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

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ABSTRACT

How are subsidiary boards making an effective contribution to the governance of risk? In the absence of literature on this precise topic, the first half of this paper draws together writing on the role of subsidiary boards and general writing on boards and risk governance. The second half provides an overview of practice in companies of different sizes in different industry sectors. The literature review and research together enable further research. This work also provides a tool for managers seeking to develop subsidiary governance to add and preserve value. It outlines the contribution subsidiary boards are making, identifies “weak links” and suggests how management practice and research might develop.

Key words

Subsidiary governance; corporate governance; risk; international governance; multinational enterprise; director; board

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Table of acronyms

AIM Alternative Investment Market. London Stock Exchange Market for smaller companies

AIRMIC Association of Insurance and Risk Managers in Industry and Commerce

BASEL Basel Committee on Banking Supervision

CEO Chief Executive Officer

CGC UK Corporate Governance Code

COSO Committee of Sponsoring Organisations of the Treadway Commission.

ERM Enterprise Risk Management

ERMF Enterprise Risk Management Framework

FRC Financial Reporting Council

FSA Financial Services Authority

FTSE Index of share prices maintained by FTSE International Limited illustrating performance of UK and European companies, e.g. FTSE100 is largest 100 (by market capitalisation).

ICAEW Institute of Chartered Accountants of England and Wales

ICSA Institute of Chartered Secretaries & Administrators (company secretaries)

IRM Institute of Risk Management

LIBOR London Inter Bank Offer Rate

MNC Multi-National Enterprise (some writers use this term, others MNC)

MNE Multi-National Corporation (some writers use this term, others MNC)

OECD Organisation for Economic Co-operation and Development

PLC Public Limited Company

SID Senior Independent Director

Turnbull UK 1999 Turnbull Report on Financial Control

Treadway see COSO above

UK Corporate Governance Code see CG C above

UN United Nations

Walker Review of Corporate Governance of UK Banking Industry and other financial entities chaired by Sir David Walker 2009

1. INTRODUCTION

1.1 Introduction

This research explores how subsidiary boards exercise their risk governance role. 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.

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2. LITERATURE REVIEW

2.1 Introduction

The body of knowledge in this field includes: academic work; public policy work, including work on foreign investment and innovation; regulatory guidance, and work by professional bodies.

However, writing on boards and risk is limited; there is none on subsidiary boards so far as the author is aware (outside requirements in regulatory reporting and accounting).Much of the literature is written in the context of multinational PLCs. To begin to help fill this gap in knowledge about subsidiary risk governance, this paper draws together the relevant literature on subsidiary governance and on boards and risk. Regulatory guidance and professional institute reports are important to obtain information post 2008 (reflecting responses to the recent economic crisis).

Little of the writing reviews: variation in practice from sector to sector; views about ‘weak links’; or changes which are making subsidiary governance frameworks more important. The appropriateness of multi-dimensional perspectives and more work is identified by international corporate governance journals. [Judge 2011a, 2011b].

Four sources (plus web and e-library searches) were particularly helpful starting points: the journals *Corporate Governance: an International Review* and *Journal of International Management;* Hood 2003 and Brelloch 2008. Regulators and professional institutes were also important, in particular ICSA, AIRMIC and IRM.

The chapter begins with corporate governance theory before moving on to subsidiary corporate governance research, risk and regulatory guidance. (Summarised in Figure 2 page 28.)

2.2 Corporate Governance Theory

This section explores how corporate governance theories contribute to answering the question about subsidiary boards contribution to effective risk governance. It explores the concept of organisational governance. It describes how groups balance integrating business and governance/entity frameworks with acknowledging the independence of subsidiaries.

Corporate Governance is understood to be "*the relationship between the corporation and stakeholders that determines and controls the strategic direction and performance of the corporation. It is the system by which corporations are directed and controlled".* [Luo 2005a p2]. It specifies how rights and responsibilities are distributed, provides structures for setting objectives, strategy and guidelines for monitoring performance.

Increasingly writers argue the value of a multi lens, multi- variate and multi- level approach to corporate governance. [Judge 2009, Judge 2011]. Although some writers say that agency theory, which emphasises control and primacy of the shareholder interest, is particularly helpful in considering subsidiary governance this ignores the complexity of subsidiary relationships. [Clarke 2007]. This section therefore expands on the multi lens concept and considers three key theories.

Agency theory is the dominant corporate governance theory. It views the firm as a nexus of constantly re-negotiated contracts by individuals each aiming to maximise their own utility. [Alchian and Demsetz 1972]. Jensen and Meckling [1976] say the essence of the agency problem is the separation of finance and management. Investors (principals) need the agents (managers) to generate returns in their funds. This requires control mechanisms to ensure the agents act in the investors' interests.

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).

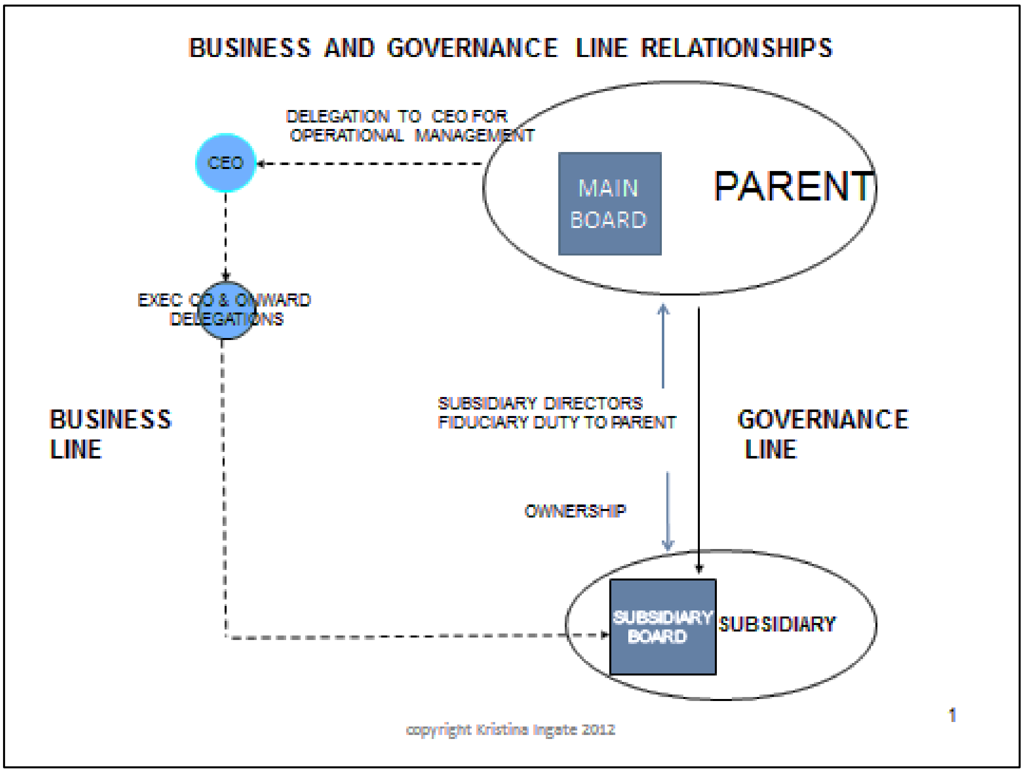

Figure 1 Business and governance line relationships (source author)

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. They also owe a fiduciary duty (a duty of trust) and a duty of care. As directors they have legal and regulatory obligations to 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/delegated - to set the boundaries which the parent company gives to its agents.

Daily et al 2003 suggest that agency theory provides an inadequate, single lens view of corporate governance, being most useful when considering the control/monitoring role of the board. Organisational theories such as stakeholder and stewardship theory are also helpful. Ward et al 2009 argue for complementary governance mechanisms or "*governance bundles"*. Stiles and Taylor 2002 note that [2], much corporate governance activity revolves around the building of trust "*because the board operates in complex and uncertain conditions and is often characterized by role conflict the potential for trust and control to coexist is apparent. Control mechanisms serve to focus members' attention on organisational goals whilst trust mechanisms promote decision-making and enhance cohesiveness"*. This is helpful in the context of subsidiary governance where the concern is about: alignment with group goals; delivering value through awareness of long term sustainability as well as short term goals; effective decision-making; and making sense of parallel roles and lines of accountability.

In brief stakeholder theory considers multilateral agreements between enterprise and multiple stakeholders. Stewardship theory maintains that there is no inherent conflict of interest between managers and owners. It points to the relationship between managers' pursuit of long-term objectives, the owner's satisfaction and that of other participants. [Clarke 2007].

