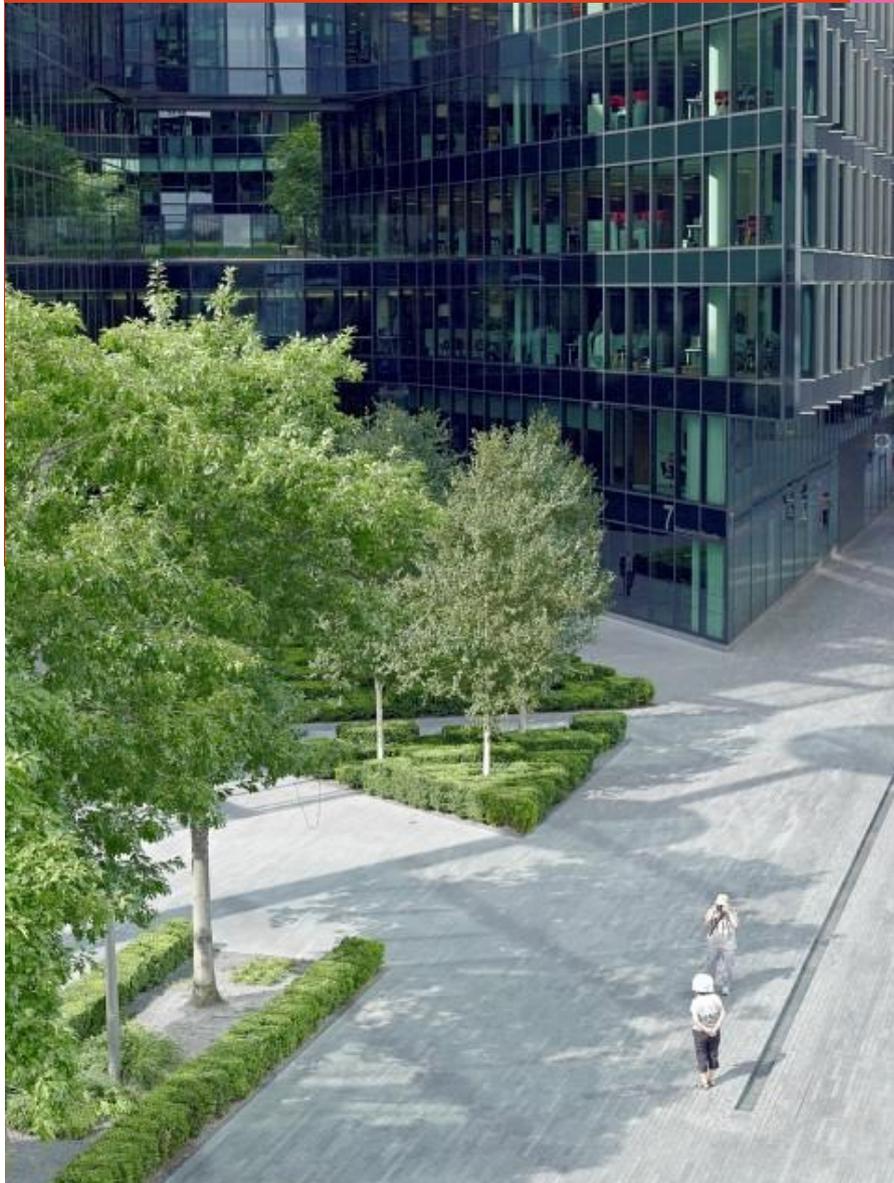


Subsidiary Governance: an unappreciated risk

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With regulation, risk and responsibilities for directors around the management of legal entities all increasing, having a strong global subsidiary governance framework can prevent costly financial and reputational damage, explain Jonathan Gibson, Kate Elsdon and Lee Johnson, from PwC Legal's Entity Governance & Compliance Team.

The main aim of any subsidiary governance framework is to protect shareholder value first and foremost. However, companies must consider the practical issues that cause either reputational damage or financial penalties that go to the heart of shareholder value. Quite often when you look at corporate governance failings, they have occurred at subsidiary level. The management of legal entities, internationally, is therefore on the radar.

Increased regulation

In recent years, domestic and international regulatory developments and the enforcement of those regulations have forced multinational companies to focus on the governance and management of all entities within their group.

