It has been said that governance failures usually happen within the subsidiary structure of a large business, but all governance focus tends to be at the main board level. Is the focus on the right area and, if not, what improvements could be made?

Following the accounting scandal at the Italian subsidiary of British Telecoms, it was remarked that 'if there isn't strong supervision from the mother ship over the smaller vessels, things such as financial irregularities and fraud will almost certainly happen'[1]. Of many governance failures that have occurred in recent memory, it can be observed that many of these have occurred within the subsidiary structure, where there is not an imposed requirement for corporate governance, rather than at the main board level.

Recent notable examples include the accounting scandal relating to overstated profits at the FTSE-listed Tesco plc's subsidiary Tesco Stores Ltd, the previously mentioned accounting irregularities scandal at the Italian subsidiary of FTSE-listed British Telecom's plc and in Switzerland, the recent scandal with the government owned PostBus subsidiary understating its earnings to claim millions in government subsidies.

Arguably, for entities listed in the UK, with a corporate governance code that focuses requirements at the main board level combined with a number of recent high-profile governance issues that have been revealed in the subsidiary structures, now is the time to consider whether there should be more focus on subsidiary governance measures, rather than further focus at the main board level. Over the course of this essay, I will consider whether a main board centric approach to corporate governance is appropriate in a landscape that comprises a wide variety of legal entities and will review a number of measures that could be implemented or extended to improve governance at a subsidiary level.

Existing corporate governance codes: a tool for subsidiary governance?

A theme that can be seen across many of the existing important corporate governance codes, particularly those that have their basis in the UK Corporate Governance code (UKCGC), is that they are rooted in the belief that good governance standards will have a trickledown effect if the right tone is set at the highest level.

The UKCGC focuses its requirements on the main board and suggests that governance should come through top down leadership: 'it is important that the board sets the correct "tone from the top"'[2], comparatively, while still asserting this, the new King code IV has 'ethical and effective leadership'[3] at its foundation. In South Africa, therefore, it could be argued that the importance of subsidiary governance, in addition to governance measures for the main board, is already recognised. The King Code IV not only requires all companies to apply <u>and</u> explain how they manage the risk associated with subsidiary governance, but also views subsidiary entities as stakeholders of the group[4]. Part V of

1 Financial Times *BT Italia scandal sparks soul searching over global* 1 July 2017

2 UK Corporate Governance Code 2016, preface pg. 6

3 Institute of Directors Southern Africa, King IV: Report on Corporate Governance for South Africa 2016. pg. 10

4 Institute of Directors Southern Africa, King IV: Report on Corporate Governance for South Africa 2016. pg. 7

the code on stakeholder relationships outlines a number of recommended practices for how subsidiary governance within the group should be approached[5].

The King IV code became applicable for financial years starting on or after 1 April 2017 and it will be interesting to see if these recommended practices prevent governance failures within the subsidiary structure as it continues to be applied. Should a demonstrably positive effect be evident, it may be that the ideas in the recommended practices of the King Code IV be considered to be included as provisions in future versions of the UKCGC. Alternatively, if subsidiaries were to be included within the definition of stakeholders that directors of the main board should have consideration to while discharging their duties under section 172 of the Companies Act 2006, this could also become an area of reporting in future. While a focus can be observed in the UK towards strengthening the stakeholder voice at board level, the scope of stakeholders that are currently outlined in section 172 does not include subsidiaries and legislative change would need to be considered for reporting to legitimately be required on subsidiaries as stakeholders.

Following the collapse of British Home Stores (BHS), a large privately held company, in 2016, its failure was attributed, in part, to weak corporate governance which enabled Sir Philip Green to 'use a network of private companies to channel profits to a family business located offshore'[6] it is unsurprising therefore that the government consultation on corporate governance included a suggestion to extend the application of the UKCGC, which at the moment only applies to listed companies, to large, privately-held businesses. It was recognised that it would be inappropriate to extend an obligation to comply with the UKCGC to smaller or subsidiary companies, while simultaneously acknowledging that many companies already adopt elements of the corporate governance framework in their subsidiary businesses as part of their internal risk management.[7] I believe this is the right response regarding smaller entities as the UKCGC has been drafted with listed entities with a premium listing in mind and many of the requirements would be inappropriate for smaller subsidiary entities. It could prove beneficial, however, if adoption of elements of the UKCGC, on a voluntary basis, were to be encouraged at a subsidiary governance level.

