The Canadian Chamber of Commerce of the Philippines

La Chambre de Commerce Canadienne des Philippines

Corporate Governance

in Family Businesses

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The Philippine Governance Model

Predominance of:

- **Family owned or controlled corporations (FAMCORS)**
- **Closely-held corporations**

FAMILY BUSINESSES are the…

- Backbone of Philippine commercial society,
- Engine of economic development, and
- Provider of employment to majority of the population.

GENERATION of FAMILY BUSINESS MODEL

	SAMPLE	
	1 (One man show)	2 (One family Show)
Parents	1st Gen.	1st Gen.
Children*	2nd Gen.	1st Gen.
Grandchildren*	3rd Gen.	2nd Gen.
Great Grandchildren*	3rd Gen.	3rd Gen.

***In exceptional cases, extended-family members, including in-laws and loyal non-members are included (Quasi-family members).**

Many FAMILY BUSINESSES are now at the crossroad because…

- Many patriarchs and matriarchs are aging,
- Heirs are either restless or not interested in the business at all,
- Succession plans are either inexistent, vague, done too late, or not at all discussed in the family, and
- There is no easy transition of business to the next generation.

The 3rd Generation Phenomenon

Famous sayings:

"From rags to riches to ruins."

"First generation creates, second generation inherits and preserves, and third generation squanders."

Can your FAMILY BUSINESS survive the 3rd generation phenomenon?

PRESENTATION COVERAGE

1. Overview of Corporate Governance
2. Types of FAMCOR boards
3. Board functions
4. Strategies to improve board effectiveness
5. What is a family business or corporation?
6. FAMCOR issues and concerns
7. Challenges moving forward
8. F.A.T. Principles of corporate governance
9. Concluding themes

Why should owners and heirs of family businesses learn more about Corporate Governance?

- Protect the company against negative impact of global competition. Global competition is unavoidable and no company is totally immune from its onslaught. Thus, many companies, even profitable ones, could close down. **BOOM** companies of today may translate to **BUST** companies of tomorrow. Success today is not a guarantee of success tomorrow.
- Appreciate the value of financial reporting as an indispensable part of corporate governance. Without proper financial reporting, owners, directors, and management have no way to base their decisions. Transition to the next generation will become murky and tortuous.
- Corporate governance is not all about profit maximization. It is also about risk minimization, effective asset utilization, and INCREASE IN SHAREHOLDERS' VALUE.
- Prepare for the 2015 ASEAN INTEGRATION.

Why should owners and heirs of family businesses learn more about Corporate Governance? …. Cont'd

- Check the adverse effects of surging fraud and other business irregularities. Fraud and irregularities result in poor profitability performance
- Appreciate the value of separate accountability for business and personal affairs.
- Many family businesses are at their crossroads.
- Many heirs are getting restless
- Good governance is the key to business survival and smooth transition of business to the next generation.

What is CORPORATE GOVERNANCE?

Corporate Governance

in its simplest definition…

is the system by which organizations are directed and controlled… *for the best interest of shareholders and other stakeholders.*

Rule of Thumb

Shareholders entrust;

Board of Directors sets rules;

Management implements.

Mgt-hired CPAs provide financial guidance to BOD and top mgt.

Internal auditors set up internal control systems

Ind. CPAs audit Financial Statements.

FINANCIAL REPORTING, AUDITING, and CORPORATE GOVERNANCE

General Assertions:

- Accounting is the language of business.
- Financial reporting is the backbone of commercial society and the main pillar of corporate governance.
- Thus, without fair, accurate, and timely financial reporting, good corporate governance system will not prosper.
- All corporate governance players depend on timely and accurate financial reports in making informed decisions.
- The areas of accounting, *auditing*, and financial reporting are the domain of CPAs.
- *Therefore,* ***responsible financial reporting*** *is indispensable in corporate governance.*

