

Good Governance and Social Responsibility

Lecture 5: Internal Institutions and Influences of Corporate Governance

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Lecture Learning Objectives:

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

1. Understand the corporate governance in the Philippines
2. Show the legal framework that affected corporate governance locally.
3. Enumerate and explain the internal foundation of corporate governance.
4. Explain the functions, duties, and responsibilities of the board of directors, chief executive officer, chief finance officer and shareholders.

INTRODUCTION

The foundation of good corporate governance is the intellectual honesty of directors and senior management. This **intellectual honesty** is expressed by acting in the best interests of the incapacitated company. The **corporation**, on formation, is a juridical person, but it is absolutely incapacitated until its **directors** are appointed and the **board** in turn delegates to management the implementation of its collective decisions.

It is the quality of governance that is important and not the quantity. Mindless compliance with a set of rules is not good governance. Good governance connotes acting with **responsibility, accountability, fairness, and transparency**. **Transparency** has a withering effect on misconduct and is absolutely critical in communicating to stakeholders any decisions of the board. In this context, transparency demands that communications consist of substance over form and contain positive and negative aspects, if any.

A company needs the right people, team, and processes. The right team making up the board must determine a common understanding of the purpose of the company, the values that drive its business and who are the important stakeholders. The board must also identify the sustainability issues which are pertinent to the business of the company.

The **board** needs to adopt an inclusive approach to governance. This means that the **board**, in its decision-making process, needs to take account of the legitimate interests and expectations of the stakeholders linked to the company.

Management must communicate with the particular groupings of stakeholders. Now that sustainability has become the moral and economic imperative of the 21st century, governance, strategy, and sustainability have become inseparable.

Long-term strategy must follow consideration by the board of directors on these **five aspects: financial, human, social, environmental and technology**. Reports to

stakeholders must integrate the impacts of the company's business on a community, economically, socially, and environmentally.

While it is the duty of directors to take risks for reward, directors must ensure that they apply the principles of good governance when taking risks for reward. **Good governance** attracts capital while poor governance will repel capital. **Capital** has become a scarce resource in a flat, borderless world. Where with the click of a mouse, capital can leave a market and destroy it.

CORPORATE GOVERNANCE IN THE PHILIPPINES

Long before the collapse of Enron and WorldCom, the Philippines had its own share of corporate scandals like BW Resources Corporation, whose share prices hit record highs and then collapsed in 1999. These scandals brought down the stock market's image and weakened private investor confidence. The scandals have their roots in management's desire to project a false picture of performance, with the aim of driving up the value of the corporation in a competitive global market.

Corporate governance is needed to make corporate managements more accountable, and their auditors more rigorous. But good governance requires fair legal frameworks that should be enforced impartially. The **Philippine Securities and Exchange Commission (SEC)**, a principal player in matters of corporate governance, issued Memorandum Circular No. 2, Series of 2002, otherwise known as the Code of Corporate Governance, under SEC Resolution No. 135, dated Apr. 4, 2002. The code is now effective and must be followed under the pain of penalty.

The Code aims to promote corporate governance reforms that will raise investor confidence, develop the capital market, and help achieve high sustained growth for the corporate sector and the economy. The code applies to: (1) corporations whose securities are registered or listed, (2) corporations who are grantees of permits/licenses and secondary franchises from the Commission, (3) public companies and (4) branches or subsidiaries of foreign corporations operating in the Philippines whose securities are registered or listed. Some of the code's salient features are as follows:

The **code** prescribes that the **Board of Directors** shall primarily be responsible for the governance of the corporation. The Board should establish the corporation's vision and mission, strategic objectives, policies, and procedures that guide and direct the activities of the company, and the mechanism for monitoring management's performance.

The Board shall also constitute committees in aid of good corporate governance such as:

1. The **Audit Committee**, whose responsibility is to inculcate in the minds of the Board members the importance of a sound system of internal control and the Board's oversight responsibility.
2. The **Nomination Committee**, whose function is to review and evaluate the qualifications of all persons nominated to the Board; and
3. The **Compensation or Remuneration Committee**, whose task is to establish a formal and transparent procedure for developing a policy on executive remuneration.

The code also emphasizes the importance of the work of the **Corporate Secretary**, who must be a Filipino and an officer of the corporation. He should work and deal fairly and objectively with all the constituencies of the corporation.

In order for the Board Members to fulfill their responsibilities, they should be provided with complete, adequate, and timely information prior to Board meetings on an ongoing basis. The **Board** is primarily accountable to the shareholders, and **Management** is primarily accountable to the Board. The Board, through the Audit Committee, shall recommend to the stockholders a duly accredited external auditor who shall undertake an independent audit and shall provide an objective assurance on the way in which financial statements are prepared and presented. The **external auditor** should be rotated every five (5) years or earlier or the handling partner should be changed.

The following **stockholders' rights** should be respected: (1) voting right; (2) preemptive right; (3) power of inspection; (4) right to information; (5) right to dividends and (5) appraisal right among others. The **management** may establish a performance evaluation system to measure the performance of the Board and top-level management of the corporation.