With a corporate landscape that seems to show a decline in the number of listed companies and an increase in private entities[8], reform consultation on the implementation of a code for large private companies may highlight how the government perceives the future of corporate governance. It is unsurprising therefore that one of the areas of reform that the Department of Business, Energy and Industrial Strategy (BEIS) corporate governance reform consultation focused on was improving corporate governance in large private companies.

The recommendation provided that a voluntary code be developed to be adopted by the largest private companies but 'should the voluntary regime fail to raise standards after a three-year period, or reveal high rates of acceptable non-compliance, then a mandatory regulatory regime should be introduced'[9]. Noting that there already exist voluntary governance codes for unlisted entities, the

5 Institute of Directors Southern Africa, King IV: Report on Corporate Governance for South Africa 2016, Part V. pg. 72

6 House of Commons, Business, Energy and Industrial Strategy Committee. Corporate Governance. Third report of Session 2016-17. Pg. 30

7 2016 Corporate Governance Reform: Green Paper, page 46

8 House of Commons, Business, Energy and Industrial Strategy Committee. Corporate Governance. Third report of Session 2016-17. Pg. 31

9 https://publications.parliament.uk/pa/cm201617/cmselect/cmbeis/702/70207.htm#footnote-142-backlink corporate governance code applicable to large private companies that has been suggested could go some way to impose higher corporate governance standards if the voluntary measures are widely applied and may allay concerns that a repeat of the BHS collapse could be experienced. The code may also be an important first step towards a mandatory code, firstly for large privately owned companies and, possibly in future, for all privately owned subsidiary entities.

While I think this could be a positive step for group structures where a large private company is at the top, a potential area for concern could be in the creation of complexities in reporting in instances where a large private company is a subsidiary, such as service companies frequently seen in a group structure. This could have the result that 'complexities would arise if these subsidiaries would fall within the remit of a separate governance code'[10]. With the introduction of a code for large private limited companies potentially signalling a future appetite for the implementation of codes for smaller entities, care would need to be taken so that these are drafted in a way that would be harmonious to the UKCGC and ensure that the reporting and governance requirements conflicts are not created.

Culture and a code of ethics

Micklethwait and P. Dimond argue that one of the two common themes that can be observed in the governance failures they examine was a flawed culture, specifically 'the behaviours that resulted from the incentive systems and organisation structures that were in place and supported by the board'[11]. Therefore, one might argue that while failings occur in the subsidiary structure, the root cause is attributable, at least in part, to the culture supported at the main board level.

In the preface to the UKCGC it states that 'one of the key roles for the board includes establishing the culture, values and ethics of the company' and that 'the board sets the correct "tone from the top"'[12]. This seems to signal that by leading ethically, a strong and beneficial culture encouraging good standards of behaviour will permeate throughout the group. It could be argued that the inclusion in the governance codes of this wording does place an obligation on the main board to ensure that the culture of the organisation, including within the subsidiary structure, encourages desirable behaviours.

Baroness Hoggs states that 'you can be getting a lot of good noises at the board level, but if the board is not taking the trouble to deep dive and discover if the words expressed in the boardroom are being performed further down the organisation, then you can easily get a disconnect'[13]. The main board therefore need to ensure that the behaviours that are being verbally endorsed at board level are being performed throughout the business and particularly in the subsidiary structure.

One way that this might be achieved, and an approach that is recommended in the IoD Corporate Governance Guidance and Principles for Unlisted Companies in the UK, is that companies adopt a code of ethics[14]. The Financial Reporting Council (FRC) have also suggested in their letter responding to the BEIS corporate governance reform green paper that a directors ethical code of conduct be

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10 GC100: conference on corporate governance, business and society *Practical Law Corporate* page 8

11 2017 A Micklethwait, P. Dimond Driven to the Brink, pg. 2

12 UK Corporate Governance Code 2016, preface, pg. 6

13 Baroness Hogg quoted in House of Commons, Business, Energy and Industrial Strategy Committee Corporate Governance, Third Report of Session 2016-17, page 13.

14 IoD Corporate Governance Guidance and Principles for Unlisted Companies in the UK, page 26 implemented that would operate alongside the directors' duties contained in the Companies Act[15]. While the directors' ethical code of conduct would apply to the main board of directors, it would also equally apply to directors of UK subsidiary boards with enforcement being undertaken by the FRC.

