

# The Influence of Corporate Control Strategies on the Headquarters-Subsidiary Relationship

*Taking an agency perspective*

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## **Management Summary**

The development of multidivisional and multinational organisations can lead to creation of synergy. It is up to the headquarters of these corporations to control the subsidiaries to overcome the organisational disadvantages and achieve these synergies. The agency theory is used to explain the headquarters-subsidiary relationship and demonstrates that control strategies are required.

The purpose of this study is to identify mechanisms which can be used to control the subsidiary in order to align the interests of headquarters and subsidiaries. A distinction is made between strategic mechanisms and structural mechanisms. Strategic mechanisms imply measures to control the subsidiary which are not directly related to the organisational structure. Structural mechanisms imply measures which can be taken to control the subsidiary through organisational structure.

This study focuses on aligning the interest of headquarters and subsidiaries through combining strategic control mechanisms and structural control mechanism. Headquarters can design a control system according to the three strategic management styles 'Strategic Planning', 'Financial Control' and 'Strategic Control'. This study will identify which control mechanisms suit each of the three control styles.

A conclusion is drawn on the influence of control strategies and control mechanisms on the headquarters-subsidiary relationship. And recommendation is provided on the choice of strategic management styles and what to take into account when designing a control system.

## **Preface**

This Bachelor thesis is a completion of the bachelor programme Business Studies and International Business Administration (as of September 2009), which I started in 2007. This programme has a very broad scope, introducing different fields of business, like accounting, finance, marketing and strategic management. Through realising that I had most affinity with strategic management I decided to write my bachelor thesis in the field of organisation and strategy. The choice of writing my bachelor thesis on the topic of “strategy and structure of multi business and/ or multinational firms” is a result of my interest in an international perspective and the idea to see the bigger picture of the multinational corporation.

The decision to write my thesis on corporate control and the headquarters-subsiary relationship was made through a discussion with Onno Cleeren, who is my thesis supervisor, as well as discussions with my father on the performance and the control of the subsidiary and the multinational corporation he works at. When searching for papers and literature on corporate control I found that the agency theory is very applicable to the headquarters-subsiary relationship and that this theory justifies corporate control. I decided to split corporate control in ‘strategy’ and ‘structure’ as I thought that these are separate distinct ways to control the subsidiary.

At first, when working on my thesis and using scientific literature, I found it difficult to find the right literature and to place the findings of this literature in the right context of my own bachelor thesis. However, in the process of writing my thesis this became easier and progress went faster. On some control mechanisms, however, the right information was hard to find.

I am thankful for the support and feedback of my supervisor, Onno Cleeren. In addition I am grateful to my parents who give me every opportunity to develop myself in my academic study. As for my future development, I must admit that this bachelor thesis together with the participation in the Economic Business week Tilburg 2010, have sparked my ambition in a career of a strategy consultant. I am therefore considering continuing my study with the Master Programme of Strategic Management. For now, I hope you enjoy reading this bachelor thesis and I appreciate your interest.

Tilburg, June 2010  
Jelle Wien

# Table of Content

- Management Summary ..... 2**
- Preface ..... 3**
- 1. Introduction..... 6**
  - 1.1 Problem Statement ..... 6
  - 1.2 Research Questions ..... 6
  - 1.3 Research Design ..... 6
  - 1.4 Data Collection ..... 7
- 2. The agency theory and headquarter-subsiary relationship ..... 8**
  - 2.1 The agency theory to headquarters-subsiary relationship ..... 8
  - 2.2 Implications of agency theory to headquarters-subsiary relationship ..... 8
    - 2.2.1 Goal Conflict ..... 8
    - 2.2.2 Information Asymmetry ..... 8
    - 2.2.3 Efficiency ..... 9
  - 2.2 Strategy versus Structure ..... 9
  - 2.3 Conclusion ..... 10
- 3. Corporate Control Strategy..... 11**
  - 3.1 Strategic Planning..... 11
    - 3.1.1 Corporate Socialisation ..... 11
    - 3.1.2 Resource Sharing ..... 11
    - 3.1.3 Knowledge and information sharing ..... 12
  - 3.2 Financial Control..... 12
    - 3.2.1 Behaviour versus Output Control..... 12
    - 3.2.2 Subsidiary-Management Compensation ..... 13
    - 3.2.3 Planning and Budgeting..... 14
  - 3.3 Strategic Control..... 14
    - 3.3.1 Monitoring and Evaluation..... 14
    - 3.3.2 Internal Competitive Arena ..... 15
  - 3.4 Conclusion ..... 16

<b>4. Corporate Control through Structure .....</b>	<b>17</b>
4.1 Charter Changes or Departmentalisation .....	17
4.2 Degree of Centralisation.....	17
4.3 Intracorporate Networks.....	17
4.4 Span of Control.....	18
4.5 Conclusion .....	18
<b>5. Conclusion .....</b>	<b>20</b>
<b>6. Recommendations .....</b>	<b>22</b>
<b>7. References.....</b>	<b>23</b>

# 1. Introduction

Since business has begun a process of expansion, diversification and globalisation, many companies have reorganised their organisational structure. This led to the separation of responsibilities in form of divisions, business units and subsidiaries<sup>1</sup> (Chandler, 1962). However, through this, corporations are faced with cost disadvantages, which can only be offset if subsidiaries perform better as members of a corporate family than as stand-alone entities (Dooms, 2005). It is up to the headquarters<sup>2</sup> of the corporation to control the subsidiaries such that the cost disadvantages (such as administration costs or management costs) are overcome and synergies are created.

