Public companies are often in the spotlight for fraud, corruption, misconduct and other lapses but the truth is that many of these problems occur within entities in the group, not at the parent company level.

For some considerable time, we have been thinking about part of the governance “eco-system” that has received little attention - the issues relating to subsidiaries and other entities within a group (including joint ventures, associates and special purpose entities) and the problems faced by directors in these entities.

We argue that many governance issues can be traced back to the complexity of company groups and the difficulty that “holding company” boards have in ensuring that they know what’s going on deeper in the “group” and in making sure that the intentions of the board are expressed in the actions of employees.

Most listed and large unlisted companies are company groups. Often, entities within these groups operate across a number of geographies and industries, each bringing its own financial, operational, compliance and reputational risks.

For example, in their latest annual reports, GlaxoSmithKline lists more than 100 “Principal Group companies” and Singapore Telecommunications Limited (SingTel) lists 77 wholly-owned subsidiaries, 6 partly-owned subsidiaries, 24 joint ventures and 10 associated companies within its stable of companies.

GlaxoSmithKline and SingTel are not exceptional; some multinational companies have thousands of subsidiaries and other group entities.

In some cases, the listed company is a pure investment holding company and business is conducted totally within the subsidiaries and other group entities. In many cases, group entities account for a substantial amount of the profits, cash flows, assets and liabilities of the groups. In a recent study of 150 of the largest listed companies in Australia, Malaysia and Singapore, we found that entities
outside of the ultimate parent company account for more than one-third of total group equity (excluding outliers) and more than 40 percent of total group profits. In some cases, these percentages are much higher.

Subsidiaries and controlled entities may be significant sources of risk.

Take the case of the BP’s Deepwater Horizon oil spill in the Gulf of Mexico. The rig was operated by BP Exploration and Production Inc.

As The Guardian (16 December 2010) put it:

“BP Exploration and Production Inc is a subsidiary of BP America Production... BP America Production is, in turn, a subsidiary of BP Company North America, which is a subsidiary of BP Corporation North America, which is a subsidiary of BP America Inc, which is a subsidiary of the parent company BP plc.”

That is, the disaster occurred many layers down from the ultimate parent company (BP plc) but caused enormous reputational and financial damage to it (to say nothing of the environmental damage). As is often the case, it appears that the directors of BP Exploration and Production Inc. had relationships with other “group” companies and, in some cases, line responsibilities within the subsidiary and the group. One can only wonder about the robustness of the risk management discussions on the subsidiary board. It also raises questions about the oversight which BP plc exercised, or should have exercised, over this and other subsidiaries.

Or consider GSK’s recent problems in China, which draw attention to the ‘subsidiary’ problem again, this time from a corruption perspective.

GSK’s first response to the accusation of bribery in its Chinese operations was to issue a statement on 11 July 2013, which said, “We continuously monitor our businesses to ensure they meet our strict compliance procedures. We have done this in China and found no evidence of bribery or corruption of doctors or government officials. However, if evidence of such activity is provided, we will act swiftly on it.”

On 22 July, the new head of Glaxo’s Chinese operations issued a statement that backtracked on the original statement, saying, “Certain senior executives of GSK China who know our systems well appear to have acted outside of our processes and controls, which breaches Chinese law.”

It now appears that a number of other pharmaceutical companies may also have paid bribes in China.

To be clear, both BP and GSK seem to be well run companies and make it very clear that, as far as their “Main Boards” are concerned, governance and safety are important priorities that should not be compromised under any circumstances. They write detailed corporate governance statements, try to promulgate their values to employees and are explicit about how their governance systems and processes are supposed to work. The “hardware” of governance is largely in place in both cases.

However, in both cases, something went wrong deeper in these groups and there are many other examples in different organizations.

The problems in these cases highlight:

1. The process and routines of governance in “groups”. How in practice can Boards of “holding companies” monitor the implementation of their policies in groups with many “subsidiaries”?

2. The importance of the behavioural aspects of governance and “incentives” within organizations.

3. The role of the “subsidiary” board in governance and potential conflicts with the “holding company” board, and the potential conflicts for “subsidiary directors” if they are also employees elsewhere in the “group”

Let’s first discuss the first two problems.

Human behaviour can be thought of as being driven by incentives (not just in the sense of financial incentives).

For example, a “Main Board” may clearly express its view that bribery is not acceptable and promulgates this view. However, the incentives in a particular subsidiary may reward performance (revenue, profit, etc.) and an attitude of “doing what is necessary”, at the expense of the “Main Board’s” explicit policies. Such an approach will set up conflicting behavioural incentives. It often seems that it is in the area of conflicting “incentives” that many governance problems arise.

Sometimes such conflicts can be perceived by directors in subsidiaries or employees as a rather cynical exercise in creating “plausible deniability” for the “Main Board” or group senior executives.

Perhaps boards need to think as much about the non-financial factors that motivate employees (and directors) to behave in particular ways, such as the sense of achievement, recognition by peers and superiors, promotions, and increased responsibility. Boards need to create “incentives” in the widest sense for all to adhere to the good governance practices they espouse. In our experience, not much attention is paid to the behavioural...
incentives that are created around governance by Boards. Then there is the problem of the role of the subsidiary board in governance and potential conflicts with the holding company, and potential conflicts for “subsidiary directors” if they are also employees elsewhere in the group.

