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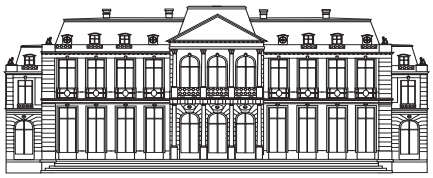

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"CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE"

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PHILIPPINE CORPORATE GOVERNANCE ENVIRONMENT AND POLICY AND THEIR IMPACT ON CORPORATE PERFORMANCE

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I. INTRODUCTION[1]

The Philippine corporate sector has become the focus of government's efforts to cope with the Asian crisis and get back on track toward sustainable economic development. This came about after the Philippines underwent a political and economic upheaval in the 1980s, a full decade ahead of the current Asian crisis. During that period, the Philippine corporate sector dealt with issues like the state ownership of business, "crony capitalism" and state-sanctioned monopolies and subsidies to business. With a change in government in 1986, the country resolved to let government set the rules and private sector to conduct business. Part of the adjustments was a settlement of losses from "crony capitalism" and the failure of public corporations under the previous government. The unilateral debt moratorium declared by the government in the early 1980s lasted up to 1991. Only at about that time did the financial sector get back on solid footing and the private sector began to access the foreign debt markets to finance its investments and restructuring for growth.

The corporate sector and the government emerged from the country's crisis in 1991 clearly stronger because of valuable lessons learned on managing under crisis and on prudent investing and financing. The country later exerted efforts to join the rest of the Asian countries on its "Asian Economic Miracle" but did so in small, measured steps. When the Asian crisis came in 1997, the government was in an advantageous fiscal position, the financial system was strong and the corporate sector had accumulated internal funds from three years of robust profits. More importantly, the Asian crisis did not catch the corporate sector investing, and financing it by debt, into a recession. The Asian financial crisis revealed that the Philippine non-financial corporate sector has been a relatively efficient user of funds of Philippine savers although there were indications of over-expansion using leverage a few years before the Asian crisis in 1997.

While the sector avoided the full impact of the Asian financial crisis, the corporate sector still needs to address structural weaknesses that constrained its growth in the past. A number of these key structural weaknesses are identified in this Study. The large shareholder, family-based ownership of corporate groups results in a governance structure that depends entirely on internal control systems. It has led to investment and financing policies that are based on a trading-on-equity, a strategy that makes the corporate sector vulnerable to deep economic shocks as already evident in a steep decline in its 1997 performance. Another structural weakness concerns the significant presence in the corporate sector of affiliated groups that include large commercial banks. Banks represent an important external control agent for large shareholders-based corporate governance systems. Common ownership of banks and non-financial companies in affiliated groups weakens the role of banks as external control agents because they become part of corporate groups and may be smaller than the groups of companies that they serve.

This Study reviews the historical development of the corporate sector in the Philippines, examines its performance, investment and financing structures and examines the sector's corporate governance framework and key regulations. The Study conducts an empirical assessment of the financial structure and performance of the corporate sector in the period 1988 to 1997. Using data

[1] This Study used data and results of analysis of a previous Study conducted by the author for the Asian Development Bank, RETA 5802: *A Study of Corporate Governance and Financing in Selected Developing Member Countries.*

from the SEC-*Business World* annual survey of the largest 1,000 Philippine corporations and the databank of the Philippine Stock Exchange (PSE), this Study analyzes the financial performance and structures of companies in relation to their ownership corporations and their accessibility to capital market investors. The Study identifies and analyzes large corporate groups, estimates their significance relative to the entire corporate sector and assesses their influence on the corporate sector's financing structure and investment performance. Based on the results of these analyzes, the Study recommends reforms in corporate governance.

This paper presents the results of the Study in three sections. Part II covers the corporate governance environment in the Philippines and its impact on corporate performance and finance. Containing the main findings of the Study, this part is divided in three subsections. Section A of Part II reviews the general economic context of the country, the impact of the Asian financial crisis on the corporate sector and the responses of government and the corporate sector to the crisis. Section B profiles the attributes of Philippine corporate governance and their relevance to the financial crisis. It reviews the historical development of the corporate sector and the patterns and composition of Philippine corporate ownership. Section C analyzes the financial performance of the corporate sector in relation to corporate ownership and governance variables. Part III reports on the Philippine regulatory framework and policy as a limiting factor for corporate governance. Section A of Part III reviews the scope of shareholder rights in law and in practice while Section B is a parallel review of the role of the board of directors. Part IV presents the key conclusions and recommends reforms to improve the governance structure of the Philippine corporate sector.

II. A PROFILE OF CORPORATE GOVERNANCE ENVIRONMENT AND POLICY AND THEIR IMPACT ON CORPORATE PERFORMANCE AND FINANCE

A. THE GENERAL ECONOMIC CONTEXT

The Philippine economy lagged behind the "tiger economies" in Southeast Asia because it faced a major political and economic crisis in the 1980s. The economy achieved a turning point after the turnover of government from the strongman rule of President Marcos to traditional democratic institutions under President Aquino. Economic recovery accelerated after the Middle East crisis in 1990 to 1991. Real GDP grew by an average of 4.5 percent per year from 1992 to 1997 with the highest real GDP growth of 5.9 percent achieved in 1996. Real GDP growth rates during the five-year period were considerably lower than those of Thailand, Malaysia, Indonesia and Korea. Figure 1 shows comparative GDP growth rate performance over 1990 to 1998 of the Philippines relative to these countries.

The largest component of GDP was the services sector with about 43 percent share and growing at 5.3 percent per year from 1993 to 1997. The industrial and agriculture sectors contributed about 34 percent and 21 percent of GDP in 1997 with annual growth rates of 4.7 percent and 2.6 percent, respectively. Exports had been growing at about 20 percent per year from 1995 to 1997. Manufactured products accounted for 80 to 85 percent of exports and grew at about 25 percent per year during the period. Commodities exports accounted for the balance of 15 to 20 percent of exports and grew at a much slower rate of 2 percent per year. In 1997, semiconductors accounted for about

52 percent of manufactured exports with growth rate of about 33 percent per year. The second largest export, garments, accounted for about nine percent of manufactured exports but had been declining by four percent per year from 1995 to 1997. In sum, 60 percent of manufactured exports were in two products, one of which was clearly declining in international competitiveness. Most commercial, industrial and service activities in the economy are oriented to the domestic market.