The function of corporate control is to align the interests of headquarters and subsidiary, to overcome disadvantages that arise from the organisational structure and through cooperation of headquarters and subsidiary create synergies. “Control, then, involves all those mechanisms through which business units with potentially divergent interests can be managed by company headquarters to achieve the organisations goals” (Dooms, 2005 p. 19-20).

Taking an agency perspective, the relationship between headquarters and subsidiaries is also relevant. According to the Principal-Agency Theory (Eisenhardt, 1989) the agent acts out of self-interest (self-seeking behaviour) and the principal wants to be able to control the agent in such a way that they can enforce the agent to act in its interest. This principal becomes more relevant as the distance (geographically, culturally, linguistically) between headquarters and subsidiaries becomes greater and alignment of interests is less likely.

In this thesis a distinction will be made between organisational or structural mechanisms, which are related to the structure of the corporation, and strategy mechanisms, which are all non-structure related mechanisms. By combining views on organisation theory and subsidiaries- and control strategies, it becomes possible to discuss the “fit” of structure and strategy of corporations regarding subsidiaries. Different structures and strategies will have different impacts on the headquarters-subsidiary relationship.

## 1.1 Problem Statement

What is the influence of control strategies and control mechanisms, through structure and strategy, on the relationship of the headquarters and subsidiary, taking an agency perspective?

## 1.2 Research Questions

The problem statement will be answered by the following research questions:

1. In which way can the agency theory explain the headquarters-subsidiary relationship?
2. How can control strategy and structure be used to control subsidiaries?

## 1.3 Research Design

This thesis will be a descriptive study on literature on organisational structure, control strategy and headquarters – subsidiary relationship. It is a descriptive research on the influence of structure and strategy on the headquarters – subsidiary relationship. The purpose is to identify the different corporate structures and control strategies, in order to combine these with regard to the managing of the headquarters – subsidiary relationship.

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<sup>1</sup> – Although there is a difference in definition of business unit, division, profit centre and subsidiary, they will be considered as synonyms in this thesis. –

<sup>2</sup> – Although there might be differences in the definition of headquarters, corporate centre, the centre and parenting firm, they will be considered as synonyms in this thesis. –

## **1.4 Data Collection**

Literature that is used, was mainly found through the catalogues of the Tilburg University library and consists, of among others, of papers of the Academy of Management Journal, the Journal of International Business Studies, Strategic Management Journal and the International Business Review. For more information on papers and sources, please see the references. In addition, papers of E. Dooms and A. van Oijen, both professors at Tilburg University and experts on strategy and headquarters–subsidiary relationship, are used. Key search-words that will be used to find literature will be: control, control mechanisms, corporate/ organisational structure, subsidiary strategy, headquarters–subsidiary relationship and agency theory.

## **2. The agency theory and headquarter-subsidary relationship**

In this chapter the agency theory will be introduced and linked to the headquarters-subsidary relationship. This will clarify why control strategies are a necessity in multinational corporations and which problems may arise and should be overcome. In the second part of this chapter the relationship between strategy and structure is reviewed. This relationship is illustrated with some possible links of strategy and structure.

### **2.1 The agency theory to headquarters-subsidary relationship**

The agency theory (Eisenhardt, 1989) is a theory which is relevant when someone is working on behalf of another. The agent, in this thesis the subsidiary, works on behalf of the principal, the headquarters. The theory assumes that agents are self-interested, risk-averse, rational actors who always attempt to exert less effort and higher capabilities than they actually have. The agency theory implies that an agency problem arises when cooperating parties have different goals and different visions on labour (Jensen & Meckling, 1976). Two problems regarding this agency problem can be resolved through the agency theory. The first problem arises when the desires or goals of the agent and principal are in conflict and it is difficult or expensive for the principal to see what the agent is doing. The second problem is that of risk sharing, where the principal and the agent may prefer different actions because of different risk preferences (Eisenhardt, 1989).

### **2.2 Implications of agency theory to headquarters-subsidary relationship**

Agency theory ideas are helpful to designers of control systems in understanding the principal-agent relationship. The task of a control system is to manage the relationship optimally to achieve the organisational goals. Therefore the control system in an organisation has to deal with the agency problems among its participants. Agency problems can be found throughout all levels of the company as long as there is cooperation. However, in the headquarters-subsidary relationship the focus of the agency perspective on an organisational level is most relevant. Eisenhardt (1989) adopts the following organisational assumptions: partial goal conflict among the participants, information asymmetry between principal and agent and efficiency as the effectiveness criterion.

#### **2.2.1 Goal Conflict**

The agency theory (Eisenhardt, 1989) assumes self-interest at an individual level and goal conflict at an organisational level. Because of the organisational form of multinational corporations (MNC), interdependence or interactions between organisational units are likely to involve an element of conflict (Aiken and Hage, 1968). In order to create synergies, subsidiaries have to deal with integration with- and interdependence on the headquarters. Through this integration and cooperation, subsidiaries can effectively compete with domestic firms (Hymer, 1976). However, subsidiaries also need to respond to the local market, with different goals. Through this the headquarters-subsidary relationship often becomes strained (Bartlett and Ghoshal, 1986) as the subsidiary attempts to respond to both independent and interdependent interests.

#### **2.2.2 Information Asymmetry**

The agency theory takes into account the information asymmetry regarding the power order of the participants. It assumes that individuals are bounded by rationality and that information is distributed asymmetrically throughout the organisation. It is argued here that information systems inform the principal of what the agent is actually doing, and this will decrease opportunism as the agent realises that he or she cannot deceive the principal (Eisenhardt, 1989).



