Extracts from

The contribution of subsidiary boards to risk governance. An overview of the literature and developing practice

MSc in Corporate Governance and International Business Ethics

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September 2012

Table of contents

1. INTRODUCTION

1.1 Introduction

This paper is an extract from an MSc dissertation which explores how subsidiary boards exercise their risk governance role. It includes the literature analysis section, summary of findings, analysis of those findings and conclusions (section cross-references refer to the original report). It was originally produced to fulfil the undertaking made to interviewees to provide feedback. It has not been written as a standalone document, publication, or to be used for decision-making purposes. Nonetheless it is hoped that it will prove to be an accessible way of reading key sections of the dissertation. Permission must be obtained to use any of the material and the source acknowledged appropriately.

The report is necessarily somewhat speculative since it is based on a small number of interviews. To make these more representative of a wide range of sizes and sectors they included a partner from a global audit firm and senior manager and consultant from a leading firm providing governance, company secretarial and registrar services. They included interviews with experts from ICSA and AIRMIC (risk institute).

There is relatively little research into subsidiary boards and, so far as the author is aware, none on their risk governance role. This dissertation aims to begin to fill that gap. It draws together literature on subsidiary boards and that on the role of main boards and risk. It complements that with research into what is happening in practice. The aim is to enable the practice of subsidiary corporate governance, and encourage further research.

1.2 Research question

The primary research question is *how are subsidiary boards making an effective contribution to the governance of risk?*

1.3 Context

The importance of large companies to the economy and society is widely recognised. Ensuring that the main board has a clear line of sight to material risks across the whole business is a key corporate governance principle; as is the importance of managing risks in a way which adds value. [FRC 2011, AIRMIC 2011]. There are similar expectations as regards the stewardship of funds to achieve the purposes of not-for-profit and public organisations.

Recent guidance on risk adds clarity about the issues main boards should consider. [FRC 2011, IRM 2011, AIRMIC 2011]. However these say little about the issues for subsidiary boards; these do of course have a duty to consider risks to the on-going sustainability of the company.

Risk governance is viewed as worthwhile if it adds or preserves value. So a key question is how/whether subsidiary boards assist in doing this. This could be by: adding financial value; maintaining the firm's licence-to-operate; ensuring the organisation continues to be sustainable and a going concern.

Subsidiary governance is multi-dimensional. Typically groups are organised through the business line, which has primacy; subsidiary entities are a secondary "tool". Groups must manage two-tiers of governance, parent-level and subsidiary-level. [Luo 2005a]. Directors must hold in tension their accountability to stakeholders and shareholders with their obligation to achieve group strategic goals. They must make sense of two "hats", their management hat and their director hat, and the duty of trust and care that they owe. Their ability to do so makes a difference to the effectiveness of subsidiary boards.

The use of subsidiaries, and their development, differs from one group to another. For example they may be set up to meet commercial or fiscal/investment requirements; for licence-to-operate reasons; for group operational reasons. So a key question for groups is: how to integrate subsidiaries whilst maintaining an appropriate independence?

During the period when work on this paper took place, there was an increasing interest in risk governance and subsidiary governance. Global economic factors and public policy decisions appear to have been amongst the catalysts. For example non-UK government fiscal decisions in the light of the Eurozone financial crisis. Some new academic work on the HQ/subsidiary relationship was published, and professional institutes increased work on subsidiary and risk governance. That, together with the willingness to participate in this research indicates its timeliness.

1.4 Conclusion

Understanding the changing external and internal environment in which subsidiaries operate is important in order to ensure that their risk governance framework is an asset which enables the creation and preservation of value. This includes the contribution of individual directors. As the OECD Principles of Corporate Governance 2004[1] explain "*the presence of an effective corporate governance system, within an individual company and across the economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth".*

The first half of this paper reviews the literature. The second half explores practice. The analysis and conclusion explore how subsidiary boards make a limited contribution to subsidiary governance, where there are "weak links", and the potential to leverage additional value. They make recommendations to management and suggest further research.

[1] page 11

2. LITERATURE ANALYSIS

2.1 Introduction

The first half of this paper draws together literature on subsidiary governance and risk. This serves two purposes. Together with the practical research in the second half it provides the basis for further research. It can be used as a management tool when reflecting on the development of subsidiary boards.

Key themes are summarised in Figure 2 on page 28.

One driver for this research was the author's need for a professional reference text on subsidiary governance practice, ideally on risk, and the discovery that there was none. The academic work is mostly qualitative. One barrier is the difficulty that research into subsidiaries involves research inside multiple organisations on sensitive subjects. This is resource intensive. It limits research approaches. Much of the literature and information suggests models or tells us what one would hope to find or is contained in regulatory or good practice guidance.

Literature consulted but not reviewed or explicitly referred to in this paper is included in the bibliography. It is encouraging that more academic and practitioner work is taking place. [Ciabuschi et al 2012, ICSA 2012, AIRMIC 2012, Judge 2011].

