



## On the board's agenda

# Governance in a multidimensional environment

As organizations expand their operations, many do so by creating or acquiring legal entities to operate in new markets or different jurisdictions, to protect the parent organization against certain risks, and to facilitate the way it manages its local and global operations. Traditionally, the governance of these subsidiaries was not given a lot of attention, and as a result many of their governance practices evolved organically. Entities that are organized by division or region may have also found that the governance practices of the parent and subsidiaries operate in silos, with little consideration being given to the entire extended organization.

Under company law in many jurisdictions, a board has a fiduciary duty to act in the best interests of its organization. However, for organizations that are either parents or subsidiaries of other entities, fulfilling that responsibility effectively is often a complex process within a complicated governance environment.

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**Traditionally, the governance of subsidiaries was not given a lot of attention.**

Customers and other stakeholders often view parent organizations and their subsidiaries and other investments as a single entity, and there have been instances where the courts have held parent organizations ultimately responsible for their subsidiaries. Despite this, parent boards often cannot impose all of their governance practices on their subsidiaries in other jurisdictions because of differences in legal and regulatory requirements, business cultures and other practices. Acquired subsidiaries have existing cultures that make it difficult for the new parent to impose its culture and governance practices. Parent organizations without a wholly-owned interest in an entity face greater difficulties in influencing that entity's governance practices.

To properly carry out their fiduciary responsibilities, subsidiary boards are expected to act in an independent and objective manner. However, because of their ownership structure, it is often difficult for subsidiary boards to achieve that independence. Usually, the parent organization nominates the directors to the subsidiary's board who are often directors, officers or employees of the parent. For this reason, the interests of the parent may take precedence over those of the subsidiary.

Regulators want a greater understanding of the governance practices of parent organizations and their subsidiaries. For example, the 2009 edition of the King Report on Corporate Governance (King III), South Africa's governance code, states that a governance framework should be agreed between the parent and subsidiary boards of directors, and be disclosed in the integrated report of the subsidiary. The draft King IV Report goes further by allocating responsibility for overseeing the implementation of a group governance framework to the parent organization's board, and that framework should be approved and adopted by each subsidiary's board.

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## **Regulators want a greater understanding of the governance practices of parent organizations and their subsidiaries.**

### **Managing subsidiaries**

One reason why organizations establish subsidiaries is to limit risk. Some may be acquired as part of a business combination, while others may be set up to facilitate a specific transaction or business outcome. Some may be necessary in countries that require organizations to do business through a locally incorporated entity. Many subsidiaries are also established for tax purposes. In some organizations, the processes for establishing subsidiaries may also be informal, where subsidiaries are established in an ad hoc way, and those that have fulfilled their purpose may not be wound up when they have served their purpose.

In many parent organizations, ownership of subsidiary governance is assigned to a senior executive, such as the general counsel or corporate secretary, while some organizations appoint a designated subsidiary governance officer. They would be accountable for developing and issuing the subsidiary governance policy, subject to approval by the board, and thereafter performing the day-to-day oversight of the subsidiaries' compliance with the policy. Many organizations also

utilize their internal audit function to evaluate the robustness and compliance of the subsidiary governance practices put in place by conducting periodic assessments.oversight of the subsidiaries' compliance with the policy. Many organizations also utilize their internal audit function to evaluate the robustness and compliance of the subsidiary governance practices put in place by conducting periodic assessments.

## **Governance of subsidiaries**

A leading practice is for parent organizations to categorize the importance of each of their subsidiaries, based on factors such as the parent's level of investment in a subsidiary, its strategic importance, the risk it poses to the group and other factors including the maturity of the subsidiary's governance practices. Parents could then establish the appropriate governance structures and practices for each subsidiary. For example:

- Parents may want their subsidiaries to have similar governance practices to those of the parent, including having a board of directors. A legal entity principal "officer" (such as the CEO of the subsidiary) may be given the responsibility for ensuring that the subsidiary adheres to the parent organizations' policies and any statutory requirements.
- For higher priority subsidiaries, the parent may want to have subsidiary board members and officers meet periodically with the parent board (in addition to obtaining minutes of subsidiary board meetings in a timely manner);
- For the most strategic subsidiaries, the parent may want to have common directors on both the parent and subsidiary boards, which may include having independent non-executives on the subsidiary board.