### 2.2.3 Efficiency

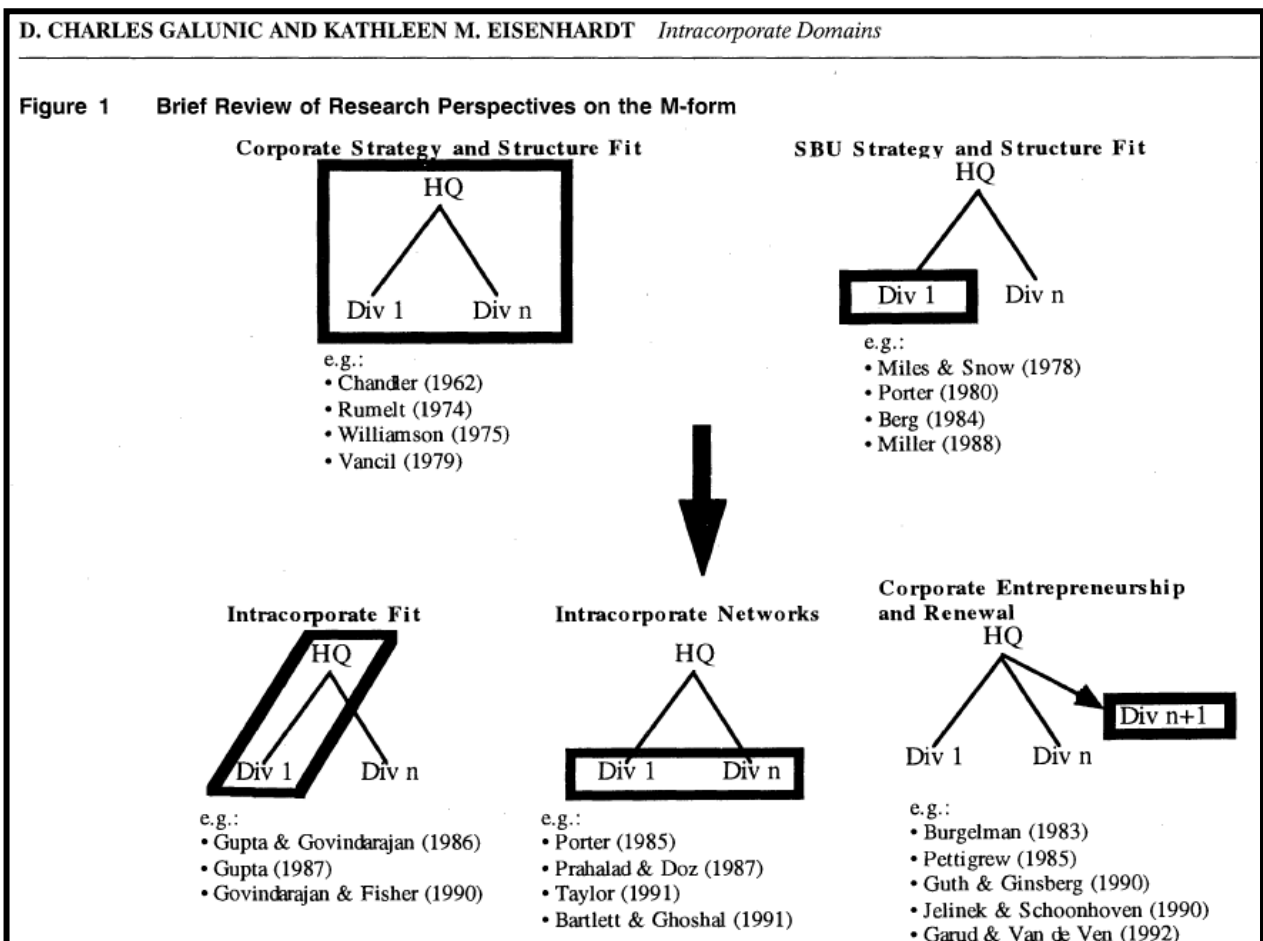
The efficiency perspective of the agency theory adopts the view that efficient processing of information is a criterion for choosing among various organisational forms (Galbraith, 1973). This implies the optimal structuring of control relationships resulting from reporting and decision-making patterns (Eisenhardt, 1989).

## 2.2 Strategy versus Structure

The relationship between strategy and structure and how they contribute to synergy, is controversial. When Chandler (1962) was researching the development of the American corporations he adopted a model in which environment and resources (including resource capabilities) generate a strategy which determines the structure. This implies that when environment and resources change a new strategy needs to be adopted. And in order to stay efficient the structure needs to change to support the strategy.

Hall & Saias (1980) argue that structure determines the introduction and subsequent development of strategic formulation. Strategic formulation in an organisation is dependent on the presence of a person or a group of persons who advocate long-term thinking. Information on the environment and the resources is received at different levels of the organisational structure and this generates a new strategy. In this way, structure precedes or at least influences the formulation of strategy. Hall & Saias conclude that structure is the result of a complex play of variables other than strategy.

However, nowadays most researchers accept that strategy and structure are interdependent and support one another. Galunic and Eisenhardt (1996) summarized some relationships of strategy and structure (figure 1).



“Corporate Strategy and Structure Fit” focuses on which structure theoretically is most suitable to support the strategy. In the “SBU Strategy and Structure Fit” the focus lies with the fit between the SBU (subsidiary) strategy and the structure.

