مركز الحوكمة
CENTER FOR GOVERNANCE

SUBSIDIARY GOVERNANCE

Ensuring Accountability and Alignment Across Corporate Groups

A PIF COMPANY

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Center for Governance

Report

TABLE OF CONTENTS

INTRODUCTION

Subsidiaries can be great vehicles for new markets, new products, services or business lines, mergers and acquisitions, corporate structuring, tax efficiencies, risk limitation and regulatory compliance. Their number increases as companies grow. In 2022, the largest public companies in the world had on average 59 subsidiaries each. Vinci, a French construction company, is a notable exception with 2,689 subsidiaries. Smaller companies counted fewer than 50. Many governance failures have been caused by failures at subsidiary level. Subsidiary governance matters and should be seen and practiced as part of sound risk management. Over time, subsidiary structures become more complex. Although parents and subsidiaries have their own, unique legal entities in the same or different jurisdictions, parents tend to do the governance heavy lifting, establishing and overseeing frameworks, while subsidiaries work out specific governance and operational requirements. Challenges abound, from extending governance "downstream" to finding the right subsidiary governance model and structure for effective oversight. Although subsidiary governance is a new field, it is increasingly on the radar of regulators and boards.

THE LANDSCAPE OF SUBSIDIARY GOVERNANCE

Subsidiaries present governance dilemmas; control independence, standardization versus local adaptation, how to ensure the "river of governance" flows downstream and reflects the desired and fit-for-purpose system of governance for the whole group. Governance is fundamentally about oversight, advisory and decision-making: when any of these functions is ineffective, subsidiaries can fail, with significant reputational and economic damage also for the parent. Recent examples include the closure of a local subsidiary of Swedish battery maker Northolt due to strategic misalignment, the fraud and under performance troubles at Western Asset Management, a subsidiary of Franklin Templeton; bankruptcy proceedings of two subsidiaries of Evergrande, a Chinese property developer; Heineken's group liability for the abuse of dominant position by its Greek subsidiary Athenian Brewery; crisis at the UAE subsidiaries of KPMG, Dechert and Baker McKenzie; Toyota's wrongdoing troubles at several of its subsidiaries, and subsequent, public apology by its Chairman. Historically, subsidiary governance costs and risks have been under-appreciated and under-researched. Issues include the role of subsidiary boards, to what extent they can make independent decisions, board composition and DOA. Subsidiary governance is frequently overlooked, not well thought through or fit for purpose. Often it is assumed not to be a responsibility of the parent's board, although directors remain legally responsible for the actions of all legal entities they serve, wherever based. Businesses and regulators increasingly recognize that subsidiaries play a crucial role in effective and efficient governance across the entire organization. Regulatory developments are also forcing companies to focus on the governance of all entities within a group. For instance, since July 2023, economic substance requirements for foreign subsidiaries require multinationals to focus on legal entity level, be clear about the purpose of those entities (the "why" question) and make decisions on their governance.

Subsidiary governance is a spider web of intricate structures, policies, procedures and behaviors potentially entailing significant risks to companies. The top two questions to get the subsidiary governance mix right are: given the risks, how to extend sound governance policies and practices downstream and what should be the appropriate governance structure to add value to subsidiaries and enable effective oversight.[1]

[1] Global spending on cybersecurity solutions is expected to reach $300 billion by 2026 (a 12% increase from 2022). Source: IDC 2023 (International Data Corporation). Ostermann Research & Cognito (2021). Managing Risk from Subsidiaries: Goals, Friction and Failure. Available at: https://www.cycognito.com

RISKS OF SUBSIDIARY GOVERNANCE

The most significant risks associated with subsidiary governance are compliance, financial management, cultural differences, communication and cybersecurity.

3.1 Compliance

Navigating compliance can be complex and risky, especially in different jurisdictions or when subsidiaries operate in different industries or industry segments. In the 1990s Walmart's German subsidiary struggled due to significant differences in labor laws and local regulation of minimum cost of goods. Volkswagen's 2015 Diesel Dupe was uncovered in its US subsidiary and eventually spread to subsidiaries in Europe and Asia. In 2021, Royal Dutch Shell was found in breach of its duty of care towards local communities impacted by the operations of its Nigerian subsidiary. A robust compliance system with regular audits, ongoing training and learning, close monitoring and tracking of regulatory requirements can help prevent issues.