2.2 Corporate governance theory

Recent work advocates a multi- lens, multi-level and multi-variate approach towards corporate governance theory, including the idea of "*governance bundles".* [Daily et al 2003, Ward et al 2009, and Judge 2011]. Conceptually this resonates with the idea that a "*matrix of the mind"* [Bartlett and Ghoshal 1987] is necessary to use subsidiaries effectively in international strategies.

This multi-dimensional approach is helpful given the complexity of subsidiary board risk governance. It highlights the balance to be struck between control and stewardship/stakeholder mechanisms; the need to drive value creation whilst preserving value. It reminds us that subsidiary boards operate within two-tiers (parent and subsidiary level) and the two arms of organisational governance.

Figure 2: Literature analysis summary: Subsidiary governance and risk **(source author)**

Literature sources	Key themes and application
Corporate governance theory	Multi-lens perspective Control (agency) v stewardship/stakeholder Adding and preserving value Two-tiers, parent and subsidiary; two arms of organisational governance
Subsidiary governance	Subsidiary governance as a core competency Context influences development “pathway” Alignment of structure is important Impact of internal and external environment; local, parent and group factors.
Frameworks	Multi-dimensional environment of subsidiary Corporate governance/accountability Informal and formal, hard and soft framework Independence and integration (congruence) Board’s understanding of its role is important
Risk and regulation	Adding and preserving value Clear line of sight across the business Effective boards Possible over-focus on business line? Alignment is important – understanding risk appetite, tolerance, objectives Relevance of “soft” and “hard” risk factors e.g. decision-making/culture and finance Risks to business model, reputation, licence-to-operate, plus financial Formal and informal assurance systems and knowledge transfer networks

Whilst control (agency theory) matters in the context of risk governance, effective corporate governance is also about trust, good decision-making and entrepreneurial leadership, leading to long term added value. Stewardship theory, with its emphasis on long term value, and stakeholder theory, with its acknowledgement of wider interests are both relevant in this context. [Clarke 2007].

Caldwell and Karri [2005] make a similar point about sustainability and relationships. They underline the importance of reward (financial and other) systems which promote organisational loyalties. The risk literature makes a similar point saying that rewards and targets create risks for companies by creating conflicts of interest.

The idea of using this multi - lens approach as an aid to reviewing risk governance is developed in the research analysis section. It seems possible that the particular theoretical model any one business adopts may influence its approach to corporate governance and risk governance.

2.3 Subsidiary governance

Nelson [1991] and Kogut and Zander [1992] suggest that organisational structure can be viewed as a core competency/asset of the firm. If so, appropriate subsidiary governance is potentially very significant to the firm's sustainability, and inappropriate subsidiary governance is potentially destructive. This includes ensuring an appropriate tension between integrating subsidiaries whilst maintaining their independence as legal entities.

From a risk governance point of view it is therefore important to understand not just how groups are using their frameworks, but whether they are well aligned and the subject of on-going review. The subsidiary environment is continually changing, and subsidiaries themselves are on a development "*pathway*". [Birkinshaw and Hood 1998] The subsidiary environment includes the external and internal environment, parent level environment and subsidiary level environment. The requirement for the subsidiary may cease, as may its materiality to the group or its socio-economic context. Those changes will have implications for the subsidiaries risk environment, the potential risks to the group, and the group specific subsidiary framework. [Kim et al 2005]

There is known to be an interest in the way in which different sectors and companies are developing their risk frameworks. The literature suggests that it may develop along "*pathways*" and that it is important to understand emerging factors which may influence the development of the subsidiary risk governance role. Achieving on-going alignment with corporate strategy, structure and culture is important if subsidiary boards are to add value and for effective risk governance. [Birkinshaw and Hood 2001, Tricker 1994, FRC 2011]. Changes may require amendment to the subsidiary control framework including board composition. [Leksell and Lindgren 1982 Tricker 1994, Kim et al 2005, Kiel et al 2006,Du et al 2011,Judge 2011].

Although there are studies about whether the role played by subsidiaries has an effect on delegation to the subsidiary and role of the board [Baliga and Jaeger 1984], it is not clear what this means from a risk perspective. The literature focuses on strategic role rather than value. [Brellochs 2008]. Work on investment such as that by Feinberg and Gupta [2006] focuses on how groups respond to increased country risk e.g. by internalising trade with existing subsidiaries, rather than on the role of subsidiary boards as such. Any proper consideration of risk would need to consider non-financial risks. It might also consider the HQ/subsidiary balance in value-driving/entrepreneurial activity and monitoring. [Ciabuschi et al 2012]. and the correlation of active boards with certain types of subsidiary. [Du et al 2011]. It seems likely, from reading the literature, that some of the confusion is because of a lack of clarity about strategic role, value, materiality and risk.

This suggests that there is a need to understand more about how groups align their subsidiary board frameworks, including whether they take account of materiality, and approaches to the use of subsidiary boards in adding value.

2.4 Subsidiary governance frameworks

Previous reference has been made to the multi-dimensional context of subsidiary governance. This includes two-tiers; the two arms of organisational governance (managerial and corporate governance); informal and formal aspects of frameworks; corporate governance and accountability; and the two "hats" that subsidiary director/managers must wear. They must "sense-make" their fiduciary duty (of trust) and duty of care as a director to their wider stakeholders and parent company shareholder.