In more recent streams like the "Intracorporate Fit", the interrelationship between these two levels in the corporation is examined. In particular, fit is examined between SBU strategies and the nature of corporate governance and control. With “Intracorporate Networks” the focus is on the horizontal relationships of subsidiaries. "Corporate Entrepreneurship and Renewal" focuses on two major areas. The first emphasises the process by which new businesses (and, often, new subsidiaries) are created within large corporations. And the second emphasises how pre-existing businesses are transformed and renewed.

### **2.3 Conclusion**

The agency theory (Eisenhardt, 1989) assumes that the goals of the agent (the subsidiary) and the principal (headquarters) are different and that the principal needs measures to control the agents such that it follows the goals of the principal. The control system is used to overcome agency problems, such as goal conflict, information asymmetry and efficiency, and to create synergies.

In debate whether strategy follows structure or vice versa, it is generally agreed that there is not a single solution. Multiple combinations of strategy and structure can all institute synergy for the multinational corporation.

### **3. Corporate Control Strategy**

This chapter contains the strategic measures to control the subsidiary. This implies that, in this chapter, all control mechanisms are not directly related to corporate structure. Control mechanisms are measures that align the interest of headquarters and the subsidiary and drive performance of the subsidiary. These mechanisms to reduce agency problems are often complementary rather than substitutes. The three main styles of strategic management of Goold and Campbell (1993) are used to identify which control mechanisms are most suitable for the different styles of corporate control.

Goold and Campbell (1987) identify three main strategic management styles: Strategic Planning, Financial Control and Strategic Control. Goold and Campbell concluded that each style has strengths and weaknesses and that each could add value, but in different ways and to different types of subsidiaries. Headquarters adds value most easily when its style fits the conditions the subsidiaries are facing. Control mechanisms which are described below may be used differently among the three strategic management styles.

#### **3.1 Strategic Planning**

Companies that use this style focus on a few core businesses with headquarters actively participating in formulating strategies with the subsidiaries, aiming to help the subsidiaries make better strategic decisions, and often initiating strategic thrusts among interrelated subsidiaries.

##### **3.1.1 Corporate Socialisation**

Van Maanen and Schein (1979, p. 4-5) define organisational socialisation as ‘the process by which an individual is taught what behaviours and perspectives which are customary and desirable within the work setting’. As Buchanan (1974), Edstrom and Galbraith (1977) and Ouchi (1979) argued, socialisation of subsidiary managers can be a powerful mechanism for building identification with and commitment to the organisation as a whole. Some of the key processes through which such socialisation occurs are job rotation across subsidiaries and management development programs involving participants from multiple subsidiaries (Edstrom & Galbraith, 1977). Through these processes subsidiary managers’ values and norms become closely aligned with those of headquarters.

More recently, Lubatkin et al. (2001) have persuasively argued that self-serving behaviour on the part of managers can be mitigated by corporate socialisation. Here, the corporate socialisation mechanism refers to those organisational mechanisms which build interpersonal familiarity, personal affinity, and convergence in cognitive maps among personnel from different subsidiaries (Gupta & Govindarajan, 2000). In their study, Gupta and Govindarajan (2000), also separate "lateral" from "vertical" socialisation mechanisms. Lateral socialisation mechanisms are: job transfers to peer subsidiaries and participation in multi-subsidiary executive programs. Vertical socialisation mechanisms are: job transfers to corporate headquarters and participation in corporate mentoring programs.

##### **3.1.2 Resource Sharing**

Resource sharing or resource allocation is a control mechanism where resources are allocated among subsidiaries or shared between headquarters and subsidiaries or among subsidiaries. Govindarajan and Fisher (1990) define the level of resource sharing as the extent to which a subsidiary shares functional activities like marketing, manufacturing, and R&D with other subsidiaries within a firm. They find that the costs of resource sharing imply the cost of

coordination and reduced flexibility of the subsidiary. On the other hand, the benefits are increased control (since subsidiaries usually need to consult headquarters) and a synergistic cost advantage (Gupta & Govindarajan, 1986; Porter, 1985). In addition, Porter (1985: 330) argues that resource sharing can enhance differentiation by contributing to the uniqueness of an activity and by lowering the cost.

One of the most influential resource control mechanisms is human resources. As Van Oijen and Douma (2000, p. 563) stated: “One of the most powerful instruments with which to influence the business units is the selection of their managers”. As headquarters has the possibility to appoint the management and other key personnel of the subsidiary, it can insure that it instates people who have a commitment and affinity with the goals of the headquarters (the principal).

### **3.1.3 Knowledge and information sharing**

Knowledge sharing can be an important mechanism for headquarters to control subsidiaries. As stated before in chapter two, the assumption is made that information and knowledge is distributed asymmetrical through the organisation. Given a situation of information asymmetry between headquarters and the subsidiary, it can therefore be in the subsidiary’s interest not to transfer knowledge to other subsidiaries, even though this would enhance overall MNC performance. The potential importance of knowledge as a strategic resource has brought attention to the transfer of competences across subsidiaries as a challenge for headquarters (Björkman, Barner-Rasmussen & Li, 2004). By accessing the knowledge residing in subsidiaries, the MNC can both exploit existing repositories of knowledge and combine these sources of knowledge to explore new issues and opportunities (Frost, 2001).

Knowledge sharing may be enforced or incentivised by other control mechanisms such as monitoring or evaluation and compensation. In addition, Gupta and Govindarajan (2000) have found knowledge flows in MNCs to be positively related to the use of corporate socialisation mechanisms. They argue that greater participation in corporate socialisation mechanisms would have a positive impact on the richness of transmission channels between the subsidiaries.

