ADMINISTRATION IN A LARGE SCALE ORGANISATION

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Abstract:

Achieving good governance in a large organisation requires a harmonisation of various activities that occur in various functional groups. Chartier, B.J. (2006). Main board activity is often the key priority for corporate secretaries and compliance officers. In most big companies, there are also several downstream entities that need to have the right processes and proper guidance to maintain high governance standards. Not paying attention to all the various entities can lead to governance failures and often result in damaged corporate reputations. Technology needs to be part of a total solution in building an effective governance framework. Subsidiaries need to be included in the total corporate picture when it comes to compliance activities and should be included in the corporate governance initiatives. The risk of not taking this approach is that they will either flounder or develop their own solutions which can lead to increased costs, duplication or worst, non-compliance with regulatory codes.

Good governance is not achieved by simply adhering to checklists of recommended best practices, but is a more complex equation that is highly dependent on the attitudes and actions or inactions of the people involved

Basics of Subsidiary Governance

Typically, large organisations focus substantial attention at 'top-tier' governance activities. They ensure that the main board, shareholders and analysts are well fed with information and that all the legal requirements are met. Drilling down deeper into the core of a large publicly traded company, often the emphasis on corporate governance weakens farther down to the organisational chart to the extend that Sound governance practice at the top of an organisation is of great importance. At the second level it becomes more of a management practice and by the third and fourth levels it can become diluted in the business and has minimal governance. Below the fourth level, governance activity is often ad hoc and entirely up to the business unit. There is often little or no governance oversight at this level.

Many large organisations channel their governance activities at the main board level. Naturally investors, regulators, rating agencies and analysts focus their attention on the parent company as it would be near to impossible to permeate the corporate structure for all public companies. What is significant to know is that in today's complex structures, the corporate office is merely the tip of a much larger pyramid that can be comprised of hundreds and even thousands of legal entities. Attention needs to shift to how well large organisations cope with their complex and often global structures. These, after all, are the parts that equal the whole. The parent company is where the financial streams all lead and pool into the financial results that the company reports to the stakeholders. Thus, not paying attention to the parts can lead to costly kinks in the corporate structure that may not manifest for a few quarters depending on the efficiency of information flow and what systems are in place supporting oversight and governance.

The Challenges of Governance in Large Organisations

Here are some fundamental questions that all public companies should be able to answer.

(1) How and where do subsidiaries exist?
(2) Why do they exist?
(3) Are they operational subsidiaries or shelf companies?
(4) `Who is the contact?
(5) Are they compliant with corporate policy?

(6) Are they compliant with jurisdictional law?
(7) Who is on the board and why?
(8) Who are the corporate secretaries?
(9) Who is ultimately responsible for them?

The acquisition of a major asset by a subsidiary would most likely require the signatures of the board members of that subsidiary. Knowing who those directors are becomes very crucial when a deal is about to close. Companies often scramble to gather this information, often by contacting several people in multiple departments. The process is long and inefficient and in some cases the integrity of the information is suspect. Emphasis on the word 'today' as we want to make the point that complex corporate structures are always in motion. Subsidiaries come and go with acquisitions and divestitures, just as directors and officers and their pertinent information.

Why Companies Have Subsidiaries

There are several reasons why subsidiaries exist, here are just a few;

1. Separation of business and product lines
2. Regulatory requirements
3. Tax efficiencies
4. Hold assets
5. Country laws
6. Risk mitigation
7. 'Egos'.

Some of the reasons are clear and require little explanation. The separation of business and product lines is often straightforward and makes managing the corporate contribution clearer. Regulatory requirements usually happen in highly regulated industries such as banking or insurance whereby subsidiaries allow the expansion of the business into areas that would not be allowed by a parent due to regulatory policy. An example would be that in some jurisdictions, (such as Canada), banks are not allowed to sell insurance. They get around this by having a wholly owned subsidiary that is licensed to sell insurance products thus allowing them access to a lucrative market and build their total product offering to a well established client base. Tax efficiencies often involve having subsidiaries in tax favourable jurisdictions such as the Caribbean or the Channel Islands. Subsidiaries in these lower taxed countries allow companies to move assets where they are taxed at lower rates or will sometimes invest surplus capital in those jurisdictions so that the returns are taxed at lower rates. Country laws simply mean that in order to do business in a particular country, a company must have a legal entity registered there. As for holding assets, sometimes it is wiser to hold certain assets in separate legal entities. For example, many organisations will hold their corporate jet in a separate legal entity to limit the parent's liability exposure, should there be a catastrophic event involving their plane. Courts may not absolve the parent entirely, depending on circumstances, but isolation of the asset in a subsidiary can certainly lower the potential exposure and avert a liquidity crisis's. (Baysinger,1985)