In addition, the board of the parent organization should review this tiered subsidiary governance model on an annual basis to ensure that the way the subsidiaries are categorized continues to be appropriate.

Directors of a subsidiary board need to have the same degree of orientation, guidance and support as directors of the parent board. They should also have an appropriate mix of skills, experience and backgrounds to provide effective oversight of the subsidiary and its operations – which often times, could differ from what is required for the parent. Formal evaluations of the subsidiary board, its committees and directors should be conducted in the same way as they are conducted at the parent level, and the results of the subsidiary board evaluations should be reviewed by the parent board (or an appropriate committee of the parent board) to ensure that the subsidiary board is functioning effectively.

The size of a subsidiary board should reflect the size and complexity of the subsidiary's operations. Larger subsidiaries often have one or more directors who come from outside the subsidiary in order to bring greater objectivity to the board.

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**Parent and subsidiary boards also need to determine how to balance the level of independence for the subsidiary with the needs of the group.**

## Adapting governance to local conditions

While the governance practices of a subsidiary will ideally be similar to those of the parent, it may not be possible to implement all of those practices identically across the entire organization. Subsidiaries need to be able to adjust policies and practices to reflect their operational needs and ownership structure as well as their local jurisdiction's tax, legal and other business regulations. Parent and subsidiary boards also need to determine how to balance the level of independence for the subsidiary with the needs of the group. Therefore, a good governance practice is to have an ongoing dialogue between the subsidiary and the parent at the board, management and operating levels, to better ensure that all parties clearly understand each other's objectives. Having one or more common directors on both the subsidiary and parent boards will facilitate this dialogue, which will help to avoid surprises and improve the ability of parents and subsidiaries to work together effectively.

Approving and overseeing the organization's strategy is a key board responsibility. Subsidiary boards need to be adequately informed of the group's objectives and strategy, while the parent board needs to clearly understand the risks associated with the subsidiary. An emerging practice is for the parent organization's representative on the subsidiary board to keep the subsidiary board informed of the parent's strategies and activities. To fulfill their fiduciary duty to the subsidiary while also contributing effectively to the parent, the subsidiary board may also provide input into the parent's strategy (by submitting its proposed strategic plan to the parent), which helps ensure that strategies are practicable at both the parent and subsidiary levels and are aligned to collectively achieve the group's objectives.

Risk oversight and internal control across the entire organization cannot be effectively managed solely at the parent level. In some industries, the parent organization's risk appetite is cascaded to each subsidiary; each subsidiary board can then determine whether it has adequate internal controls in place that reflect local circumstances and there is an appropriate balance between local controls and those provided by the parent organization.



**Susan Hwang**

Partner

Governance, Regulatory and Risk

*"It is important to have a clear understanding of the reason(s) for setting up or acquiring a subsidiary and the strategic role that the subsidiary plays within the group. These reasons will help to determine the appropriate degree of business practice consistency that the parent should demand and the control that the parent should exercise on the subsidiary. Having the right balance of governance oversight is critical to realizing the value of having the subsidiary while managing the risk to the group."*

Susan Hwang has extensive experience working with Boards of Directors, Board committees and executive management teams on corporate and risk governance. She has provided many governance and risk training and awareness sessions to Boards of Directors, and supported Boards in developing the organizations' risk appetite, facilitating discussions on risk, assessing Board governance effectiveness and assisting Boards in discharging their risk oversight role. In addition to providing governance advice, Susan has also assisted many organizations on enterprise risk management (ERM). Susan is a frequent speaker at various conferences on the topics of risk management and governance, and chairs Deloitte's bi-monthly ERM Roundtable attended by senior chief executives of various organizations.

Given the increasing focus by stakeholders and regulators on how global entities have organized themselves, parent organizations should also consider disclosing their governance – and subsidiary governance – practices. If a presentation of each subsidiary’s governance practices isn’t practical because of the number of subsidiaries, an overview of their governance practices might be segregated by the subsidiaries’ jurisdiction, industry, or other grouping that matches the description of the parent’s business strategy.