Since the financial crisis, regulators such as the FSA (now the FCA) have focussed their attention on governance and compliance, with increased intrusion and prosecutions for compliance failures. During 2012, the FSA levied a record £311m of fines (2011: £60m, 2010: £89m) for regulatory breaches, as well as continuing to name and shame companies for failure to implement good corporate governance. This demonstrates that if companies fail to exercise good governance throughout their organisation, they will not only incur substantial financial costs, but also find themselves subject to reputational damage.

A continual lack of global harmonisation around legislation and regulation also means it is no longer appropriate for groups to focus only on parent company governance. For example, the UK Corporate Governance Code (the Code) only applies to listed companies and doesn't specifically refer to the management of subsidiaries. However, the principles that underpin the Code are good, common sense, governance principles and should be applied throughout any group.

In addition, there is movement towards recognising the role subsidiaries have in terms of corporate governance, reporting and managing risk. For example, in South Africa, King III has introduced a requirement for listed companies to explain, in their annual report and accounts, how they manage the risks associated with subsidiary governance. In the US, the Foreign Accounting Tax Compliance Act is focussing attention at the legal entity level, forcing companies (mainly financial institutions) to categorise the entities they have in their group, but also to understand the purpose of each of those entities, and maintain a record of that information for 10 years.

These regulatory developments around corporate governance at the subsidiary level have forced a shift in regulators' focus, from business units to legal entities. Operating complex and unwieldy group structures only serves to magnify the additional governance and compliance burden and comes at a time when resource has never been more constrained, meaning that governance functions are having to deliver more for less; exercising effective subsidiary governance and robust legal entity management can help achieve this.

Increased risk and cost

Historically, there has been a lack of awareness of the risks associated with foreign entities as well as the costs of managing those entities; it is, in effect, an unappreciated risk. In many multinational groups the internal subsidiary governance is often not fit for purpose, tending to be overlooked or assumed to be another function's responsibility. In some cases therefore, businesses don't really understand the risks attached to subsidiaries until something goes wrong.

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The legal risks associated with subsidiary governance include personal exposure for directors and officers, legal and regulatory compliance failure and potentially unauthorised commitments (for example, orphan companies, directors being arrested on arrival in a country or being placed under house arrest, or transactions being rendered void); in addition, multinationals with numerous foreign subsidiaries carry greater financial, tax, commercial and operational risk. Identifying, understanding and mitigating those risks is a key role for any governance function.

Likewise, corporate governance should be an integral part of a company's risk management framework, with regular internal audits of governance and legal entity management processes and controls. A key failure in recent times has been the lack of audits focussed on this area, but there is now an emerging trend of companies making greater use of their second line of defence functions to carry out assurance based reviews of subsidiary governance and compliance.

Increased responsibilities

There is increased interest from shareholders, regulators and the public on how legal entity governance risks are managed; directors are legally responsible for the actions of their companies, wherever based, and must understand their duties. The issues surrounding directors' responsibilities are amplified by a lack of harmonisation of legislation internationally and by insufficient guidance or support for subsidiary directors around their duties and liabilities when appointed to multiple boards in multiple jurisdictions.

Whilst there are some common themes around directors' duties, including a duty of care, exercising independent judgement and managing conflicts of interest, many jurisdictions have key differences. For example, parent company directors may owe fiduciary duties to subsidiary companies, there may be a cap on the number of directorships an individual may hold, plus there is a wide range of personal and criminal liabilities that apply to directors. Company Secretaries have a role to play in helping directors who hold several directorships across a group understand, and comply with, each set of local requirements.

Company Secretaries are the custodians of governance and are increasingly taking responsibility for assisting directors manage their responsibilities. Co-ordinating the induction and ongoing directors' training programmes is a fundamental role for the Company Secretarial function.

Some groups are tackling this by adopting a tighter control around the composition of subsidiary boards and exercising greater focus on the calibre of subsidiary directors, with a ring-fenced group, or "slate" of individuals being identified as being those people with the appropriate skill set to act as directors of subsidiaries.

This makes the task of ensuring directors receive sufficient training, both on induction and on an ongoing, and tailored basis, far easier.

However, using a 'slate' of directors also makes it even more important for those directors to know what is happening in each of the entities they are appointed to; a good information flow is therefore critical.