About 80 percent of the country's imports were capital goods and raw materials and intermediate goods. The largest imports, power generating and telecommunications equipment grew at an annual rate of 30 percent from 1995 to 1997. Average deficit in net trade in goods and services was about 5.7 percent in the same three-year period. Net investment flows were growing by an average of about 48 percent per year from 1992 to 1996, to about $3.5 billion in 1996. Gross new foreign investments grew from $0.74 billion in 1992 to $3.6 billion in 1996, or a rate of 40 percent per year. Foreign investment flows were much lower than comparable Asian countries but they gathered momentum in the years preceding the Asian crisis in 1997. The growth in foreign investments appeared to have fueled the high growth of the manufacturing and services sectors during the years prior to the Asian crisis.

It seems that the Asian crisis visited the Philippines only through "contagion" because the Philippines was not heavily dependent on foreign capital flows and its corporate sector was focused on domestic markets. For these reasons, the effects of the Crisis were relatively mild. The Bangko Sentral ng Pilipinas (or BSP, the Philippine Central Bank) initially responded to the crisis by selling foreign exchange and increasing the key overnight interest rates. On July 11, 1997, it allowed a relatively moderate depreciation of the peso compared to other Asian countries, from P27.67 in July 1997 to P35.13 to the U.S. dollar in December 1997. After the devaluation of the local currency, relatively mild government measures turned out to be sufficient to stabilize the economy. The crisis came at a time when the government was in surplus fiscal position with the highest surplus of $6.3 billion (0.3 percent of GNP) achieved in 1996. Even on the crisis year 1997, the government still had a budget surplus of $1.6 billion. A 7.8 percent drop in net foreign investments marked the height of the Asian crisis' impact. The economy sustained the effect because net capital outflows amounted to only $200 million a month at their highest levels in May and June 1997. By August 1998, net foreign investments were still below 1997 levels. By August 1998, the economy generated a surplus with a 20 percent increase in exports and a 15 percent decrease in imports compared to 1997. In 1998, the Philippines was the only country in its group that had avoided an economic recession. It expects to show a GNP growth rate of 2.5 percent in 1999.

The longer-term impact of the Asian crisis on the financial system and corporate sector is evident in interest rates, bank lending rates, loan demand, non-performing loans and new investments. Bellwether government Treasury bill rates were between 11 to 13 percent from 1993 to July 1997. These rates rose to a high of 22.7 percent in January 1998, sparking a rise in interest rates on corporate loans. Average bank lending rates increased to the highest range of 25.2 to 28.2 percent in November 1997. Lending rates ranged beyond 20 percent during the height of the Asian crisis, from July 1997 to March 1998. Figure 2 shows Treasury bill rates and bank lending rates before and after the start of the Asian crisis.

The combined effect of shrinking demand and high interest rates reduced the demand for corporate loans. Loans outstanding of commercial banks started decreasing by the first quarter of 1998, in varying degrees depending on industry sector. In October 1998, the top three borrower industry sectors had reduced their credit exposures. Compared to 1997 levels, manufacturing reduced its loan outstanding by 11 percent, wholesale and retail trade sector by 12 percent and real

estate remained at the same levels. Figure 3 shows the loan outstanding of commercial banks with the three largest borrower sectors the year before and after the start of the Asian crisis.

Loan loss provisions and non-performing loans (NPL) increased to a high of 11.5 percent by September 1998. It should be noted, however, that Philippine banking has gone through a worse crisis in the past, one that ended only in 1988. Figure 4 shows that the low, single-digit NPL ratio prevailed only in 1994-96 and the NPL effects of the crisis (thus far) are less severe compared to the country's last major banking crisis in the mid-1980s. Net capital increases by businesses reached a peak of P145.7 billion pesos in 1995 and abruptly declined to P121.7 in 1997 or by 8.4 percent per year. Some 82 percent of capital increases in 1995 came from the real estate sector. Capital increases in the real estate sector went down by about 20 percent from 1995 to 1997.

The government policy responded to the crisis by managing the monetary system to control inflation, ensuring a market-oriented foreign exchange system, building up a fiscal position and strengthening the banking system. The country's policy and regulatory responses to the Asian financial crisis focused on monetary and credit systems, fiscal position, and the financial system. BSP rationalized foreign exchange trading to control speculative activities. It acted to control non-deliverable forward contracts, monitored the foreign exchange positions of banks, regulated banks and their subsidiaries on a consolidated basis and introduced a hedging facility for borrowers with foreign currency-denominated loans. BSP managed the system's liquidity by adjusting key interest rates, liquidity reserve requirements and the statutory reserve ratio for banks. BSP aimed to control inflation and to bring down domestic interest rates. After reducing bank reserve requirements, BSP got the banks to reduce their lending spreads from three to eight percent over the 91-day Treasury bill rates to 1.5 to six percent. Finally, BSP actively regulated problem loans levels by prescribing a limit on banks' loans to the real estate sector, reducing the period for classifying unpaid loans as past due loans, requiring fixed loan loss provisions based on gross amount of portfolio, increasing bank capital requirement by 20 percent for universal bank (40 percent for ordinary commercial banks) and improving the disclosure requirements on the financial position of banks.

The policy directions and measures taken by government appeared to have effected a recovery of the economy from the crisis. The country avoided a recession in 1998 attaining a barely positive GNP growth in 1998 and expects a 2.5 percent growth in 1999. With prudent monetary management and favorable fiscal position, the government expects to control inflation to a level below 10 percent. Average T-bill rates have come down since mid-1998. Responding to measures to reduce bank intermediation costs, bank lending rates have also come down (see Figure 2). NPL levels are stabilizing and improving because of the decline in lending rates (see Figure 4). Banks' real estate portfolios are declining and remain well below BSP's regulatory ceiling.

B. CORPORATE GOVERNANCE CHARACTERISTICS IN THE PHILIPPINES: RELEVANCE TO THE FINANCIAL CRISIS

1. Historical Development and Overview of the Corporate Sector

The Philippine corporate sector contributes a significant part of the country's economic activity. While there is a greater number of small and medium-scale businesses, the larger companies account for a large proportion of business activities in each industry. There is a high degree of concentration in most Philippine industries. From 1946 to the early 1980's the government adopted policies of protecting domestic industries from foreign competition. It

set up high barriers to entry and assured the continued survival of inefficient businesses. During that period the banking sector was itself tied to the same protectionism policies that hampered its own growth. The financial system was not competitive because of restrictions on entry of foreign banks, licensing of new banks and branching by local banks. Government gradually reformed trade and financial sector policies beginning in the early 1980's. The political crisis from 1983 to 1986 delayed economic growth and reforms. A change of government in 1986 and the transition to an elected government under President Fidel Ramos assured continuity of the process of economic reforms. The government of President Ramos relied on the corporate sector to implement market-based reforms and liberalization of trade and investments as basis for its industrial development policy. The Ramos Government gauged the success of its economic policies from the corporate sector's performance and responses to its policies, ushering the beginning of closer relationship between government and the corporate sector on policy matters.