## **3.2 Financial Control**

Financial control companies mainly delegate strategic decisions to profit-responsible business unit managers, and headquarters’ role is to agree and monitor demanding short-term financial targets for the business.

### **3.2.1 Behaviour versus Output Control**

In organisational literature there are two different approaches to control: performance evaluation and socialisation. This implies that the control mechanism that is most effective is dependent on the measurability of output or behaviour. Govindarajan & Fisher (1990) adopt the model from Ouchi (1979) and Eisenhardt (1985) and modified it for better predictions of effectiveness of control mechanisms (see figure 2).

**FIGURE 2**  
**Control Types and Antecedents, Modified Model**

		Task Programmability	
		Perfect	Imperfect
High outcome observability	High behavior observability	1 Output or behavior control	5 Behavior control
	Low behavior observability	2 Output control	6 Output control
Low outcome observability	High behavior observability	3 Behavior control	7 Behavior control
	Low behavior observability	4 Behavior control	8 Behavior control

In their model Govindarajan and Fisher define task programmability as: “a task's susceptibility to clear definition of the behaviours needed to perform it” (1990, p.261). If a task's programmability is perfect, the behaviours needed for its successful performance can be well understood. When outcome observability is low, behaviour control is more effective. With low behaviour observability, output control is more effective. Note that whenever there is a choice between output or behaviour control (as in cell 1), corporations are most likely to choose output control, since behaviour control is generally more costly. In cell 5, behaviour control is preferred in order to avoid risk taking by the agent. Through this model, corporations can align their approach to control with their strategy. In the example of a low-cost strategy (Porter, 1985), cost control is most important where outcome observability is high and this implies that it is more effective and less costly for headquarters to apply control mechanisms that control output.

Agency theorists generally agree that a combination of outcome (incentive) based and behavioural control mechanisms should be employed (Tosi and Gomez-Meija, 1989; Tosi et al., 1997).

### 3.2.2 Subsidiary-Management Compensation

Subsidiary managers are responsible and can be held accountable for the performance of the subsidiary, or the ‘agent’ in the headquarters-subsidiary relationship. Therefore, subsidiary-management compensation is a mechanism to align the goals of headquarters by providing compensation for meeting headquarters’ goals.

Van Oijen & Douma (2000) identified this role of the centre as motivation. Headquarters needs to provide subsidiary managers with financial and career incentives. Here the corporate centre has several options, choosing between fixed and variable (performance) pay. Van Oijen & Douma (2000) suggest that when the incentives a subsidiary manager receives will also be linked to the performance of the firm as a whole, this could encourage the transfer of resources, as this presumably improves the overall corporate performance.

According to O'donnell (1999) the nature of specific outcomes upon which the incentive compensation is to be based will vary depending upon the nature of the principal-agent relationship and the behaviours or outcomes desired of the agent. The assumption is that subsidiary managers will make decisions to increase their total compensation and if their compensation is tied to a particular performance criterion, they will act to increase firm performance along the dimension they are being compensated for. So the subsidiary managerial compensation should be based on alignment of the firm's strategic objectives.

In their research, Fisher and Govindarajan (1992) consider two factors on profit centre management (PCMs) cash compensation. These factors are market factors and political & human capital factors. Market factors include performance and size of the firm and the profit centre. Political and human capital factors include relative business unit size, job tenure, firm tenure, age and education. Fisher and Govindarajan found a strong relation between firm size and compensation, which is consistent with larger organisations being more complex and needing more expertise to manage. Another finding is that an increase in age meets with a larger bonus ratio, which implies managers require more control through compensation mechanism.

### **3.2.3 Planning and Budgeting**

Van Oijen & Douma (2000) assign the role of planning to headquarters. Planning, or the formulation of a subsidiary (business) strategy, indicates how a subsidiary should compete in a given industry or country. Headquarters can be involved to a greater or lesser extent in the development of subsidiary strategies. A greater involvement of headquarters can improve the quality of the strategies, as headquarters may have more or better information. Involvement of headquarters can also foster cooperation among subsidiaries thus creating synergy.

Budgets are financial blueprints that quantify a firm's plans for a future period. Budgets require management to specify expected sales, cash inflows and outflows, and costs; and they provide a mechanism for effective planning and control in organisations. Budgets in the organisations can serve multiple roles of planning, evaluation, coordination, communication, and decision-making (Flamholtz, 1983).

## **3. 3 Strategic Control**

Companies applying the strategic control style have a strong commitment to decentralisation and they emphasise control against demanding targets for their subsidiaries, but in addition they tend to have extensive strategic planning systems and processes, through which headquarters seeks to add value by reviewing, challenging and monitoring subsidiary level strategies.

### **3.3.1 Monitoring and Evaluation**

Jensen & Ruback (1983) argue that agency problems can be overcome and control can be held by headquarters through separation of risk-bearing from management functions. This requires separation of the management function (initiation and implementation) from the control function (ratification and monitoring). Here, headquarters (institutionalising the board of directors or trustees) holds the control function and is able to ratify and monitor the subsidiary (institutionalising the subsidiary management).

According to Van Oijen & Douma (2000) one of the roles of headquarters is evaluation. Headquarters has to allocate financial resources to the subsidiary so that it can execute the plans and strategies that have been formulated. Headquarters then has to monitor the subsidiaries to ensure that the resources are utilised well. The corporate centre can use different criteria in these evaluation processes. When headquarters is less involved with the subsidiary operations and when output control is the logical choice, then standardised financial measures, such as ROI and EVA are effective evaluation criteria.