Financial Reporting Responsibilities

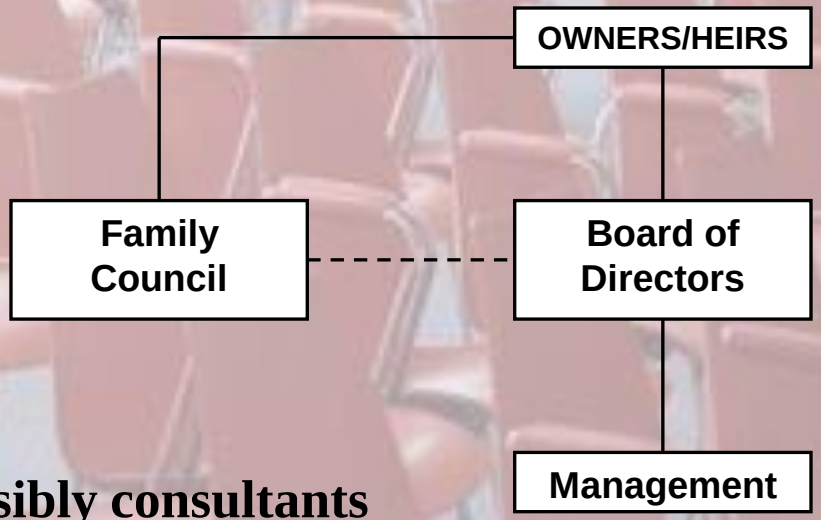
- Board of Directors have primary responsibility for the preparation of the financial statements.
- Management-hired accountants prepare the financial statements. Internal audit department serves as the eyes and ears of the BOD Audit Committee.
- Internal Audit sets up and evaluates internal control system.
- *Independent CPAs express opinion on the financial statements prepared by Management.*
- Audit Committee reviews Audited FSs for submission to and approval by the BOD.
- Independent CPAs audit company books and records and issue audit report on company financial statements.

In the Philippine context, dominated by FamCORs, are boards of directors really necessary?

Typical FAMCOR Boards:

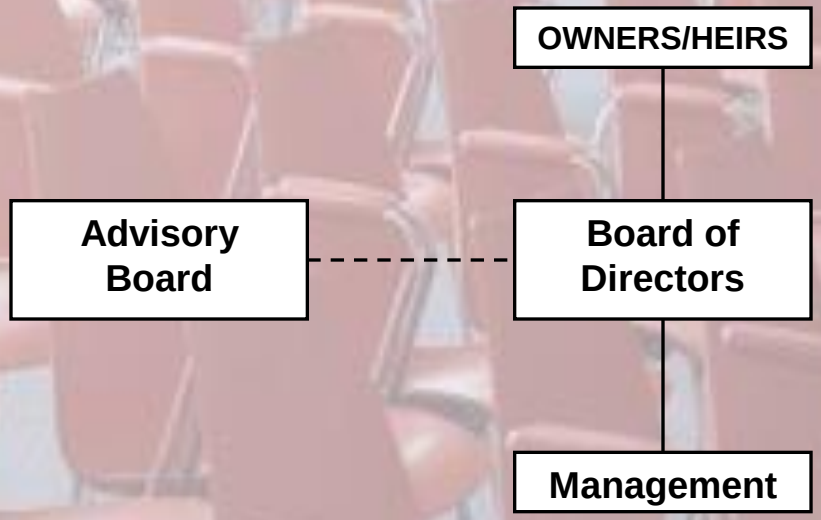
1. Family Council
2. Advisory
3. Statutory
4. Strategic

Family Council



- **Informal, i.e. no legal personality**
- **Attendance – owners, heirs, and possibly consultants**
- ***Direct role in family business?***
- **Backed up by a Family Constitution**
- **Examples of matters taken up during meetings:**
  - ***Succession***
  - ***Family issues and conflicts***
  - ***Management of transition***
  - ***Selection of representation to the board of directors***
  - ***Defining roles and responsibilities of family members in the business***

Advisory Board



- **No fiduciary responsibility**
- **No legal accountability**
- **Minimal or no legal exposure for members**

***Duties and responsibilities*:**

- Sounding board on critical and significant issues,

- Provide valuable strategic-level advice and support to the BOD, and

- Accept any other assignments and projects as may be requested and delegated by the BOD

Statutory Board

- Fiduciary responsibilities
- Legal accountability to shareholders
- Legal exposures for board and individual directors

Strategic Board

- **Is a statutory board filled with the right mix of directors with experience in various fields of profession and business, united and working towards common and shared company objectives and goals.**

- **Has a proper balance of executive and non-executive directors, including independent directors.**

- **Also called *MANAGEMENT BOARD* or *WORKING BOARD***

Functions of the Board

Outward Looking	**Accountability** • report to shareholders • ensure legislative/ regulatory compliance • review audit reports	**Strategy Formulation** • Initiate/review strategic planning • set corporate direction • determine strategy
	Conformance Roles	**Appoint CEO** / **Performance Roles**
Inward Looking	**Monitoring and Supervision** • Executive performance • review results • monitor budgets • instigate and check corrective actions	**Policy Making** • Approve budgets • determine compensation policy for senior executives • decide corporate policy • create corporate culture

Past & present **Future**

Adopted from Tricker, RI: International Corporate Governance (1994) p. 149

Owner/Chairman and CEO

- Is prevalent in Philippine context.
- Effectively controls the corporation.
- Can veto board-level decisions.
- Chooses and appoints his own directors and members of his top management team.
- Can choose not to be transparent, etc.