a) Size of the Corporate Sector

The corporate sector contributes to the growth and stability of the Philippine economy. The GNP of the Philippines in 1997 was about P934 billion in constant 1995 prices and grew at a compound annual rate of 4.5 percent per year. The Study used the *Business World* and the Securities and Exchange Commission list of the largest 1,000 corporations of the Philippines as proxy for the corporate sector. Table 1 lists the number of companies and gross sales of the corporate sector by industry sector. Gross sales of the corporate sector amounted to about P1.64 trillion. Assuming that companies generated about 50 percent of its revenues in value-added, the corporate sector contributed about 42 percent of 1995 GNP. The corporate sector contributes a significant proportion of the country's economic activities. In 1997, the main industry sectors in terms of share in total revenues were manufacturing (46.7 percent), financial services (20 percent) and trading (14.4 percent). Interestingly, industry sectors that figured in the 1997 crisis like the utilities, real estate and construction sectors were not among the top three most important subsectors in terms of contribution to corporate sector revenues.

B) MULTINATIONALS AND PUBLIC COMPANIES IN THE CORPORATE SECTOR

Multinational companies and publicly listed companies contribute to the stability and growth of the corporate sector. Multinational companies operate with established technologies and practice internationally-proven governance systems. These advantages underlie their sustained growth and dynamic positions in their industries. Publicly listed companies have proven track records and management competence. These companies have better access to financing sources than privately owned local companies. Public companies are subject to rules and regulations that promote transparency and protection for investors.

Multinational companies have a significant presence in the Philippine corporate sector. Table 2 presents the number and gross sales of multinational companies in the

corporate sector from 1986 to 1997. The number of companies increased from 233 companies in 1986 to 272 in 1997, or by only 1.4 percent per year. Sales grew from about P297 billion in 1986 to about P807 billion in 1997, or a growth rate of 9.5 percent per year. Before the crisis, gross sales of multinational companies were even higher at P1,072 billion with an average growth rate of 43.4 percent per year for the period 1990-95. In 1997, multinational companies accounted for about 27 percent of the number and about 33.5 percent of the gross sales of the corporate sector.

Table 3 presents the number and gross sales of publicly listed companies in the corporate sector. Publicly listed companies increased from 68 companies to 97 companies from 1986 to 1997 or a growth rate of 3.3 percent per year. Publicly listed companies are not necessarily large companies. Among the 219 companies listed in the stock exchange as of yearend 1998, only 97 had sales revenues that allowed them to join to the list of the largest 1,000 corporations. In fact, the share of publicly listed companies in the gross sales of the corporate sector for 1997 amounted to only 21.6 percent. Considering that the largest private corporations and privatized government corporations are publicly listed, the small share of publicly listed companies among the corporate sector's revenues is surprising. Multinational companies have a more significant presence in the corporate sector than publicly listed companies. However, publicly listed companies larger, with average annual gross sales of about P5.36 billion per company while multi-nationals averaged about P3.0 billion in annual sales per company. Together, multinational companies and publicly-traded companies accounted for about 55 percent of sales in 1997 although they accounted for only 37 percent of the number in the top 1,000 companies. This suggests a high concentration of corporate activities among these two groups.

2. The Corporate Governance Agents

a) Historical Review of Patterns Of Philippine Corporate Ownership

Three historical factors shaped Philippine corporate ownership, namely, the country's colonial past, the changing industrialization policies of the government and the emergence of industrialists from a growing middle class. During the Spanish and American period of the country's history, a number of families owned land and large businesses. These families built and preserved their businesses over several generations under the leadership of patriarchs who ran their businesses as an "extended family."[2] During the early decades of the country as an independent nation, the government adopted import-substitution policies to develop industries and trade. Government gave local investors preferential treatment and imposed quantitative restrictions and high tariffs imported products that compete with locally produced goods. Government granted incentives to "infant" industries. Government subsidized credit to companies in industries considered by government as priority development areas. An unintended result of these government policies was the creation of an entire class of industrialists, businessmen and bankers who accumulated profits and capital. Former traders took advantage of incentives and subsidized credit offered by government to those who responded to its call to set up "pioneer" industries in the country. The early years of the country's industrialization in the 1950s up to the 1970s also gave rise to well-known personalities of Chinese descent, some of them emigrants from China, who dominated certain industries. Their dominating

[2] *Business World*, Anniversary Report: "Who Owns the Philippines," July 1994.

presence ensures that their families shall continue to own these businesses in the next several generations.

With the emergence of a growing middle class in the 1980s and 1990s, the government called upon leading managers and businessmen from its ranks to become "captains of industry" and help in pursuing industrial development through vigorous growth of the corporate sector. Government sought to forge a partnership between government and industry in a pattern similar to Singapore's and South Korea's. Industrialists helped the government formulate industrial development policy. Some of them turned over their businesses to their trusted family members and business partners to enable them to occupy advisory or cabinet positions in government. Through their business sense and management ability, they became major owners of new large companies and influenced growth, development and government policy in their industries. Because large shareholders tend to allocate their investments in several businesses, they typically control these investments by forming groups of companies. In sum, large shareholders that dominate ownership of the Philippine corporate sector are families whose wealth dates back to the colonial era, early industrialists and ethnic Chinese emigrants and entrepreneurs and professionals from the middle class. Large shareholders manage their investments through corporate group structures.

Groups of companies commonly include commercial bank and other financial institutions like insurance and finance companies. Large shareholders either directly owned these banks or controlled them through companies that they owned. Commercial banks hold the largest share of financial resources in the country. Past government policies sought to ensure stability in the financial system through regulations at the expense of growth and competition. Past government policies restricted entry, set up minimum capital requirements and limited the number of local branches and foreign bank operations in the Philippines. With the capital markets still underdeveloped, commercial banks came to control the financial resources of the system and to capture excess profits in the process. Corporate financing depended on intermediation by commercial banks. Large groups responded by acquiring significant ownership of commercial banks. Once banks were part of a corporate group, member companies of the group improved their prospects for accessing loans at favorable interest rates and terms. BSP introduced major reforms to strengthen the banking system and increase competition. Some of these reforms are the liberalization of interest rates and foreign exchange in the 1980s, entry of foreign banks in the 1990s, and as a response to the Asian crisis, increased capital requirements.