[*SECTION FROM LITERATURE REVIEW ADDED HERE*]

A challenge for subsidiary governance generally is to manage the tension of integrating the subsidiary through the business line whilst maintaining the legal independence of the subsidiary.

In the group context the parent company is the investor/shareholder (principal).The board of the subsidiary are the agents (managers) responsible to the investor. In parallel the board of the parent company delegate responsibility to the CEO of the parent company to manage their affairs (figure 1 below).

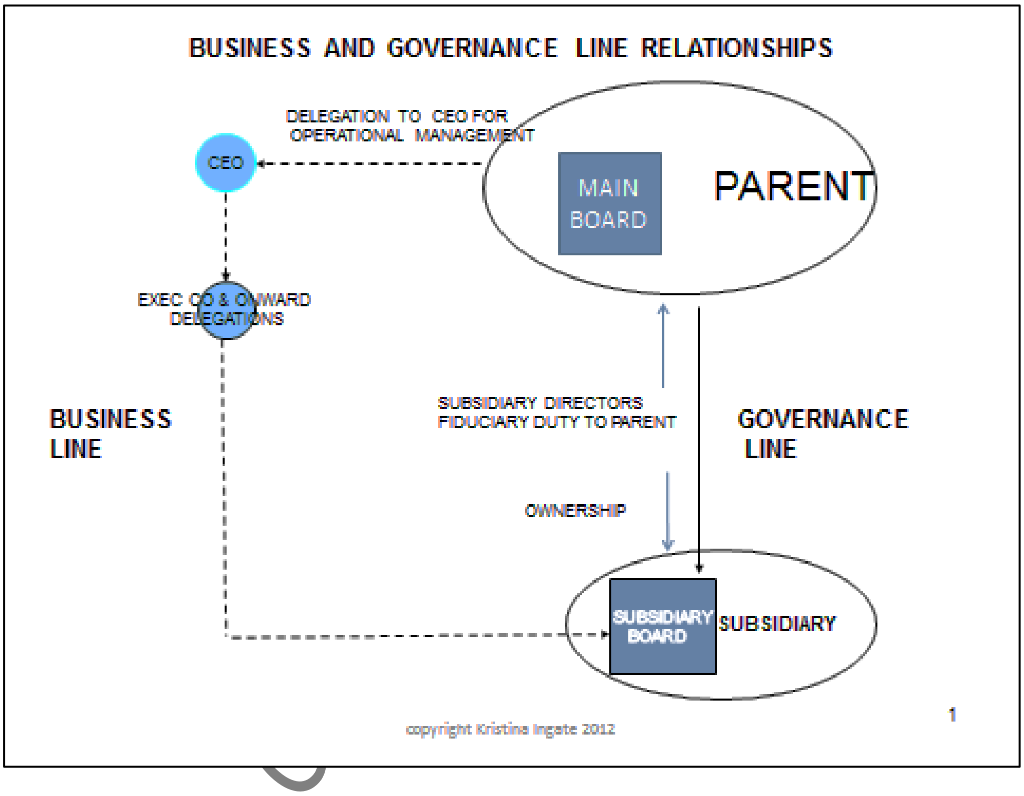

Figure 2 Business and Governance Line Relationships (source author)

The diagram outlines the parent-subsidiary and business-governance line relations which the subsidiary governance framework must hold in tension. The oval shows companies, the rectangle boards. The need is to integrate the subsidiary, whilst acknowledging its independence, balancing enabling value-add activity with appropriate controls.

Agency theory underlines the responsibilities of the directors of subsidiaries to the parent company/group, not simply their own (company) interests. As directors they have legal and regulatory obligations to all their stakeholders. [Tricker 2009].

Subsidiary board directors' relationships are complex in that most are managers subject to the ultimate direction of the CEO. That CEO typically has the authority of the parent company shareholder – given through matters reserved to the board- to set the boundaries for the subsidiary board (the agents of the parent company). [END OF SECTION FROM LITERATURE REVIEW]

Birkinshaw and Hood [1998 p236] describe the concept of assigning subsidiary charters or mandates as "*the business – or elements of the business – in which the subsidiary participates and for which it is recognised to have responsibility within the MNC".* Individual groups may or may not recognise this concept explicitly or link it to subsidiary governance frameworks. The literature review section 2.33 [not included in this extract] describes: "hard" aspects such as: business plans; legal agreements which assign rights and obligations to the subsidiary; together with mechanisms e.g. Luo 2005b: market-based, culture-based and discipline-based mechanisms. Individuals are important to these frameworks.

Kiel et al [2006], Kim et al [2005], and Tricker [1994] underline the importance of case by case solutions which reflect company specific characteristics, which includes strategy, structure and culture, as well as the external and internal environment in determining board roles and frameworks. Luo [2005b] refers to the complexity of structures, strategies and environments in groups, a point which underlines the importance of understanding how roles and frameworks are mutually facilitative in order to achieve the alignment that is important in risk governance.

Research suggests that corporate culture; planning, budgeting and pricing; formal standards and subsidiary codes of corporate governance and conduct are particularly important to effective subsidiary corporate governance. [Brellochs 2008].