From time to time, issues of how to deal with conflicts between the parent and the subsidiaries arise even where the subsidiary is wholly owned. Examples of some specific issues that we have seen include:

- **New product launches**: The “parent” wants to launch a new product but a majority of the subsidiary board believes this is costly and inappropriate
- **Declaration of dividends**: The “parent” wants maximum dividends declared while the subsidiary board wants to retain profits for investment in the company
- **Regulatory issues**: The “parent” wants to comply with home country regulation or practice, but the subsidiary believes that is inappropriate
- **Minimum working age/time/pay**: The “parent” wants to follow home country or its view of global practice, but the subsidiary believes that such action puts the subsidiary at a disadvantage in the local market
- **Factory closure**: The “parent” wants to consolidate manufacturing but the subsidiary finds it hard to justify redundancies when manufacturing is moved offshore

Beyond the issues of how the parent should exercise oversight of its group entities and how to resolve conflicts between the parent company and these entities, there are issues of how directors of group entities deal with role conflicts and discharge their fiduciary responsibilities.

Most people who hold “director” titles are in fact directors of subsidiaries and other group entities, and are frequently also employees in these entities. Often, they act as shareholder representative for another company elsewhere in the organizational “chain”. These directors constantly have to make decisions involving conflicts between the interests of the parent and the group entity. They also have to take into account the incentives applicable to them as individuals.

Whilst the legal position is clear - that directors of a subsidiary or joint venture or associated company must act in the best interests of that entity - the practical reality is far more complex, especially as these directors often have line responsibilities or are directors of the parent or other group entities. We have seen it get so difficult that local employees of the “owner” refuse to serve on the subsidiary board. It does not help that most organizations provide little training and have, frankly, little sympathy for the predicament.

**Closing thoughts**

From a financial reporting standpoint, the impact of group entities are accounted for through accounting methods and procedures, such as consolidations; equity accounting; disclosure of subsidiaries, joint ventures, associates and special purpose entities; and related party disclosures. Accounting has recognized the economic substance of groups and moved away from the legal demarcations that exist amongst different entities. In contrast, corporate governance standards and guidelines have evolved more along the “legal” than the “economic substance” route. Rules, regulations and codes for corporate governance largely ignore the governance issues that entities within a group and directors serving on boards of these entities face. The focus of most governance literature and most director education is on those who sit on the boards of listed companies.

We are not advocating that parent companies “micro-govern” their subsidiaries. This is not only impractical given the complexity of company groups, but may undermine the separate legal entity status of subsidiaries and the “ring-fencing” of risks in these subsidiaries, and in some cases, violate local laws and regulations. However, it is also inappropriate to let the subsidiaries completely self-determine their corporate governance.

Some large company groups are realizing the importance of subsidiary governance by putting in place a subsidiary governance programme. The emerging literature and our own experience suggest the following as being key components of a robust subsidiary governance programme:

- **Overall corporate governance framework/policy**: This should deal with key issues such as board composition, the role of the board and their responsibilities, conflicts of interest, the process for appointment of directors and officers, director training and directors’ remuneration.
- **Board composition**: Having the right people on any board is critical. We have seen cases of unlisted subsidiaries having non-executive independent directors who are not employees of the organization, although this is relatively rare. At the other extreme, it is common for unlisted subsidiaries to have boards comprised entirely of management of the subsidiary, which raises questions about the effective oversight by the board. Some company groups, have introduced policies requiring some directors who are independent from the subsidiary – e.g., from unrelated business within the group or from head office.
However, care is needed to minimize the risk of conflicts for these “outside” directors because of the other positions they hold within the group.

- Board’s role: The roles of the parent and the subsidiary boards need to be clearly delineated, for example, through the drafting of board mandates. For example, what is the subsidiary board’s role and the parent board’s role in relation to remuneration of executives within the subsidiary?

- Specific policies and procedures: These can include those relating to qualifications of key officers (e.g. compliance and risk officers); delegations of authority; communication between entities within the group; the creation and dissolution of subsidiaries; the development of materials and guidance for subsidiary directors in the form of guidelines and directors’ handbooks; audit requirements, code of conduct and whistle-blowing policy. Of course, if the subsidiary is listed, its corporate governance will have to take into account rules and codes applicable in the jurisdiction of listing. In the case of joint ventures and associated companies, the “owner” has to calibrate its approach to ensuring proper governance so that it does not breach the joint venture agreement, violate the spirit of good governance, or, in the worst case, break the law by over-asserting its rights. For example, we have come across situations of directors representing the “owner” of an associated company going directly to management of the associated company to obtain detailed operational data which is not made available to the other shareholders of the associated company. However, despite these difficulties, the “owner” must take steps to ensure proper governance because it faces financial and reputational risks.

- A focus on the behavioural incentives that exist within the group structure relating to governance issues: How well does the main board understand the culture of subsidiaries and the impact of that culture on practices? Does the main board really understand the incentives (in the widest sense) that operate within subsidiaries? Does the main board understand and attempt to eliminate conflicting behavioral incentives throughout the group? There is clearly a need for greater focus from parent company boards and regulators on issues relating to the governance of subsidiaries and other group entities and for better education of those who are directors in such entities. At the same time, companies need to expend as much effort on the behavioral aspects of governance as they do on the legal and accounting procedures. In some ways, these issues are more vexing than those relating to boards and directors of listed companies.