BSP's reforms are probably changing the conduct but not necessarily the structure of banks. In particular, banks' ownership remains large shareholder and family-based. Through common ownership, ties of commercial banks with corporate groups of companies remain strong. Concentration of ownership in banks weakens the regulatory capacities of BSP. To accelerate recovery from the crisis, BSP sought to reduce the lending rates by bringing down Treasury bill rates, the bellwether for lending rates. It did not get the expected response from banks. Foreign banks increased in number but not local banks still dominated domestic credit and deposit markets. By raising capital requirements, BSP wants to strengthen the capital base and increase the size and stability of banks as a safeguard against future financial crisis. However, capital build-up demonstrates the advantage of corporate groups in raising capital from their own internal capital market. Increasing capital shall heighten the concentration of ownership and expand the scope of own-group lending by these larger banks in the future. Several banks merged after the Asian crisis in a process that involved divestments by large shareholder group and increased ownership by another.

b) Composition of Ownership

Ownership is the key element in corporate control and governance. Of the four central forces (Jensen, 1993) that resolve problems regarding the compatibility of corporate decisions and social good, two – external control through the capital market and the corporate internal control system – depend on the degree of share holding.[3] Companies that are publicly listed *and* widely held enable dissatisfied shareholders to exit by selling their shares. Capital market investors control these companies and discipline management of companies toward broad, market standards of efficiency. In under-developed capital markets, publicly listed companies may not be widely held by public investors. In that case, external control is not present. In the Philippines, public listing rules require public issuance of only 10 to 20 percent of outstanding shares. Ownership by large shareholders of publicly listed companies limits the trading of those shares. Public investors could not readily influence the price of shares through their trading activities. The growth and survival of those companies then depend on the effectiveness of control systems within the company's organization. Because large shareholders manage these internal control systems, any disciplining force generated by such systems is about equal to that coming from self-control.

The composition of ownership of publicly listed companies according to shareholder type by industry sector is shown in Table 4. Because of limitations in shareholder ownership data, Table 4 describes the composition only of the largest five shareholders of publicly listed companies[4]. The largest shareholder type is the non-financial company, controlling an average of 52.1 percent of non-financial and 33.5 percent of financial companies in 1997. Non-financial companies include pure holding companies. In four out of nine commercial and industrial sectors, non-financial companies held majority ownership. Large shareholders set up pure holding companies to own operating companies to gain central control over many companies in a group. Pure holding companies are a means of pooling ownership of family members over many companies to enable family members to share the risks and profits of the group. They could also better manage their income taxes because family incomes pass through a holding company. The importance of these advantages is evident in the popularity of holding companies among publicly listed companies. The majority ownership by *privately* owned companies of publicly owned companies suggests that the corporate sector's corporate governance structure is based on internal controls.

Ownership by financial institutions suggests the presence of external controls. The fiduciary responsibilities of financial institutions call for protection of their investments by monitoring management performance and actions. Table 5 identifies financial institutions in the top five shareholders with their corresponding average ownership shares. These are investment trust funds (4.7%), commercial banks (1.3%), securities brokers (1.1%) and insurance companies (0.1%). As a group, they own an insignificant 7.2 percent ownership of non-financial companies in 1997. Regulators limit investments by banks and insurance companies in the stock market. Investment trust funds are the most important institutional investors. These are mainly contributions to provident and retirement funds of government and private sector employees that are managed by two separate

[3] The other two are legal/regulatory systems and product/factor markets. Legal/regulatory systems are covered in this Study. The product/factor markets provides the ultimate discipline because a firm could not survive if it does not provide products and services competitively.

[4] The analysis therefore *understates* the true share of shareholder types in the ownership of publicly listed companies. The percentages shown in Table 4 are the minimum levels of ownership of those ownership types for the indicated groups of publicly listed companies.

institutions[5]. These institutions mainly invest in shares of large capitalization and liquid companies in the communication, power and energy and food & beverage industries. Investment funds have a significant presence in these sectors, ranging from 8.5 to 12.6 percent of market capitalization in communications and power/energy sectors, respectively, in 1997. Because of limited ownership by institutional investors, there is no real market for investment information. The Philippine capital market does not have an active analyst community similar to that in more developed capital markets.

c) Ownership Concentration

The average ownership of the largest one, five and 20 largest shareholders of publicly listed companies is shown in Table 6. The largest shareholder owned an average of 40.8 percent of the market value of the non-financial companies in 1997. The counterpart figure for the financial sector is 27.2 percent. The ownership by one shareholder was highest and constituted majority ownership for companies in the property sector (54.8%) and for holding companies (53%). Other non-financial sectors with a high (more than 25%) degree of one-shareholder control in 1997 were construction, manufacturing/trading and communication. Average ownership by a single shareholder was lower than 25 percent only for industry sectors with large capitalization like power & energy and transportation services and industry sectors with high risk like oil exploration and mining. Even for publicly listed companies, a single shareholder had strong or even dominant control.

The largest five shareholders owned about 65.3 percent for the non-financial sector and 59.2 percent for the financial sector in 1997. On average, only five shareholders held majority control over Philippine publicly listed financial and non-financial companies. The highest degrees of ownership by five largest shareholders were holding companies (78.4%), construction (74%), property/real estate (69.8%), manufacturing & trading (68.4%) and communication (67.3%). Five shareholders controlled, to a degree equal to about two-thirds majority, five out of 13 industry sectors. Except in transportation, food & beverage & tobacco, hotel & recreation and oil exploration sectors, the top five shareholders held majority ownership of publicly listed companies.

The largest 20 shareholders owned 75.9 percent of companies in the non-financial sector and 76.2 percent for the financial sector. Except for the manufacturing/trading sector, the largest 20 shareholders held majority control over companies in all sectors. In 10 out of 13 industry sectors, the top 20 shareholders exceeded the two-thirds majority ownership. Of the three exceptions, two – mining and oil explorations – are industry sectors of insignificant market capitalization. Excluding these three sectors, the largest 20 shareholders held a commanding share ownership and management control in the average publicly listed company in every Philippine industry sector.

Degree of ownership defines management control. The Philippine Corporation Code requires approval of management decisions by a majority vote of the board of directors. Strategic decisions, because of their major impact on a company, require a two-thirds majority. On average, the largest five shareholders held sufficient majority ownership to approve operating and strategic management decisions of companies. Minority shareholders could not achieve majority without the support of one or more of the five largest shareholders. Well-organized minority shareholders can probably elect only a member of the board of directors and even then only with effective use of cumulative voting privileges. Concentration of ownership at these high levels reveal that publicly listed Philippine companies are not truly publicly owned. Many companies listed in the Philippine stock exchange

[5] The Social Security System manages provident funds of private company employees while the Government Service Insurance System assumes the same function for government employees.

have issued only the minimum number of shares needed to gain public listing. By limiting the ownership shares issued to public investors, controlling shareholders reduce minority shareholders to passive roles in corporate governance.

