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Corporate Governance: SMEs Experience in Metro Cebu, Philippines

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ABSTRACT

The paper is based on the study on the perception and practices of SMEs in Metro Cebu on corporate governance, and tested a theory that size, company specifics, and corporate governance practices influenced compliance with the Code of Corporate Governance. The problem was answered with a descriptive research and inferential design utilizing convenience sampling of 30 SMEs-board members using questionnaire, interview, and analysis of audited financial statements. Perception on corporate governance of SMEs in Metro Cebu highly complied with the Code of Corporate Governance. However, practices on corporate governance disclosed gaps such as no independent board, no formalized written code of conduct, pre-audit task of internal auditor, and high debt ratio. Code emphasis on board governance, supply of information, accountability and audit, stockholders' rights and protection of minority stockholders, evaluation systems, disclosure and transparency, and commitment to corporate governance differ significantly between SMEs. The theory was confirmed that size, company specifics, and corporate governance practices influenced compliance with the Code of Corporate Governance. Recommendations were offered to help SMEs champion corporate governance. A Code of Corporate Governance for SMEs must be developed; setting-up corporate governance structure should consider the size of assets of SMEs as well as the costs and benefits; Securities and Exchange Commission, in coordination with industry associations, shall initiate orientation requirement of new BODs, continuing education of current BODs,

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dissemination of corporate governance as a topic in all business-related courses and as an elective in non-business courses.

Keywords: *corporate governance, SME, stockholder, practices, Phillippines*

Introduction

Cebu corporations demonstrate corporate governance weaknesses. The study of Racaza (2005) disclosed that Cebu corporations experience delays in providing information, and high dependency on debt. Recent corporate scandals involving lack of transparency and disclosure of financial reports (Lipman & Lipman, 2006) are corporate governance failures. Corporate governance is 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 market place (Code, 2002). In the Philippines, it has been applied to public companies in general, and the banking and insurance industries in particular (Villanueva, 2009). Corporate governance is a regulatory, market, and self enterprise discipline (ACIIA, 2009). Self enterprise discipline is on the micro level while regulatory and market disciplines are macro level safeguards. Looking into the self enterprise discipline of Cebu corporations can provide global opportunities and competitive advantages.

As the furniture capital of the Philippines, Cebu contributes a steady 60% share of the Philippine global sales (Pearl2, 2007), is recognized as a strong potential for growth in the country's Small and Medium Enterprises (SMEs) Development Plan, comprises 20% of the entire Philippine furniture industry, is composed mostly of SMEs (ibid), which are closed-family corporations, and whose capital structure is largely from investments other than the stockholders.

Closed-family corporations are non-listed corporations which are encouraged by Securities and Exchange (SEC) to follow the Code as practicable to promote the perception of good corporate governance. However, the capital structure of Cebu furniture SMEs raises corporate governance issues using the criteria of Mallin, 2004. Financial meltdown in United States of America (USA), Cebu's primary furniture customers, greatly affected Cebu's furniture industry. Corporate governance is one of the supporters of corporate management (Valladhaneni, 2008) to survive in the financial crisis.

Analysis of secondary data confirmed that the SMEs under study had financial difficulty based on the computed average return on equity of negative 4%. In financial distress situation where liquidation is probable, an independent board's responsibility shifts to protect the creditors (Lipman & Lipman, 2006). Normally, in ordinary economic situation, the board upholds the interests of stockholders. However, based on the non-independent board characteristic of the SMEs under study, creditors cannot expect any protection. The creditors were at high risk in financial exposure.

This paper evaluated the perception and practices of corporate governance of SMEs in Metro Cebu. Specifically, the paper described the distribution of the SMEs in terms of firm specifics and board characteristics; extent of the current corporate governance practices on the Code emphasis in terms of: 1. board governance, 2. supply of information, 3. accountability and audit, 4. stockholders' rights and protection of minority stockholders, 5. evaluation systems, 6. disclosure and transparency, and 7. commitment to corporate governance; differences among small and medium enterprises on the Code emphasis, identified gaps in the implementation of the Code of Corporate Governance and the corporate governance practices of SMEs; and provided recommendation to enhance compliance.