[2] Stiles and Taylor (2002:123-124) Boards at Work: How Directors View their Roles and Responsibilities, Oxford, OUP quoted in Clarke 2007

Caldwell and Karri [2005] argue the relevance of the managerial stewardship model for subsidiaries given the emphasis on reciprocal dependence and vulnerability –and therefore willingness to trust. They say that agency theory tends to focus on control, whereas maximisation of long term wealth in the interest of principals and stakeholders is important. So governance systems should reinforce an understanding of corporate obligations or "covenants". They argue for reward systems which promote organisational loyalties and emphasise the importance of the ethical tone set by the CEO, points which appear again in writing about risk.

Multi-National Enterprise (MNE) corporate governance has two tiers 1) parent-level corporate governance and 2) subsidiary level corporate governance. This means that it must deal with the need for subsidiary board directors' responsibility to their shareholders and stakeholders whilst simultaneously answering to and integrating with the parent firm. [Luo 2005a].

Luo [2005a p3] describes corporate governance as part of organisational governance, which also includes managerial governance[3]. He explains that "*corporate governance involves governance and control of corporate affairs while managerial governance emphasises those internal processes and structures that regulate operational decisions and business activities".*

2.3 Subsidiary governance

2.3.1 Introduction

Most subsidiary corporate governance research takes place in the context of MNEs. A small proportion considers the role of subsidiary boards. There is some work on how subsidiaries evolve and the frameworks used to integrate and align them with

[3] This paper uses the term "business line" following general usage.

group strategy, structure and culture. That work is potentially relevant to considering how subsidiary boards can make an effective contribution to risk governance. It is generally accepted that alignment with changing environment is an important aspect of effective enterprise risk management.

2.3.2 Role of subsidiaries

A key concept in the literature is that the parent company assigns a role to the subsidiary. The way that role evolves is influenced by the internal and external environment; group, parent and subsidiary environmental factors.

The subsidiary "*charter"* is defined by Birkinshaw and Hood [1998 p236] as "*the business-or elements of business - in which subsidiary participates and for which it is recognised to have responsibility"*

The role the parent company assigns to a subsidiary board could be: to meet jurisdictional requirements; to facilitate external relations (either on a passive advisory or active decision-making basis): to facilitate internal control and integration. [Leksell & Lindgren 1982].

Kiel et al [2006] suggest that there is a link between the international strategy a company adopts and its subsidiary board model. They identify four potential models on a continuum with increasing levels of board and external input. The choice of model is basically a trade-off between market responsiveness and integration. Where market responsiveness (including local stakeholder awareness) is important there will be a higher element of dual reporting to a subsidiary board and through the management line. In practice most organisations adopt a direct control model limiting the role of the subsidiary board. Du et al [2012] describe "*active*" subsidiary boards as more likely where they perform tasks beyond legal requirements, e.g. world mandate subsidiaries.

In practice the role assigned to subsidiaries is neither static nor simplistic. A company's legal/governance structure is a function of its strategy and acquisitions, and jurisdictional requirements. Most companies align their statutory companies with their business structures, giving primacy to the business structure. Companies change strategies and business structures from time to time. The external and internal environment at group, parent and subsidiary level all potentially influence the role of the subsidiary. According to Ghoshal and Nohria [1989] this includes internal differentiation to fit different environmental and resource contexts. It also includes the parent company structural context [Gupta and Govindarajan 1991] "*and entrepreneurial activities of subsidiary employees"* [Birkinshaw and Hood 1998 p249]. Another factor is the organisation's approach to vertical and lateral integration, and the way in which it creates intra-firm relationships. [O'Donnell 2000]. Organisational cultures, including differences between national cultures, governance, and investment systems are also significant e.g. European, American and Asian headquartered companies. [Kriger 1988].

Birkinshaw et al [1998 p279] say that "*subsidiary initiative"* is relevant, meaning that managers of subsidiaries seeking to create value change the subsidiary level environment. This comes about through an interplay between parent company strategy, host country opportunity and subsidiary manager initiative. This is relevant to risk governance which is about preserving value and enabling enable value creation.

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 significant to the firm's sustainability. This argues for on-going review to ensure that subsidiary corporate governance frameworks are appropriately aligned and leveraged for maximum value.

Birkinshaw and Hood [1998] describe how subsidiaries evolve in a path dependent way related to their environment. This may be constrained. For example group culture and board composition are two control mechanisms. Many jurisdictions require at least one director to be a citizen. This constrains director appointment choices. Groups may therefore need to be proactive to ensure directors participate in informal networks which foster awareness of group priorities and risk preferences.

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 and is contradictory. For example it is assumed that strategically important subsidiaries will have greater autonomy, but companies exhibit concern about risk in the case of strategic investment. [Brellochs 2008]. Feinberg and Gupta [2006] write that country risk influences approaches to equity investment on entry. They also say that where country risk increases MNCs are likely to respond by increasing internal, as opposed to external sales, although this reaction is weaker where there is more experience of high risk countries. However they do not discuss the role of the board. There is also a problem in that excessive monitoring is counterproductive. [O'Donnell 2000]. A bigger problem is that the literature does not consider the range of risks. It may be that some of the recent work on the HQ/subsidiary role in value creation and monitoring will shed further light on these issues. [Ciabuschi et al 2012]. Perhaps some of the confusion is because of a lack of clarity about strategic role, value, materiality and risk.

2.3.3 Control frameworks

Corporate governance and managerial governance have been defined as two arms of organisational governance. It is important to integrate and align the subsidiary entity governance structure with decision-making in the business (managerial) line As already discussed this is multi-dimensional, and made more challenging by the complexity of structures, strategies and environments in groups. This includes the influence of global stakeholder and shareholder expectations and their socio-economic interests.

The need for alignment has been used to argue the importance of a strong link between corporate governance and accountability as being mutually facilitative. [Luo 2005]. It has been described as creating *"global wheels"* e.g. corporate culture, brand, codes of conduct and business ethics, so that effective governance supports effective accountability [Nohria and Ghosal 1994].

Luo [2005b] identifies three governance mechanisms: market-based (e.g. board composition, interlocking directorates, size and chairmanship); culture-based (e.g. governance culture and corporate integrity) and discipline–based governance (e.g. conduct code, ethics programme, internal audit). Similar typologies are described by other writers. For example: *"the sum of four orientations: cognitive, strategic, power and administrative".* [Doz and Prahalad 1981 p15]. Alternatively: outcome (performance-based), behavioural; and cultural (based on shared norms and values) systems; [Ouchi 1979]; or network based systems. [Jaussaud and Schaaper 2006].

Much writing on frameworks refers to the importance of synergy between strategy formulation and implementation of governance mechanisms. Sometimes only small shifts in corporate mechanisms are required to achieve synergy. [Doz and Prahalad 1981; Tricker 1994]. Writers identify the value of effective information and knowledge transfer, an important risk management topic. A weakness is that writers do not always make it clear which mechanisms must be entity based.

Groups use various formal and informal governance frameworks to achieve a balance between integration and appropriate acknowledgement of the independence of the subsidiary. This includes: legal agreements between the companies; transfer pricing (also subject to external regulation); board appointments; entity based investment and business planning; contractual arrangements to ensure subsidiaries follow group policies e.g. financial policies such as tax and treasury policies. Other elements include: involvement of governance, finance, compliance and audit/assurance functions; information systems; reward (financial and non-financial); and culture. [Tricker 1994, Luo 2005b]. Work by Brellochs [2008] 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.

There is an expectation that the composition of the board will be matched to its role in any given company environment, and that consistency and clarity of board procedures will enhance its effectiveness. There will also be a need to consider the organisation's approach to vertical and lateral integration, and the way in which it creates intra-firm relationships. [O'Donnell 2000, Kiel et al 2006; Kim et al 2005, Tricker 1994].

A problem is that directors may ignore their board role if they perceive the subsidiary board role to be insignificant. Internal directors intentionally appointed to subsidiary boards to ensure integration, or provide a "quasi- independent" input, may fail to perform the necessary role. A different dilemma arises in the case of external directors. This is the extent to which information is willingly disclosed. [Leksell and Lindgren 1982].

This raises an interesting question, beyond the scope of this study, as to whether directors would be more motivated if they perceived their role to be more significant if it was described as "identifying issues of material importance to the sustainability of the group", and viewed their obligations through this lens.

2.4 Risk literature

One of the drivers for this research was the discovery that despite the risk literature e.g. Fraser and Simkins [2010], there is apparently no work on subsidiary board risk governance. In drawing together risk literature with subsidiary governance research this paper helps fill that gap. Particular areas of interest are: directors risk responsibilities and the attributes needed to fulfil those roles; knowledge transfer; and risk frameworks.