Disclosure is a vital and dominant theme in the Code. The more transparent the internal workings of the company and cash flows, the more difficult it will be for management and controlling shareholders to misappropriate or mismanage company assets.

Corporations shall promulgate and adopt their corporate governance rules and principles in accordance with the Code. **Rules** shall be in manual form, available as reference by the directors and submitted to the SEC. Any corporation who fails to adopt a manual of corporate governance shall be penalized P100,000 after due notice and hearing. All corporations affected by this Code shall submit their manual by July 1, 2002, to be effective Jan. 1, 2003.

INTERNAL FOUNDATION OF CORPORATE GOVERNANCE

BOARD OF DIRECTORS

A **board of director** is a body of elected or appointed by **shareholders** who jointly oversee the activities and the overall managerial and operational aspects of the corporation. The said activities are determined by the powers, duties, and responsibilities delegated to it or granted by an authority which can be from the shareholders and/or from the by-laws itself.

A mere mention the phrase “board of directors” to the average investor, will probably imagine the images of nicely dressed men and women in a well-set room converged on a round mahogany table, bringing corporate folders with them, smiling amiably. This is fully reasonable considering that many annual reports prominently feature glossy photographs of just such a sight. However, if we ask the average investor to explain the main responsibilities of the board of directors only very few will be able to give you a good and definitive answer.

Authority and Responsibility and Purpose of the Board of Directors

The most important responsibility of the board of directors is to protect the resources entrusted to them by the shareholders and make sure the latter receive a decent return on their investment. In some European countries, the sentiment is much different; many directors there feel that it is their **primary responsibility** to protect the employees of a company **first**, the shareholders **second**.

The **board of director** is the top governing authority within the management structure at any publicly listed company. It is the board's job to select, evaluate, and approve appropriate compensation for the company's CEO, assess the attractiveness dividend payment scheme and its amount, recommend stock splits, oversee share reacquisition programs, approve the company's financial statements reports and other financial highlights, and recommend or in some instances discourage acquisitions and mergers.

Structure and Makeup of the Board of Directors

The **board** is made up of individual men and women, the "directors" who are elected by the shareholders. Many companies work on a rotating system so that only a fraction of the directors is up for election each year; this makes it much more difficult for a complete board change to take place due to a hostile takeover.

In fact, this system is purposely employed as a device as one of the tactics under anti-takeover defenses. In most cases, directors either: **1.)** have a vested interest in the company, **2.)** work in the upper management of the company, or **3.)** are independent from the company but are known for their business abilities.

Committees on the Board of Directors

The board of directors' responsibilities includes the institution of the audit and compensation committees. The **audit committee** is responsible for making sure that the company's financial statements and reports are reasonably accurate and use fair estimates in accordance with the applicable financial reporting standards. The board members select, hire, and work with an outside auditing firm. The **firm** is the entity that actually does the auditing and assurance services. The **compensation committee** places base compensation, stock options awards, and incentives bonuses for the company's executives, including the CEO. In recent years, many board of directors have come under fire for allowing executive salaries to reach at an unchecked level.

Ownership Structure and Its Impact on the Board of Directors

The particular ownership structure of a corporation has a huge impact on the efficiency and effectiveness of the board of directors to govern. In a company where a large, single shareholder exists, that entity or individual investor can effectively control the corporation. If the director has a trouble, he can appeal things to the controlling shareholder.

In a company where no controlling shareholder exists, the directors should act as if one did exist and attempt to always protect this imaginary entity, even to the extent of firing the CEO, making changes to the structure that are unpopular with management, or turning down acquisitions due to cost consideration.

In a relatively few numbers of companies, investment of one person can account as much as 50% to 60% or even more. In this case, the controlling shareholder can also serve as the **CEO and/or Chairman of the Board**, being the supermajority. In this case, a **director** is completely at the will of the owner and has no enough muscle to override the majority stockholder's decisions.

CHIEF EXECUTIVE OFFICER (CEO)

The **Chief Executive Officer (CEO)** is usually the singular organizational position that is principally accountable in carrying out the strategic policies and procedure as established by the board of directors. In this case, the chief executive officer (CEO) is directly under the board of directors, and thus presents its reports and output to the board. It is the responsibility of the **chief executive officer** to bring into line the company, internally and externally, with their long-term vision. The central part duty of a CEO is to make it possible to engage business outside of the company while directing employees, managers, and other executive officers towards a central objective. A **CEO** must have a balance of internal and external initiatives to put together a sustainable organization.

Typical Responsibilities of a CEO are as follows:

(1) Support to the Board

One of the responsibilities of the CEO is to support operations and administration of the board by giving information and advice to board members. **The CEO** should be serving as the crossing point between board and staff, supporting whatever the Board's evaluation of chief executives as well as evaluation of other high-ranking people in organization.

(2) Delivery of Program, Product and Service (PPS)

Administer design, marketing, promotion, delivery and quality of programs, products, and services. The CEO is expected to be the brand bearer. For example, **John Francis Welch Jr.** of GE (1981 – 2001) and the late, **Steve Jobs** of Apple and many other CEOs are considered as the icons of their respective companies.