Theoretical and Conceptual Framework

The legal basis of the paper covered the Corporation Code of the Philippines or known as Batas Pambansa Blg. 68; Republic Act 9501, the Micro, Small, and Medium Enterprises (MSMEs) law or known as Magna Carta for MSMEs; Republic Act 9178 an act that promotes the establishment of Barangay Micro Business Enterprises (BMBEs); and the Code of Corporate Governance or the SEC Memorandum Circular No.2, series of 2002.

The Corporation Code of the Philippines, Article 2 Section 1 defines Corporation as an artificial being created by operation of law, having the right of succession and the powers, attributes and properties expressly authorized by law or incident to its existence. The owner is called the stockholder or shareholder. The advantages of corporate form of enterprises include renewable 50-year corporate existence, ownership is easily transferable, stockholders have limited liability, greater source of capital, and permit the use of specialists. The disadvantages of corporate form of enterprises on the other hand comprise more difficult and costly to organize, subject to more legal restrictions, subject to higher tax on business income, stockholders have little control over the management of business, and subject to more government controls. The SEC is a government agency that directly monitors the corporation which requires submission of articles of incorporation, by-laws, as well as the annual general information sheet and financial statements. Publicly listed corporations and publicly accountable entities such as financial institutions are required to comply with the Code of Corporate Governance while small and medium enterprises are encouraged to follow corporate governance framework reflected on the SEC memorandum circular no. 2.

Republic Act 9501 recognizes the specific needs of the MSMEs and promotes entrepreneurs, encourages the establishment of MSMEs, and ensures their continuing viability and growth that will attain countryside industrialization. Corporate form of MSMEs is also subject to the requirements of SEC. Ensuring the continuing viability and growth of the corporate MSMEs would require strengthening their corporate governance. Perception of good corporate governance will make the owners of the corporation trust the management.

One vision of the RA 9501 is for SMEs to be excellently managed and globally competitive entities. Innovation is one of the strategies for competitive businesses. Asia Pacific Economic Cooperation (APEC) Ministers recognized that innovation is the main driving force that creates dynamic SMEs and sustains growth in the current globalized marketplace given their flexibility and ability to respond more quickly to current conditions (APEC, 2005).

Republic Act 9178 provides incentives and benefits to BMBEs with assets ranging from less than 1 million to 3 million pesos. Incentives and benefits of barangay micro business enterprises will make micro enterprises to grow and become small, then medium, and graduate to become large entities. The corporate governance framework must be disseminated.

The basis of Corporate Governance in the Philippines is the SEC Memorandum Circular No. 2, series of 2002. The Code of Corporate Governance (Code) includes the board of directors' (board) duty to determine the corporation's purpose and value including strategies and general policies. The code aims to raise investor's confidence, develop capital market, and help achieve high sustained growth for the corporate sector and the economy. It emphasizes the board governance, supply information, accountability and audit, stockholders' rights and protection of minority stockholders' interests, evaluation systems, disclosure and transparency, and commitment to corporate governance. SMEs are encouraged to observe the Code in the absence of any mandated corporate governance rules adopted by other government agencies.

Methodology

The problem was answered with a descriptive research and inferential design utilizing convenience sampling of 30 SMEs-board members using questionnaire, interview, and analysis of audited financial statements. The study did not include sub-contractors, and other furniture industry players who were not a member of Cebu Furniture Industry Foundation, Inc. (CFIF). Respondents represented one-third and two-third from small and medium enterprises, respectively. Analysis of data was tested using one way analysis variance (ANOVA) with Statistical Packages for Social Sciences.