I will note at this juncture that Enron had a 64-page code of ethics and defined their values as 'Respect; Integrity; Communication; Excellence'[16][17]. I would therefore argue that a code of ethics, even one enforced by the FRC, will need further integration by companies to ensure it has the desired effect on subsidiary governance. At Enron, the behaviours that were rewarded seem to have been exclusively linked to financial results, with behaviours rewarded that could be viewed as being in complete contravention of the ethical code[18]. In such an instance, where a code of ethics is adopted by the board in word but management's actions do not support it and the board's endorsed reward framework undermine it, 'a written code is near worthless'[19]. For such a code of ethics to have a meaningful impact on subsidiary governance, it needs to not only be adopted but also integrated in to the way the company is conducted. A. Micklethwait and P. Dimond argue that 'When corporate values are published they suggest that these are things that the organisation values. Yet they only become strong signals if recognised by way of compensation and incentive systems'[20]. I would argue therefore that the implementation of a code of ethics, even with enforcement where directors fall below the standards expected, would be most impactful on subsidiary governance if its significance is signalled in the business through the company's reward systems.

Section D of the UKCGC requires that 'Executive directors' remuneration be designed to promote the long-term success of the company'[21]. R. LeBlanc argues that 'Companies do not fail: boards fail'[22] and A. Micklethwait and P. Dimond 'extend the culpability [of corporate failures] to include leadership teams'[23]. I would argue therefore that the principle and provisions contained in section D of the UKCGC could be extended to include leadership teams in its remit given their impact on the long-term success of the company. 'Reward systems are important influences [of culture]'[24] and should be designed and endorsed at the main board level but then implemented in a way to ensure that the desired behaviours are being promoted and rewarded in the subsidiary structure.

Enron provides a stark example of a rewards systems based solely on financial performance, in this case employees' ability to book earnings that would result in mark to market accounting profits. The reward system at Enron, despite the presence of a code of ethics, contributed to a culture that was short-termist and dangerous to the long-term success of the company. While I would not endorse the view that companies should be required to report on how they have applied the principles of the

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15 FRC correspondence to BEIS Select Committee, 30 November 2016

16 2000, Enron Code of Ethics http://mishkenot.org.il/Hebrew/docs/ethics/%D7%A7%D7%95%D7%93%D7%99%D7%9D%20%D7%90%D7%AA%D7%99%D7%99%D7%9D%20%D7%A9%D7%9C%20%D7%90%D7%A8%D7%92%D7%95%D7%A0%D7%99%D7%9D%20%D7%A2%D7%A1%D7%A7%D7%99%D7%99%D7%9D/Enron%20Code%20Of%20Ethics.pdf

17 Enron's 1998 Annual report, page 73 http://picker.uchicago.edu/Enron/EnronAnnualReport1998.pdf

18 Examples include the Death star and Fat Boy strategies used to inflate the cost of power supplied to California discussed in 2003 B McLean and P. Elkind The Smartest Guys in the Room

19 2017 A Micklethwait, P. Dimond *Driven to the Brink,* pg. 11

20 2017 A Micklethwait and P. Dimond *Driven to the Brink,* pg. 11

21 UK Corporate Governance Code 2016, Principle D *Remuneration*

22 Leblanc, R. (2015) Harvard University Summer 2018, MGMT S-5018 Corporate Governance syllabus, page 5

23 2017 A Micklethwait, P. Dimond *Driven to the Brink,* page 1

24 2017 A. Pryce and R. Thomson *Strategy in Practice,* page 114 code at every level of their organisation, the principles contained in the code are based on common sense and applying them on a voluntary basis to subsidiary governance, such as remuneration, is to be encouraged. Such practice could be used to promote ethical behaviour below board level and internally place a focus on a wider group of individuals whose actions influence the long-term success of the company.

The UK Corporate Governance Code, and other governance codes from around the world, predominantly focus their attention at the main board level and are not required to be applied to entities within the subsidiary structure; despite consultation on this area, I believe this remains the correct approach. Over the course of this essay I have argued that the implementation of a separate mandatory corporate governance code applicable to large private entities or other subsidiaries within a group structure could be beneficial but should be approached with caution, particularly in instances where this would require conflicting codes to apply to entities in the same group. I have also argued that the voluntary application of some principles of the UK Corporate Governance Code to all entities within the subsidiary, particularly to do with promoting the company's ethics, should be encouraged and can be used to create a beneficial culture that helps to promote the long-term success of the company.