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Emerging best practice around subsidiary governance

Corporate governance is critical to any organisation, yet getting it right can be a major challenge and is one of the largest unappreciated risks within most multinational groups. There are a number of challenges facing such organisations looking to achieve governance function efficiency and effectiveness and to implement a robust global subsidiary governance framework. On a global scale, the challenges present themselves when there is a lack of consistency and control over the management of legal entities. Historically, governance has been managed in a reactionary way, but more recently this is changing and governance is now being approached in a far more proactive manner, often via the use of a subsidiary governance framework.

Flexible consistency

Multinational groups are reliant on the individuals in each jurisdiction adhering to the governance standards in place, leading to differing levels of compliance. The big issue for multinationals is ensuring that there is consistency across international entities; the ability to police compliance but without stifling operational activities.

Groups are taking a range of approaches to legal entity management, depending on their business needs. Some operate under a centralised, head office controlled framework whilst others devolve responsibility to operating divisions or jurisdictions, with an assurance mechanism in place to monitor compliance. Similarly, approaches can range from a codified basis, with head office mandating the use of approved policies, to a standard or principles based approach, offering flexibility to meet business needs as well as local legal and regulatory requirements.

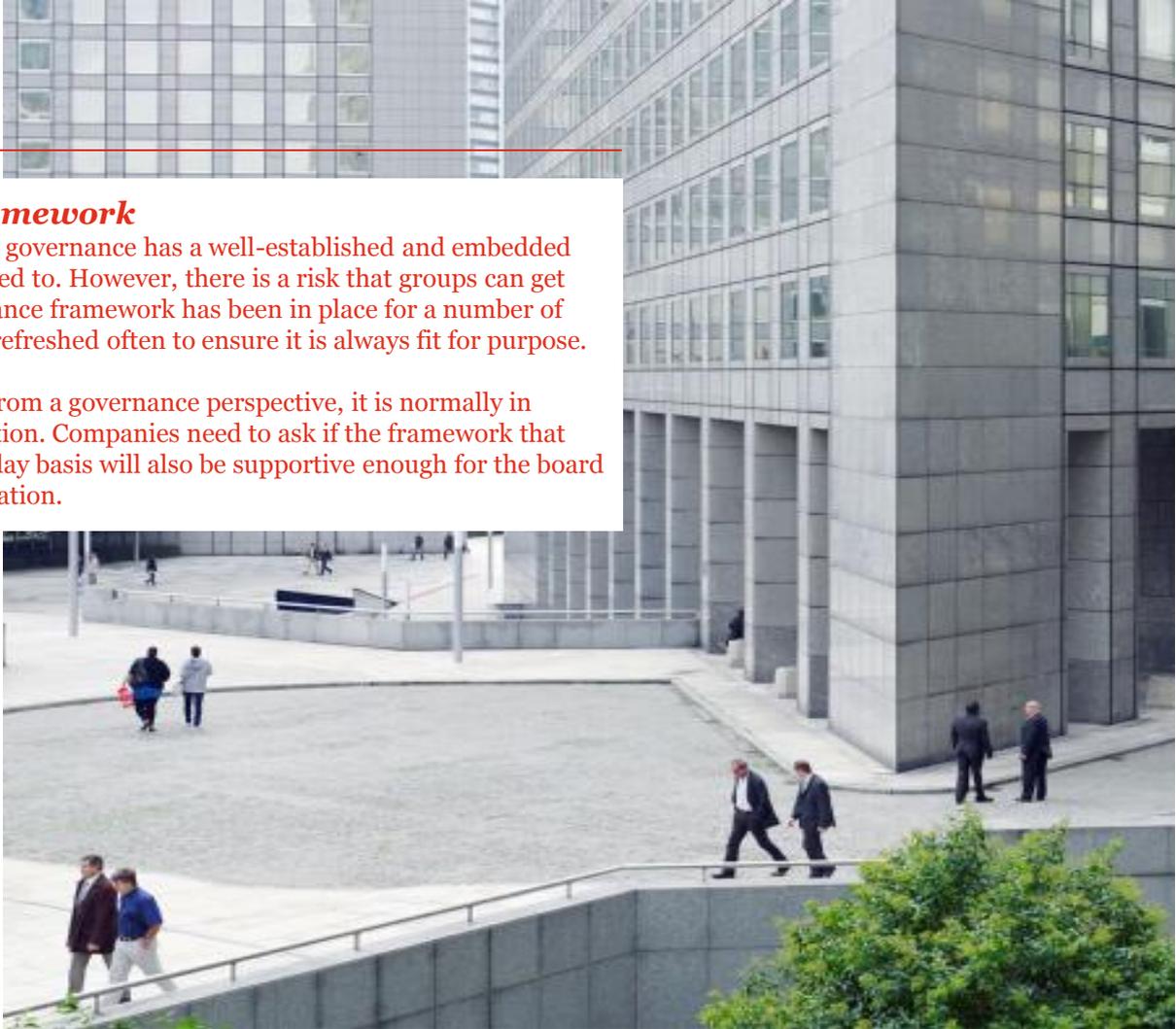
A commercial subsidiary governance framework will ensure legal entity governance and compliance, but in an appropriate manner. Many groups manage their legal entities by classifying them according to whether they are regulated, trading, non-trading, dormant companies etc, on a risk basis. Trading companies are classified as high risk and apply the entire governance subsidiary framework, while the dormant companies are deemed to be low risk and only apply certain standards, ensuring the right balance is struck between managing the compliance burden and adding value through governance.