This suggests that it is important to understand the detailed frameworks that groups use, with an emphasis on risk governance aspects, including those which are particularly important in effective risk governance. This might also give an indication of any particular "weak links" and/or areas of developing practice to assist management.

The literature also suggests that the composition of subsidiary boards, and skills and understanding of their role by board members makes a difference to their effectiveness. [FRC 2011, AIRMIC/Cass 2011]. Including a director from outside the subsidiary business unit, and the involvement of corporate headquarters staff are potential ways of ensuring congruence. [Tricker 1994, Kiel et al 2006, Du et al 2011]. An associated theme is the importance of the ethical values and cultural tone set by the CEO and board. The suggestion is that this, and the basis on which they are rewarded, will drive the behaviour of subsidiary directors, consciously or subconsciously, whatever their understanding of their role. They influence the focus of their efforts and "sense making" of their director role. [Caldwell and Karri 2005, AIRMIC/Cass 2011, FRC 2011]

2.5 Risk literature and regulatory expectations

Guidance on the role of the main board is that it should provide "*entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed".* This includes "*driving value creation without exposing the company to excessive risk of value destruction making well-informed and high-quality decisions based on a clear line of sight into the business".* [FRC 2011 p.2]. It anticipates clarity about risk appetite and tolerances and presumes alignment across the business.

The risk literature is largely silent about subsidiaries, suggesting that enterprise risk management and governance focuses on the business line rather than making significant use of subsidiary boards, except where they have a formal assurance role in the financial services/banking sector. [Fraser and Simkins 2010, OECD/Anderson 2004]. This may compound what has been described as a "*glass ceiling*" whereby the flow of information is impeded, or "*board risk blindness*" if it impacts on the way in which the board engages with risks to the business model, reputation and "licence to operate" issues. [AIRMIC/Cass 2011].

This suggests that it is important to understand how groups ensure that their subsidiaries are aligned, what weak links there might be, and how practice is developing. This should include the ways in which subsidiary boards review risk information and how this feeds up through organisation frameworks. Those frameworks are likely to differ depending on the sector, reflecting variations in complexity, volatility and risk time frames. [Walker 2009, Brown et al 2009].

Writing and regulatory guidance on governance and risk points to the importance of people with appropriate skills and understanding of their roles for boards to be effective. [Kiel et al 2006, AIRMIC/Cass 2011, FRC 2011]. This includes an understanding of non-financial dimensions, effective decision-making, and the concept of "*soft risks".* [Fitzsimmons 2011, Sobel and Reding 2004, AIRMIC/Cass 2011, FRC 2011, IRM 2011].

The literature also suggests that a number of formal and informal assurance and "*boundary spanner*" [Schotter and Beamish 2011] roles are important. Effectiveness could be enhanced if frameworks which ensured all key players contributed in a way which leveraged their knowledge and expertise e.g. internal audit, risk, governance, legal, finance. [Schotter and Beamish 2011, Frigo and Anderson 2009]. A better understanding of knowledge sharing and intra-group communication governance mechanisms could be valuable. [Fraser and Simkins 2010; Andresson and Mats 1996; Athanassiou and Nigh 2000; Gnywali et al 2009].

This suggests that finding out more about how directors exercise their role, and which roles are involved in subsidiary governance could be helpful.

2.6 Conclusion

This section has analysed the corporate governance, subsidiary governance, risk and regulatory literature to provide an overview of particular relevance to subsidiary risk governance. (Summarised in figure 2 above.) This provides the background for the research in part 2.

3. RESEARCH ANALYSIS

This extract is limited to the analysis of research findings in 3.6. The paper reports key findings under thematic headings.

The primary research question is: *how are subsidiary boards making an effective contribution to the governance of risk?*

The results are necessarily speculative given the sample although this included interviewees providing a broad perspective and “sense check”.

3.1 Introduction

This section analyses and reflects on the research findings with reference to the literature, building on comments at the end of previous sub-sections.

Subsidiary risk governance takes place in a multi-dimensional environment created by changes at parent, local and group level. These changes impact on strategy, structure, culture and operating context. Changes in the complex risk environment include issues such as the extended firm, regulatory and licence-to-operate issues; shareholder and stakeholder expectations.

3.2 Corporate governance theory

The literature analysis suggests that subsidiary governance is best approached using multiple corporate governance theory lenses, and a multi-level, multi-variate approach. [Judge 2011a, Judge 2011b]. This is particularly relevant to risk governance which strives to balance value add and value preservation. Some theories focus on control (agency theory) and others on long term value (e.g. stewardship and stakeholder theory). [Daily et al 2003]. This approach is supported by the idea of governance bundles. [Ward et al 2009]. “*Control mechanisms serve to focus members’ attention on organisational goals whilst trust mechanisms promote decision-making and enhance cohesiveness.”* [Stile and Taylor 2002]. Whilst control matters in the context of risk governance, it is also about good decision-making and entrepreneurial leadership, leading to long term added value. [FRC 2011].