C. CORPORATE BEHAVIOR AND PERFORMANCE

1. External Control Systems

Governance of Philippine corporations depends on three external control factors, namely, regulation, the capital market and control by group or affiliate structures. The SEC enforces regulations on conduct and disclosure according to the country's U.S.-based Corporation Code. Publicly listed companies have to meet conduct and disclosure requirements by SEC and the PSE. The stock market features some of the leading corporations. Public investors could enforce external discipline on these companies by trading their shares. The financial media monitors management practices and performance of publicly listed companies. The common affiliate structures in the Philippine corporate sector are the corporate groups and industry alliances or associations. Corporate groups have family-based ownership structures. Industry alliances based on advantageous sharing of information and policy lobbying activities are emerging. Many industries have organized industry associations where larger companies play prominent roles.

To determine the impact of these three external control factors on corporate sector performance, the Study classified companies by ownership and by external control structures. Ownership structures classify companies into the categories of publicly listed, multi-national and privately owned companies. Public investors partly own publicly-listed companies and assisted in their external control roles by two local regulators (SEC and PSE). Foreign investors and central headquarters own branches of multinational corporations. Family-based owners own and control privately held companies. Conglomerate control structures refer to membership in corporate groups. Independent companies are those that ate not affiliated with conglomerates.

a) Impact of external control on corporate performance and financing

Ownership structures, working through their influence on corporate governance, impact corporate performance as follows:

1) Publicly listed companies, being the large, top-tier players in their industries, have good access to external financing of their investments. They require a larger asset base to sell at lower profit margins to support their goal of market share leadership. They need to meet expectations of returns by investors in the local capital market. These expectations shape these companies' performance characteristics like high leverage, higher than average return on equity, low efficiency in asset use and low net profit margins.

2) Multinational companies enjoy mobility in capital. They invest only if sufficiently assured of returns. Many are global companies that must meet expectations of high returns by investors in foreign capital markets. They are willing to borrow more if funds can be employed to increase returns to shareholders. Multinationals would exhibit high return on equity, efficient asset utilization and high leverage.

3) Privately-held companies have limited access to external financing and are not competitive with larger companies. They could not expand their investments because of limited capital and the presence of large competitors. They would have lower leverage and returns but would efficiently use their limited asset base.

The Study selected a sample of companies and classified them according to the above external control categories. To be included in the sample, a company should have a complete time series of financial statements information from 1988 (or their start-up years, if later) up to 1997.[6] This requirement ensures the validity of the time series of financial performance ratios computed from the sample. Financial ratios include standard profitability ratios like return on capital, return on assets, operating profit margin, net profit margin leverage and asset turnover ratios like total asset turnover and fixed assets turnover. The resulting ratios, summarized in Table 7, confirm the priors on the characteristics of the three groups, in particular:

- Publicly-listed companies had a high average ROE, 17.2 percent, and leverage, 2.79 times equity. They had the lowest total asset turnover of 0.3 and lowest net income margin at 6.6 percent.

- Multinationals had the highest average ROE, 20.5 percent and efficiency of asset use in terms of total asset turnover of 0.86, total fixed asset turnover of 4.46, and average ROA, 5.6 percent. Its leverage was relatively high, especially by developed country standards, at 2.53 times equity.

- Privately owned companies had the lowest average ROE, 10 percent and average ROA, 3.3 percent. Their advantages were their lower leverage, 2.14 times equity and higher efficiency than publicly listed companies in use of total assets, 0.43.

- The Asian financial crisis caused a steep decline in rates of return and net profit margins for the entire corporate sector in 1997. Average leverage in 1997 increased notably for privately-held companies to 2.2 times capital. However, that level is still lower than the level of 3 to 3.4 times capital experienced in 1988 to1990. Leverage of publicly listed companies was high at almost 2.8 and comparable to the leverage of Thai companies of 2.9 in 1997 (Alba, et. al, 1998).

The Study identified main patterns of corporate financing from aggregate corporate sector[7] funds flows from 1988 to 1997. The indicators of investing and financing patterns are: a) net investment in fixed asset relative to total asset growth (measured by the change in fixed assets over the change in total assets), b) the capacity for self-financing of new fixed assets from income (NIC to change in fixed assets), c) equity financing rate (ratio of change in SE to change in total assets) and d) net equity financing rate for assets except fixed assets (ratio of change in stockholders equity less change in fixed assets to change in total assets excluding fixed assets). The results of these financing ratios are shown in Table 8 with the following emerging patterns:

- Fixed assets were a small component of total asset growth, averaging only about 18 percent. The corporate sector consisted primarily of light industry, trading and holding companies.

[6] The SEC-*Business World* annual survey of top 1000 largest corporations does not have the same set of corporate names on a year-to-year basis.

[7] The data from SEC-BW survey of top 1000 corporations is suitable for describing the aggregate investing and financing flows of the corporate sector.

- Net income, without considering dividends, was an important internal source of funds but for local companies, it was insufficient to meet new investments in fixed assets. Only multinational companies could finance their fixed assets growth entirely from contemporaneous income.

- Equity, including retention of earnings, financed only a small part of growth in investments, an average of 33 percent for the past decade. Multinational companies used a higher percentage of equity to finance asset growth, at an average of 43 percent.

- The effects of the Asian crisis are evident in the funds flows for 1997. Net income was lowest across all categories of companies in the preceding four years. The average increase in total liabilities for the corporate sector was more than twice the highest level experienced in 1995, causing an immediate increase in leverage and a decline in profitability due to higher financing costs.

- Equity, after deducting the amount to cover fixed assets growth, financed only a small proportion, or an average of 18 percent, of assets growth. The corporate sector heavily used external debts to finance growth in investments and working capital. Because sales have been growing by about 19 percent per year, debt partly financed permanent or fixed working capital requirements. The resulting mismatch of tenors between short-term financing and long-term investment exposed the corporate sector to refinancing risk and made it vulnerable to sudden rises in interest rates as happened during the crisis. This explains why many companies who worked down their investments to pay off debts suffered substantial losses and reduction of capital. Weakly capitalized companies could not absorb these losses and had to declare bankruptcy.