The governance duty of directors in respect of risk is driven by: their fiduciary duty and duty of care; company and other legal and regulatory requirements in the local and parent jurisdiction; fiscal and licence-to-operate requirements; stakeholder requirements and expectations (moral licence-to-operate); socio-economic obligations; requirements for due diligence in decision-making. [Branson 2010]

Enterprise risk management is [Frigo and Anderson 2011a p81] *"seeking to strategically consider the interactive effects of various risk events with the goal of balancing an enterprise's portfolio of risks to be within the stakeholders appetite for risk.. ……The ultimate aim is to ensure strategic objectives are realised and value preserved and enhanced".*

Risks[4] are considered to be growing in complexity and volume, driven by shifts in external and internal environments with a consequential need to review stakeholder

[4] A definition of risk frequently used in the risk literature is *risk is a function of how poorly a strategy will perform if the "wrong" scenario occurs.* [Porter 1990]

and shareholder value and the implications for risk tolerance, appetite and alignment. [Frigo and Anderson 2011b]. A review of recent *Corporate Governance: An International Review and Journal of International Management editions,* compared with Birkinshaw [2003] suggests the following trends in the subsidiary agenda: the extended firm; corporate social responsibility; emerging economies; local regulation (including fiscal policy), foreign ownership; foreign investment and public policy; and the subsidiary/HQ role.

The need for risk committees, in addition to audit committees, is argued from a regulatory perspective [Walker et al 2009] and more generally. Where there is no main board risk committee it is usual to find an executive risk group [Fraser and Simkins 2010]. Studies also point to variation in frameworks required depending on where companies sit on the risk complexity and volatility spectrum. For example the complexities of the long term investment horizon, R&D intensive, patent & licensing, and drug testing environment of the biotech industry [Brown et al 2009]

Given risk management takes place in the business line one question is, what role should subsidiary board directors play whilst ensuring that risk oversight does not fall down a gap or is not duplicated? The literature does not answer that question, but the following activities associated with the director role are perhaps particularly relevant to subsidiary directors assuming an Enterprise Risk Management Framework (ERMF) process is in place in the business line. *"Providing expertise, judgement and professional "scepticism"; considering upside and downside risk, financial and non-financial dimensions; alignment; ethical tone".* [based on Sobel and Reding 2004 p31 paraphrased].

The importance of sharing knowledge and communication within firms is a key risk literature theme [Fraser and Simkins 2010]. Knowledge ties, subsidiary embededness, and the network of vertical and horizontal intra-group relationships are considered to be important in the work on the effective governance of groups. [Andersson and Mats 1996, Athanassiou and Nigh 2000, Gnywali et al 2009]. This includes the way in which subsidiaries are integrated with, whilst being independent from the group, the potential benefits in understanding the impact of external environmental change, and the potential implications for subsidiary development. This work offers a potential resource for further work on the role of subsidiary boards and risk.

Schotter and Beamish [2011] suggest that "*boundary spanners"* (e.g. internal audit, corporate governance, legal, human resources) facilitate relationships within the organisation. They help overcome perception gaps and potentially influence HQ/subsidiary conflict situations towards higher levels of organisational effectiveness. Participating in communities of practice may facilitate this.

Work on a strategic framework for Governance, Risk and Compliance (GRC) [Frigo and Andersen 2009] similarly suggests that effective integration and alignment of key governance, risk and control players delivers shareholder value. This requires recognising and protecting the unique roles of each GRC function (such as legal, internal audit, corporate governance, relevant technical functions and finance) whilst leveraging the core skill sets, common processes and sharing knowledge.

2.5 Regulatory and other reports

2.5.1 Introduction

Recent reports and guidance on managing risk are focused on main boards. There is an absence of literature on subsidiary boards. Individual jurisdictions do of course place requirements on individual directors and companies. The main exception is the impact of regulatory codes in the banking/financial services sector. This section therefore sets out key guidance, to be used alongside material on subsidiary governance, to provide an indicator of what might be relevant to risk governance and subsidiary boards.

2.5.2 Role of the board

The primary guidance emphasises the importance of quality decision-making, a clear line of sight to material risks, and an integrated approach to risk governance.

The UK Corporate Governance Code (other jurisdictions have similar provisions) states "*the board is responsible for determining the nature and extent of the significant risks it is willing to undertake to achieve its strategic objectives*".[p7]

The FRC Guidance on Board Effectiveness states "*the role of the board is to 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*, [demonstrating] "*ethical leadership, displaying – and promoting throughout the company - behaviours consistent with the culture and values it has defined for the organisation, [*being] *accountable, thinking carefully about its governance arrangements and [*embracing*] evaluation of their effectiveness".* [FRC 2011 p2].

The inclusion of guidance for executive directors and on decision-making in this revised FRC board effectiveness guidance potentially adds to its relevance for subsidiary boards.

Similarly, the Treadway Commission in the US in 2004 called for an integrated approach to enterprise risk management. [COSO 2004].

2.5.3 Implementing regulatory requirements, the effective board

Subsidiary governance is essentially part of an intra-organisational framework. So understanding the implementation of regulatory requirements is especially relevant.

The FRC guidance on effective boards warns about "*insufficient attention to risk, and treating risk as a compliance issue rather than as part of the decision-making process, especially in cases where the level of risk involved in a project could endanger the stability and sustainability of the business itself".* [p8]

The Institute for Risk Management 2011 *Risk Appetite and Tolerance Guidance* suggests boards ask five key questions (Appendix C p98) covering whether managers understand: the aggregated and interlinked risk for the organisation; the extent to which they are allowed to expose the organisation to risk; that risk appetite is not constant; and that decision-making should give full consideration to reward.

The question is, are subsidiary boards asking these questions? Do they have the information and understanding with which to contribute value in this way? Is it expected of them?

AIRMIC's *Roads to Ruin* 2011 study of 18 high profile corporate crises undertaken by Cass Business School identifies seven key underlying risk issues for boards to address. The study suggests that these risks lead to "*group think*", which increases the chances of corporate crises. They include: inadequate skills; "*risk blindness*"; failure to consider organisational complexity; "*glass ceiling*"; how behaviours are influenced by incentives; and the "*tone from the top*". (Appendix D p98).

AIRMIC define "*risk blindness*" as "r*isks from board failure to recognise and engage with risks inherent in the business, including risks to the business model, reputation and "licence to operate", to the same degree as they engage with reward and* *opportunity".* By "*glass ceiling*" they mean "*risks arising from the inability of risk management and internal audit teams to report on and discuss, with both executive and non-executive directors, risks emanating from higher levels of their company hierarchy, including risks from ethos, behaviour, strategy and perceptions".*

The AIRMIC report underlines the relevance of "*soft risks" "such as ethos, culture, behaviour, poor leadership, inappropriate incentives, poor…communication, change and complexity, reputation"*. [Fitzsimmons 2011 p9].

Perhaps most relevant to this paper is the risk that the subsidiary board framework fails to ensure a clear line of sight from the main board to subsidiary board risks. This could happen if subsidiary level risks are seen as "operational" and information about potential damage to the group does not flow up until substantial reputational damage has been done. That damage may have a strategic impact and substantial cost.

2.5.4 Implementing regulatory requirements, other topics

An OECD [2004] report, focusing on the banking/finance sector, identifies some issues of particular relevance to subsidiary governance. These are: the extended enterprise; the value of improved assurance arrangements, especially where organisations have significant societal responsibilities; risk culture; the scope and nature of risk work; and on-going review of corporate governance arrangements.

The concept behind Ruggie's [2011] *Protect, Respect, and Remedy* guidance for the UN on MNE operations is potentially relevant to subsidiary governance, particularly given in the context of the extended firm. It takes a corporate due diligence approach, as part of managing enterprise risk and sustainability, advocating "*a comprehensive, proactive attempt to uncover human rights, risk actual and potential,* *over the entire life cycle of a project or business activity, with the aim of avoiding or mitigating those risks"*. [UN 2011 p16].

Finally, the Walker Review [2009] sets expectations that risk appetite is articulated and aligned with future strategy. It requires a separate risk-audit committee report. FTSE 100-listed banks and insurers must consider establishing a risk committee. It seeks to control the quality/experience of appointees to certain roles in the banking/finance sector. It looks for a "*second line of defence*" through designating a senior executive to advise on enterprise-wide risk management issues.

2.6 Conclusion

To begin to address the literature gap this paper draws together the relevant literature on subsidiary governance and literature on boards and risk.

The review demonstrates the multi-dimensional nature of subsidiary governance which is relevant to the multidimensional nature of the subsidiary environment and its associated risks. It suggests that it is necessary to ensure that both informal and formal frameworks, and people and processes pull in the same direction to integrate the subsidiary whilst adequately acknowledging its independence.

3. LITERATURE ANALYSIS

3.1 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].

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

3.2 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.

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.