The last two are more complex. Risk Mitigation is what the corporate lawyers defend as necessary for the protection of shareholders. We agree that from a purely legal standpoint that you can mitigate risk this way if there is a business failure. Essentially it can be isolated to the one subsidiary and in some cases a subsidiary can be put into bankruptcy and dissolved with minimal impact on the parent. This is not so true in cases where the risk of a damaged reputation from abandoning social responsibility can negatively impact a parent. For example, when Firestone made headlines due to defective tyres on Ford Explorers, the parent Bridgestone would have suffered irreparable damage if it had walked away from Firestone, its subsidiary. It bore a social responsibility and it faced serious damage to its reputation if it chose not to support Firestone. Inevitably, Bridgestone agreed to replace thousands of tyres on Ford Explorers and preserve its reputation. The same scenario was true with Ingersoll-Rand when its subsidiary Kryptonite made headlines in 2004. A group of teenagers discovered that their trademark U-shaped bike locks could be opened with a Bick pen. Despite efforts

to diffuse the bad publicity, the end result was a replacement programme that cost $10 million US While the expense was borne at the subsidiary level, it inevitably funnels upward to the parent company, Ingersoll-Rand.(Horowitz, 2005)

Egos go directly to corporate culture. An organisation that fosters entrepreneurship and internal competitiveness often leads to the building of internal empires. Corporate empires are often successful growth businesses led by strong leaders that have drive and a winning attitude. It also means that they like to build their businesses through acquisition and organic growth which often leads to mini-conglomerates within the company. A closer look may reveal that many of the subsidiaries in these structures are not needed or can be amalgamated with other legal entities. The problem of course, is in convincing the head of a business that there is value in doing so. Such as taking an economic value approach and demonstrate the net impact on the bottom line if the number of subsidiaries can be reduced.

Why Should You Care?

As a business leader, why is subsidiary governance important to the overall business of growing stakeholder value?

1. Subsidiaries are new branch from the organisation of which the cooperate heads are responsible for most things needed for effective operation
2. Image
3. Brand protection
4. Litigation
5. Reputation
6. Liquidity and value
7. Your investors care.

If a 16 year old daughter accidentally backs the car into the neighbour's house and ends up parked in their living room, who is ultimately responsible for the repair bill? The laws say that as long as she is under the age of majority, the parents are financially liable for her actions. The same is true for subsidiaries. Piercing the corporate veil, (*the legal description for the courts making parent companies accountable for the actions of their subsidiaries*) is becoming increasingly frequent in today's business environment. So just as everyone must bear the financial brunt as parents for any trouble children get themselves into, so must corporate parents accept responsibility for their subsidiaries.

Subsidiaries are a reflection of the company. When thinking of General Motors, is the thinking of it in terms of the Pontiac Division or the Buick Division or Saturn? No the thinking of the company must be holistic. As consumers, should not drill down the corporate structure. the thinking of the whole company and its public brand. In this case, GM. Similar to reputation, protecting the brand and ensuring that a brand is not negatively impacted because of the problems in a subsidiary is of paramount importance. Litigation and reputation go hand in hand. If there is major litigation happening with a company's subsidiary, it can negatively impact the reputation of the entire company. Outside the organisation, shareholders, consumers, analysts and all other stakeholders view the company as a whole rather than a multitude of entities.

Financial problems and litigation in a subsidiary can have a negative impact on the entire organisation. It can impact on a company's liquidity and threaten its ability to grow the business or even force it into bankruptcy. Capital markets and lenders are sensitive to the total picture, so if a major crisis develops in a company's offshore subsidiary, they consider this when making decisions affecting the company or writing a brief for the investment community.

Lastly there should be need to care about the subsidiaries because the investors care. Today, investors large and small, expect governance in a company to go beyond the main board to transcend all its entities regardless of where they are.

What You Need to Know as a Business Leader

There are several questions that every company should be able to answer quickly and accurately. As simple as these questions may seem, surprisingly many organisations struggle when this information is required to respond to regulators or for other reasons such as merger/acquisition filings or in response to litigation discoveries.