Every organization with subsidiaries will need to determine its own unique framework and practices to govern both the parent and its subsidiaries. While the appropriate governance model will vary from one organizational group to another, and may also vary over time depending on the changing circumstances of the parent, subsidiaries or both, it is essential that boards at both levels remain focused on their fiduciary duty to act in the best interests of their organization as well as that of the entire organization.

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**Dan Konigsburg**  
Managing Director  
Global Center for Corporate  
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Deloitte Touche Tohmatsu Limited

*“Subsidiary governance is often more complex than it may at first appear. If the governance of a single organization can be considered one dimensional, among a group with multiple, different subsidiaries it becomes multidimensional, reflecting the variety of operating circumstances and jurisdictional differences of the various entities. As a result, one organization may choose to govern its subsidiaries much differently than another, but ultimately their choice will often be based on their cultures.”*

# A director's perspective



## **Olivia F. Kirtley**

Director, U.S. Bancorp, Papa John's International, and ResCare, Inc.,

Olivia F. Kirtley is a non-executive director of U.S. Bancorp, Papa John's International and ResCare, Inc., and has served on other public company boards since 1997. She is the president of the International Federation of Accountants, which includes over 175 member bodies in 130 countries representing almost three million accountants; she is also a past Chairman of the Board of the American Institute of Certified Public Accountants. The National Association of Corporate Directors has named Ms. Kirtley as one of the top 100 corporate directors and governance professionals in the United States.

## **In organizations that consist of a parent and subsidiaries, governance of the full enterprise is often shared between the boards of the parent and the subsidiaries. What are the key issues for parent boards?**

Transparency and accountability – it's as simple as that.

A lot of what goes on at the subsidiary level may be outside the control of the parent. For example, a subsidiary board may need to deal with issues unique to the subsidiary's own circumstances, including issues that are dictated by local regulatory or other national requirements. Therefore, it is important that the parent board knows the issues being discussed by the subsidiary board, and is assured that all of the appropriate issues are being addressed. When something important comes up, mechanisms and protocols need to be in place to elevate these matters to a higher level for awareness, follow up, remediation or any other reason.

Having said that, it's always a challenge for the parent board to know how to interact with its subsidiaries, how frequently to interact, what type of information subsidiaries should be asked to provide, and at what point the parent board needs to be involved with certain matters. There isn't a one-size-fits-all answer for how to go about doing that other than to say the basic goal should be transparency and accountability.

## **Subsidiary boards need to act in the best interests of the subsidiary, but also have a responsibility to the parent organization. How should the subsidiary board balance these responsibilities?**

Ideally, the interests of the parent and subsidiary will be aligned, but when that isn't the case, it is the subsidiary board's responsibility to make sure the parent understands why a particular solution or course of action is not a good one for the subsidiary. In some situations, it may be that the proposed solution is not the optimal one for the subsidiary, or could be just a matter of preference.

On the other hand, the issue may be about something substantial, for example because of a difference in business models, a difference in the format for accumulating data, or because the solution may be overly expensive or difficult for the subsidiary to implement. In these situations, it is important for the subsidiary board to make its case to the parent so the parent is aware of the issues and the related consequences. This will allow the parent to weigh all of the pros and cons when making choices for the entire organization.

## **Would having common directors on both the parent and subsidiary boards help facilitate transparency?**

That is certainly a good practice. There often are cross-over directors on the parent and subsidiary boards, but those individuals are not always parent company independent directors; sometimes, senior members of management of the parent company will serve on the subsidiary board. They are normally expected to report up to the parent on any issues arising from the subsidiary's board or committee meetings that would be viewed as significant and of interest to the parent's full board or its committees.

Depending on the regulatory regime, some subsidiary boards may be required to have one or more independent directors on the board. In these situations, I believe it is important to have direct communication with the independent directors from time to time, for example, by asking them to present at the full parent board or creating some other mechanism for dialogue. I have seen situations where we've had a joint meeting of the audit and risk committees of the parent and subsidiary boards, for instance, and we've asked the independent directors and managing director of the subsidiary to also join these sessions to discuss the issues they see coming on the horizon so the parent board is fully aware of them.

For existing and ongoing issues, the minutes of the subsidiary board – and if it operates in a committee structure, the minutes of its committee meetings – should be reviewed at the parent level, whether it be on a board-to-board basis, or a committee-to-committee basis. If the full parent board or committee doesn't review the subsidiary minutes, at least the chairmen should do so.