Increasingly, subsidiary governance frameworks are being used to align the legal entity structure with the operational structure of businesses, allowing the day to day business operations to continue whilst also enabling effective and legal decision making. This is often achieved via a robust business-wide delegation of authority framework. To work effectively, there must be a good understanding of the business, with the governance framework applied in a way that works for each individual entity.

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Another challenge is making sure that what works during business as usual also works in a crisis situation. Organisations need to be able to adapt quickly, using a flexible standard-based approach rather than a prescriptive approach. A subsidiary governance framework ensures the ongoing and consistent management and control of issues, thereby avoiding those crisis situations.



A governance framework

In the UK, plc corporate governance has a well-established and embedded framework that is adhered to. However, there is a risk that groups can get complacent. If a governance framework has been in place for a number of years, it will need to be refreshed often to ensure it is always fit for purpose.

When things go wrong from a governance perspective, it is normally in reaction to a crisis situation. Companies need to ask if the framework that works well on a day-to-day basis will also be supportive enough for the board if faced with a crisis situation.



Commercial approach

If carried out effectively, legal entity management is a strategic activity and can enable the Company Secretary, through thought leadership around governance, to ensure they are helping the organisation manage and reduce risk. In addition, this level of group-wide governance can also control and reduce costs, simplify operations and enhance a group's reputation for good governance in the market place. Many organisations are incurring significant cost because they are not managing compliance and governance in, perhaps, the way they should, in terms of efficiencies and utilising resources. A subsidiary governance framework essentially links back to the overriding business objectives, which feature risk management, and cost control and reduction, and would ensure the company is as agile and as efficient as possible.

Complex group structures only serve to amplify regulatory, legal and compliance burdens. The most effective way to manage the cost and risks attached to complex and unwieldy group structures is to embed a continuous entity reduction programme into the subsidiary governance framework, under which legal entity owners have to justify the existence of each entity on an annual basis. Some groups also make an internal recharge per entity to help prohibit the creation of more entities.

Assurance

The on-going maintenance and assurance of the subsidiary governance framework is critical to its success. One of the main problems for organisations is that although they may have the policy documents in place, often they are left gathering dust and aren't managed properly. If a governance framework has been in place for a number of years, it should be refreshed on a regular basis to ensure it remains fit for purpose.

As in most cases, prevention is better than the cure, particularly as a slow drip feed of small issues and corporate failures can cause the most reputational damage.

Technology is playing an increasing role in legal entity management, underpinning and supporting the governance framework. Legal entity management systems now go further than simple data retention and can be configured to help support the governance framework, for example automating approval processes and providing clear audit trails for decision making. This has been evidenced recently by one of our clients, Parker Hannifin, winning the US Corporate Secretary Award for the Best use of Technology in Governance.

Finally, informal audits of subsidiary governance frameworks should be carried out on a regular basis to monitor the level of compliance internationally and to assess any areas of weakness.

Role of the Company Secretary

The role the Company Secretary plays in managing legal entity governance has changed dramatically in recent years and perhaps a more befitting title for the role is now Governance Director or Leader. In today's regulatory environment, the Company Secretary plays a more strategic enabling role, making sure directors are protected and proactively ensuring legal and regulatory governance compliance, throughout a group.

The purpose of the Company Secretary is now much more commercial and strategic and is focused around anticipating business needs and being proactive in terms of managing those needs. Today's Company Secretaries must embed themselves within the business so that they can pre-empt risks before they happen.