1. How many subsidiaries do we have and where are they?
2. Which are active/inactive?
3. Who is responsible for them?
4. Who is on the board?
5. Are they regulated?
6. Are they legal operating companies or virtual entities?
7. Are they compliant with internal and external policies?
8. How much do subsidiaries affect the bottom line?

Business leaders need more than ever to show that they are in control. While they may foster arms-length relationships with their subsidiaries, they must demonstrate that they have a good system of oversight and governance in place. Failure to do so, increases the risk of a governance or compliance failure that can result in losses and lower share values. Even directors on internal boards need complete, accurate and timely disclosure of all material information to properly execute their fiduciary duties. Only technology can ensure an effective and timely flow of information.

Leveraging Technology to Enhance Subsidiary Governance

Complex structures, regulatory changes, Sarbanes Oxley, country laws and information proliferation, are all adding to the challenges of leadership. It is time for technology to revolutionise corporate governance and managers should note the following

1. Technology alone does not enhance subsidiary governance
2. Companies need a comprehensive framework that transcends business lines and geographic borders
3. There is no 'one size fits all' solution
4. Entity management software is best leveraged as an enterprise system
5. An effective and comprehensive governance system must include a technology solution
6. intranet networked solutions are the most effective
7. Scalability is important, especially in an expanding company.

Technology needs to become the centrepiece of the subsidiary governance framework. It starts with entire management software but stress that is just the first step. Companies need to seek out expertise to help them build a comprehensive governance framework around their technology so that it becomes fully leveraged as an enterprise system. Many organisations have spent millions on accounting systems, yet will hesitate to spend a few hundred thousand on software that will enhance governance and reduce the costs associated with regulatory compliance. It is a matter of cultural and behavioural change. Entity management must be more than just a database to store information. Technology needs to handle corporate filing for compliance, act as a document repository, manage intellectual property, securities information, stock options, director and officer information and maintain an ongoing electronic history of all corporate structure changes globally. Combined with the right strategic placement and supported with policies and operating guidelines, a company will then have a solid interactive subsidiary governance framework in place.

It is important to understand that while technology needs to be part of a total solution, it also has to conform to the corporate environment and operating structure. Trying to change the company to adapt to the technology will cause resistance and gaps in the effectiveness of the governance framework. When approached with a clear corporate strategy, the software can evolve into an enterprise system supporting several internal functions such as law, finance, treasury and taxation. The most effective systems are accessible throughout the company on their intranet thus allowing it to be further leveraged in all departments and locations around the globe.

Technology and Behaviour

There is a cultural shift taking place in organisations. Much of this shift can trace its roots back to October 16, 2001, the day Enron announced its third quarter results and that it would be taking a $544 million earnings charge and a $1.2 billion reduction in shareholder equity. This was the snowball that was set rolling down the mountain that would grow into a massive boulder that would change corporate governance culture forever. There should be need to use technology solutions to change how employees behave and react to corporate entity management.

1. One must drive the other – in fact the forces must come from both directions
2. Policies and guidelines are needed to support the technology solution
3. Life cycle management needs to be the norm for ‘all’ subsidiaries
4. Creating
5. Dissolving
6. Integrating.

Implementing technology will *not* on its own, drive better subsidiary governance. However, as part of a comprehensive strategy, with governing guidelines and corporate policies built around the system, behaviour will conform to new norms. Life cycle management of subsidiaries, real time corporate data, electronic filing, document management, etc., will all change how staff manage information and respond to changes in corporate structure. These new norms will also create new career opportunities in the field of governance. Like any enterprise system, effectiveness is contingent on the people it was designed to support doing their part.

Technology Solutions

There are several technology solutions on the market today. Choose wisely and find the one that is not only a good fit for today’s business environment, but also one that is well supported by a supplier that is committed to evolving the product with the changes in regulatory and governance standards. Initially you need to look for;

(1) An enterprise system that tracks and stores corporate data and records,
(2) Provides automatic compliance reminders and allows for electronic filing and forms creation,
(3) Is the definitive source of corporate information for all functional groups,
(4) Scalable to adapt to the corporate structure,
(5) Supports tax and industry compliance filings,
(6) Has archival capabilities,
(7) Supports intellectual property management,
(8) Provides securities management and
(9) Enhances productivity and reduces the cost of governance and compliance tasks.