Results and Discussions

Products of the SMEs under study were categorized into indoor or outdoor furniture or both. The products, primarily chairs and tables, were described in marketing brochures and collaterals as home accessory, home furnishing, home furniture, home decor, and outdoor furniture. Products were exported primarily to USA, Europe, Canada, Australia, Asia, and Middle East.

1. Board Governance

The Code specifies that the Board should establish the corporation's vision and mission, strategic objectives, policies, and procedures that may guide and direct the activities of the company. In addition, the Code requires the Board to establish committees within such as audit, compensation, and other committees where necessary. An audit committee serves as oversight on all matters related to financial reporting, and a compensation committee formulates and evaluates top management pay package. Ultimately, the Board is responsible for the continuing soundness, effectiveness, and adequacy of the control environment and maintenance of effective controls (Hall, 2004, IIA, 2008).

There were no significant differences between small and medium enterprises on a number of board governance items, namely, the basic requisites of SME such as clear policy and processes for suppliers, commitment of board and chief executive officer (CEO) to abide with the code of conduct, definition of legislation requirements, mix of competent directors and CEO, succession planning, and professional development program.

A written code of conduct was not yet compiled and formalized. Some SMEs defined written code of conduct as company's memoranda on conduct as well as expected conduct embedded into the policies and procedures. Legislation relevant to operations such as monitoring changes in, compliance, impact of local and national government requirements.

Basic requisites are governance mechanisms that allow SMEs to introduce strategic changes in the processes of framework, formulation, and implementation needed to turnaround any SME (Brunninge et al., 2007; De Necker, 1998). The findings support the vision of the RA 9501 for SMEs to be excellently managed and globally competitive entities.

However, there were significant differences between small and medium enterprises on some board governance items, namely, the institution of vision/mission, policy and processes for employees and government, written code of conduct, internal control, risk management, internal audit, and external audit. These were points challenging the success of SMEs under study.

Institution of internal control covers risk management, control environment, control activities, evaluation, and monitoring. Risk management's pre-requisite is risk identification based on mission and objectives of SMEs vis-à-vis its external and internal environments.

2. Supply of Information

The Code denotes that management should have an obligation to supply the board with complete, adequate, and timely information.

There were significant differences between the small and medium enterprises on all items related to the manner of supplying complete, adequate, and timely information to the board.

Majority of the board of SMEs were composed of stockholders and family members with no independent board member(s). Further, the board members took part in the management either as president, vice president for finance, vice president for operations, or treasurer which lead to the description of an active board. When the manager himself is part of the board, a threat of self review was present and any counter checking is not practicable, thus, active board impeded a system of check and balance (ISA-WBI, 2003). A unique observation for SMEs, consider a study of about the Corporate Governance Mechanisms and Extent of Disclosure: Evidence from Listed Companies in Malaysia showed an inversely related relationship of the family members on the board and the level of disclosure in their annual report (Wan Mohamad, W. & Sulong, Z., 2010). This context was also observed in the Cebu SMEs.

The type of data needed for planning, risk assessment or evaluation is determined by an independent board and not by a management team (Lipman & Lipman, 2006). A plan of activities and its financial budget commonly serves as the benchmark for monitoring management team's performance.

There were some non-functioning boards whose creation was made for government compliance, thus, paving for one-man show.

3. Accountability and Audit

The manager's job is to represent the interests of stakeholders (Guay et al., 2004), and are held accountable for the performance of the corporation to various stakeholders. There were no significant differences between the small and medium enterprises on a number of items related to accountability and audit, namely, establishment of clear system of rewards and penalties, observance of risk assessment, periodic evaluation of the assessed risks, and coordination between internal and external audit function, these were the processes interacting in the dynamic management of SMEs.

As pointed out earlier that a mixture of governance and management functions had a threat of self review. The board cannot be objective in a review of its strategies created and implemented unless the board is an independent from the implementation. For instance, the periodic evaluation of the assessed risks and the process of risk assessment have no check and balance if the one who assessed was the same who evaluated. In the same manner, setting up a system of rewards and penalties for all officers and employees had a threat of self review because it was applied to the board members who were active managers themselves.