On the other hand, when headquarters is involved in the subsidiary operations and when behaviour control is better, such standardised financial measures could lead to a loss of synergy. The benefits and costs of cooperation are often not distributed evenly over subsidiaries. Subsidiaries may be unwilling to share knowledge, information and competences when they are solely judged on financial measures and they receive no useful skills in return. Therefore in subsidiaries with closely related activities and many opportunities to exchange resources, Van Oijen & Douma (2000) find that financial measures are supplemented with more strategic criteria. These strategic criteria involve both subjective criteria, such as the collaboration between business units, and more objective non-financial criteria, such as market share.

The mutual monitoring system is a control process whereby headquarters obtains information from interacting subsidiaries. When agents (subsidiaries) interact to produce outputs, they acquire low-cost information about colleagues, information not directly available to the higher level agents (headquarters). In addition, if agents (subsidiary managers) perceive that evaluation of their performance is unbiased, they value the fine tuning of the reward system that result from mutual monitoring information, because it lowers the uncertainty of payoffs from effort and skill (Jensen & Fama, 1983).

Govindarajan and Fisher (1990) note that it is not possible to use the same set of criteria to evaluate every subsidiary since, by definition, different subsidiary strategies imply different goals and priorities.

### **3.3.2 Internal Competitive Arena**

The subsidiary's internal environment consists primarily of three sets of actors: internal customers for the subsidiary's products or services, internal suppliers of various components and services, and internal competitors (Birkinshaw, Hood & Young, 2005). We can apply Porter's five forces (1985) also to the internal market, where 'rivalry' is maybe the most important force. In this internal market subsidiaries can be each other's clients, suppliers or competitors. Birkinshaw et al. (2005) suggest that internal competition can be very effective, as it raises the awareness of internal dynamics of subsidiary managers, it increases knowledge sharing, and creates sophisticated internal labour markets. However, they present no empirical evidence. Geographically the competitive markets are usually distant, however subsidiaries may also compete for investments of headquarters.

Competition may be upheld in multiple ways. One such way is a system where subsidiaries 'bid' on future investments. A second measure is internal benchmarking in order to identify the laggards and the leaders, where future investments are usually reserved for the leaders. A third possible measure to create or increase competition is to assign geographical markets which overlap the subsidiaries.

However, internal competition also may have negative implications. As the study of Birkinshaw (2005) demonstrated some subsidiaries subdue because of internal competition and may be lost. It also may reduce cooperation among subsidiaries because of the perception of 'rivals' and because of a lower level of trust. Moreover, due to internal competition subsidiaries usually are very focused on the internal market and competitors. This may cause a loss of opportunities on external markets and may blind subsidiaries to threats of external markets. In their study of 12 cases of internal focused subsidiaries, Birkinshaw, Hood & Young (2005) concluded that this group was underperforming relative to groups that were dual focused or externally focused.

### **3.4 Conclusion**

Strategic planning is a style which focuses on core businesses with active involvement of headquarters in formulating strategies with the subsidiaries, aiming for better strategic decisions and strategic thrusts among subsidiaries. Corporate socialisation can serve to control behaviour of subsidiary personnel through creating affinity with- and aligning with the goals of the corporate headquarters. It allows convergence in cognitive maps among personnel from subsidiaries and aligns values and norms in the corporation. A second mechanism suitable for this style is resource sharing, which allows more control of corporate headquarters because of the interdependence of subsidiaries to share functional activities. In addition, appointment and sharing of human resource through job rotation is one of the most powerful control mechanisms to headquarters. Knowledge sharing may help solving the agency problem of information asymmetry and may help creating synergies through knowledge as a strategic resource.

Financial control companies delegate strategic decisions to subsidiaries and headquarters monitors demanding short-term financial targets for the subsidiaries. Important here is the decision to monitor and control output or behaviour. Generally a combination of output and behaviour control is advisable, however circumstances may prefer either output or behaviour control as can be seen in figure 2. Also, it must be noted that output control usually is less costly than behaviour control. The control mechanism of subsidiary management compensation can be used to align the goals of the agent and the principal. Providing the right incentives will encourage subsidiary management to get involved with internal cooperation and resource transferring which will raise overall performance of the corporation. Furthermore, involvement of headquarters in planning and budgeting can improve the quality of the subsidiary strategies and budgeting serves as creating the blueprints to quantify these strategies.

The strategic control style institutes decentralisation and emphasizes control against demanding targets for their subsidiaries. Headquarters seeks to add value by reviewing, challenging and monitoring subsidiary level strategies. In monitoring and evaluation headquarters allocates resources to subsidiaries and monitors to ensure that resources are utilised well. Also, a monitoring system can be used to gain information for interacting subsidiaries. A second control mechanism in this style can be internal market competition. Internal competition can be very effective in increasing knowledge sharing and creating good internal labour markets (allocation of human resources is a very powerful mechanism). Subsidiary competition also allows internal benchmarking where well-performing subsidiaries can be rewarded. However, a danger with this mechanism is that focus on external markets and opportunities is lost.



## **4. Corporate Control through Structure**

This chapter contains measures on structure that can be taken to control the subsidiary. Control through structure implies all measures that align the interests of headquarters and the subsidiary and drive performance of the subsidiary due to (changes in) organisational structure.