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## **Stakeholders and the courts often consider parents and their subsidiaries as one entity. What impact does this have on the parent board?**

The general public and most stakeholders – investors in particular – have little or no idea of the organization's corporate structure, which is why they don't distinguish between parents and their subsidiaries. That's why the parent board has to feel comfortable that it is getting all of the important information from the subsidiary, that the subsidiary board is functioning effectively and has qualified directors.

When it comes to the courts, one can never predict the outcome. But in general, we're seeing awards getting bigger and plaintiffs always want to take their case as far as they can – which is often to the parent company. For that reason, an important consideration for the parent board is to ensure that the parent's Directors & Officers' insurance extends to the actions of the subsidiary.

### **Where, at the parent company, should the responsibility lie for oversight of the subsidiaries?**

Most commonly, it is the role of senior management as part of the governance structure for that level of oversight. When it comes to setting up or shutting down a subsidiary, I believe that should be part of the legal and finance team's responsibility.

As far as the parent company's board is concerned, I think the best way to ensure there is effective governance at the subsidiary is for the parent board to have an awareness of the subsidiary's board and committee structure, know who is serving on its board and committees, and be satisfied that those people are qualified, engaged and have the right experience to execute the subsidiary's business model and to address the risks and issues it may face. The bottom line is having the appropriate knowledge, experience, expertise and composition is no less important at the subsidiary board level than it is at the parent board level. Of course, not every subsidiary has a board, but if it does have one for national, regulatory or other reasons, the parent board should be totally satisfied with its composition, its processes and procedures, as well as its outcomes.

### **Historically, organizations weren't always fully aware of the risks facing their subsidiaries. Are they better at understanding these risks today?**

There's no one answer to this because different organizations are at different levels of maturity in their risk model, and some are much more mature than others. However, after the global financial crisis, the whole subject of risk began building momentum. It was no longer a case of just going through the exercise and having a risk assessment, but one of actively monitoring, mitigating and following existing and emerging risks.

When it comes to risk, I think there are two big dangers. One is not having a true understanding at the parent level of the culture, climate and environment that the subsidiaries operate in. The other is to assess risk based solely on materiality, because some risks are extremely disproportionate to their financial materiality. For instance, most anti-money laundering or anti-bribery regulations have very low tolerance levels – it's not a materiality issue, it's an event issue – and that can really have very disproportionate consequences to the financial issue at hand.

I think there is a lot of room for improvement, though many companies' risk processes may be very good. But depending on how they're structured, how centralized or decentralized their compliance and their risk processes are, the diversity of their human capital, and the parent board's awareness of cultural norms and what happens within and across national borders, I think that most boards should pay close attention to the way risks are being identified, monitored and mitigated.

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**When an organization needs to quickly get its values embedded in a new subsidiary, putting parent company management into the subsidiary's operations may be the best approach.**

### **Would rotating management between the parent and subsidiaries help the overall organization better understand its risks?**

Some companies certainly do that and have done it for a long time. I think it not only increases the knowledge management has of the subsidiaries, but sometimes, particularly with an acquisition, it is the best way to ensure that the organization's culture gets embedded into the new organization. Things can be written on a piece of paper, such as a code of conduct, but only by seeing it in real time can you tell how that code is being interpreted and adopted. When an organization feels it needs to quickly get its values embedded into a new subsidiary, particularly one in a developing country that may have less experience with large, formal corporate structures, putting parent company management into the subsidiary's operations may be the best approach.

### **Is technology making the task of subsidiary oversight easier?**

Technology is certainly very helpful, particularly when the parent and subsidiaries are on common platforms, because it allows for the retrieval of data in real time, the gathering of data in various formats, or the manipulation of huge amounts of data to show trends or patterns. With technology, the collection and analysis of data is not dependent on it going through someone else's human hands. Instead, you can retrieve the data yourself, in whatever format you want, and do it in real time.

Many organizations, however, may not be on common platforms and that makes data collection and analysis across the parent and subsidiaries a challenge. To maximize the effectiveness of their technologies, I think we will see organizations increasingly moving to centralized data systems and common platforms.

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