However, there were significant differences between the small and medium enterprises on the extent of coverage in the external audit, and the function of internal audit. Secondary data disclosed that SMEs under study complied with the minimum standards set out in the Philippine Financial Reporting Standards. External auditors coordinated with the internal auditors in the areas of actual periodic inventory taking.

The study found that SMEs entrusted their operational audit with the internal auditors who became part of the operational implementation. Further, the SMEs practiced pre-auditing done by internal auditor(s). In addition, some internal audit heads reported to the head of an accounting department. Internal auditors acting as part of the recording phase of accounting violates the new definition of internal auditing.

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve the effectiveness of risk management, control, and governance processes (IIA, 2008). Internal audit standards state for a limited advisory role of internal auditors (ibid) in order to provide value and maintain their independence in mind and appearance. In turn, an internal auditor should be hired and compensated by and report to an audit committee within the board (Lipman & Lipman, 2006) but administratively report to the president (IIA, 2008).

4. Stockholders' Rights and Protection of Minority Stockholders

Stockholders' rights and protection of minority stockholders' interests include voting right, pre-emptive right, power of inspection, right to information, right to dividends, and appraisal right as stated in the Code. Only if stockholders have clearly defined these enforceable rights can they impose financial and economic discipline on corporate insiders (Nabi & Luthria, 2002).

There were significant differences between the small and medium enterprises on all items related to stockholders' rights and protection of minority stockholders, namely, board demanded a deep sense of responsibility for efficiency and cost effectiveness by serving the needs of its stakeholders; ensured to listen to all responsible parties with a point of view on issues to be resolved; and tried to be fair to all parties including minority stockholders of SMEs.

5. Evaluation Systems

There was significant difference between small and medium enterprises on evaluation system of budget as guide to operations. Budget is a quantitative account management's plans and its distribution of scarce resources over a specified future time period (Schneider & Sollenberger, 2009; Wygant, Kimwel & Keiso, 2008). Budgeting is employed as a planning and controlling tool. Plans are translated into action efficiently through budgeting. Subsequently, an approved budget appropriately serves as the reference for evaluating performance of SMEs.

However, there were no significant differences between small and medium enterprises on items related to evaluation systems, namely, the periodic check on operational measures, the use of financial measures, and the evaluation of board performance. Management evaluated each functional area of operations such as marketing, finance, production, and human resources. These functional evaluations are collated into an overall report. Periodic check on operational measures rests with the internal auditors and implementation of recommendation thereafter will be the responsibility of the concerned department or division (IIA, 2008).

It was pointed out earlier that majority of the active boards were also active managers, thereby, neither counter checking nor evaluation system is practicable.

6. Disclosure and Transparency

The general purpose financial statements (FSs) are to be disclosed to the company's board, statutory stakeholders, auditors, as well as to any interest groups to whom such information is deemed relevant in light of accountability and audit. These financial statements reflect the general interests of stakeholders who are not in the position to tailor them, namely, employees, creditors, suppliers, government, donors, and owners/members.

Transparency and disclosure are fundamental to responsible decision making by companies which rest on reliable accounting standards and auditing practices (Nabi & Luthria, 2002) and proper interpretation of FS (Greening & Koen, 2001). Companies that were transparent and professionals were considered as best managed (Bustos & Roman, 2004) while worst companies were those with poor credibility, speculative, huge debts, secretive, and had no long term strategy.

There was significant difference between the small and medium enterprises on the set-up of an adequate accounting system. All small and medium enterprises were required financial reporting on statement of financial position, income statement, statement of cash flows, and the notes to financial statements. Moreover, medium enterprises were required to report other accounts related to compliance with the generally accepted accounting standards, and information related to the system of internal control established (Hall, 2004).