There are several software products in the market today that provide entity management solutions. Proper diligence will help your company make an informed decision about which is the right one for you. There are several features that should be considered. First of all, it should be a software that stores all corporate information on all legal entities, such as, directors, officers, licenses, contracts, regulatory filing, bylaws and investments. Today, electronic filing capability and form creation should also be key in your decision process. This is important for meeting filing deadlines and managing contract renewals associated with your legal entities. A good technology will also support intellectual property management, which is increasingly important to global companies. Software with built-in audit trails helps manage the integrity of the information and provide an added level of security for corporate data. Finally, software that is flexible and scalable is imperative for it to last over the long term. If you buy a technology that cannot adapt to the ever-changing requirements of today’s governance environment, it will quickly lose its internal credibility as a governance tool. Buying a simple, inexpensive system that just meets today’s needs could end up being the more expensive choice.

The Economic Value of Subsidiary Governance

Business schools teach their MBA students that there need to be an economic value proposition for every strategic initiative. Some companies are already predicting that their earnings will be lower this year as a result of the cost of complying with Sarbanes Oxley Section 404. Your subsidiary governance framework should save your company money and have an economic advantage for stakeholders. Consider the following:

(1) subsidiaries are costing you money,
(2) actual costs vary by company but here are some real life examples
(3) dormant/inactive subsidiary $40,000/year
(4) virtual entity $60,000/year
(5) mid size operating subsidiary $80,000/year
(6) large operating subsidiary $800,000/year

The fiscal aspect of managing an organisation's legal entities can be staggering. In one case, by eliminating over 150 subsidiaries from a company's structure, they were able to eliminate more than $40 million from its operating costs. The cost structure varies by company but the end result is powerful information in implementing effective life cycle management for subsidiaries. A company should be effective in coordinating the affairs of its subsidiaries in order to achieve its stated objectives (Chartier, 2005)

What are the Expenses Associated With Subsidiaries?

Consider that all your subsidiaries are incurring some, if not all, of the following;
(1) system and GL costs
(2) accounting costs
(3) regulatory filing expenses
(4) tax reporting/filing/levies
(5) resolutions and bylaws
(6) meetings, materials, people
(7) administration expenses
(8) management salaries
(9) risk – enterprise, reputation, economic
(10) Audits (internal and external) and related costs.

Expenses driving subsidiary costs vary greatly by company and by entity. Any subsidiary that resides on a company's general ledger is incurring costs to exist. The cost increases with activity and size. Sceptics argue that these are 'sunk' costs and that they would be there anyway. The fact is, most of the costs are real and increase with size and activity. An operating subsidiary that has regular board meetings and files regulatory and tax returns generally incurs the most expense to exist. They usually require both internal and external audits, they file tax returns and if regulated, they have regulatory filing. There are also less tangible costs, such as risk. Every legal entity poses some risk to an organisation. Most companies can fix a price associated with that risk and that can then be applied to a subsidiary. Total transparency in reporting would mean considering all business risks that exist within a company, including their subsidiaries.

Conclusion

Implementing a subsidiary governance framework does not imply creating a bureaucratic system of policies and infrastructure. It should, in fact, be a clean business-driven strategy that simplifies management and governance of the corporate structure while at the same time, creating value through cost savings and reduced risk. The end result should be a uniform system of subsidiary governance that is applied enterprise-wide.

Markets expect companies to provide accurate information in a timely fashion. Many organisations are struggling to implement effective systems for gathering data and keeping them

current. Having a comprehensive framework for subsidiary governance is smart business. Regulators, investors, analysts and employees now expect sound governance across the entire organisation, not just at the parent level. Those companies that do this correctly will reduce the cost of compliance and quickly increase transparency. There are several companies out there today that are benchmark organisations in subsidiary governance. They realise the value, both economically and publicly of being in control. This does not mean controlling in autonomous business unit, but rather, acting as a responsible parent and knowing what the kids are up to. Follow this simple model;

1. Set your goals; where do you want your company to get to in terms of subsidiary governance?
2. Where do you want the main focus for subsidiary governance to be, in the business unit or at the parent level?
3. Develop a value proposition; how will a subsidiary governance framework benefit the company?

   Those companies that get it right will reap the long-term benefits of investor confidence for years to come.

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