The variation in models adopted by organisations was not the subject of explicit investigation. However the continuum of approaches to corporate governance and mix of mechanisms used in corporate governance and risk governance frameworks is suggestive of differences.

The author suggests that the theories are useful lenses, which can be used as management tools in reflecting on how to develop any given organisational governance structure.

3.3 Aligning strategy and subsidiary structures

An appropriate organisational framework can be viewed as a complementary asset/source of competitive advantage. [Kogut and Zander 1992; Nelson 1991]. The primary structure for groups is the business line, with subsidiary entities a secondary "tool". It is important for groups to hold in tension integrating subsidiaries with the business line and maintaining their appropriate legal independence (figure 1). Ensuring strategic alignment is important to ensure that subsidiaries add value, for the long term sustainability of the group and in effective risk management. [Luo 2005, Birkinshaw and Hood 1998, Tricker 1994, AIRMIC/Cass 2011, IRM 2011].

The nature of the subsidiaries role is usually linked to internal or external environmental contingencies (factors) at group, parent and subsidiary level. [Leksell and Lindgren 1982, Kiel et al 2006]. Detailed frameworks are likely to be case specific. This should be the case in order that governance frameworks reflect group strategy, structure, and culture. [Kim et al 2005, Tricker 2004]. They will reflect the particular internal and external environment of that company, and its response, over time to those environmental changes i.e. the development "pathway" of the subsidiary.

However we expect to find some similarities because many subsidiaries factors are common. For example: challenges about ensuring independence and integration; emerging factors which make subsidiary governance more important, e.g. the increasing attention given to the "extended firm". The general findings, although speculative, are in line with the literature. The extent to which companies have developed risk governance and risk governance frameworks appears to be a "*pathway*" specific and a function of the external environment, including regulatory requirements. The banking sector and pharmaceutical sector provide examples (see below).

However it appears that small companies in particular are either unable to, or do not consciously, review the way in which they develop to ensure that their subsidiary structure is an asset. This may be due to a lack of resources, short-termism, lack of awareness, or in some cases a conscious decision that given the simplicity of their structure, risk profile and ownership structure, a routine review is not necessary. The danger of not reviewing structures is that they become “stuck”. So instead of being an asset it becomes a liability which fails to preserve or enable value. The AIRMIC/Cass research identifies the way in which underlying risks can create crisis for companies. The legal liability and financial risks of a mismatched framework are getting increasing attention in the governance community.

Three examples illustrate the first point. The banking/financial services sector necessarily has a highly structured framework to meet regulatory requirements. Its pathway is influenced by its economic and regulatory context. The pharmaceutical industry is influenced by its external stakeholders, including patients, and the very long research and testing timescales which are part of its regulatory framework. A professional services company is less complex. Its key risks may simply be quality of service, sufficient continuity of partners and costings. Outside the largest companies the framework is more “patchy”, for example assurance mechanisms are likely to be limited.

Some companies have on-going review processes to check the alignment of their subsidiaries. Their approaches include changes to composition and frameworks, identifying redundant subsidiaries, alignment with strategy. One company had identified the key subsidiaries which were subject to higher levels of governance review. Materiality was defined on the basis of impact on the group and/or economies in which they operated, bearing in mind aggregate risk.

Subsidiary boards might potentially be in a position to contribute to this if they are risk aware (risk intelligent).

3.4 Subsidiary governance frameworks

This paper reviewed the literature on subsidiary governance frameworks in order to describe the potential scope of those frameworks, including both “hard” or tangible and “soft” or intangible elements. The author suggests that the comprehensive information (section 2.3.3 original paper), including the references to the work on network based frameworks, provides a management as well as an academic research resource. The mix of elements is particularly relevant in the context of risk governance given the relevance of effective communication and skills of board members to board effectiveness.

The research into practice focused on risk governance frameworks, in particular the role of the subsidiary board. The findings (chapter 5 in the original paper) suggest that business planning, and the overlapping roles of individuals who serve as directors and managers are key to risk governance. They are supported by formal guidance, enterprise risk management reporting processes and equivalents, and by effective corporate reporting relationships. Entity based financial and risk reporting and monitoring, approvals for business plans, and year end shareholder (parent) approvals are other elements of the risk governance framework. Some companies had/were developing separate guidance for directors, and in some cases board effectiveness programmes. However frameworks are likely to be "patchy" in small companies.

A potential weakness is the heavy reliance on business planning to achieve alignment and as part of the control framework. This is a particular problem if it does not consider entity based financial and risk information. In general it seems likely that although large organisations, and those in some regulated sectors, will be looking at entity based financial and risk based information presented in a format which is different from management information, this may be a particular area of weakness. This is a concern because risks which are entity based may be missed and directors may fail to meet their shareholder and stakeholder obligations.

The role of directors is considered subsequently.

3.5 Risk frameworks

Regulatory guidance requires that the main board provides entrepreneurial leadership within an appropriate risk framework. This includes "*driving value creation without exposing the company to excessive risk of value destruction".* [FRC 2011]. This ensures maintaining a clear line of sight to the business – including alignment on appetite and tolerance. [FRC 2010, FRC 2011]. The role of the subsidiary board in this is not clear, although there are clear expectations about risk frameworks

[Frigo and Anderson 2009] and how these should be applied to companies in different risk environments. [Brown et al 2009, Fraser and Simkins 2010].

