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Companies around the world are seldom characterized by a simple structure. They may be complex groups of legal companies, but they can also include substantially stand alone divisions and branches. All of these are here termed subsidiaries. This article explores the implications of this reality after briefly considering some manifestations of weaknesses in corporate governance. It concludes that boards must pay more attention to the structure of a company’s operations in structuring corporate governance arrangements.

The general approach to corporate governance

Around the world, good corporate governance is acknowledged as crucial for corporate performance. Moreover, there is widespread acceptance about how this objective might be achieved: company boards should be predominantly part-time and act as a check and balance on senior executives. Boards should oversee financial reporting systems and internal controls including risk management, and appoint and dismiss senior management. Such powers are best underpinned by effective shareholder rights.

Under this model it is argued that the function of the board is not to run the company on a day to day basis as that is the prerogative of senior management. The internal organization of a company is thus predominantly in the hands of management. There is also an extensive management literature covering areas such as multi-product firms.

This single company approach is, however, inadequate in practice and in underpinning both advice to companies and in thinking about policy.

Problems often occur at some "distance" from the main company.

Three recent examples illustrate the issues that can arise in companies with subsidiaries, legal or otherwise. In 2010, an Airbus 380 experienced a near catastrophic explosion of an engine near Singapore. The cause was traced to a small oil pipe which had been manufactured by a Rolls Royce plant in northern England. The pipe did not correspond to the technical requirements set out by Rolls Royce engineers. However, this enquiry also showed that the plant had a history of not meeting technical specifications: a culture of laxness was apparent.

There is also the example of the “London Whale” when a trader at a US bank’s London subsidiary engaged in risky trading losing the bank some 6 billion dollars. These trades for the treasury functions of the bank were supposed to be low risk.

In another example, HSBC has had to pay record fines for problems in anti-money laundering arrangements at its Mexican branch. This is still a major risk for the company’s franchise in North America.

So what went wrong?

It is tempting to argue that inadequate performance at the above subsidiaries reflected a lack of appropriate internal controls for which the main board is ultimately responsible. While there is some truth in this, it is ultimately not sufficiently nuanced.

There are good reasons why senior management has established subsidiaries, either legal ones or divisional structures. Perhaps the strongest reason is fear of bureaucracy within the company. Detailed controls do not promote lower levels of management taking responsibility and responding flexibly to challenges. Lack of responsibility at lower levels is also, it is argued, not conducive to innovation. Plants may also be established in different jurisdictions and localities to spread risks, including those due to labor practices.

Such moves to decentralize have also been stimulated by experience with corporate failures when local management (i.e. managers of subsidiaries) had insufficient powers to respond to local conditions. Subsidiaries responding in a mechanical way to central directives has often resulted in loss of market share and to failure. An example of this is the failure of the UK’s General Electric in contrast with the US General Electric that gives significant freedom to its subsidiaries.

The implications for corporate governance

The organizational structure that suits an enterprise will depend on many factors such as jurisdictions of operation and the nature of the market. These are quite correctly issues for management to decide. However, the corporate governance arrangements must be compatible with the company’s structure and it is not simply a matter of internal controls. The major elements would appear to be the following:

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Know your company structure and its raison d'etre. This principle has been enunciated by the Basel Committee on Banking Supervision for banks. The main bank boards should understand in which jurisdictions and markets it operates and in what corporate form. However, the principle also applies to companies in general and should be taken into account in determining the composition of the main board. Some companies are now holding board meetings at subsidiaries around the world allowing members to understand local conditions and to evaluate local management. Meetings are also held in major markets even though no foreign subsidiaries might be involved.

Establish appropriate internal controls over subsidiaries

A number of large complex companies have established special controls over their subsidiaries. For example, in one big consumer goods company, subsidiaries are banned from starting new legal subsidiaries unless approved by the main board and by the office of the company secretary. Moreover, the powers of attorney are very restricted and are also subject to approval by the main board.

The situation can be more complex when for legal or other reasons subsidiaries take a corporate form and have their own boards. These are often internal boards (i.e. staffed by company employees) but on occasion can be problematic when it comes to following instructions from the main board and central management (i.e. to whom do directors owe loyalty). Problems are most acute when there are other shareholders and also in the case with joint ventures. Governance arrangements must take these specifics into account.

Internal controls and risk management should ensure a consistent system of checks and balances

In the case of HSBC noted above, the compliance manager for the Mexican company did not report directly to the head of group compliance but to the local board. This would not have been problematic if the group compliance had also been able to bring its concerns directly to the local board, which was not the case. Many different corporate structures are possible but the corporate governance arrangements of a company must be compatible.

Ensure that senior management has the appropriate skills to manage subsidiaries

It is not only board skills and competencies that must suit the company structure. The same is also true of senior management. This appears obvious but there are many examples where senior management was not in a position to monitor local management. A documented case concerns the UK bank HBOS where the board and the senior management were all drawn from retail banking. When a newly merged company was formed, it included significant treasury, commercial banking and investment banking arms. These three divisions were responsible for the collapse of the bank with senior management and the board failing to exercise their responsibilities due to lack of knowledge and experience.

What is to be done?

Clearly the current understanding of good corporate governance practice needs to be further extended in order to incorporate features of modern companies, especially subsidiaries. However, the situation is complex as companies are very heterogeneous. What is therefore required is systematic work to identify key challenges and identify good practices. At a later stage these might be refined as principles for incorporation into existing codes and laws.

In conclusion it is time to widen corporate governance concepts to include subsidiaries where for better or worse many decisions are taken.