3.2 Financial Management

Inadequate planning, reporting, lack of clarity on local taxation or currency fluctuation can lead to blind spots in decision making at parent and subsidiary level. Standard reporting systems, training on local financial regulations and regular touch points on financial management can avoid financial losses and enable financial health.

3.3 Cultural Differences

Boards have a core responsibility for performance and risk. Board engagement with culture can help both. Differences in the way "we do things around here" can mean different ethical values and standards, often deeply culturally rooted. Building a unified corporate identity, culture and risk-performance approach requires adaptation and an ongoing balancing act. In most companies, Codes of Ethics or Supplier Codes of Conduct prohibit staff from accepting gifts (increasingly regardless of monetary value), however, subsidiaries in certain countries might be unable to function without some degree of flexibility around the cultural significance of gifts. Child labor is legal and acceptable in some countries but illegal and unacceptable in others. Multinational companies that have been found using child labor in parts of their supply chains have been judged harshly by their customers and regulators. There are hazards in adapting to cultural norms, establishing different policies and procedures for parents and subsidiaries means that the behavior of a company and its employees will be judged by different ethical standards, creating risk exposure and feelings of injustice.

3.4 Communication

When parents and subsidiaries are in the same country, they often rely on implicit communication, unspoken rules that "everyone gets". A familiar tone of voice helps people understand a message in the same way and when people know one another well there is often no need to finish sentences to get their point. With subsidiaries in different or same countries implicit communication does not work well. Parent boards and management should be mindful that messages or requests can get lost in translation: it is important to ensure that messaging is received and understood accurately (on both sides). Encouraging people to recap key messages and their understanding of a conversation (or a policy document or governance charter), or ownership (who is expected to do what by when) can avoid misunderstandings and inefficiency. This isn't about embracing bureaucracy, rather avoiding the creation of governance fault lines ("us' versus "them" dynamics).

3.5 Cybersecurity

With investment in cybersecurity globally on the rise, boards, management and staff need to understand the cybersecurity landscape, ongoing threats, strategies and frameworks, and monitor IT security risks at subsidiary level. Subsidiary IT set up can include assets not directly managed but representing a significant cybersecurity risk for the group. A recent subsidiary cybersecurity risk study found that 54.7% of respondents had at least one of their subsidiaries implicated in a cyberattack. As cyber threats grow more unpredictable and security breaches more frequent, subsidiaries may be points of entry for cyber-attacks.

Building an effective cyber leadership and a cyber-aware workplace culture at all levels is crucial for resilience and operational continuity. Cybersecurity protocols need to be explicit and robust across parent and subsidiaries (and adjusted when subsidiaries have their own IT infrastructure) with intentional, regular security assessment.

GETTING SUBSIDIARY GOVERNANCE RIGHT

To extend sound corporate governance downstream, the parent's board will establish subsidiary boards (increasingly a best practice even in jurisdictions where there is no regulatory requirement to do so). These are expected to act independently and with objectivity to be able to carry out their fiduciary duties. Due to ownership structure, board independence can be challenging and parent's interests, it may over- shadow those of the subsidiary. Parents and subsidiary boards are expected to collaborate on drafting the subsidiary governance model and framework, the approach, roadmap and visual representation of how governance practices are set and performed. At its core, a subsidiary framework aims to enable control of issues and consistent oversight, advisory and decision-making. Context, cultural differences, jurisdiction and business goals must inform governance choices. Directors' personal, legal responsibilities remain the same, particularly when the parents and subsidiaries operate in the same jurisdiction. The key is to be able to demonstrate (internally and externally) that an effective chain of oversight has been established and is being lived.

Governance should be harmonious across all operations (so it can 'flow'), yet "flexibly consistent": if variations are needed, boards should be able to articulate how and why. A subsidiary governance framework also maps out duties, responsibilities, reporting and information flow parent-subsidiary-parent and reflects the risk management approach desired for and from subsidiaries. This depends on subsidiary relevance to the parent (level of investment, strategic importance, growth/maturity stage and risk) and the compliance labyrinth. Ultimately, subsidiary governance frameworks should enable good governance during business as usual but also in crisis situations, and exist to ensure consistent management and issue control, in other words, to avoid crises.

As to the appropriate governance structure to add value to subsidiaries and enable effective governance, boards should keep in mind the balance between flexibility and prescription. One size fits all approaches can be dangerous, given that subsidiaries are typically at different stages of development, growth and independence from the parents. It is best to involve subsidiary board and management teams in crafting or updating the governance framework.

