Teneo

Simplifying Corporate Structures

Have you as a board ever questioned why you have so many companies in your group structure and what they are all for? Do they have a valuable purpose or do they increase risk and/or give the impression of opaqueness?

This article explains why simplifying a group structure can support stakeholder transparency and enhance internal accountability within a business. As you review your annual report this year, ask yourself why you have all of those entities listed as subsidiaries and what purpose they serve.

Why are stakeholders increasingly focused on corporate structures?

Over time, globalisation, historical tax optimisation, sophisticated capital structures and M&A activity has increased the complexity of corporate structures.

In parallel, the level of scrutiny on large corporations has dramatically risen, as a variety of stakeholders demand enhanced transparency of corporations and are holding boards to account on the governance of their corporate footprint.

Key drivers include:

Regulatory Pressure

This is especially relevant in financial services, where regulators require transparent reporting on group structures to assess risks and clearly identify where regulated business is conducted within the group.

Government Scrutiny

A report published by UK Government MPs on the collapse of Carillion identified that the group had become overly complex with too many distractions outside of its core business.

It added that Carillion had 326 entities within its structure which contributed to difficulties in identifying key information and compromised governance of the group.

Tax Transparency

Tax has become a reputational issue for boards and several mandatory transparency regimes are being implemented across the world with tax authorities increasingly demanding more detailed disclosures.

Transparency & Risk

A large volume of entities within a group can be viewed as a tool to isolate risk at affordable cost. However, following recent business failures, buyers including the UK Government are scrutinising group structures for the purpose of contracting with more resilient entities.

The Companies Act 2006 S409

This legislation sets out the requirements for information on related undertakings to be provided in the notes to annual accounts for UK companies.

IFRS 12

Similarly to the Companies Act 2006, this accounting standard requires disclosures to be made in group financial statements about interests in subsidiaries.

Shareholder Activism

With greater information at their disposal, activist shareholders are challenging boards to explain, and in some well publicised examples, change the structure of a group.

How can corporate simplification support effective governance?

From a governance perspective, there are several challenges that complex group structures create for a board:

- Line of sight governance accountability can become challenged in complex structures.
- Unnecessarily complex structures can generate risks whilst delivering limited economic benefits to a business. For example, contingent off-balance sheet liabilities can be harboured in legacy entities where corporate memory may have faded. Furthermore, contracts may have been entered into by the wrong entity, or one which is no longer appropriate.
- Directors of non-core subsidiaries are often senior executives with board level responsibilities. Dealing with a high volume of appointments, particularly in territories where directors may not be familiar with local rules and regulations, can consume significant amounts of time. This time is therefore not available to deal with the value-add activities of the business.

One of the avenues open to boards to address these issues is to reduce complexity by eliminating legal entities which do not provide economic benefits to the group. The advantages of doing this may include:

- A less complex structure that will naturally enhance transparency by aligning the corporate footprint more closely to a business's operating model. Operational efficiencies can then be achieved by removing duplication amongst reporting and accounting processes.
- Accountability is improved because a more streamlined structure will enhance the visibility of risks faced by a business and enable these to be dealt with more efficiently.
- The process of liquidation is a proven tool for addressing legacy contingent liabilities and concluding them.
- A greater proportion of senior management's time and resources can be spent focused on the key value creating activities of a business.

Matters to consider

1.

Do you have a clear understanding of the group structure, the number of entities within the group and how many continue to be active?

2.

Is there scope to reduce the level of complexity within the group structure by eliminating entities so that there is enhanced transparency and accountability to enable senior executives more time to focus on strategic priorities?

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