Separate Chairman of the Board

- Most important person in the board.
- Provides independent, professional leadership.
- Sets the meeting agenda and manages board meetings.
- Liaison between the owners, family members, board and management.
- Enhanced image for the corporation.
- Enforcer of governance rules.

Members of the Board

- Executive directors
- Non-executive directors
- Independent directors

What is an effective Board?

- Led by an independent chairman, *if possible*
- ideal board structure
- Ideal board composition.
- Working board committees.
- Able, competent, financially literate members.
- Regular meetings with free exchange of ideas.
- Well-planned meeting agenda.

i.e. <u>A strategic board.</u>

BOARD OF DIRECTORS CONTINUUM

Degree of Involvement	Work Done	
High	Catalyst	Takes the leading role in establishing and modifying the mission, objectives, strategy, and policies. Has a very active strategy committee.
	Active Participation	Approves, questions, and makes final decisions on mission, strategy, policies, and objectives. Has active board committees. Performance, fiscal, and management audits.
	Nominal Participation	Involved to a limited degree in the performance or review of selected key decisions, indicator, or programs of management.
	Minimal Review	Formally reviews selected issues that management brings to its attention
	Rubber Stamp	Permits management to make all decisions. Approves all recommendations that management brings to the board.
Low	Phantom	Never knows what to do, if anything. No involvement at all.

What is a Family Business?

A Family Business is one where:

- Ownership and management are concentrated within a family unit, or

- Equity ownership of over 50% is held by a single family and the overall management is vested in the same family.

Profile: Owners/Founders/Patriarchs of a Typical Family Business

- **Put family needs above all.**
- **Create positions for family members in the business.**
- **Anoint successors.**
- **Believe that success means working hard till wee hours in the morning and being involved in every business detail and day-to-day operations.**
- **Believe that succession is important but not immediate.**
- **Run the business till death or incapacity.**
- **Have the complete loyalty of family members.**

Attributes of a Typical Family Business

- **Business is connected to the family. The family is the foundation of the business enterprise.**
- **Business success or failure reflects the glory or disgrace of the family.**
- **Profound loyalty to the hierarchical structure of authority.**
- **Trust given to relatives and close friends.**
- **Dominant aspirations of patriarchs: to preserve family wealth and ensure that business is passed on to the next generation.**

Attributes of a Typical Family Business …cont

- **No clear separation of family wealth and business resources.**
- **Protect financial data about company and family.**
- **Senior managers recruited from within immediate family.**
- **First priority long-term view: family prestige.**
- **Strong finance function not a priority. Many family members are not financially literate.**

Perceptions of a Family Business

- Non-transparency in their net-worth/resources and profitability.
- Keeping few sets of books of accounts.
- Non-payment of correct amount of taxes.
- Tendency to expropriate business resources for family needs.
- Non-disclosure of related party transactions and conflicts of interest.
- Manipulation of the board, board committees, or management by dominant owners.
- Neglect of corporate responsibility and accountability.

Typical FAMCOR Survival Notions*

- Thriftiness guarantees survival.
- Hard work to the point of exhaustion is very important to ward off many hazards present in an unpredictable world.
- The only people you can trust are family.
- The judgment of an incompetent relative in a family is more reliable than that of a competent stranger.
- Obedience to the patriarchal authority is essential to maintaining coherence and direction in the business.
- Decision to invest is not based on abstract principles, i.e. NPV (Net Present Value)
- Tangible assets like real estate or gold are preferred investments over intangibles.