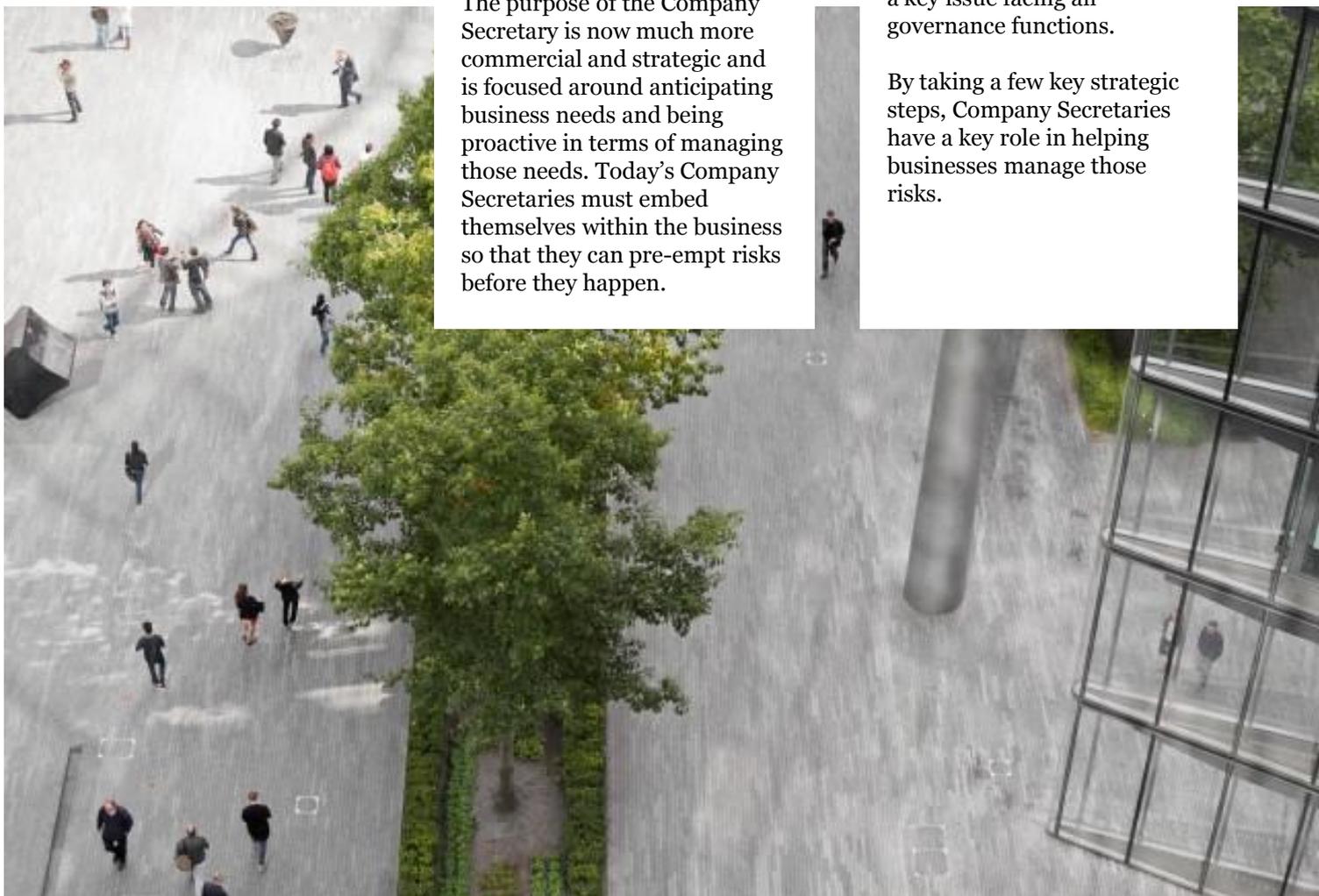
A subsidiary governance framework can assist Company Secretaries in managing the compliance burden, but also provides an opportunity for them to add real value to the business by creating efficiencies, minimising risk and reducing costs.

Conclusion

Failing to plan and put in place a robust subsidiary governance framework that is adhered to, is planning to fail.

Managing the unappreciated risks around global subsidiary governance and compliance is a key issue facing all governance functions.

By taking a few key strategic steps, Company Secretaries have a key role in helping businesses manage those risks.



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