3.3 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.

3.4 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 and duty of care as a director to their wider stakeholders and parent company shareholder.

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.

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. Section 2.33 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]

3.5 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.

3.6 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 p28 above.) This provides the background for the research in part 2.

4. RESEARCH METHOD AND METHODOLGY

4.1 Introduction and research paradigm

The primary research question asks *how are subsidiary boards contributing to effective risk governance*? The value of research to fill the knowledge gap about practice was established through informal conversations before the research began.

To meet that need the study is exploratory/descriptive in nature. Strictly speaking it cannot be generalised for wider application. However given that the study uses a purposeful sample, complemented by information drawing on a wider population it is possible to speculate. The research provides data which management and researchers can draw on to develop their own practice and research. The study takes a qualitative inductive approach. It assumes that knowledge is created and negotiated between humans, rather than tested and replicable.

The approach was planned in advance [Yin 2009] so that the data captured, analytical procedures, and unit of analysis were relevant to the research question.

A major challenge for research on subsidiaries, particularly current practice insensitive areas such as risk, is finding an approach which allows the researcher to obtain internal data on several companies in a relatively short period of time. Historic data has less value. These barriers are recognised to be one reason why there is limited research in this area.

The main data collection method used to extract “rich” data was a semi-structured interview using purposeful sampling. There were three interviewee groups (see section 4.5): a) individuals from large companies and subsidiaries, b) commentators providing an overview of practice in companies covering a range of industries and sizes, c) governance and risk experts.

The data collected provides an overview of several areas. To make it accessible it is summarised and presented in thematic form in chapter 5. More detail is available in Appendix B. The findings are discussed in section 5.6 with reference to the literature. This is appropriate given that this is qualitative (phenomenological) research where data collection and analysis are not distinct.

4.2 Research questions

Primary research question

- *How are subsidiary boards making an effective contribution to risk governance?*

Related questions are as follows:

- *Are organisations confident that there is a common understanding of risk appetite and tolerance across the group?*

- *Is subsidiary governance becoming more important to groups, and if so why?*

- *What risk governance frameworks do groups adopt? What are the “weak links”? How are subsidiary boards involved? How do groups ensure subsidiary boards are effective? Is there a typical composition? What other roles contribute to their risk governance role?*

- *Are there variations from sector to sector, industry to industry, and with company size?*

4.3 Interviews

The semi-structured interviews were conducted face-to-face wherever possible, or by telephone. Interviews were informed by pre-reading company reports and web sites.

All the interviews were conducted by the author, a qualified company secretary. This was important in creating trust and having the professional knowledge to conduct the interview and interpret the answers in a short space of time. The interviews were about one hour in length.

The participants were sent the questionnaire in advance, together with an appendix containing key definitions and indicative topics for further comment. It was explained that the interview could be approached flexibly. This proved effective in obtaining information about practice within a short time frame. In the case of those providing an overview or expert view tailored questions were used.

4.4 Questionnaire

Section 5.2 sets out the research questions. The challenge was to devise a suitable semi-structured interview framework which would gather data within a realistic one hour maximum interview timeframe. The approach chosen was to produce a questionnaire (see Appendix A) in a familiar format to assist participants to reflect on the topics in advance, whilst adopting a flexible semi-structured interview format. The questionnaire was not followed prescriptively. This was straightforward to communicate by email, suited participants and worked well. A pilot questionnaire was tested for accessibility and on individuals with corporate governance knowledge.

Following the first three interviews the questionnaire was revised slightly without changing its scope. Given its use as a flexible framework this did not change its validity. Experts and those providing an overview were given tailored questions (Appendix A).

4.5 Sample

This study aims to enable practice and further research. The purposeful sample includes as many contrasting examples as possible within the scope of this study.

The first group of interviewees are from large companies representing as wide an industry cross-section as possible. These include UK and non-UK headquartered firms. They include some interviewees from subsidiaries; business to business and business to consumer relationships

A second group of interviewees from a leading global audit firm and a provider of governance, company secretarial & registrar services provided an overview and “independent” perspective, compensating for the lack of smaller companies in the sample. A third group of governance and risk experts provided specialist information and a sense-check. These two groups add to and strengthen the data interpretation.

Table 2: Interviewees

FIN SERVE1	Financial services group 130 companies, UK HQ. Part of international group, 800 companies
TELE/MEDIA1	UK subsidiary with own subsidiaries. HK headquartered media/telecoms group. 10-99 group companies.
TRANS	Public sector transport infrastructure project company
FOOD	Subsidiary, own subsidiaries. Continental Europe based food & beverages group over 1,000 companies
HEALTH	International healthcare group. UK headquartered
NFP	International charity with substantial trading activity. UK headquarters about 15 subsidiaries
ENERGY	International energy group 1000+ subsidiaries. UK and HK headquarters
BANK	UK headquartered international bank and financial services provider
TELECOMS2	UK headquartered international quoted telecoms group with over 400 subsidiaries
PHARMA	UK headquartered pharmaceutical company 800 plus subsidiaries
MINING	UK headquartered global quoted mining group with over 800 subsidiaries
AUDIT	Global audit firm, managing partner
GOVERNANCE	Company secretarial, governance & registrar services provider, senior manager & consultant
ICSA	Institute of Chartered Secretaries and Administrators,CEO and Director Policy
AIRMIC	CEO

Table 2: Interviewees

Most interviewees were Company Secretaries (or Deputies) or General Counsel. Some interviews included a manager with responsibility for subsidiaries and/or risk. One interviewee was a Senior Independent Director (SID) and Audit Committee Chair.

4. 6 Ethics

Informed consent is a key research principle, achieved through providing information and confirmation at several stages in a format tailored to this interview group. The purpose and use of the research was explained in the request for an interview made by email at the invitation stage. The email agreement to participate provided the necessary consent. The explanation of purpose and use was repeated in the questionnaire sent to participants prior to interviews. Interviewees were assured that their companies and identities would be kept anonymous, unless specific permission was given. The information was repeated at the face-to-face/phone interviews and in a follow-up email sent after the interviews. The researcher undertook to provide interviewees with a copy or summary of the final research report. The assurance of confidentiality and anonymity and potential to adopt a flexible approach to interviews, were critical to gathering rich data on the range of topics covered by this study.

5. RESEARCH FINDINGS

5.1 Introduction

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

This chapter reports key findings under thematic headings. The summary of interview responses in Appendix B provides more detail. To meet confidentiality and anonymity undertakings sources are unattributed and not direct quotes. The results are necessarily speculative given the sample although this included interviewees providing a broad perspective and "sense check".

5.2 Strategic approach to corporate governance & risk

Interviewees were asked to comment on their company's approach to corporate governance and strategic risk management, or perspective on variety in practice. This provided context, an insight into approaches to subsidiary governance and control, and insight into whether subsidiary governance was increasing in importance. Typically the business line was the primary structure.

5.2.1 Corporate governance

Roughly half the individual interviewees described their corporate governance approach as "*legal and compliance*" rather than "*the system by which all companies in the group are their work are coordinated, managed and controlled, it contributes to long term strategic success*".

Individual interviews were typically confident that risk was embedded in strategic planning and/or that risk appetite was aligned across the group.[5]

One explained that "*strategy is the driver, if this is clear it should lead to better risk governance",* anticipating that a review of their governance approach would follow a review of strategy [paraphrased, HEALTH]. Overview commentators suggested that most took a legal and compliance perspective; suggesting that size, resources, and the functions involved were a factor. [AUDIT, GOVERNANCE]. There were indications of increasing investment in subsidiary governance beyond large FTSE firms. [GOVERNANCE].

The subsidiary entity focus may have influenced responses. [TELECOM2, NFP].

5.2.2. Strategic approach to risk

Corporate governance codes set an expectation that companies will identify strategic and material risks, create appropriate control and risk frameworks, and ensure that there is a clear line of sight for the main board. This includes all risks which impact on the groups' sustainability and potential to operate as a going concern. Directors of subsidiaries have similar responsibilities.

The implication is that group risk maps, including high level controls, delegations and processes for identifying material risks, should cover the subsidiary entity dimension, not just the business operations dimension. [ICSA].

Research suggests a comprehensive approach is not universal, especially for smaller companies. Underestimating the aggregate impact of reputational risk is a

[5] For comparison a 2008 study of 153 European companies found that 40.8% viewed corporate governance as a strategic tool [Brellochs 2008].

particular weakness. For example, the AIRMIC/CASS Road to Ruin research and recent media coverage of failures due to poor IT systems upgrades demonstrates how operational matters can become strategic issues. [AIRMIC].