### **4.1 Charter Changes or Departmentalisation**

In the multidivisional firm, or M-form corporations (Williamson, 1975), business domains are divided among subunits or subsidiaries. The assumption is made that these subsidiaries are fixed, however they are not. Business areas may be added or taken away and may be switched from one subsidiary to another. This is called 'division charter change' or may also be referred to as 'departmentalisation' (Galunic & Eisenhardt, 1996). Galunic and Eisenhardt (1996) describe the division chart as a statement of purpose which includes the task, market, and the customer the subsidiary is concerned with. It also shows how the subsidiary is linked to the rest of the company. In their research Galunic and Eisenhardt (p. 256, 1996) state that "charter change can be viewed as a critical adaptive device for M-form corporations. In essence, charter changes are an organising strategy by which M-form corporations continually align evolving business areas with pockets of corporate resources." The reason for charter changes usually is a change in the environment or in technology. However, charter changes can be used to realign the goals of the headquarters-subsidiary. It is therefore a possible control mechanism for corporate headquarters.

### **4.2 Degree of Centralisation**

In their research on roles of the corporate centre (headquarters), Van Oijen & Douma (2000) define one of the roles of the corporate centre as 'support'. It is the role of headquarters to perform services for subsidiaries. This is commonly referred to as the degree of centralisation, which is the extent to which functions such as marketing or R&D are shared with subsidiaries. In literature, Williamson and Bhargava (1972) first referred to this phenomenon as the CM form, or corrupted multidivisional. Because of headquarters' involvement in the operations of the subsidiary this structure was labelled as corrupted multidivisional firm. However, Hill (1988b) and Hill and Hoskisson (1987) argue that the realisation of synergies requires exactly this kind of involvement and label the CM-form as centralised multidivisional (Hill, 1988a, 1988b).

The centralisation of business functions implies that little decision-making power and authority of the headquarters is shared with subsidiaries regarding these specific business functions. The facilitation of services towards subsidiaries may create a synergistic cost advantage. Additionally, it gives the headquarters more power since the subsidiary becomes partially dependent on the services of the headquarters. Here, headquarters can also use formalisation and standardisation to control the subsidiaries. Formalisation and standardisation is the extent to which policies, rules, job descriptions, et cetera. are written down in manuals and other documents, and procedures are established through standard routines (Martinez, Jarillo & Carlos, 1989).

### **4.3 Intracorporate Networks**

The intracorporate networks perspective looks at the lateral relationships of subsidiaries. The goal of this perspective is to create synergetic advantage through interdependence and cooperation of subsidiaries (Galunic & Eisenhardt, 1996). Here headquarters has a coordinating role to encourage cooperation. Galbraith (1973) and Nadler and Tushman (1987)

identified liaison positions, task forces, and permanent committees as some of the key mechanisms for integrating multiple subsidiaries of an organisation. A task force can be described as subsidiary bodies with a limited timeframe and the objective to complete specific tasks or goals. According to Van Oijen & Douma (2000) this mechanism is however only beneficial for subsidiary with related or similar activities.

#### **4.4 Span of Control**

Meier and Bohte (2000) offer a general theory on the functional form of the span of control-performance relationship for organisations. They hypothesise a quadratic relationship in which initial increases in span of control produce increases in organisational performance, however a decreasing rate of return. By illustrating the potential nonlinear impacts of span of control, an important contribution is made to the discussion of the influences of structure on performance (Theobald & Nicholson-Crotty, 2005).

Span of control (Gulick, 1937) has a straightforward logic; individuals in management positions should oversee a relatively small number of subordinates. Urwick (1956) claimed that six was the maximum. As the number of subordinates under an executive's control increases, monitoring the behaviour of subordinates becomes more difficult. Simon (1946) criticised this logic, claiming that a case could be made for adopting a contradictory principle of management. If the span of control is limited and executives oversee a relatively small number of subordinates, the number of levels within an organisation's hierarchy will increase. As the number of levels within an organisation increases, the amount of red tape<sup>3</sup> moving across different organisational levels also tends to increase. To avoid this problem, Simon suggests that organisations be designed with few organisational levels.

Theobald & Nicholson-Crotty (2005) suggest that attempts to maximise multiple goals may require different structural choices by subsidiaries and headquarters. There may be an optimal span of control for the production of one goal, but this may not be optimal for the production of another goal within the same organisation.

#### **4.5 Conclusion**

In corporate structure often the assumption is made that divisions are fixed. However, charter changes or departmentalisation allows headquarters to add or remove business areas from subsidiaries, thus realigning the goals of the subsidiary and headquarters. Charter changes are often the result of a changing environment or technology.

The degree of centralisation is the extent to which functions of the headquarters are shared with subsidiaries. It is argued that this kind of involvement of headquarters creates synergies in centralised multidivisional corporations. It gives headquarters power or control, because the subsidiary is partially dependent on headquarters.

Intracorporate networks imply lateral relationships of subsidiaries to create synergetic advantages because of interdependence and cooperation of subsidiaries. Headquarters' role is coordination and encouragement of cooperation. A task force of subsidiary bodies with a limited timeframe can be formed to achieve specific tasks or goals.

Research on the span of control provides evidence for the influence of structure on performance. It can be argued that a wider span of control increases difficulty of monitoring

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<sup>3</sup> official rules and processes that seem unnecessary and delay results

behaviour of subordinates. On the other hand, a narrow span of control can lead to corporations with many hierarchical levels, which in turn can decrease efficiency. It is also argued that the span of control may not accommodate multiple goals.

## 5. Conclusion

In this chapter a conclusion is drawn on the problem statement. The relationship of headquarters and subsidiaries will be explained through the agency theory. Secondly, the three strategic control styles will be combined with the structural mechanism.