2. Role of Major Shareholders and Corporate Groups

a) Importance of Corporate Groups

In many Asian countries, large shareholders controlling corporate groups emerged from development policies of the government and historical circumstances that enabled certain entrepreneur groups to accumulate capital. When capital markets and legal structures are weak, shareholders deal with the problem of moral hazard in governance by accumulating controlling ownership shares. The Study investigates the importance of these shareholder groups and the characteristics of this control structure. Based on publicly available shareholder information and published reports, 39 corporate groups were identified from the annual SEC-*BW* list of top 1000 corporations in the Philippines. Table 9 identifies these groups, their main companies and industries, the total number of companies, total sales in 1997 and their affiliate banks are shown in Table 9.[8] The Study estimated sales of these groups at P746 billion or 31 percent of the total sales of the corporate sector in 1997 although they constituted only 25.6 percent of the number of companies. Twenty financial institutions were affiliated with these groups, including 16 commercial banks. Significantly, corporate groups control a majority -- 16 of only 31 local commercial banks in the country.

[8] The analysis excluded government companies. In cases where two or more groups share control over a firm, the sales of the firm were allocated pro rata to the groups based on their relative percentage ownership

Current rankings of companies in the Philippines refer only to corporate entities and does not make any reference to controlling owners. By grouping sales of all companies belonging to the major shareholder groups and comparing them with the sales of independent (non-group) companies, one can generate a list of top corporate "entities." In case where two groups control one company, the company's sales were allocated to the groups in proportion to their percentage ownership. Only 12 such companies were involved in the 1997 sample, indicating that groups do not cooperate by jointly owning companies. The results for 1997 data are presented in Table 10. It shows how the profile of the corporate sector would change if one focuses on ownership rather than legal personality of companies. The top three corporate entities are corporate groups and are far bigger than the largest independent company, the government-owned National Power Corporation. A total of 25 out of 39 corporate groups entered the list of 50 largest corporate entities in 1997. Together, sales of the 25 groups contributed 57 percent of the total sales of the top 50 entities in 1997. The overall picture reveals the importance of the 39 corporate groups in the corporate sector and in the economy.

Members of corporate groups tend to dominate or become major players in industries where they participate. It is interesting to find out how groups choose to invest in certain industries. Table 11 presents the different industries in the corporate sector, the sales of the corporate groups per industry, the share of the market, the identity of the corporate groups involved in the industry and the percentage share in the industry of each company. The market influence and competitiveness of the 39 groups are evident at the industry level based on Table 9. Corporate groups dominated or were major players in industries that are capital intensive (for example, power, cement airlines, telecommunications), difficult to enter due to start-up barriers and economies of scale (for example, real estate, car manufacturing, shipping), regulated (for example, power generation and distribution, mass communications, retail trade, banking, mining and agriculture) and subject to government restrictions. Examples of industries under government restrictions that seem to attract (or at least, not deter) groups of companies are food and automotive (restrictions on imports), telecommunications, cement (regulations on quarry rights, anti-pollution guidelines), real estate (zoning and land use restrictions) and coconut/agribusiness (development requirements and restrictions). Corporate groups held dominant shares of industry sales in 1997. They had more than 30 percent share in 33 industries (3-digit SIC). In many industries, a group member company accounted for over 30 percent of total industry sales. Dominant companies held 80 to 98 percent of the industries sales (examples are mining, pipelines and beer/cola industries).

In sum, the conduct and structure of corporate groups were molded by the government's past industrial and infrastructure development policies and the recent emergence of a new industry leaders. There was a high concentration of industry sales in a few leading companies. Large shareholders owned dominant companies. To leverage their holdings, large shareholders organized their companies into conglomerate groups. These corporate groups gathered capital and allocated them to an internal market of affiliates. To ensure a continuing flow of external financing, they acquired active minority or majority ownership of a large commercial bank. Due to social benefits generated by their businesses (e.g., employment, tax payment, etc.) their leading shareholders gained influence in society and government. Large shareholders leveraged this influence by entering industries that have high entry barriers. Dominant ownership shares and assurance of bank financing for the corporate group were the means whereby large shareholders achieved control of corporate groups.

b) Impact of Large Shareholder-Based Group Structure on Corporate Performance and Financing

Groups of companies in the Philippines operate at varying degrees of effective central control. Some members of the groups have autonomous operations. They separate operating management from central control and allow them to raise their own financing without gross guarantees. Other corporate groups have a central management that makes all major investment and financing decisions for the group. Philippine corporate groups are characterized by the presence of a large family-based shareholder group, majority or active minority ownership of affiliate companies, and a CEO who is a large shareholder. Philippine groups of companies tend to diversify toward industries related to the flagship company's business. This strategic direction ensures availability of competent management within the group and scale economies from central purchasing, logistics and financing. To illustrate the diversification pattern of corporate groups, Table 12 shows the number of industries on three-digit SIC for four of the six largest Philippine groups of companies. As shown for these four corporate groups, many of the companies in their respective corporate groups were in related businesses that accounted for a large share of their total group revenues.

Corporate governance depends on ownership type and control by corporate groups. Owners with greater control are more likely to avoid management inefficiencies (that is, the moral hazard problem of management-controlled companies) but may tend to over-borrow, knowing they could pass on any loss from credit-financed projects to creditors (that is, the moral hazard problem of creditors). Stated another way, corporate groups can be expected to show good profitability but may have higher leverage risks. Using individual company data from 1988 to 1997, the Study analyzed returns (on equity and assets) and leverage relative to two corporate government variables, owner type and corporate control structure while controlling for industry effects. The methodology involved alternately regressing ROE and ROA and leverage on group membership and ownership type dummy variables along with industry dummy variables.

The results of regression analysis for profit performance using ROA are shown in Table 13 (a). Return on assets is positively related to the foreign owned dummy and negatively related with leverage. The negative relationship of ROA with leverage suggests that companies were inefficient in expanding their assets, a result consistent with the hypothesis of over-expansion using borrowed funds. The coefficient for group member dummy is not significant. ROA's significant positive relationship to foreign owned company dummy variable supports previous observations on the superior profitability of foreign owned companies.

Leverage is regressed on profit performance as measured by ROE and ROA and the two corporate governance factors. The regression results are presented in Table 13 (b). Leverage is significantly and positively related to ROE and negatively related to ROA. Companies successfully used borrowed funds to generate returns for shareholders but appear to be investing them inefficiently at the margin. Leverage is significantly and negatively related to the group member dummy, the publicly listed dummy and foreign owned dummy variables. The negative sign of the coefficient of group member dummy suggests that conglomerates did not have a tendency for to over-borrow in the period 1988 to 1997. There are various explanations for a tendency of groups toward lower leverage. Some possible explanations are the relative efficiency of internal capital markets of groups, the support by affiliate commercial banks in these groups, the stock market boom in 1992 to early 1997 that enabled groups of companies to let their affiliates to go public and the country's debt moratorium up to 1991 that prevented companies from tapping foreign debt markets. Leverage is significantly and negatively related to publicly listed and foreign owned dummies. Companies in these two corporate control types are subject to external controls from the capital market. The tendency for lower leverage justifies the importance of external control mechanisms to regulate corporate governance.