This is key area of interest in answering the research question; however there are few pointers in the literature as to how this might be achieved. The corporate governance literature considers strategic role rather than value, materiality or risks. This research, and limited external evidence, suggests that some groups have consciously developed governance frameworks based on the materiality of their subsidiaries and/or risk profile. However this was by no means universal.

The research suggests that the boards of wholly owned subsidiaries may play a limited role in risk review and reporting, the focus being through the business line Arrangements for jurisdictional and shareholder reporting will vary depending on the size of the company, whether or not it is a PLC and the impact of regulatory structural requirements e.g. those of the banking/financial sector. See figure 3 below.

In the diagram the oval shows the company, the rectangle shows the board, and the triangle shows the group governance or management audit/risk committee. The parent company is the shareholder of the subsidiary, and the main board is the agent of the parent.

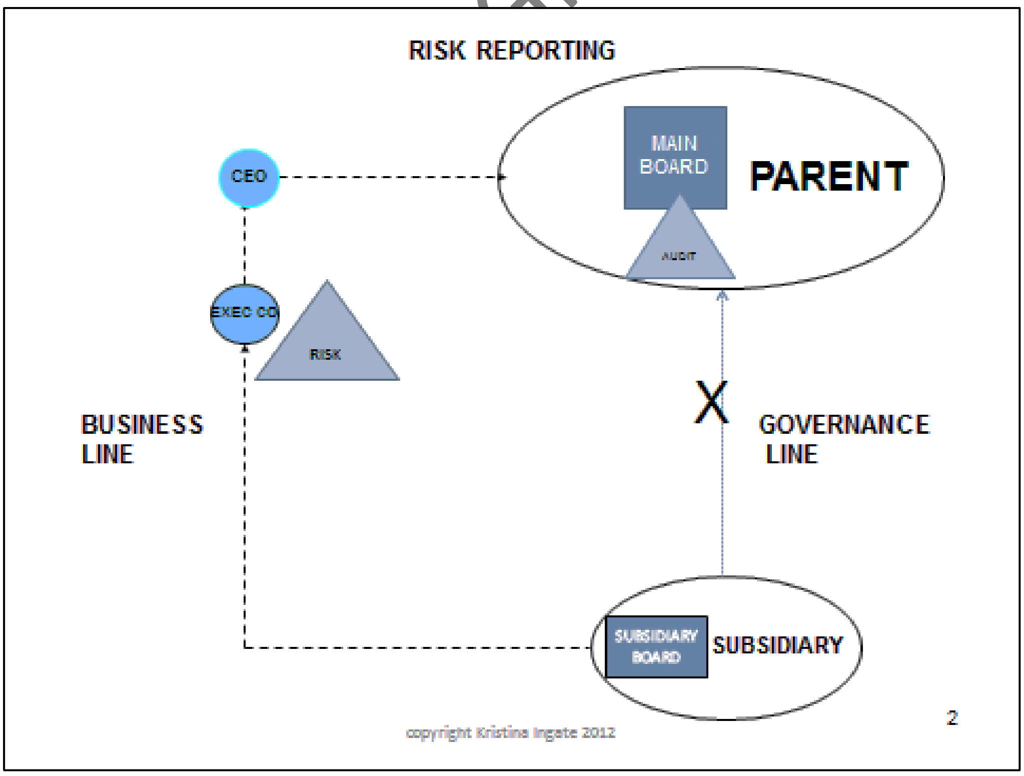

Figure 3 Risk reporting (source author)

Reporting to the main board is based on information from the group audit/risk committee, often through an executive risk committee. Systems involving parallel referral through the governance line are less likely, unless this is a sector requirement. Depending on company size, arrangements make use of Enterprise Risk Management Frameworks (ERMF) and other tools, and internal audit, compliance and risk teams. For very small companies the approach is often more limited.

Potential weaknesses include: limited discussion of entity financial and risk information; lack of structured informal discussion about long term sustainability, including group risks. This is similar to the problem of "*risk blindness*" described by AIRMIC.

However other companies reported year end parent shareholder sign-off arrangements which required subsidiary directors to give risk review assurances; structured informal risk discussions; and regulatory expectations of parallel reporting lines; or internal guidance setting out the expectations of directors.

These findings suggest that management should ask the following check questions: are arrangements such in any given company to address subsidiary board accountabilities to shareholders and stakeholders? Are subsidiary boards reviewing risk effectively and in a value-add way?

3.6 Effective boards

The literature about the duties owed by directors, effective decision-making, and the mind-set they should adopt is potentially helpful in considering how subsidiary board directors might and should contribute value e.g. in due diligence, the group sustainability perspective, host country stakeholder sense-making, ethics. [Brown et al 2009, Sobel and Reding 2004, Fraser and Simkins 2010, FRC 2011]. The literature also suggests that the composition of boards, the skills and understanding of their role by board members makes a difference to their effectiveness. [Tricker 2009, Kiel et al 2006, Du et al 2011]. Writing on risk and board effectiveness generally suggests this will be relevant in their ability to contribute to effective risk governance. [FRC 2011, AIRMIC/Cass 2011, IRM 2011].

