Governance in company groups

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What do BP, Lehmann Brothers, The Co-operative Bank, Sime Darby Bhd, GlaxoSmithKline, Barings Bank, Royal Bank of Scotland (and many other company groups) have in common?

In all these cases, governance problems arose in group entities which had a very significant effect on the listed entity but the listed entity appeared to have been unaware of a problem developing.

We became interested in the topic of governance in company groups some years ago because, looking around the business environment, it seemed to us that most governance attention from regulators, companies and commentators was focused on listed entities or holding companies and not enough attention was being paid to group entities.

The exception is regulated financial institutions, where regulators have increasingly required parent companies to exercise oversight over group entities. However, in these institutions, this has led to tensions between the boards of parent companies and group entities as regulators have also imposed strict governance requirements on the boards and management of these group entities.

We wanted to try and answer some questions:

- How common is it for group entities to be used?
- How important are group entities to listed company performance?
- How do company groups currently govern their group entities?
- How can company groups better manage governance in group entities?

We recently completed a report based on a research project that looked at those questions (in conjunction with CPA Australia and Iclif), in which studied 150 companies listed on Bursa Malaysia (BM), the Singapore Stock Exchange (SGX) and the Australian Stock Exchange (ASX)

The prevalence of the use of group entities in company groups and their financial importance to them is striking.

- We found that most of the companies we looked at comprised many group entities. The mean (average) number of entities disclosed was 93 (ASX), 90 (BM) and 47 (SGX), and the largest number disclosed by companies was 554 (BM) 440 (ASX) and 239 (SGX)
- Many of the largest listed companies are holding companies only, with most of the assets and liabilities being held in group entities. In Malaysia, there are 33 holding companies, in Singapore 23. The "pure" holding company is least common in Australia, where there are five.
- In all the countries, group entities are very important to the financial performance and financial position of company groups. In the Malaysian companies studied, they contributed 45% of the latest year's total profit and 32% of the group equity (in Singapore, the contributions are 42% and 40% respectively, and in Australia, 39% and 28% respectively).

Looking specifically at the 50 Malaysian companies, an idea of their scope and complexity can be gained by looking at some numbers based on the disclosures of significant subsidiaries and other group entities:

- Twenty-one have group entities spread across more than 10 jurisdictions based on the place of incorporation. In some cases, entities may be incorporated in certain jurisdictions for tax reasons or to take advantage of more flexible business regulation (such as the British Virgin Islands, Cayman Islands and Jersey) while business operations are conducted elsewhere. The maximum number of jurisdictions is 37, spanning across Asia, UK, the US, Africa, Europe and Australia.
- On an average (mean), they have:
  - 47 wholly owned subsidiaries — 389 in the case of the largest;
  - 31 partly owned subsidiaries — 354 in the case of the largest;
  - Six associates — 18 in the case of the largest;
  - Four joint ventures — 35 in the case of the largest

Large, complex Malaysian-based multinationals are a reality. But have governance practices kept up with the growth in complexity and the consequent increase in risk?

The performance and the risk management of group entities, which are often legally separate from, but managerially integrated with, the listed entity have a very significant impact financially. It is also clear from looking at the cases mentioned at the beginning of the article and others that they can have an extremely serious impact on the reputation as well as the financial performance of companies.

In order to see how companies addressed this critical area, we looked at disclosures in the annual report by these companies about measures they use to govern their group entities, and compared it with the measures identified in the literature and interviews with directors, senior executives and others on steps that these companies could take. We classified the measures into five areas as follow:

- **Group Governance Programme.** Is there a formal and comprehensive approach to governance of entities throughout the group? For example, is there a comprehensive group governance framework or formal policy on creating and dissolving group entities, a central database tracking all group entities and a head of group governance?
- **Board Governance.** Are there structured approaches to involving parent company directors or management sitting on boards of group entities, appointment of nominee or independent directors, and board committees with group-wide responsibilities in areas such as remuneration, nomination of directors, human resource management, compliance, health and safety, and sustainability?
- **Learning and Development.** Are there formal training programmes for directors and senior executives of the parent company and group entities, site visits by directors and senior executives of the parent company, formal interactions between directors and senior executives of the parent and group entities, and group-wide internal control/risk/fraud awareness sessions?
- **Group-wide policies.** Are there group-wide policies in areas such as business conduct and ethics, risk management, whistleblowing, remuneration, authority limits, and treasury?
- **Audit, Risk Management and Financial Controls.** Are practices such as group-wide risk management and systems, internal audits, control self-assessments, written representations/ assurances, budgets and management accounts in place?

We found that the most commonly disclosed measures were in the area of group-wide policies and audit, risk management and financial controls and this was true of Malaysian companies as well as the others.

Very little or nothing is disclosed in respect of group governance programmes, board governance or learning and development, which we take to mean that not much is done in these areas.

This did not surprise us, as our own experience, discussions with directors, senior executives and other industry practitioners and the literature tell us that the impact of governance problems on company groups and individuals is often under-estimated. Further, in most organisations, little training or guidance is provided for the individuals who face these conflicts, leaving them to resolve many of the dilemmas that inevitably arise without guidance.

There often seems to be little sympathy or understanding of the conflicts placed on individuals holding directorships in group entities from parent boards and directors. We have heard comments from directors of subsidiaries and parent boards that the view from the top is "don't get an inflated idea of your own importance, you're not a real director" and "your job is just to implement what the parent board decides, not to make problems".

Perhaps it is assumed that individuals would put their duties under the law ahead of their other duties as employees or representatives of the ultimate or intermediate parent company which put them there. Unfortunately, the practice is often very different. We therefore regularly see reports of employees who have broken the law or behaved unethically even though they are subject to codes of conduct imposed by the parent company that clearly prohibit them from doing so.

It is commonplace when a governance problem arises in a group entity for the group to say, "It's against our policy, we didn't know what was going on". However, this rings rather hollow and it can sometimes appear that the objective of the parent board is "plausible deniability".

In reality, employees and/or directors of group entities are often uncomfortable raising the conflicts and dilemmas that they face, feeling that doing so may damage their career prospects or continued retention as a director. However, in the interviews that we conducted, we found such individuals acutely conscious of the problems.

Unfortunately, the most frequently adopted approach to the problems of group governance appears to be to ignore them and hope for the best. The effect of this is to place the burden on the shoulders of directors of these entities, who are "expected" to do the "right thing" but also to be "team players" and not to "rock the boat".

Many of the things that can go wrong in company groups can go wrong even if the business operations are not undertaken through separate legal entities such as subsidiaries, associates and joint ventures. For example, they could go wrong in a business unit, division or branch which is not separately incorporated.

However, the use of separate legal entities can create additional problems. For example, companies often incorporate separate legal entities for tax reasons or to "ring-fence" their risks but continue to manage them like a division or branch, ignoring the fiduciary duties owed by those who sit on the boards of these entities.

If things do go wrong in these entities, the parent of these entities may hide behind a "separate legal entity" defence, even though all the key decisions are actually made by the parent with little input from the boards of the group entities. Further, the law as it stands in most countries generally links the fiduciary duties of directors to the legal entity, rather than to the group. Therefore, directors of parent companies have fiduciary responsibilities that do not match up with their decision-making authority.

In our report, we provide a framework to guide boards of company groups in improving their governance of group entities. This framework includes the five categories of governance measures we mentioned earlier, and the internal and external environmental factors which should be considered when evaluating the approach and type of measures to use in governing group entities.

We also make several recommendations for regulators and companies to improve the governance of group entities. These recommendations include reviewing laws, regulations, corporate governance rules and guidelines, and putting the agenda of governance of group entities on the agenda of boards of company groups and improved disclosures.

A full copy of the report is expected to be published this month and will be available from The Iclif Leadership and Governance Centre from July. E

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