Given the primacy of the business line, strategic risks and control frameworks, were typically defined at main board level. Where subsidiaries were listed, substantial, and/or had their own subsidiaries there was greater participation by the subsidiary board and tailored frameworks. [e.g. MINING, OIL, FOOD, PHARMA].

One world mandate subsidiary interviewee drew an analogy between presenting their strategic plan to their parent (shareholder) for approval and that made by the parent company to investors about the risks associated with its strategy.

Overview commentators suggested that as companies decreased in size on a continuum and ownership models change (small quoted, AIM and private companies) the approach to risk management would be more "*patchy*" and less strategic [AUDIT, GOVERNANCE].

Those interviewed were interested to understand the potential to leverage the contribution of subsidiary boards e.g. adding value through enhancing business sustainability. They were interested in understanding trends in practice, including drivers such as emerging risks. They were concerned to avoid distraction from entrepreneurial, value-add activity.

These responses suggest that subsidiary governance is increasing in importance to groups. Company approaches to governance and risk strategy tend to be "top down". It seems possible that approaches to subsidiary governance may be influenced by the primacy given to the business line and perhaps the group's concept of corporate governance, i.e. whether it is about legal and compliance issues (control) or potentially has a broader contribution to make.

5.3 Alignment and key risks

Interviewees were asked whether subsidiaries and parent companies had a common understanding of risk appetite and risk tolerance. They were asked to identify issues which might be making subsidiary governance more important.

5.3.1 Common understanding

Most interviewees were confident that there was a common understanding of risk appetite and tolerance. Typically business plans and individual director/managers were key in ensuring alignment.

One interviewee outlined their "tier" approach to ensuring a focus on key subsidiaries, aiming to ensure the main board had a clear line of sight to key subsidiaries. The 30 to 50 material subsidiaries had been identified, defined as those material to the group and/or economies in which they operated, bearing in mind aggregate risk. [BANK]

One respondent explicitly mentioned the important distinction between entity based business plans/investment approvals and business line approvals, including testing financial and risk consequences. [FOOD]. Overview commentators thought it unlikely all companies made this distinction, especially smaller companies. [AUDIT, AIRMIC]

The second key factor in achieving alignment was through managers who were board members, including their understanding of corporate strategy, risk and priorities. This linked the business and subsidiary entity lines.

Overview commentators suggested that manager/directors' true understanding of strategy and risk appetite is a key factor in ensuring alignment. However they suggested they did not necessarily *hear the message they were intended to receive*. Identified weaknesses included incentives/targets acting as contradictory drivers.

[AIRMIC]. Companies invest in systems and communication, including face-to-face, and value statements with “no tolerance” policies, to seek to avoid this problem. [FINSERVE, HEALTH, PHARMA].

This suggests that effective business planning processes, directors and communications are key in determining whether objectives, risk appetite and tolerances are aligned. This finding is in accordance with the literature.

This research highlights the importance of these two “mechanisms”, suggesting it is important for companies to consider the strength of their formal and informal mechanisms, and associated drivers in these areas, including the potential impact of any planned changes. The literature and research suggests that even small changes can have significant positive or negative effects, including in Merger and Acquisition contexts. [Doz and Prahalad 1981, AUDIT, AIRMIC/Cass]

The literature and research responses also suggest it is important to consider whether drivers such as reward systems/targets do or do not lead to behaviours which promote long term corporate interests.

5.3.2 Key and emerging risks

Respondents were asked to identify key risks for their company, prompted by a list of potential risks. They were also asked to comment on managing subsidiary company risks/issues, including emerging risks.

Responses from interviewees from individual companies showed that although financial risks were important, including those related to the macro-economic climate, regulatory (in the broadest sense) and reputation risks were high on the agenda. However the smaller the company, the more likely it is that the focus will be limited to financial risks and regulatory and accounting compliance. [AUDIT]

At subsidiary level an overview of responses indicates that risks are typically related to preserving value or licence-to-operate, and in some cases the cost of investment. Risks included: fiscal policy e.g. tax and foreign investment, licence-to-operate, and government policy which directly affected the business e.g. food and drugs legislation, and licenses which give access to markets. Stakeholder matters, including those related to managing the "extended firm" were also relevant. Some were customer related and some triggered by societal concerns about socio-economic and environmental issues. They encompassed issues such as brand, approaches to intellectual property litigation. They included matters such as bribery, fraud and related legislation.

These risks are not necessarily a consequence of creating subsidiaries. However companies must recognise the independent nature of the subsidiary in their management approach, bear in mind host country perceptions and balance their concern for integration with the consequences of being the ultimate owner of the subsidiary. Further, financial and other risks at subsidiary entity unit may differ from those based on the business unit. [BANK].

These responses suggest a need to continually re-evaluate the alignment of subsidiary structures with group strategy, culture and structure; and with changes in the external and internal environment. This includes work to ensure that subsidiary risk governance recognises, for example, licence-to-operate, stakeholder, and host country fiscal and regulatory policy changes. Responses also suggest a growing interest in proactively working to ensure subsidiary entity risk governance is effective. Subsidiary boards might potentially be in a position to contribute to this if they are risk aware.

5.4 Frameworks

Interviewees were asked to describe the risk governance frameworks in their group, or perception of approaches used by companies. Again business planning and the director contribution were key to effective formal and informal systems.

5.4.1 Frameworks

Academic literature, observation and practice suggest that group governance frameworks are based on a mix of: formal agreements, codes and policies, culture, director appointments, formal and informal networks. This aims to manage the tension between integrating the subsidiary whilst maintaining its independence. Interviewees were asked to describe the frameworks used in their organisations (or those with which they were familiar). Taking all the interview responses together the elements of governance control frameworks included: intra-company agreements , business plan/investment approvals; subsidiary board director appointments, authorities and matters reserved to subsidiary boards; commitment to treasury and fiscal policies; code of conduct and handbook for subsidiary board directors including conflicts of interest; business planning, reporting and policy obligations; board effectiveness reviews; annual risk discussions; entity based financial and risk information; protocols for the composition of subsidiary boards and other governance matters based on the strategic importance and risks associated with the subsidiary; distinguishing between signing authorities for directors and delegated decision-making for managers. [ALL RESPONSES]. It was unlikely that any one company had all of these elements in place. For example some smaller companies were introducing board effectiveness reviews, but one company with a comprehensive framework did not use board effectiveness reviews for its subsidiary companies. [GOVERNANCE].

Interviewees were asked to explain how risk limits were set for subsidiary boards and individual directors.

In most cases risk limits were explicitly or implicitly defined through business plans and delegations/matters reserved to the board. In the financial services/banking sector more elaborate risk models were also used. In many cases the requirements for boards or board directors formed part of wider operating guidance for local operations.

Some companies were developing separate guidance for directors and/those involved in supporting subsidiary companies to achieve a better understanding of roles, associated risks and issues. [TELECOMS2. MINING].

Some responses referred to the difference between the business line and entity authorisations and the potential difficulties if these were not managed properly.

These responses indicate significant variation in practice, some of it size and some of it sector related. Possible reasons for this are considered in section 5.6. The responses suggest that risk limits are often set through business planning approvals and delegation/matters reserved to the board structures. Again they underline the importance of individual director/managers to effective frameworks. The responses suggest that managing the business line/entity governance line might need attention in some cases to ensure that there are no “weak links”.

5.4.2 Aligning frameworks with group change

The literature highlights the importance of ensuring that subsidiaries are aligned with changes in group strategy, structure and culture – taking into account changes in the external and internal environment, group, parent and subsidiary level change. An area of interest was to understand how far groups aligned and reviewed frameworks with changes, and also with the value/materiality of subsidiaries. One company was developing corporate protocols to guide their approach depending on the strategic importance, risks and type of company concerned. [HEALTH].

Section 5.3.1 described the materiality based approach used by one respondent to prioritise governance review and alignment activity based on assigning subsidiaries to "tiers" depending on materiality to the group and economies in which they operate. [BANK].

Others had regular review processes where subsidiary companies "*justified their existence".* Subsidiary frameworks and board compositions were re-aligned on a case by case basis to reflect current corporate strategy and subsidiary purpose. [MINING, PHARMA].

Overview commentators suggested that small firm frameworks would be "patchy", in part because of time and resource limits, although sector and jurisdictional environments would be a driver. For example more developed frameworks in smaller firms in the banking/finance sector, and potentially also in the public and not-for-profit sector given public accountability expectations. [AUDIT, GOVERNANCE].

This suggests that whilst some companies have on-going review arrangements which recognise the changing role of subsidiaries, this is by no means universal. It also suggests that the comprehensiveness and scope of the frameworks, including the formal and informal elements used, is likely to vary significantly from one company to another.