The interview respondents made similar points about how the qualities of individual directors, and their understanding of the corporate perspective, made a difference to their ability to contribute in an effective way. A further factor to consider was different cultural perceptions of the role, sometimes influenced by jurisdictional variations. In some subsidiaries there might be a very small “talent pool” from which to appoint given that it must include someone from the business line and often one citizen. Some directors were better able to make a positive contribution, bringing a good understanding of group strategy and risks, and could hold in tension their group role and legal accountabilities. Others, perhaps because they had not had the opportunity to participate in corporate networks, or were simply focused on their local interests found it harder to contribute effectively. “Good” directors understood their role in ensuring congruence; were engaged; and exercised their responsibilities appropriately. Some respondents said that it was important that the received “tone from the top” and reward systems were such that they resulted in appropriate director behaviours. Those that rewarded entrepreneurialism without regard to other considerations were counterproductive.

Based on overall responses, there is scope for improvement. Examples given of problems included: directors not engaging with their role, directors creating liabilities for fellow directors or the group; possible weaknesses in the alignment between the business authority and entity authority structures. Some companies, including smaller companies, were investing in this area, for example in board effectiveness programmes or reviewing their subsidiary governance frameworks. Others commented on the need to set clear expectations and give permission to challenge. For example in some cultures challenging the subsidiary CEO was not considered to be acceptable, and potentially damaging to the organisation/brand, even when their behaviour merited challenge and/or whistleblowing to the group and failure to challenge was in fact damaging.

These responses, answers to other questions, and the literature (see sections 3.2.3, 3.4, 3.5 and 6.6 in the original report) suggest that for subsidiary boards to be effective management should consider: whether there is an appropriate match between board members and the board role; the interplay between the board and corporate functions; subsidiary board directors understanding of their role, taking into account cultural and jurisdictional expectations.

This is especially important given the significance of individuals to effective risk alignment.

3.7 Adding value

Respondents were interested in the potential to leverage subsidiary boards to add value and developing trends in doing so. However they were cautious about adding governance layers which detracted from value creation. They saw merit in value enabling or preservation. They were interested in sector variations and possible “weak links”.

The findings suggest that four particular issues for management to consider are: alignment between subsidiary structure and strategy; dependence on the business planning process; dependence on the individual director/managers; and whether arrangements adequately acknowledge the subsidiaries independence and accountabilities.

Specific detailed points in respect of the engagement of subsidiary boards are: whether analysis and discussion of business planning and financial and risk monitoring is based on entity information; the scope for boards to add value through structured informal discussion of entity based risk focusing on long term sustainability and group interests, this should consider adding, preserving and destroying value; alignment with group strategy, structure and culture; board effectiveness, including members understanding of their role and ability to fulfil it. This should include what drives board behaviours.

4. CONCLUSION

4.1 Overview

These conclusions are necessarily speculative given the sample, despite including overview commentators. However findings “sense-check” against recent evidence from seminars, articles and other external perspectives.

Based on the literature review and research it appears that subsidiary boards are making some limited contribution to effective risk governance. However there is scope to improve this, leveraging more value. The interviews suggest a consensus that development of subsidiary risk governance is worthwhile.

The literature and the research highlight the fact that although there are common factors, solutions are organisation specific. Internal and external environments differ, as do “pathways”. Organisational and governance solutions must be tailored to specific environmental and strategic contexts. Organisational risk environments vary in complexity and time horizons.

There are a number of important qualifications to add to the conclusion that subsidiary boards are making a contribution. There is a significant difference between very large and smaller companies. This variation covers the scope of frameworks used and their “patchiness”, the level of understanding and consideration of the issues, the time and other investment in subsidiary governance. Where subsidiary boards are making a contribution there are potential weaknesses, and scope to leverage the contribution of subsidiary boards.

4.2 Key issues for management

Four particular issues for management to consider are: alignment between subsidiary structure and strategy; dependence on the business planning process; dependence on the individual director/managers; and whether arrangements adequately acknowledge the subsidiaries independence and accountabilities.

Specific recommendations are identified under the headings below

4.3 Is the approach to risk aligned?

Aligning objectives, risk appetite and tolerance is recognised as important in risk governance. According to the literature ensuring an appropriate “fit” is a complementary asset. Misalignment is a potential liability and/or risk in several ways. If the subsidiary structure gets “stuck” then it will potentially destroy value rather than acting to preserve it or enable adding value. Alignment is also important to ensure that the subsidiaries are appropriately independent whilst adequately integrated in the group structure.

In line with the literature the research suggests that the development of subsidiary risk governance appears to be path specific i.e. related to the internal and external environment of the group. The environment includes factors such as the regulatory framework, the complexity of that framework, and emerging trends with particular implications for subsidiaries. Those include stakeholder expectations, fiscal policies which impact on individual subsidiaries.