A good place to start includes;

- Establishing the overarching subsidiary governance model: set out the approach/principles for relationship structure, strategic degree of integration and mode of oversight between parent and subsidiaries, reporting and monitoring relationships, managing conflict and confidentiality, the objectives of subsidiaries and how they will be achieved and monitored;
- Reviewing the group structure: analyzing company's records and mapping a visual representation of the set up;
- Running regular health check: a three-way check, delving into statutory records, in-country trade register and any electronic records;
- Compiling a calendar of annual compliance: getting clarity on annual filings, filing types and dead-lines country by country, subsidiary by subsidiary.
- Drafting or updating the governance framework: the visual representation of how the subsidiary governance model comes to life, outlining for different categories of subsidiaries (i.e. fully owned, majority or non-majority shareholding, controlling and non-controlling interest), fundamental rules around board composition (who the directors should be), board work (roles and responsibilities, how often the board meets, which committees are mandatory and which fit-for-purpose), and reporting to and collaboration with the parent board.

Parents should also regularly review the composition, skills and effectiveness (evaluation) of subsidiary boards, including after major events such as acquisitions or significant growth and expansion. This includes ensuring visibility and oversight of subsidiary directors' service contracts. Parents can significantly support and add value to subsidiaries by making group policies and standards available to subsidiary board and management, particularly on group-relevant topics such as whistle blowing, health and safety, human rights, or anti-bribery, so that subsidiaries do not need to reinvent the wheel and there is one, group-wide yet culturally-sensitive approach to these important issues. Parent boards also need to be clear about expectations of subsidiary boards, reporting lines and interactions, and decision-making. Subsidiary boards and all subsidiary management and staff need to understand these expectations.

Engagement and communication needs to be encouraged for governance to flow, beyond subsidiary board meetings. This is particularly important to avoid misunderstandings around risk and conflict of interests, their approval or disclosure. Good subsidiary governance requires parent and subsidiary staff to under- stand the 'why' of certain choices and their rationale. Appointing governance champions, regular training at subsidiary level and board inductions can significantly help with staff buy-in.

LOOKING AHEAD

Companies and regulators increasingly recognize that subsidiary governance is critical to risk management. Many subsidiary governance practices have evolved organically due to historical lack of governance focus in this area. Although boards in most jurisdictions have a legal responsibility to act in the best interest of the entire organization, effectively fulfilling this duty is complex and often not straightforward. Ideally, subsidiary governance structures should reflect or be aligned with those at parent's level, yet a certain degree of adaptation is often required. The needs at group level must be balanced with those of subsidiaries and their cultural and regulatory context. A best practice that underpins subsidiary governance is clarity of intent (why the subsidiary was established in the first place, what is its purpose and that of its governance). Another best practice revolves around operational, strategic and governance dialogue between parent and subsidiaries at board, executive and staff level, so that expectations are clear, compliance is understood and monitored, and warning signs are caught before they become red flags. Appointing directors who serve both the parent and subsidiary board can facilitate this dialogue. This can also facilitate information about and alignment with the parent's strategic plans and activities.

Overall, there is a clear, global trend towards more attention to and disclosure of subsidiary governance policies and practices, how they may change over time and understanding how directors' fiduciary duties towards the entire organization are set and practiced at parent and subsidiary level.[2]

[2] Decreton et al. (2019). Headquarters Involvement, Socialization and Entrepreneurial Behavior in Subsidiaries. Long Range Planning, 52(4); Du et al. (2015) The Roles of Subsidiary Boards in Multinational Enterprises. Journal of International Management, 21(3), 169-181; Du, Deloof & Jorissen (2011). Active Boards of Directors in Foreign Subsidiaries. Corporate Governance: An International Review, 19(2), 153-168.

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ABOUT THE CENTER FOR GOVERNANCE

The Center for Governance was established by the Public Investment Fund (PIF) in 2020, and is dedicated to enhancing corporate governance capabilities and know-how in Saudi Arabia and beyond. We are a catalyst for governance excellence in the Kingdom, delivering practical solutions that elevate standards, build trust and foster societal progress.
sectors in three core areas:

- We undertake board evaluations for all kinds of entities, and provide advisory services relating to governance, risk and compliance.
- We design and deliver development programs aimed at board members, the C-Suite and governance professionals.
- Through rigorous research and thought leadership, we uncover new insights that raise awareness and understanding of governance, directorship andorganizational performance.

For further information on how the Center can support your organization, please contact **info@cfg.sa**

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