5.4.3 Risk and audit committees

5.4.3.1. Reporting lines

This research suggests that typically the emphasis for subsidiary risk reporting is the business line rather than the governance 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. This is shown in 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. Each subsidiary has a board of directors who are agents of the subsidiary. The parent company board delegates authority to its CEO (and others). Depending on their role subsidiary companies also delegate authority.

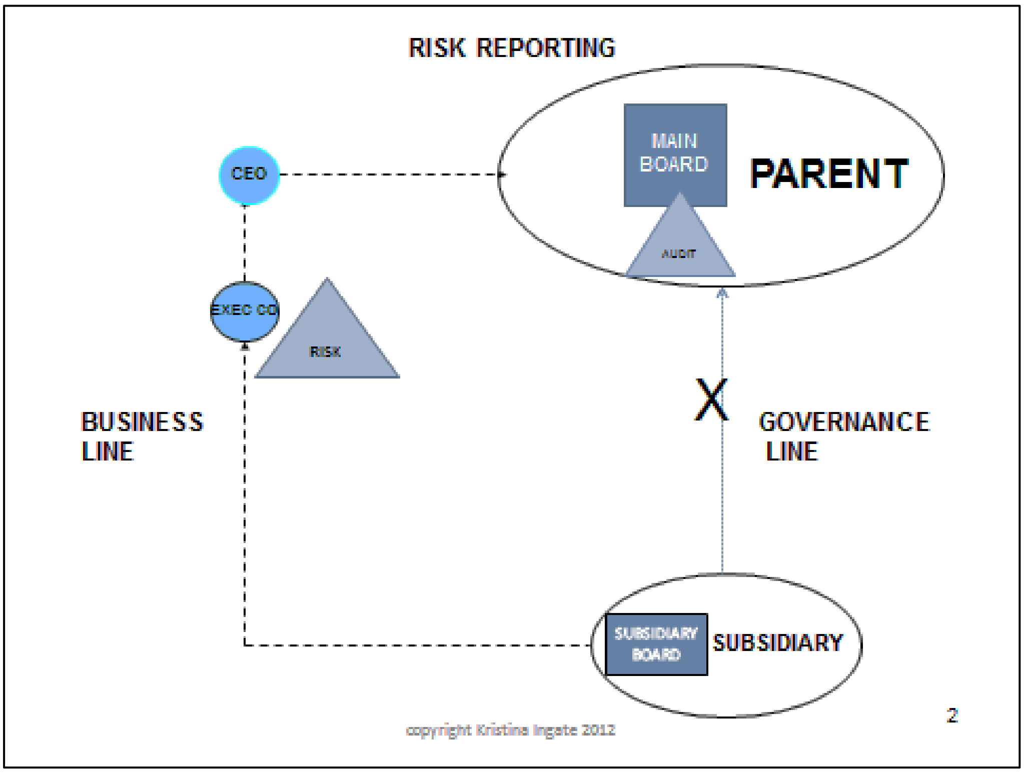

Figure 3 Risk reporting (source author)

This research, covering companies ranging in size and different industries, suggests that the business line focus means that the boards of wholly owned subsidiaries frequently play a very limited role in risk governance, the focus being through the business line. Reporting to the main board is based on information from the risk committee, often through an executive risk committee to a governance audit/risk committee. Systems involving parallel referral through the governance line are less likely, unless this is a sector requirement.

5.4.3.2.Risk reporting and review

The extent to which subsidiary boards routinely discuss risk, or receive reports on entity based data varies. In some cases it is not an agenda item. Some discuss entity based information. Others discuss management line based information. In some cases year end reports – which the parent shareholders representative votes to accept-include a reference to risk, although in very small companies this is not necessarily the case. In the very smallest companies any risk review might be limited to a review based on quarterly management accounts and year end accounts. [ALL RESPONSES INCLUDING AUDIT AND GOVERNANCE].

Typically groups utilised risk committees at group level, usually an audit and risk committee and executive committee risk review group arrangement. Risk reporting for the subsidiary was usually through the business line, using Enterprise Risk Management Frameworks (ERMF) and other tools, and internal audit, compliance and risk teams.

In the banking/financial services sector subsidiary boards provided a second line of assurance and risk was explicitly part of the agenda. Only a few subsidiary boards had an annual risk discussion separate from the management review. In some cases reviews were essentially a repeat of the management line risk register review. This missed the opportunity for a “structured informal” conversation taking a broader perspective, including risks to group sustainability. [GOVERNANCE]. This is similar to the problem of “risk blindness” described by AIRMIC.

Other business line arrangements included: regional risk governance committees with an internal audit involvement [TELECOMS]; an alert system which identified issues on the group radar to be referred up by subsidiaries (including e.g. litigation which might impact the group reputation); a monthly round table to review what to refer to the main board [FOOD].

These findings raise the questions: are arrangements sufficient in any given company to address subsidiary board accountabilities to shareholders and stakeholders? Are subsidiary boards reviewing risk in a value-add way?

5.5 Role and composition of the subsidiary board

Interviewees were asked to describe the composition of subsidiary boards and their effectiveness. Responses to other questions indicate that individuals are key in achieving alignment with group strategy and risk appetite. However not all individuals have the necessary corporate awareness. Drivers such as reward/culture/targets may influence their behaviours.

5.5.1 Composition

Typically interviewees described boards of three directors including: a senior manager from the business line and from finance for the relevant jurisdiction, with an additional member appropriate to the role of the board. This member was often drawn from the business line. Holding and investment companies were more likely to have directors from corporate functions. [PHARMA, MINING].

The size of the board and inclusion of corporate functions, such as legal and corporate secretariat, was often related to the strategic importance and size of the subsidiary, and experience of past problems. Some companies included directors of other companies or senior managers from the executive committee or main board on subsidiary boards in order to achieve congruence and/or a quasi-independent element. [FOOD, BANK, FINSERVE, NFP, TELECOMS1]. Companies in the banking/finance sector, and listed subsidiaries necessarily had independent directors and chairmen.

Some groups had a regular review process to ensure board composition was aligned with the subsidiary role. [MINING, PHARMA, BANK]. One ensured an upward and downward flow of information by including a main board director on the subsidiary board and CEO on the board of next tier subsidiaries. [TELECOM].

Interview responses suggest that in the largest companies with established group structures, there was a proactive and effective engagement between the business line, subsidiary directors and corporate functions such as finance and corporate secretariat to maximise the value, and minimise risks of subsidiaries. [PHARMA, MINING, BANK]. One organisation implementing a subsidiary structure recognised its need for enhanced governance expertise to be effective. [NFP] .

5.5.2 Board effectiveness

Respondents described how the effectiveness of individual board members contributed to board effectiveness, including its ability to contribute corporate value. A potential weak link was individual directors understanding of their role, including expectations that they ensure alignment with group interests and risk appetite. [AUDIT].

Interviewees said that it was important to set clear expectations about the role. A frequent comment was the need to enable individuals to understand their management and director "hats". [TELECOMS2]. This included the fiduciary duty owed to the shareholder and accountabilities as a director, and how to handle conflicts of interest – including any personal interest. [GOVERNANCE].

Most referred to different cultural assumptions about how the role of board directors should be exercised, even though the role carried accountabilities and liabilities. [FOOD]. This included, for example, the legitimacy of challenging the business head/CEO in the meeting. [BANK, GOVERNANCE].

Many described the use of board effectiveness and induction programmes, alongside handbooks as important to enable subsidiary directors understand their roles.

Interview responses suggested that proactive engagement between the business line, subsidiary directors and corporate functions such as finance, risk, audit/compliance and corporate secretariat was important in aligning, maximising the value, and minimising risks of subsidiaries. [PHARMA, MINING, BANK]. Some companies, particularly small companies, appeared to take a more compliance based approach to their subsidiaries. [AUDIT]. One organisation implementing a subsidiary structure recognised its need for enhanced governance expertise to be effective. [NFP].

Speculatively this research suggests that, looking across all company sizes, much subsidiary risk governance activity is heavily reliant on the internal audit and/or finance function, and may be retrospective assurance based, which may be a weakness – especially if subsidiary boards play a limited role. The literature suggests that the value add is greater where a greater range of functions are involved and these leverage off each other. The variation may also be a function of corporate culture and/or championing of subsidiary governance and in part a reflection of different sectors. The potential value - add appears to be recognised in the approach taken by some of those interviewed for this research. [AIRMIC, PHARMA, BANK, MINING, TELECOMS2, ICSA CEO].

On-going developments in place to address (potential) weak links included: an annual review of matters reserved to subsidiary boards, and board composition for its “tier one” highly material subsidiaries. [BANK] producing protocols for its subsidiaries related to strategic and risk materiality covering composition, sign off authorities etc. [HEALTH]. Several interviewees mentioned corporate guidance which they expected would address some of the “weak links” “the way we work” and conduct policies; new sales incentive policies and no tolerance penalties as a response to regulatory penalties for illicit behaviour/misdemeanours in respect of sales of products [HEALTH]; no tolerance penalties for breach of codes [FINANCIAL SERVICES].