Some large groups had arrangements in place to regularly review the need for subsidiaries, and the appropriateness of their frameworks on a regular basis. Such reviews led to changes in board composition, matched arrangements to strategic purpose, and in some large groups had reduced the group size by over 200 subsidiaries.

The research suggests that business planning and the overlap between individual managers and statutory directors, together with effective integration with corporate functions, are important factors in ensuring alignment.

It is suggested that management review their arrangements for aligning subsidiary frameworks with changing environments, paying particular attention to business planning and director effectiveness.

4.4 Frameworks

A review of the literature suggests that there is a lack of clarity about the difference between strategic importance, material value, and material risk as regards decisions about appropriate control frameworks for subsidiary companies. This research suggests that this is a developing area of work, including the need to consider materiality in terms of the socio-economic contexts in which the group operates.

The literature and this research also suggest that this is an area where it is important for both groups and subsidiary boards themselves to ensure they are more effective in order to meet their accountabilities. At the group level boards are required to ensure a clear line of sight to material risks and have appropriate frameworks in place. At subsidiary level boards must exercise accountability to their stakeholders and shareholders, including ensuring the sustainability of the company, and returns on the investment shareholders have made.

The research also suggests that there may be a significant variation in the extent to which companies recognise the need to consider business, financial and risk planning, reporting and monitoring on an entity and well as a business line basis.

This is also evident in risk review and reporting arrangements which the research suggests may emphasise the business line and potentially fail to give adequate attention to the entity line.

If so companies may be unaware of risks and also potentially inadequately address their obligations to shareholders and stakeholders.

Management of individual companies should use the following questions to consider whether that is the case: do they consider materiality value and risk in devising frameworks? In financial, risk and other planning and reporting information undertaken on an entity as well as a business line basis? Do the risk reporting arrangements and mechanisms take full account of obligations to shareholders and stakeholders?

4.5 Effective boards

The literature and the research both suggest that board effectiveness is vulnerable to the effectiveness of individual directors. This includes matters such as their understanding of the director's role, perception of expectations as to how they fulfil the role, and ability to balance the corporate/subsidiary dimensions of their role. The research is suggestive of a growing investment in board effectiveness programmes and guidance to ensure directors understand their role.

Interviewees mentioned some "health warnings" about the problems created by an inadequate attention to subsidiary governance. For example some groups, and directors, fail to pay adequate attention to the independent nature of the subsidiary so that it is deemed to be controlled by the parent. Some subsidiary directors fail to have regard to their personal accountabilities and/or those of their fellow directors, or group arrangements fail to adequately recognise these. Some companies have addressed these through the design of comprehensive systems and frameworks, including “soft” aspects, and through board effectiveness programmes including guidance.

Management is recommended to review whether the composition of subsidiary boards is appropriate to their strategic importance, role and risks, bearing in mind risk appetite, materiality and value. Management should consider what action is necessary to ensure directors fulfil their role effectively.

4.6 The literature as a management tool

Subsidiaries operate in a multi-dimensional environment. There is potential to use a multi-lens, multi-variate approach to corporate governance theory to review approaches to subsidiary governance in any given group context.

This includes the balance between agency (control) and stewardship/stakeholder (sustainability) theories in the context of the need to promote long term value, cohesion and trust. It also recognises the two-tier, two-arm (organisational governance is comprised of managerial and corporate governance arms), formal and informal aspects of subsidiary governance frameworks.

The work on the informal “soft” aspects of systems, and on the relative contribution of HQ/subsidiaries in creating value/monitoring and control may also be useful to work on risk governance. Management are recommended to consider the potential value of using this multi-lens approach to corporate governance theory as a tool in developing subsidiary governance frameworks.

4.7 Limitations and further research

A key area for further research is to expand knowledge about how subsidiary board frameworks add and preserve value. Aspects of this include the extent to which companies of different sizes, in different industries, consciously consider the materiality of different subsidiaries. Also, perspectives on the role of HQ and subsidiaries in adding value, strategy and monitoring.

Another potential area is to develop more information about potential "weak links" which companies need to address. This research suggests that business planning processes and individual director/managers are key in managing the integration/independence tension which comes with using subsidiary companies. The research suggests larger companies are more aware of the need to examine financial and risk information on an entity basis as well as a business line basis. However this is less likely in smaller companies where in general their approach is "patchy".

This research was limited to 15 interviews and intentionally covered a wide range of topics. A wider project might interview a wider range of industries; include in-depth interviews with smaller companies; add views from the business line, directors and more corporate functions. It might examine individual topics in more depth e.g. board effectiveness, risk reporting.

Further research may be able to capitalise on increasing interest in this topic and forthcoming work in academic journals.

4.8 Summary

This two part paper seeks to fill a gap in the literature about subsidiary boards and risk by drawing together relevant work on subsidiary boards and recent literature on boards and risks. This is complemented by an overview of practice which is intentionally wide-ranging in order to provide a sketch from which others can begin to develop a more detailed picture of the landscape.

The research suggests that while subsidiary boards are making a contribution to risk governance, this is limited. There are potentially areas of weakness which it would benefit companies of all sizes to review. There is potential to use subsidiary boards to preserve and add value, contributing to the long-term sustainability of the business.