*Kao, 1993 – Lifted from a book, Family Corporations in Transition, AIM

Issues That Could Compromise Corporate Governance Initiatives in FAMCORs

- Too many family members or insiders in the board and top management
- High turnover of key personnel
- Absence of outside and/or independent directors
- Lack of related background, skills and experience of family members
- Rubber stamp board. Passive board. Few board meetings, or not at all. No AGMs, or hardly any
- Extended family influence
- Power struggle, cliques and strife in the family or clan
- Owner's belief that in the Philippines, no directors have so far landed in jail, *board seats are for status symbol only*.
- Financial, tax and other legal non-compliance

Principal Causes of Collapse of FAMCORs

- Failure to adapt organizational structure to changing times.
- Hesitation by owners to transfer leadership to next generation or professional managers.
- Lack of understanding of the different roles of owners, board of directors and top management.
- Unknowingly expropriating the company's assets.
- Unknowingly bloating the company's liabilities.
- Not knowing when to stop asset acquisition spree.
- Inability to separate business assets from family assets.
- A weak finance function.
- Managing the business from the "ivory tower".
- Lack of professionalism in the organization.
- Poor governance practices.

TYPICAL FAMCOR

- One man/one family show.
- Dominant purpose: serve family interest.
- Protect financial data about company and family
- Business not for sale- due to obligations to extended families.
- Senior managers recruited from within immediate family, often by the family patriarch or matriarch.
- First priority long-term view: family prestige.
- Financing of company by family and other friendly families.
- Weak finance function.

IMPROVED FAMCOR

- Same. However, sent immediate family members to train abroad, take up MBA courses, etc.
- Maximized shareholders wealth.
- Required audits of financial reports and other company data.
- Ok to dilute ownership, sold part of business, mergers.
- Hired professional managers; reward based on merit, cash + stock options.
- Stressed on profitability; increased in business value.
- Availed outside financing alternatives.
- Strengthen finance function by hiring professional accountants in board and senior management position.

What's Next?

Where do we go from here?

Summary:

3 Critical Stages in Transition

1. Professionalization
2. Governance
3. Succession

Challenges to Patriarchs and Matriarchs

To ensure increase in shareholders' wealth and smooth transition to the next generation:

- Professionalize top management.
- Improve and strengthen financial reporting structure.
- Have a strategic board. Segregate oversight function from managerial function. Create board committees.
- Strictly adhere to good corporate governance practices (F.A.T. Principles). Adapt own manual of corporate governance.
- Set up a family constitution.
- Organize family council.
- Hire consultants if necessary.

Good Corporate Governance is about promoting in the organization the following:

Fairness

Accountability

Transparency

FAIRNESS

There is ***fairness*** when –

- **Individual family members willingly submit themselves to continuing education to ensure their effective participation in board activities.**
- **A director or a family member sincerely considers resigning whenever he is unable to do his part, for whatever reasons, or whenever his contributions become marginal, or whenever he has continuing conflict of interest of a material nature.**
- **The directors (including family members) see to it that the board does not serve as a mere rubber stamp to formalize decisions made by owners and top management.**
- **The individual directors abstain from voting on matters involving conflict of interest of which he is a party.**
- **The board and individual directors never compromise their company's reputation; when their loyalty is to the entire organization and not to any specific shareholder group**

ACCOUNTABILITY

As the saying goes, the board can delegate its authority over the affairs of the corporation, but not its accountability. It is accountable for all actions and decisions made by their organization.

Accountability is achieved by –

- **Creating a strategic, working board, with the proper mix of directors with related broad experience.**
- **Setting up continuing assessment and performance evaluation for the board, individual directors, and senior management.**
- **Making sure its corporate governance system is up to par with global best practices.**

TRANSPARENCY

There is ***transparency*** when -

- **The company complies with relevant laws and regulations.**
- **The financial statements are prepared in accordance with international accounting standards.**
- **The owners and the board willingly presents to the stakeholders a balanced and understandable assessment of the company's financial position and profit, performance, i.e., beyond limits imposed by laws and regulation.**
- **And finally, there is transparency when the owners and the board willingly formulates policies to open channels of communication with minority shareholders and other stakeholders so that they can freely air their concerns and other views.**

Concluding Themes

There is no easy transition of family business to the next generation.

A strategic board gives a competitive edge to and enhances the VALUE and SUSTAINABILITY of a family corporation.

Corporate governance is increasingly recognized as a key critical factor to a successful transition.

Family councils and Family constitutions are also becoming important ingredients in successful transitions of FAMCORs to the next generation.

The time to plan for succession is NOW!

End of this Presentation.

Thank you!