III. THE REGULATORY FRAMEWORK AND THE ROLE OF POLICY

A. SHAREHOLDER RIGHTS

The Philippine Corporation Code and the main agency enforcing it, the SEC, are patterned after their U.S. counterparts. SEC requires all securities to be registered with the registry open for inspection to the public. Corporate stock and transfer books are open for inspection by the company's stockholders. Basic rights of shareholders are adequately protected. Shareholders enjoy one-share-one-vote rule, with proxy voting legally allowed and practiced. The Corporation Code requires the annual general shareholder meeting (AGSM) to confirm decisions of management. A shareholder can voice out his/her concern during AGSM without any required minimum shareholdings for such privilege. However, since the minority shareholders could not influence the vote, since there is no real discussion of board decisions during such meetings. Major transactions of the company require approval by two-thirds majority vote of shareholders. Examples of these transactions are as amendment of the articles, bonded indebtedness, sale of major corporate assets, investments in other companies and mergers.

Shareholders have preemptive rights under the law but the right can be denied or waived in a company's articles of incorporation. An important concern given the large shareholder groups in the Philippine corporate sector is the possible conflict of interest on transactions by managers or large shareholders. There are provisions addressing dealings by the company with directors or officers, contracts between corporations with interlocking directors and for cases when directors are in businesses that compete with the company. These explicitly identified cases require approval by the board of directors. There is no requirement of disclosure to shareholders unless transactions are presented to them for approval. A special case of conflict of interest is insider trading. The Revised Securities Act specifically prohibits insider trading and provides for strict liability by presuming violation of insider trading rules when directors, officers and principal shareholders conduct trades around insider information dates. Insider trading regulations are important because most publicly listed companies have a high degree of owner concentration and are thinly traded. However, enforcement has always been a question. Nobody has been successfully prosecuted for insider trading although SEC and the media have discussed various possible insider trading cases.

In sum, the legal framework for shareholder rights is generally adequate. However, in practice, shareholder protection is eroded by the dominance of large shareholders in corporations even for major decisions involving two-thirds vote. A serious limitation of the legal framework is its incapacity to protect minority investors from management dominated by large shareholders in areas involving conflict of interest and insider trading. There is very little deterrent on management regarding conflict of interest because at worst, the Corporation Code only requires special approval by two-thirds vote in AGSMs that can be done due to dominant control by large shareholders. Insider trading regulations has been poorly enforced in the past although there is hope in the current revision of the law.

B. ROLE OF THE BOARD OF DIRECTORS

The board of typical Philippine large public company is composed of between seven to 11 members representing the largest shareholders of the company. There is no requirement in law or in practice of representing stakeholders on boards. The board of directors is not explicitly mandated by the Corporation Code to consider the interest of minority shareholders. The Corporation Code prohibits the removal of a director without cause only if minority shareholders shall lose their representation in the board of directors as a result of such action. Interlocking directorates are common and extensive, especially for corporate groups. Directors are elected during the GM by shareholders. Outside directors are not common and not mandatory. Outside directors, if present, are brought in by controlling shareholders. Having an "independent" director is not acceptable for most companies because family members and close associates prefer to discuss business issues of highly confidential nature within the family.

Boards of Directors may create sub-committees. However, most companies do not have sub-committees of the Board of Directors. A few have management remuneration and audit committees. Companies can provide in the bylaws or approve by majority of outstanding stock the compensation of senior management including stock options. In practice, only few publicly listed companies provide stock options to management and by minimal amount (for example, one percent of outstanding shares). Directors' fees are publicly disclosed as an SEC reporting requirement. However, the amounts are shown as a lump sum for the directors and another for officers. There are provisions for disregarding the limited liability of the corporation and protection by shareholders against infringement of their rights. A stockholder can file a derivative suit against its directors. The SEC is the special body that handles conflicts involving corporations and their shareholders. Although intended to speed up resolutions of intro-corporate conflicts, SEC proceedings are known to be costly and take a very long time to resolve. In effect, enforcing the protection of minority shareholders through the courts is costly and not effective.

IV. CONCLUSIONS AND RECOMMENDATIONS

A. CONCLUSIONS

The dominating factor in Philippine corporate governance is the large, family-based ownership structure of companies. By itself, this is not an unusual characteristic because most Asian businesses and even developed countries, like Germany and Japan, also have family-based owners. However, the country's history of economic, policy legal environment and the relatively weak external control agents suggest that highly concentrated ownership constitutes a structural weakness that limits future growth and leads to inefficiencies in investments and financing in the corporate sector. The following conclusions were derived from the results of the analysis in this Study:

(1) Large shareholders that dominate ownership of companies pursue a financing policy characterized as trading-on-equity, resulting on further dominance by these companies in their industries.

Five largest shareholders hold about two-thirds ownership of publicly listed companies. Returns to shareholders increase while return on assets decrease with leverage. It suggests that companies expand their investments using borrowed funds although the returns on those investments are declining. Because larger companies have superior access to debt financing entailed in this strategy, the result is further concentration of industry sales in these larger companies.

(2) Corporate groups with affiliate banks enjoy advantages in terms of access to financing and economies of investments and operation in related industries.

Companies that operate as part of corporate groups are able to get adequate debt financing for their projects because affiliate banks leave the task of "picking winners" to the group management. Philippine corporate groups appear to be successful in investing debt funds in the past 10 years.[9] However, ownership of banks by corporate groups diminishes the capacity of banks to be effective external control agents. This is a serious weakness in the governance structure of Philippine corporate groups because as providers of mostly short-term loans, banks would have been in the best position to appraise the efficiency of the corporate group's investment and financing activities. They could have been the most suitable external control agents for corporate borrowers that are owned by large shareholders.

(3) Most publicly listed Philippine companies are not widely held by public investors.

Most publicly listed companies actively trade shares that represent only the minimum number of shares required to be considered a public corporation. The absence of a wide shareholder base in most Philippine public corporations weakens corporate governance. There is a resulting lack of active shareholder discussions of major management actions and weak signals from investors regarding their judgment of a company's performance.

(4) The regulatory framework for corporate governance is inadequate in the context of Philippine conditions like large shareholder-dominated companies, corporate groups and ownership of banks by groups of companies.