5.6. Analysis and discussion

5.6.1 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.

5.6.2 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.

5.6.3 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 p12). 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).

5.6.4 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), 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) 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.

5.6.5 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 (figure 3 page 51). 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?

5.6.6 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) 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.

5.6.7 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.

5.7 Conclusion

This chapter has presented the research findings, including an analysis of the findings in the context of the literature. It considers and suggests the use of multiple corporate governance theories as a tool in reviewing existing subsidiary governance frameworks. It describes how the development of frameworks appears to be "pathway" specific. It reviews the operation of subsidiary frameworks, including "hard" and "soft" elements and key potential weakness.

The chapter describes the business line focus of risk reporting frameworks. It examines what makes for effective boards, in particular the importance of quality individuals, highlighting the significant reliance placed on subsidiary directors and on business planning. It discusses how subsidiary boards might be leveraged to add value, concluding there is scope to improve their contribution to enabling and preserving value. Recommendations arising from this analysis are presented in the conclusion chapter.

6. CONCLUSION

6.1 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.

6.2 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

6.3 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.

6.4 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?

6.5 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.

6.6 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.

6.7 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.

6.8 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.

APPENDICES

Appendix A

Questionnaire

The questionnaire was used as a tool and indicative framework to enable face-to-face and phone semi-structured interviews. Participants were sent a copy of the questionnaire in advance, together with an appendix with key definitions and an indication of topics of interest. The interview structure was flexible to suit the preferences of individual interviewees.

The questions are designed to create a structure which gathers data to answer the research question(s). The following sources were particularly useful in framing the questions:

1. UK Corporate Governance Code and reference guidance by the FRC and ICSA
2. The IRM guidance on risk appetite, alignment and tolerance
3. Fraser and Simkins 2010 book on Enterprise Risk Management (see bibliography)
4. Brellochs 2008 research on subsidiary governance (see bibliography). This itself draws on other governance writing. This was particularly useful in drafting the sections on general corporate governance and problems in subsidiary governance (Questions shown in italics are phrased in an identical manner)
5. Ernst and Young 2009 business risk report: top 10 risks for global business (see bibliography)

University of London, Birkbeck College

Survey "Subsidiary Risk Governance"

Thank you for agreeing to take part (for approx. 45 minutes) in this research project undertaken as part of an MSc in Corporate Governance at the University of London.

It aims to find out more about the extent to which subsidiary boards are actively contributing to effective risk management.

Key findings may be made available to the corporate governance and risk community e.g. through professional institutes. Any information will be treated confidentially.

"Group" means the group of companies of which your company is a member. Main board means the board (or governing body) of the parent company.

QUESTIONS ABOUT YOUR ROLE AND THE COMPANY YOU WORK FOR

If you have a role in more than one group of companies please select one group before responding. There is an opportunity for general comment at the end.

Please indicate your role or function in this group of companies

CEO □ Company secretary/general counsel □

Finance Director □ External professional expert e.g. auditor □

Board members □ Divisional, business unit or departmental manager □

Other function or role please specify………………………………

What sector is the company in?

Pharmaceuticals □ Not-for-profit/public sector □

Financial services/banking □ Food □ Energy□

Engineering □ Business services □ Retail □

Other (please specify) …………………..

Questions about the size of the group you work for

How many companies does your group of companies consist of (rough estimate)?

2-9 □ 10-99 □ 100-999 □1000 or more□

Where in this group structure is the company you work for?

the group's headquarters □ regional/national HQ or company with administrative tasks □

operational subsidiary with own subsidiaries □ operational subsidiary, own subsidiaries □

If you are NOT attached to group headquarters, how many levels of companies are there between your company and the group's headquarters?

……………………………………………………..

Which country is your company and the headquarters of the group located in

The country your company is located in ……………………….

The country the group headquarters is located in …………..

+++

CORPORATE GOVERNANCE APPROACH

What approach does your group of companies take to corporate governance (you can choose more than) (see appendix for UK code definitions)

It is about legal issues and compliance. □

Besides legal and compliance, there are some management implications, e.g. reporting standards, so we partly use corporate governance as a management tool for the group. □

More than preventing problems, it is about integrating and coordinating the interests of the group's stakeholders, and therefore, it is part of our group's governance aims □

It is about effective decision-making. It is the system by which all companies in the group & their work are coordinated, managed and controlled. It contributes to long-term strategic success □

Board responsibilities for risk governance

The following descriptions of board responsibilities for risk governance are taken from the UK corporate governance code. Please respond to the following to indicate, in your opinion, the extent to which subsidiary boards are expected to actively contribute to ensuring assurance of risk governance in your group.

The subsidiary board is responsible for determining the nature and extent of the significant risks it is willing to undertake to achieve its strategic objectives.

Strongly agree □ Agree□ Disagree □ Strongly disagree □ Not relevant □

The board shall maintain sound risk management and internal control systems.

Strongly agree □Agree □ Disagree □ Strongly disagree □Not relevant □

+++

RISK GOVERNANCE AND THE ROLE OF THE SUBSIDIARY BOARD

In your experience do subsidiary boards have a clear understanding of the **strategic objectives** of the group/parent organisation?

Strongly agree □ agree □disagree □strongly disagree □ not relevant □

In your experience do subsidiary boards have a clear understanding of the **strategic risks** for the group?

Strongly agree □ agree □disagree □ strongly disagree □ not relevant □

Are the following in the top 10 **strategic risks** for your group? Please indicate yes/no and add other strategic risks to a maximum of ten.

Reputation □ Outdated Business model □ Talent □ Regulation/compliance □

Financial (e.g. credit crunch, solvency) □ Sustainability/CSR (incl. energy needs) □

Market competition □

……………………………………………………………………………………………

Do subsidiary and main boards have a common understanding of **risk appetite**?

Strongly agree □ agree □disagree □strongly disagree □not relevant □

Do subsidiary boards have a good understanding of group **emerging risks** to monitor because they impact the group? For example liquidity, earnings, reputation, regulatory risks?

Strongly agree □agree □ disagree □ strongly disagree □ not relevant □

++

WHICH OF THESE PROBLEMS HAVE YOU EXPERIENCED/OBSERVED IN YOUR GROUP WHEN MANAGING/CONTROLLING SUBSIDIARIES? (TICK ALL WHICH APPLY. PLEASE GIVE EXAMPLES) If you prefer to reply with information about actual or potential problems in your industry, please indicate that this is the case.

Problems in subsidiaries which damaged the whole group's **reputation** and public image

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

Example(s)……………………………………………………………………………………….

Decisions by subsidiaries which damaged the whole group's **reputation** and public image

Strongly agree□ agree □ disagree □ strongly disagree □ not relevant □

Example(s)……………………………………………………………………………………….

Financial decisions where the group and subsidiary had **conflicting interests** e.g. withdrawal of funds from subsidiary or investment of funds

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

Example(s)……………………………………………………………………………………..

Business decisions where the group and subsidiary had **conflicting interests (including** HR decisions/deployment of staff that were key to the subsidiary)

Strongly agree □agree □ disagree □ strongly disagree □ not relevant □

Example(s)…………………………………………………………………………………

Subsidiary took **business/financial decisions** which were **inconsistent with group objectives** and/or created business/financial risks for the group

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

Examples(s) ……………………………………………………………………………………….

Headquarters did not have **important information** about subsidiaries for its **decisions**

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

Headquarters **did not communicate** important information **to** subsidiaries

Strongly agree □ agree □ disagree □strongly disagree □ not relevant □

Subsidiaries did not advise headquarters of emerging problems. This came out accidentally, for example personal contacts of managers in different group companies

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

*HQ overruled **local decisions/ideas** that, in the end, turned out to have been the **right and appropriate** ones for the subsidiary*

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

Example(s)………………………………………………………………………………………

Group governance/business principles were inconsistent with local jurisdictional "licence to operate"/legal requirements?

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

Example(s)……………………………………………………………………………………………….

Group business/governance policies did not fully reflect **c**odes for multinationals

Strongly agree □ agree □ disagree □ strongly disagree □ not relevant □

Examples(s)……………………………………………………………………………………………..

+++

RISK GOVERNANCE & MANAGEMENT FRAMEWORKS

How does the group **constitute subsidiary boards** e.g. does it make use of overlapping appointments to enable communication and synergy across the group?

…………………………………………………………………………

How important are these overlapping appointments to the risk governance process contrasted with management systems and responsibilities? E.g.do they provide a complementary assurance role, does their effectiveness depend on the level of engagement of key individuals?

