opinion he will be expressing in the independent audit report.

### **Auditor's Duties**

In most countries, the **auditor** has a legal duty to make a report to the enterprise on the fact and fairness of the entity's annual accounts. This report should state the auditor's opinion on whether the statements have been prepared in accordance with the relevant standards more importantly on relevant legislation and whether they present a true and fair view of the profit or loss at any given period. The responsibility to report on the truth and fairness of the financial statements rests with the management, the auditor therefore has a responsibility to form an opinion on certain other matters and to report any reservations that he has on the reports. In the audit report, these reservations can be seen in the qualification of opinion by the auditor.

**In the conduct of an audit, the auditor must consider whether the following are present:**

1. Proper accounting records are being kept by the company.
2. Financial statement figures that agree with accounting records.
3. Adequacy of notes to financial statement and other disclosures necessary.
4. Compliance with relevant laws and standards of financial accounting and reporting.

In three (3) of the above, the auditor is impliedly given the right to access to any information or material that is relevant to examination of the financial statements. In addition, the auditor has a duty to review the other information issued alongside the audited financial statements. There is, however, no guarantee that the statements are free from misstatements and errors, this is partly because the auditor is only required to form an opinion for him to discharge his duties. Thus, must be understood that audits are not designed to discover errors, irregularities, and fraud. Activities in external auditing are only designed to form an opinion, not a conclusion; it can only give reasonable assurance, not absolute assurance.

Based on the preceding items, it can be summarized that the external auditor is there to attest to the data and other information prepared by management in accordance with some legal and other established criteria. The criteria in the Philippine setting are provided by Philippine Financial Reporting Standards and other standards. The overall role of the external auditor is to express an opinion on the financial statements prepared by management. This means that an external auditor lends credibility to financial statements which are to be used by the stakeholders and other shareholders.

**Textbook:**

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