The agency theory assumes that agents are self-interested, risk-averse, rational actors who always attempt to exert less effort and higher capabilities than they actually have. The result of this assumption is that interests of headquarters and subsidiaries are likely not to be aligned. Furthermore, it insinuates that the subsidiary is likely not to exert sufficient effort to reach the headquarters goals. Therefore, to align the interest of headquarters and subsidiary, the principal in the relationship needs measures to control the agent. Headquarters can create a control system to manage the relationship optimally to achieve the organisational goals.

When designing a control system both structure and strategy need to be considered. In the table below the three strategic management styles are combined with the structural control mechanisms.

	Charter changes	Degree of centralisation	Intracorporate networks	Span of control
Strategic Planning	No	Relatively high	High	Narrow
Financial Control	Yes	Relatively low	Intermediate	Wide
Strategic Control	Yes	Relatively low	Intermediate	Wide

When applying strategic planning style, it is not advisable to use charter changes to align the interest. As the core of this style is close cooperation and strategic trust, charter changes would damage trust when business areas are reallocate to other subsidiaries. This style implies close involvement of headquarters and therefore a high degree of centralisation. The use of intracorporate networks is frequent, as this improves cooperation. A narrow span of control is best suited to contribute to corporate socialisation. Also a narrow span of control is suitable for applying behaviour control which should lead to resource and knowledge transferring.

Financial control allows charter changes as it focuses on monitors demanding short-term financial targets for the subsidiaries. After this short-term target has been met, changes can be made to be able to set more demanding targets in the future. The degree of centralisations is relatively low as headquarters is not involved with the functions subsidiaries are performing. It is, however, necessary to set the right incentives to encourage cooperation and knowledge sharing, which in turn should increase the output of subsidiaries. In addition, intracorporate networks can be used, but as subsidiaries are likely to focus on their own demanding targets, it is necessary to enforce cooperation. The span of control can be wide as this reduces the number hierarchical levels and thus also the unnecessary delay of results.

As stated before, the strategic control style institutes a low centralisation. Headquarters seeks to add value by reviewing, challenging and monitoring subsidiary level strategies. Reviewing and monitoring the optimal use of resources may initiate charter changes. Intracorporate networks are useful as they allow for internal competition and subsidiary benchmarking. However, the criteria for monitoring and evaluation should be set carefully, as judgement on financial targets solely can lead to a loss of synergy. When using this control style there is a danger that the focus on the internal market may lead to loss of knowledge and opportunities on external markets.

In conclusion, the agency perspective of the headquarters-subsidary relationship proves the necessity of a strategic control system and control mechanisms to align the interests. The influence of each of the three strategic management styles on the headquarters-subsidary relationship is different. The influence of strategic planning is rather large as the involvement of headquarters is high. The influence of financial control can be high depending on how demanding the targets are and how strict subsidiaries are being monitored. The strategic control style can have significant influence as it tries to add value by monitoring, evaluating and challenging subsidiaries to improve. All control mechanisms, regardless of the strategic management style, have an influence on the headquarters-subsidary relationship. The level of influence the relationship depending on how extensive and rigorous these mechanisms are applied. Which style and which mechanisms are best suited for an organisation is dependent on the environment and the resources of the organisation and they way information on these factors is received and processed in the formulation of corporate- and subsidiary strategy.

## 6. Recommendations

This chapter contains recommendations to management of headquarters of the multinational corporation.

### Managerial Implications

First of all, in order to create synergy and in order to maximise achieving the organisational goals (which often includes maximising profits) there should be some kind of involvement from headquarters with the subsidiaries. Otherwise headquarters just becomes a profit absorbing institution, which can lead to cost disadvantages and lost opportunities.

Headquarters can be directly involved through performing organisational functions for subsidiaries or indirectly by encouraging cooperation and resource sharing. The degree of involvement of headquarters should be complemented by the control style.

Secondly, when designing the control system it is important to look at which control style is most suitable for the corporation through examining the environment and the resources and taking into account the corporate strategy. For example, a corporation that is in an environment where the competitive advantage is low costs, financial control is most suitable as it allows for demanding short-term financial targets where output control is applicable to manage costs. A corporate strategy of continuous improvement would be well served by strategic control as this style is challenging subsidiaries by reviewing, monitoring and evaluating.

In addition, the choice between output or behaviour control is very important. Due to the difficulties in the measurability of behaviour and the cost of behaviour control, often output control is chosen. However, as stated in this thesis human resources is one of the most influential control mechanisms. Therefore, also the allocation of key personnel and the monitoring and evaluation of this personnel has a big impact on the headquarters-subsidiary relationship. Behaviour control is thus a control mechanism which should not be neglected in incentivising subsidiary management.

Furthermore, when initiating cooperation among subsidiaries, subsidiary management's reward incentives should be customised to this cooperation. Because of self-serving behaviour, it is likely that subsidiary management will not put sufficient effort in the cooperation as it is not being rewarded for the cooperation. Also sharing of resources and knowledge will often need to be incentivised as this is not likely to happen if there is no return for the subsidiary (management).

As for the internal competitive arena, this control mechanism is often used to keep strict control over subsidiary management and allows easy measurement through internal benchmarking. Although this mechanism can contribute to profit maximising, one should not neglect the negative implications. The internal competitive arena often leads to loss of subsidiaries through competition, loss of trust and cooperation, loss of opportunities on external markets and also possibly blinding subsidiaries from potential threats on external markets.

Lastly, when designing a control system one should always consider the interests of subsidiary and that of its management, as these may be different. Especially when subsidiary management is in control of multiple subsidiaries this difference becomes significantly important. One should create the right incentives to align the interests in these relationships to optimally achieve the organisational goals.

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