The modified U.S.-based Corporation Code that prevails in the Philippines does not address the structural weaknesses that were revealed in the Study's analysis of the integrated relationship between governance agents and performance, and corporate investment and financing. The presence of large shareholders in most Philippine companies precludes the effectiveness of legal provisions preventing resource transfers that are adverse to small shareholders. Ownership of banks by non-financial companies may diminish the due diligence role of banks when evaluating loans to a member of its own corporate group. The Philippine Corporation Code does not adequately address adverse actions by large shareholders involving potential conflict of interest and expropriation of minority shareholder's wealth.

[9]Since the Study uses the financial reports of the 1000 largest companies, only survivors are represented, clearly a bias in the sample companies.

B. RECOMMENDATIONS

The Study offers the following recommended actions that the government should take to introduce reforms that address weaknesses in corporate governance that were identified by the Study.

(1) Review of the regulatory framework for corporate governance to strengthen the rights of minority shareholders and to improve disclosure of actions by the board and large shareholders.

SEC, PSE and BSP should formulate a sound and proactive corporate governance framework. The Study showed that the degree of control by a few large shareholders is pervasive even among public companies. It exceeds the level that is consistent with any reasonable standard of equitable distribution in society of ownership of the corporate sector. In practice, controlling shareholders can further erode the rights of small shareholders by preventing discussions of management actions during AGSMs. The currently prevailing regulatory framework appears to merely achieve parity with similar corporate regulatory standards like in the U.S. It is not enough. Without conditions prevailing in those other countries such as broad-based ownership, a strong business information media and a highly competent financial analyst community, it would not be possible to pose a strong external control, in the form of a proactive corporation law, on large shareholders.

(2) Formulate and reform the legal and regulatory basis for the establishment and operation of investment funds and venture capital funds.

Investors in publicly listed companies are mainly individuals, non-financial companies and stockbrokers that hold shares in nominee accounts. These are either large shareholders that are long-term holders or portfolio investors who hold short-term trading portfolios. The PSE's investor profile clearly has a "missing middle" category of investors, namely institutions that intend to hold shares long enough to participate in the profits and growth of a company and still trade heavily when fundamental conditions and business prospect of the company change. Investment and venture capital funds meet this description.

The conspicuous absence of institutional investors in PSE is an indication of the quality of share traded in the PSE and the weakness of the legal and regulatory basics for their operations. By supporting the establishment and operation of institutional investors, SEC and PSE will help ensure that publicly listed companies are exposed to market discipline. The effectiveness of external investors as governance agents was illustrated in the recent acquisition of Philippine Long Distance Co. (PLDT) by First Pacific. It became feasible only after the government investment fund (SSS) and a foreign fund (First Philippine Capital) offered to sell their holdings in block to First Pacific.

Institutional investors vote their agreement or disagreement with corporate management with their checkbook. However, to do so, they must have fairly good information about investee companies. With institutional investors in action, an active financial analyst community begins to form. Other investors benefit from the information that these analysts produce for these institutional investors as information technology soon makes their output a public good. In this process, the investee companies eventually measure their performance according to their stock price. Eventually they find that their conduct, like their investing and financing decisions, affect stock price. Only at that stage that investee companies achieve market discipline and control of corporate governance is

based on the capital market. A legal structure that promotes the establishment and efficient operation of investment funds should be formulated as a first step in this direction.

(3) Adopt policies and regulations to broaden the supply of securities in the stock market.

To promote the capital markets as an external control agent in corporate governance, SEC and PSE should increase the supply of quality securities from top-tier local companies in the Philippine stock market. The Study found that PSE companies, on average, trade barely the minimum number of shares to be considered public. The lack of liquidity deters investors who want to participate in the future success of the business. The resulting absence of a reliable and fair price make the prices of shares of these companies vulnerable to temporary business shocks and to manipulation or insider trading by large shareholders. In short, the stock price of stocks that are thinly traded relative to total outstanding shares become subject to many influences other than the corporate management's business performance. Price of a thinly traded stocks are not fairly set. To the extent that most companies in the PSE publicly list and trade only a small proportion of their outstanding shares, the entire Philippine market is not inherently a fair market. Regional fund managers appear to have this consensus because they largely bypass the Philippine stock market when they want to take a large position in the Asian market.

The road to a stock price-efficient market is one for PSE and SEC to traverse. The PSE needs to convince listed companies to expand their share offerings to the public. The SEC has a task similar to the BSP's periodic call for banks to expand their capitalization. By regulating to increase the proportion of public issues, SEC and PSE will be requiring publicly-listed companies to increase the share of public investors in their total capitalization. Large shareholders are likely to oppose these actions because they do not want their control diminished or to handle activism by an active minority shareholders in AGSMs.

(4) Improve external audit standards and information disclosures for all corporate businesses.

Effective external control systems in corporate governance require accurate and timely information about the company. Audited financial statements contain the basic independent information about a company's financial position and performance. The SEC requires all corporations to submit audited financial statements. The Philippine Institute of public Accountant (PICPA) has a clear set of guidelines for ethical and technical practice of external audits. The country has some of the best-trained audit professionals in the Asian region. The top audit companies in the world operate in Manila. Yet the consensus of investors is that current audit standards and information disclosure requirements do not sufficiently protect stock market investors. Recent cases of failures of external audits involved leading public corporate names in their industries, for example, Victorias Milling Corporation and PLDT. Victorias Milling Corporation, a leading sugar miller received loans from banks partly on the strength of clean audit opinions on its financial statements. VMC suddenly went into troubled debt restructuring without indicative signals from those audited financial statements. PLDT was acquired by First Pacific but later questions about the audited financial statements of one of its subsidiaries raised doubts about the fair value of the purchase.

Much of the problem of adequate audit and disclosure stems from the tendency of SEC and the PICPA to be satisfied with replicating the audit standards and disclosure requirements of their counterparts in the U.S. Very little attention is given to the conditions, not necessarily present in the

Philippines, that make those U.S. regulations effective. Disclosure requirements of SEC and of external auditors are stated but not very specific in many instances. Consequently, investors get very low quality information. In practice, auditors have a wide scope of disclosure styles. Penalties for poor conduct or non-compliance are weak and poorly implemented. In spite the many well-known case of poor quality of audited financial statements associated with investor's losses, no auditor has been sanctioned by SEC or PICPA. Companies that ignore requirements of audited financial statements are subject to small penalties for the offense. SEC and PICPA need to act toward better standards because of the costs of these problems to investors. The longer-term cost is the resulting inability of investors and creditors to discipline companies because of the absence of quality information on their performance and conduct.

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