………………………………………………………………………………………………

Are **subsidiary boards expected to exercise a risk governance role** e.g. by carrying out an annual risk review, distinct from any management risk reporting arrangements?

Yes □ No □ Don't know □ Not relevant □

……………………………………………………………………………………………..

Is there a **risk committee** for the main board? □ For the subsidiary board? □

Which individual **owns responsibility for risk management for the subsidiary board**?

………………………………………………………………………………………………

To whom does that individual communicate risks identified by the subsidiary board?

……………………………………………………………………………………………….

Do **subsidiary boards operate within a code or framework** which defines the degree of risk to which they are permitted to expose the group?

Yes □ No □ Don't know □ Not relevant □

Are there sector specific codes which apply e.g. banking code
…………………………………………………………………….

Do **individual directors on subsidiary boards operate within a framework** which defines the degree of risk to which they are permitted to expose the organisation?

Yes □ No □ Don't know □ Not relevant □

How does the subsidiary boards **risk management activity feed into the group Enterprise Risk Management Framework (ERMF) or similar frameworks**?

……………………………………………………………………………………………………….

Do subsidiary boards contribute to group risk management through more **informal decision-making processes,** communicating issues across and up the group?

Strongly agree □agree □disagree □strongly disagree□ not relevant □

How is the subsidiary's risk process **communicated, formally and/or informally to external shareholders/stakeholders**? This may include statutory reports, codes and investor communications.

……………………………………………………………………………………………………….

Do the following play a recognised **role** in subsidiary boards' risk management?

Chief Risk Officer (CRO) □ Company Secretary/General Counsel □
External Audit □ Internal Audit □

Please indicate other functions with a recognised role………..

++

COMMUNICATION BETWEEN THE GROUP AND SUBSIDIARIES.

Are subsidiaries informed about relevant activities of their sister companies e.g. common markets or clients? (relevant in this context means relevant to group or subsidiary risk)

Yes □ No □ Don't know □ Not relevant □

What are the main ways in which the group communicates the strategic aims of the group to subsidiary boards?

What are the main ways in which the group communicates strategic risks to subsidiaries?

……………………………………………………………………………………………..

What are the main ways in which the group communicates its risk appetite to subsidiaries?

………………………………………………………………………………………………………

What is main ways in which the group communicates its risk tolerance to subsidiaries?

……………………………………………………………………………………………….

ANY OTHER COMMENTS?

E.g. to what extent do you think risk is embedded in strategic planning?

E.g. 2 Do subsidiary boards understand the concept of **"Black Swans**" i.e. rare, hard to predict, high impact events which cannot be modelled which would impact on the future of the group? (this question seeks to identify whether subsidiary boards are likely to have the capacity to contribute to informal judgements of potential risks)

THANK YOU

Thank you very much for your time and your help!

If you would like to receive the executive summary once the research is complete, please provide your email address ……………………………………………………………………….

If you have any questions please contact

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Questions asked of experts and those providing an overview

All of the experts and participants providing an overview were sent a copy of the main questionnaire as background. Some were also sent tailored questions as set out below.

These were intended to capture additional insights and validate feedback from other interviewees. The responses to the questions have been transposed into the main summary under the most relevant headings (in some cases the comments section at the end).

John Hurrell CEO of AIRMIC

1. Do main boards have a common understanding of risk appetite and tolerance?
2. Do main boards have a clear line of sight to subsidiaries material risks and/or a proportionate approach to risk?
3. What are the weak links, including board composition?
4. What are the emerging issues which might be making effective risk governance by subsidiary boards more relevant e.g. regulatory issues, environment, tax, and ethics?
5. Are main boards or their committees (possibly CSR as much as audit and board effectiveness) actively considering risk governance by subsidiaries?
6. What other points should be considered?

Seamus Gillen of ICSA

Provided comment on his expectation of the risk governance framework, bearing in mind the UK corporate governance code and FRC guidance on board effectiveness (authored by ICSA directed by SG) –and how this flowed through to subsidiary governance and the directors role.

Simon Osborne CEO of ICSA

Provided comment based on board effectiveness review

How far do main boards give consideration to subsidiary board effectiveness reviews?

Do you have a view on how well companies approach to subsidiary board membership is working? For example most use overlapping frameworks, although patterns vary. Are individual personalities a consideration?

How thoughtful are companies about how their board composition and responsibilities framework manages risk?

Global audit firm managing partner

Provided general comment based on experience of PLCs, large, private and family firms –including US and UK headquartered firms across all sectors. Interview informed by questionnaire headings.

Appendix B

Summary of interview responses

The interview responses were summarised in an Excel spreadsheet which forms an integral part of the dissertation document. Although that information was anonymised that detailed information has been removed from this web published version of the dissertation. The findings are summarised in the section which starts on page 42.

The level of detail provided by interviewees in response to different question areas varies. This is not necessarily a function of unwillingness to answer e.g. in-depth questions about problems in controlling subsidiaries. It typically reflects a focus, within the time available, on risk appetite and alignment, key risks, the governance and frameworks used, the role of subsidiary boards, and weak links.

Summary of interview questions not included for the purpose of web publication..

Appendix C

Institute of Risk Management, Risk Appetite and Tolerance Guidance

This guidance for boards identifies five key questions to ask:

1. Do the managers making decisions understand the degree to which they (individually) are permitted to expose the organisation to the consequences of an event or situation?
2. Do the executives understand their aggregated and interlinked level of risk so that they can determine whether it is acceptable or not?
3. Do the board and executive leadership understand the aggregated and interlinked level of risk for the organisation as a whole?
4. Are both managers and executives clear that risk appetite is not constant? It may change as the environment and business conditions change. Anything approved by the board must have some flexibility built in.
5. Are risk decisions made with full consideration of reward? The risk appetite framework needs to help managers and executives take an appropriate level of risk for the business, given the potential for reward.

Appendix D

Extract from

Roads to Ruin - A study of major risk events: their origins, impact and implications

A report by Cass Business School on behalf of AIRMIC

The report suggests that there are seven underlying risks which contribute to company failure:

A. **Board skill and NED Control:** risks arising from limitations on board skills and competence and on the ability of NEDs to monitor and, as necessary, control the executive arm of the company
B. **Board Risk Blindness:** Risks from board failure to recognise and engage with risks inherent in the business, including risks to the business model, reputation and "licence to operate", to the same degree as they engage with reward and opportunity
C. **Inadequate Leadership on Ethos and Culture:** risks from a failure of board leadership and implementation on ethos and culture
D. **Defective internal communication:** risks from the defective flow of important information within the organisation, including up to board level
E. **Risks from organisational complexity and change:** this includes risks following acquisitions
F. **Risks from incentives:** this includes the effects on behaviour that results from both explicit and implicit incentives
G. **Risk "glass ceiling":** risks arising from the inability of risk management and internal audit teams to report on and discuss, with both executive and non-executive directors, risks emanating from higher levels of their company hierarchy, including risks from ethos, behaviour, strategy and perceptions

Appendix E

Directors' duties (extract from handbook by the author for a global not-for-profit)

This section provides a short overview of Directors' duties and accountabilities. It is based on English common law and statute law (Companies Act 2006).

Two basic principles

There are two basic principles. The director owes a:

Duty of trust – to exercise a fiduciary responsibility to shareholders

Duty of care - to exercise reasonable care, diligence and skill

The duty of trust requires the director to:

- Act with integrity, behave honestly and fairly, "in good faith"
- Act for the benefit of all shareholders equally (providing them with sufficient and accurate information)
- Promote the aims of the company
- Operate solely within the company constitution
- Not treat the company as if it exists for their personal benefit
- Avoid conflicts of interest
- Declare any interest in a proposed transaction or arrangement
- Not make "secret profit" or take any unapproved benefit

The duty of care requires the director to

- Exercise independent judgment and care, skill and diligence (this will also take into account their specialist expertise e.g. a lawyer, accountant or engineer)
- Fulfill their obligations as a statutory officer of the company (including the legal obligations and liabilities)

Statutory duties

The Companies Act 2006 (England and Wales) sets out seven statutory duties for directors. They must:

1. Act within their powers
2. Promote the success of the company (see below)
3. Exercise independent judgment
4. Exercise reasonable care skill and diligence
5. Avoid conflicts of interest

6. Not accept benefits from third parties
7. Declare any interest in proposed transactions with the company

Promote the success of the company means considering the:

- Long term consequences of decisions
- Interests of employees as result of decisions
- Need to foster business relationships with suppliers customers and others
- Impact of the companies operations (and thus their decisions concerning those operations) on the community and the environment
- Desirability of the company maintaining reputation for high standards of business conduct
- Need to act fairly as between members of the company

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