(3) Financial, Risk and Tax Management

Recommends yearly budget for board's approval and cautiously manages organization's resources within the bounds of budget guidelines. This utilization of resources may also have other bases such as laws, regulations, and other directives. **Housing projects** is one good example for this, wherein there is certain regulation that a developer should set aside certain percentage for low-cost housing to cater the lower customer class.

(4) Human Capital Management

Efficiently manages the human capital of the organization based on sanctioned personnel policies and procedures that fully conform to current laws, regulations, and standards both local and international.

(5) Public Relations (PR)

Pledge that the organization and its mission, programs and initiatives, products and services are consistently presented in a strong and physically visible manner to the community. It is also the job of the CEO to package and build a positive image of the company to its relevant stakeholders.

CHIEF FINANCIAL OFFICER (CFO)

For many privately held businesses, the decision to hire a chief financial officer (CFO) is often a difficult decision. Beyond the issue of whether the company can afford a high-caliber financial professional, many business owners are often confused over just what it is that a CFO does or should do. More than just a glorified accountant or someone whose long service to the organization has been rewarded with a fancy title, a **chief finance officer (CFO)** has a number of responsibilities within the corporation that are essential in providing a strong financial foundation for a growing and expanding business. The following are some of the critical areas which an effective CFO will work on in discharging his functions:

Functions of a CFO

(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 will also handle and supervises those projects that require significant quantitative and qualitative interpretations and analysis in order to reach at an understanding of the options that are available. For example, a **CFO** will take responsibility for developing a company's annual budget, working together with the business owner and division or department managers to ensure that the final financial product accurately and objectively projects the real things. A **CFO** might also carry out a meticulous analysis of a company's future capital investment requirements as a pre-requisite 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 at the company's bank 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 emergent companies. Because of his/her 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 financial figures.

(5) Drives Major Strategic Issues

A good CFO can also be expected to take part in important role of attending some major strategic issues that will have an impact on the company's long-term future. These issues include the hatching of the company acquisition strategy which in the end would help fuel and boost 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 of 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 risk 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 "tree top", their views are real, and they are in proximity to hard figures that could back their decision.

The CFO's 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 risk transactions and the adverse consequences of a changing external environment. This 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 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 being done not 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 principle of good corporate governance, board 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 these matters of financial compliance reporting.

SHAREHOLDERS

Shareholder Rights and Responsibilities

Share ownership carries with it important rights and responsibilities. **Share**

ownership gives the owner with the right to a share of the income of the company called **a dividend** and a right to a share of net proceeds on the sale during liquidation of the company. Ownership of a share in the equity of a company also includes the right to sell or transfer that share without the need to inform or getting the consent of the other stockholders.

An important right and responsibility of shareholders is to **vote**. This **voting right** includes the right to information about the company and the right to express an opinion on the company's performance. In most public companies, there is a separation of ownership and control, making it difficult to pursue the rights to information and to provide feedback. While no one disputes that shareholders own companies, the fact is that management often controls the company. As long as there is a gap between the objectives of management and the objectives of owners, there is a risk that management will act in its own self-interest and possibly to the detriment of the owners.

In pursuing the rights to information and influence, shareholders must keep in mind their responsibilities:

- They must ensure that the obligation to provide information to shareholders does not detract from the company's ability to compete in its marketplace. The information should not cost competitiveness.
- They must ensure that their right to attempt to influence the company does not translate into behavior that will paralyze and be detrimental to the company. It should not spin at a level wherein the principal (shareholders) and agent (officers) will now becoming adversarial in running the corporation. The rule of the thumb is that managing a company is not a constant exercise of stockholders' referendum.

Reviewing the Role of Shareholders

General

The **directors** and not the shareholders are responsible for the management of the corporation. However, under the corporate statutes, certain matters are considered so fundamental that they require the approval of the shareholders. Under the Corporation Code of the Philippines these matters include:

- Effecting certain mergers or reorganizations.
- Selling all or substantially all of the corporation's assets.
- Adding or removing any restrictions on the business that the corporation may carry out.
- Changing the corporation's share capital.
- Increasing or decreasing the number of directors or the minimum or maximum numbers of directors.

- Confirming by-laws.
- Adding or changing restrictions on the issue, transfer, or ownership of shares.

Shareholder Ability to Change the Board

Shareholders who are dissatisfied with how the directors are running the corporation may remove the directors or refuse to re-elect them. In practice, this may be a difficult course to take, particularly where the shares of the corporation are widely held.

While the corporate decrees require a corporation to provide a list of shareholders to any shareholder who requests it, thereby enabling shareholders to mount a proxy battle over the election of directors, many shareholders do not have the time, or resources required to counter a management proposal.

The exceptions are large institutional investors who have, on occasion, made their voices heard at annual meetings or in private meetings with representatives of a corporation prior to a shareholder meeting. Occasionally, proxy battles do occur which result in the replacement of the board of directors.

Textbook:

Good Governance & Social Responsibility, Dr. Christopher Biore, Dr. Roberto Gonzales, Prof. Jose Lemuel Caparas, Dean Nilo Burgos and Prof. Win Ballada, ASEAN (Academicians, Students, Educators and Alliance) Inc.
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