However, there was no significant difference between the small and medium enterprises on compliance with transparency requirement of financial statements. Full disclosure of financial statements provides users of financial data relevant and timely information for proper interpretation (Grenning & Koen, 2001).

The SMEs under study (43%), representing thirty out of sixty-nine SMEs which were CFIF-SEC registered members, filed annual report and complied with the minimum Philippine Financial Reporting Standards provided in Philippine Accounting Standard No. 1 (Presentation of Financial Statements) revised in 2003 as a disclosure and a transparency guide as of December 31, 2007. These minimum requirements included the statement of financial position where assets, liabilities, and equity were presented; income statement where revenue, costs and expenses were presented; and cash flows statement where movement of cash were presented; and notes thereof. The Philippines was aligned with International Financial Reporting Standards (IFRS) and the International Auditing Standards (IAS).

7. Commitment to Corporate Governance

Commitment to corporate governance is demonstrated when a corporation evolved in transparency, fairness, and accountability. Meyer (2004) illustrates that corporate structures are seen as well designed if they coordinate in every aspect of an organization. Its people, equipment, and money work in concert toward the strategic objectives of the firm where behaviors are ethical and productive, costs are controlled, investments are judicious, and everybody's efforts are well aligned.

There were no significant differences between the small and medium enterprises on the provision of the requirements of corporate governance and the top management's commitment to corporate governance. Institute for Solidarity in Asia (ISA) and World Bank Institute (WBI) advocated the observance of the fundamental principles of fairness, transparency, and accountability. The board, being independent, set the tone for self enterprise discipline for corporate governance. The duty of an independent board is to protect the stockholders in normal business climate, which, in difficult financial times will shift to protect creditors (Lipman & Lipman, 2006). However, based on non-independence of the board of most SMEs under study, creditors cannot be protected. Yet, there were significant differences between small and medium enterprises on the commitment to corporate governance of middle, operational, and rank and file employees.

The gaps identified in the study were no independent board, no formalized written code of conduct, use pre-audit, and SMEs under study depended 78% of their resources from creditors.

Conclusion

In conclusion, the perception on corporate governance of SMEs highly complied with the Code of Corporate Governance. However, practices on corporate governance disclosed gaps such as no independent board, no formalized written code of conduct, pre-audit task of internal auditor, and high debt ratio.

Code emphasis on board governance, supply of information, accountability and audit, stockholders' rights and protection of minority stockholders, evaluation systems, disclosure and transparency, and commitment to corporate governance differ significantly between small and medium enterprises. Setting-up corporate governance structure should consider the size of assets of the furniture enterprises as well as the costs and benefits.

Furthermore, the assumed theory that the size and company specifics and corporate governance practices was concluded to influence compliance with the Code of corporate governance.

Recommendations

In view of the above findings and subsequent conclusions, the following recommendations are offered to help SMEs champion corporate governance.

A Corporate Governance Code for SMEs must be developed. Although, the recommendation is not to regulate the SMEs' Corporate Governance like the public, banking, and insurance companies (Villanueva, 2009) but to guide them such as the Securities and Exchange Commission, in coordination with industry associations, shall initiate orientation requirement of new board and continuing education of current board and coordinate with the Commission on Higher Education to dissemination the corporate governance as a topic in all business-related courses and as an elective to non-business courses.

Being family and private businesses, Metro Cebu SMEs can benefit the presence of independent directors to promote good corporate governance. An independent board oversees the strategic management of the SMEs; with institution of various committees within the board such as compensation committee to consider the pay package of the management team, audit committee to oversee the operational and financial reporting, nomination committee to consider admission requirement of board members. In addition, an establishment of a dispute resolution mechanism shall be effective automatically once the founder dies or retires (Lipman, & Lipman, 2006). The daily activities of managing the furniture industry player should be assigned to hired professional managers and or stockholders who are non-Board members.

Re-orientation of the International Standards of Internal auditing which states that Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve the effectiveness of risk management, control, and governance processes (IIA, 2008).

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